

SIMULATIONS PLUS INC
Form 10-Q
April 09, 2014

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Security Exchange Act of 1934 for the quarterly period
ended **February 28, 2014**

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 10th Street West
Lancaster, CA 93534-7059

(Address of principal executive offices including zip code)

(661) 723-7723

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(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

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

Accelerated filer

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 April 9, 2014 was 16,162,460; no shares of preferred stock were outstanding.

Simulations Plus, Inc.

FORM 10-Q

For the Quarterly Period Ended February 28, 2014

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SIMULATIONS PLUS, INC.

CONDENSED STATEMENTS OF OPERATIONS

For the three and six months ended February 28,

(Unaudited)

	Three months ended		Six months ended	
	2014	2013	2014	2013
Net sales	\$3,081,492	\$3,118,121	\$5,722,492	\$5,408,215
Cost of sales	492,199	498,778	940,619	885,648
Gross profit	2,589,293	2,619,343	4,781,873	4,522,567
Operating expenses				
Selling, general, and administrative	1,103,547	854,983	2,174,638	1,786,043
Research and development	354,007	247,522	516,123	427,857
Total operating expenses	1,457,554	1,102,505	2,690,761	2,213,900
Income from operations	1,131,739	1,516,838	2,091,112	2,308,667
Other income (expense)				
Interest income	7,957	17,074	16,983	30,802
Miscellaneous income	–	15,390	–	30,794
Gain on currency exchange	4,428	22,988	28,137	97,642
Total other income (expense)	12,385	55,452	45,120	159,238
Income from continuing operations before provision for income taxes	1,144,124	1,572,290	2,136,232	2,467,905
Provision for income taxes	(334,260)	(510,715)	(641,213)	(819,344)
Net Income	\$809,864	\$1,061,575	\$1,495,019	\$1,648,561
Earnings per share				
Basic	\$0.05	\$0.07	\$0.09	\$0.10
Diluted	\$0.05	\$0.06	\$0.09	\$0.10
Weighted-average common shares outstanding				
Basic	16,107,327	16,004,397	16,078,173	15,965,890
Diluted	16,356,544	16,336,353	16,319,902	16,305,235

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

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Supplemental disclosures of cash flow information

Interest paid	\$-	\$-
Income taxes paid	\$572,192	\$1,382,545

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

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.

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.

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 \$383,652 and \$359,013 for the six months ended February 28, 2014 and 2013, respectively, and amortization of software development costs was \$191,823 and \$176,928 for the three months ended February 28, 2014 and 2013, 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 February 28, 2014 for assets and liabilities measured at fair value on a recurring basis:

	Level I	Level II	Level III	Total
Cash and cash equivalents	\$9,701,417	\$ -	\$ -	\$9,701,417
Total	\$9,701,417	\$ -	\$ -	\$9,701,417

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.

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 each of the six months periods ended February 28, 2014 and 2013 was \$3,750 and was \$1,875 for each three month period ended February 28, 2014 and 2013. Accumulated amortization as of February 28, 2014 was \$15,000.

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 and six months ended February 28, 2014 and 2013 were as follows:

Six months ended	Three month ended		Six month ended	
	02/28/2014	02/28/2013	02/28/2014	02/28/2013
Numerator:				
Net income attributable to common shareholders	\$ 809,864	\$ 1,061,575	\$ 1,495,019	\$ 1,648,561
Denominator:				
Weighted-average number of common shares outstanding during the period	16,107,327	16,004,397	16,078,173	15,965,890

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Dilutive effect of stock options	249,217	331,956	241,729	339,345
Common stock and common stock equivalents used for diluted earnings per share	16,356,544	16,336,353	16,319,902	16,305,235

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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 is calculated 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 \$71,087 and \$70,253 for the six months ended February 28, 2014 and 2013, respectively, and was \$55,727 and \$32,154 for the three months ended February 28, 2014 and 2013, respectively. This expense is included in the condensed statements of operations as Selling, General and Administration (SG&A), and Research and Development expense.

Recently Issued Accounting Pronouncements

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.

In July 2013, the FASB issued ASU 2013-11, *Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists*, which eliminates diversity in practice for the presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss or a tax credit carryforward is available to reduce the taxable income or tax payable that would result from disallowance of a tax position. ASU 2013-11 affects only the presentation of such amounts in an entity's balance sheet and is effective for fiscal years beginning after December 15, 2013 and interim periods within those years. Early adoption is permitted. We are evaluating the impact, if any, of the adoption of ASU 2013-11 on our balance sheet.

Note 3: Property and Equipment

Property and equipment as of February 28, 2014 consisted of the following:

Equipment	\$ 124,042
Computer equipment	142,907
Furniture and fixtures	51,466

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Leasehold improvements	23,645
Sub total	342,059
Less: Accumulated depreciation and amortization	(229,592)
Net Book Value	\$112,467

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 expired in August 2013. The employment agreement provided 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 agreement allows the Company to 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 month's salary or b) the remainder of the term of the employment agreement from the date of notice of termination.

For fiscal year 2013, the Compensation Committee awarded a \$30,000 performance bonus to Walter Woltoz, our President/Chief Executive Officer, which was paid in September 2013.

On August 22, 2013, effective as of September 1, 2013, the CEO's employment agreement was renewed for another year by the Compensation Committee and provides for an annual bonus of up to five percent (5%) of the Company's net income before taxes of the previous fiscal year not to exceed \$60,000. In addition the agreement calls for the granting of ten (10) options to purchase shares of the Company's common stock for each \$1,000 of net income before taxes that the Company earns at the end of each fiscal year (up to a maximum of twenty thousand (20,000) options over the term of the agreement) at an exercise price equal to ten percent (10%) over the market value per share as of the date of grant (the number of shares to be adjusted accordingly for any stock splits or reverse splits after the date of the agreement). A copy of the agreement is attached to the Company's 2013 Form 10-K filed with the SEC on November 18, 2013 as Exhibit 10.9.

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

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The Board of Directors declared cash dividends during fiscal year 2013. 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
11/8/2012	11/13/2012	15,927,806	\$ 0.05	\$ 796,390
12/24/2012	12/28/2012	16,021,309	\$ 0.14	\$ 2,242,983
5/7/2013	5/10/2013	16,030,433	\$ 0.03	\$ 480,913
8/12/2013	8/15/2013	16,030,894	\$ 0.03	\$ 480,926
Total				\$ 4,001,212

The Board of Directors has also declared cash dividends during fiscal year 2014. 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
11/08/2013	11/15/2013	16,073,894	\$ 0.04	\$ 642,956
2/17/2014	2/24/2014	16,149,460	\$ 0.05	\$ 807,473
Total				\$ 1,450,429

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. On February 25, 2014 the shareholders approved an additional 1,000,000 shares increasing the total number of shares that may be granted under the Option Plan to 2,000,000.

Qualified Incentive Stock Options (Qualified ISO)

As of February 28, 2014, employees hold Qualified ISO to purchase 479,000 shares of common stock at exercise prices ranging from \$1.00 to \$5.61 which were granted prior to February 28, 2014.

Transactions in FY14	Number of Options	Weighted-Average Exercise Price Per Share	Weighted-Average Remaining Contractual Life
Outstanding, August 31, 2013	532,000	\$ 1.82	3.95
Granted	100,000	\$ 5.61	
Exercised	(147,000)	\$ 1.29	
Cancelled/Forfeited	(6,000)	\$ 1.00	
Outstanding, February 28, 2014	479,000	\$ 2.78	3.88
Exercisable, February 28, 2014	289,600	\$ 1.85	3.43

The fair value of the options, including both ISO and NQSO options, granted during the six months ended February 28, 2014 is estimated at \$130,781. The fair value of these options was estimated at the date of grant using the Black-Scholes option-pricing model with the following assumptions for FQE February 28, 2014: dividend yield of 3.14%, pre-vest forfeiture rate of 6.25%, expected volatility of 38.95%, risk-free interest rate of 1.36%, and expected life of 5.0 years.

Non-Qualified Stock Options (Non-Qualified ISO)

As of February 28, 2014, the outside members of the Board of Directors hold options to purchase 45,600 shares of common stock at exercise prices ranging from \$1.67 to \$6.68, which were granted prior to February 28, 2014.

Transactions in FY14	Number of Options	Weighted-Average Exercise Price Per Share	Weighted-Average Remaining Contractual Life
Outstanding, August 31, 2013	48,600	\$ 3.79	7.85
Exercised	(3,000)	\$ 1.80	
Outstanding, February 28, 2014	45,600	\$ 3.92	7.54
Exercisable, February 28, 2014	25,200	\$ 3.45	6.37

The weighted-average remaining contractual life of options outstanding issued under the Plan, both Qualified ISO and Non-Qualified SO, was 4.19 years at February 28, 2014. The exercise prices for the options outstanding at February 28, 2014 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	Weighted Average Remaining Contractual Life	Quantity	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price
\$1.00	\$1.50	215,100	3.81	187,700	3.62	\$1.06
\$1.51	\$3.00	31,600	6.12	11,600	3.08	\$2.11
\$3.01	\$4.50	141,900	3.63	103,500	3.49	\$3.22
\$4.51	\$6.68	136,000	4.95	12,000	3.52	\$5.59
		524,600	4.19	314,800	3.67	\$1.98

NOTE 6: RELATED PARTY TRANSACTIONS

As of February 28, 2014, included in bonus expenses to officers was \$90,000, of which \$30,000 was accrued bonus representing an estimated quarterly amount of bonus payable to the Corporate Secretary, Virginia Woltoz, as part of the terms of the sale of Words+ to Simulations Plus in 1996, and \$30,000 accrued bonus representing an estimated quarterly amount of bonus payable to our President/Chief Executive Officer, Walter Woltoz as part of his 2014

employment agreement The other \$30,000, paid in September 2013, was FY2013 performance bonus to Walter Woltosz, our President/Chief Executive Officer, which was approved by the compensation committee in September 2013.

NOTE 7: CONCENTRATIONS AND UNCERTAINTIES

Revenue concentration shows that International sales accounted for 61% and 53% of net sales for the six months ended February 28, 2014 and 2013, respectively. One customer (a dealer account in Japan representing various customers) accounted for 10% of sales for the six months ended February 28, 2014 compared to two customers who accounted for 11% (a dealer account in Japan representing various customers) and 10% of net sales during the six months ended February 28, 2013.

Accounts receivable concentration shows that two customers comprised 13% (a dealer account in Japan representing various customers) and 11% of accounts receivable at February 28, 2014 compared to three customers comprising 12%, 10% (a dealer account in Japan representing various customers), and 10% of accounts receivable at February 28, 2013.

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: Geographic Reporting

We allocate revenues to geographic areas based on the locations of our customers. Geographical revenues for the six months ended February 28, 2014 and 2013 were as follows (in thousands):

Six month ended	North America	Europe	Asia	South America	Total
February 28, 2014	\$ 2,228	\$ 1,968	\$ 1,515	\$ 11	\$ 5,722
February 28, 2013	\$ 2,605	\$ 1,775	\$ 1,028	\$ –	\$ 5,408

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 \$61,756 and \$50,545 for the six months ended February 28, 2014 and 2013, respectively, and \$35,629 and \$29,731 for the three months ended February 28, 2014 and 2013, respectively.

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.

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[™].

process the data is not in question; rather, we need to determine whether the data contains sufficient information to discriminate between the different groups. The amount of data is massive (“big data”), requiring us to modify our code to handle much larger data arrays than our previous applications have required. Our goal is to show the potential of our modeling technology to provide useful classification of a subject into one of the four groups based only on MRI imaging so that we could go to various agencies (such as the National Institutes of Health) to obtain funding to develop a commercial product.

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We released Version 6.5 of ADMET Predictor during last fiscal year. This version extended our metabolism predictions by training on a much larger experimental data set, and for the first time, provided specific metabolism rates for individual atoms within a molecule, rather than only for the molecule as a whole. These improvements are also available via MedChem Designer and MedChem Studio for customers who license ADMET Predictor. Version 6.5 also adds confidence levels to most of our toxicity models so that users have an idea of the reliability of each individual prediction.

After the end of this reporting period, we released version 7.0. This new version incorporates a new model for predicting ionization constants (pKa's), developed in a collaboration with Bayer AG that enabled us to more than double the size of our data set from about 16,000 pKa values to more than 35,000, and to expand the chemical space it covers to include a larger number of molecules more like those of interest to the pharmaceutical industry today. We believe the resulting improvement in pKa prediction puts our already best-in-class model well in front of any competitor. Predicting ionization is critical to predicting most other properties, so all of our models (approximately 144) were retrained based on this new capability for version 7.0.

MedChem Designer™

MedChem Designer was launched in 2011. It was initially a molecule drawing program, or “sketcher”, but now has capabilities exceeding 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, and because most other existing molecule drawing programs are also free. Our 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, the entire 140+ predictions would be available.

We released MedChem Designer 2.5 during FY2013. This version provided specific predicted atom locations for metabolism by each of the enzymes predicted to act upon a molecule.

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. Scientists can also click on an icon to generate the likely metabolites of a molecule and then predict all of the properties of those metabolites from ADMET Predictor, including their ADMET Risk scores. This is important because a metabolite of a molecule can be harmful even though the parent molecule is not.

ADMET Risk provides a single number that tells the chemist how many default threshold values for 24 predicted properties were crossed (or violated) by each structure. The rules can be modified and new rules added by the user to include any desired rule set based on any combination of calculated descriptors, predicted properties, and user inputs. Thus, in a single number, the chemist can instantly compare the effects of different structural changes in many 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 individually examine many key properties for each new molecule (and its metabolites) to check whether any of them became unacceptable as a result of changing the structure.

We are now finalizing version 3.0 of MedChem Designer, which will add the ability to capture the image of a molecular structure from a variety of publication files with a new snapshot tool, and the program will automatically convert the graphic image into any of several computer-based chemical structure files. Converting from lines and letters on the screen to an exact chemical representation of the molecule (Optical Structure Recognition, or OSR) is a complex task. Although a few OSR programs are in existence, we are not aware of any that can accurately convert as many varieties of images to chemical representation as the OSR tool within the development version of MedChem Designer. Such a capability allows chemists to quickly capture molecular structures from the scientific literature to use in our simulation and modeling software.

*MedChem Studio*TM

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. We released version 3.5 of MedChem Designer during FY2013. The new features included such important items as:

A new licensing module from Flexera called FlexNetTM

Improvements to graphics in structure depictions and the Miner 3D module

Faster performance on large data sets

A 64-bit version to deal with much larger data sets

User-defined equations to calculate new attributes by combining others

Enhanced Miner3D graphics with expanded assortment of chart types

While MedChem Designer can be used to refine a small number of molecules, MedChem Studio can be used to create and screen (with ADMET Predictor) a very large number of molecules down to a few promising lead candidates. MedChem Studio has features that enable it to generate new molecular structures using a variety of *de novo* design

methods. Coupled with ADMET Predictor and MedChem Designer, we believe the 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 can take an interesting (but not acceptable) molecule and, using a variety of design algorithms, very quickly generate many thousands to millions of high quality analogs (similar new molecules). These molecules can then be screened using ADMET Predictor to find molecules that are both active against the target as well as acceptable in a variety of ADMET properties.

MedChem Studio version 4.0 is now in final development and is expected to be released shortly after the ADMET Predictor 7.0 release to allow for proper synchronization between the two programs. Current development has focused primarily on the OSR tool mentioned above under the MedChem Designer discussion.

NCE Projects

During late 2012, based on our strong belief in the exceptional capabilities of our ADMET Design Suite (MedChem Studio/MedChem Designer/ADMET Predictor), we initiated a new molecule (NCE, or New Chemical Entity) design project. After considering various targets, we selected the malaria parasite *Plasmodium falciparum*, both because of the 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. Our goal was to demonstrate how well the ADMET Design Suite worked to generate new lead molecules in a fraction of the time and cost normally required in the pharmaceutical industry. 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 and two precursors (almost the final designed structures, but a step away in synthesis) were synthesized and tested for inhibition of the parasite at the University of California at Riverside. We were hoping that at least one would show inhibition of the growth cycle of the parasite.

We were excited to learn that 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 newer drug-resistant strain of the parasite, and again potency was observed, with two molecules showing nanomolar activity. We believe this exercise – a software company using its own products to design novel molecules and have them synthesized and tested – is unprecedented. New software license sales resulting from presenting our results have already more than recovered our investment.

During the previous reporting period, we announced that we had completed the design of a number of new molecules for a different target – the cyclo-oxygenase-2 (COX-2) enzyme that is the target for Celebrex®. Celebrex is the only COX-2 inhibitor remaining on the market, after the withdrawal of other approved drugs (such as Vioxx®) due to cardiac toxicity. It appears from the scientific research that was conducted after the withdrawal of other COX-2 inhibitors from the market that it is important to inhibit both COX-2 and COX-1 at a certain ratio in order to provide the benefits of COX-2 inhibition without the cardiotoxicity risk that has been associated with inhibiting COX-2 alone. We designed our new molecules based on activity models for both COX-2 and COX-1 built from public data, with the goal of providing an acceptable ratio of COX-2 to COX-1 inhibition. This is more challenging than designing for a single target, as we did for the earlier malaria NCE project. Results reported after the end of this reporting period showed that we were once again very successful, with all four molecules that were synthesized inhibiting both the COX-2 and COX-1 enzymes, and one of them providing the desired characteristic of higher affinity for COX-2 than COX-1. This is a remarkable achievement, and once again demonstrates that our ADMET Design Suite can save considerable time and money in developing new lead compounds for particular targets.

DDDPlus

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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.

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 the widespread use 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 all 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, and ensures that we are in front of the audience of member pharmaceutical companies and regulatory agencies.

Version 8.5 of GastroPlus was released during the current reporting period, adding a number of important new capabilities requested by customers as well as improvements we have identified in-house, including:

A new model for precipitation based on classical nucleation theory

Infant physiologies, including for babies born as much as 16 weeks premature

A unique method for using transporter data from preclinical experiments to predict transporter effects in human and other animals

A number of additional expression levels of enzymes and transporters in human and animal physiologies

An interim release (8.6) is planned for the very near future to enable certain customers to take advantage of a new physiological model for minipig, which has become a more frequently used animal species in preclinical development, and to add the ability to simulate populations within the Drug-drug interaction Module.

The next major release, version 9.0, is now well along in development. This version will add the ability to simulate dermal (through the skin) drug absorption from patches, creams, and ointments. This capability has been in development since May of 2012 through a funded collaboration with a top-5 pharmaceutical company, and is already in use at the customer’s sites at this time. A number of other improvements will be included in version 9.0 that will be announced with the release of the product.

MembranePlus™

MembranePlus is a new product that has been under development for a number of years, but was put on hold for several years due to other priorities. It was revived in the past year and is now nearing commercial release. Like DDDPlus, MembranePlus simulates laboratory experiments, but in this case, the experiments are for measuring permeability of drug-like molecules through various membranes, including several different cell cultures (Caco-2, MDCK) as well as artificially formulated membranes (PAMPA). The value of such a simulation results from the fact that when the permeabilities of the same molecules are measured in different laboratories, results are often strikingly different. These differences are caused by a complex interplay of factors in how the experiment was set up and run. MembranePlus simulates these experiments with their specific experimental details, and this enables the scientist to better interpret how results from specific experimental protocols can be used to predict permeability in human and animals, which is the ultimate goal. MembranePlus is unique and our customers have expressed significant interest in the new capability.

Priorities for developing material for our imminent training workshops required us to delay the development work on MembranePlus. We now plan to release version 1.0 of MembranePlus in the third fiscal quarter.

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 scientific meetings worldwide in the past four years. We frequently conduct contracted studies for large customers (including the largest five 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 steadily increasing, and we have expanded our Simulations Studies team to meet the increased workload. Long-term collaborations and shorter-term consulting contracts serve both to expand and showcase our technologies, and to build and strengthen customer relationships.

During the second quarter of fiscal year 2014 we continued to work on our 5-year Research Collaboration Agreement (RCA) 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 part 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 early on 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, and this is now a standard part of the program available to all users. 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.

After the end of this reporting period, we announced another five-year RCA, this time with the Office of Generic Drugs (OGD) within the FDA. This RCA is directed toward the FDA's evaluation of mechanistic IVIVCs (in vitro-in vivo correlations), an approach to determine whether mechanistic absorption modeling (MAM) correlates laboratory (*in vitro*) dissolution experiments with the *in vivo* behavior of a dosage form better than traditional empirical methods. We have proposed this method for about 15 years and believe in it, so we are pleased to see the FDA giving it serious consideration with this RCA.

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.

With our significant cash reserves, seeking suitable acquisitions is a priority. 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. We declared a \$0.04 per share dividend in November 2013 and a \$0.05 per share dividend in February 2014. We anticipate the dividend to be \$0.05 per share per quarter, however 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.

Results of Operations

Comparison of Three Months Ended February 28, 2014 and 2013.

The following table sets forth our condensed statements of operations (in thousands) and the percentages that such items bear to net sales(because of rounding, numbers may not foot):

	Three Months Ended			
	02/28/14		02/28/13	
Net sales	\$3,081	100.0%	\$3,118	100.0%
Cost of sales	492	16.0	499	16.0
Gross profit	2,589	84.0	2,619	84.0
Selling, general and administrative	1,104	35.8	855	27.4
Research and development	354	11.5	248	7.9
Total operating expenses	1,458	47.3	1,103	35.3
Income from operations	1,144	36.7	1,517	48.7
Other income	12	0.4	55	1.8
Income from operations before taxes	1,144	37.1	1,572	50.4
(Provision for) income taxes	(334)	(10.8)	(511)	(16.0)
Net income	\$810	26.3%	\$1,062	34.0%

Net Sales

Net sales decreased \$37,000, or 1.2%, to \$3,081,000 in the second quarter of Fiscal Year 2014 ("2QFY14") from \$3,118,000 in the second fiscal quarter of Fiscal Year 2013 ("2QFY13"). Although software sales to new customers were very strong during the quarter, these increases were not able to compensate for a major customer deciding to move a global renewal order that had been received in the second fiscal quarter last year to the third fiscal quarter this year in order to synchronize with their internal budget timelines. Analytical study revenues decreased by \$112,000 during the quarter as a consulting study contract from another client was delayed by their legal review process. The total effect on revenues of the customer budget timing and the delay in the study contract totaled approximately \$350,000.

Cost of Sales

Cost of sales decreased by \$7,000, or 1.3%, to \$492,000 in 2QFY14 from \$499,000 in 2QFY13. As a percentage of revenue, remained constant at 16% in 2QFY14 and 2QFY13. A significant portion of cost of sales for pharmaceutical software products is the systematic amortization of capitalized software development costs. Amortization cost increased approximately \$15,000, or 9%, in 2QFY14 compared with 2QFY13. Royalty expense, another significant

portion of cost of sales, decreased approximately \$30,000, or 13%, in 2QFY14 compared with 2QFY13. We pay a royalty on the core GastroPlus software licenses but not on its optional modules. We also pay royalties to Accelrys on a portion of the ADMET Predictor Metabolism Module. Workshop/Training costs increased by \$23,000 as we did more workshop programs and more onsite training in 2QFY14 compare to 2QFY13.

Gross Profit

Gross profit decreased \$7,000, or 0.7%, to \$2,589,000 in 2QFY14 from \$2,619,000 in 2QFY13. We attribute this decrease to the decreased revenues outweighing the decrease in cost of sales.

Selling, General and Administrative Expenses

Selling, general and administrative (SG&A) expenses increased \$249,000, or 29.1%, to \$1,104,000 in 2QFY14 from \$855,000 in 2QFY13.

The major changes in SG&A expenses for 2QFY14 vs 2QFY13 were:

Commission expense - increased by \$36K, we incurred increased commissions to our Japanese and Chinese dealers as we recorded significantly increased sales in our Asian markets

Marketing labor costs - increased by \$24K, substantive employee time was incurred in conjunction with updating of training material, trade shows and visitation of our Asian dealers

Travel expenses - increased \$33K as the company strategically increased its presence at a number of trade shows and conferences in 2QFY14, in addition, a higher percentage of travel was at international destinations

Consulting Fees - increased by \$44K, we used consultants in 2QF14 for review of contracts and other corporate transactional issues

Professional fees - increased by \$29K, primarily due to costs associated with review of proxy issues and legal issues associated with the company's amendment of its 2007 Stock Option Plan

Salaries and wages - Increased \$32K due to annual salary review increases and duplicated salaries associated with the transition of the company's CFO.

Research and Development

We incurred approximately \$714,000 of research and development costs during 2QFY14. Of this amount, \$360,000 was capitalized and \$354,000 was expensed. In 2QFY13, we incurred \$568,000 of research and development costs, of which \$320,000 was capitalized and \$248,000 was expensed. The increase of \$146,000, or 26%, in total research and development expenditures from 2QFY13 to 2QFY14 was due to an expansion of staff as well as increases in salaries and stock-based compensation increases for existing employees. In addition, the company incurred \$26K of costs associated with its COX-2/COX-1 NCE initiative (see NCE discussion in Business section above).

Other income (expense)

Net other income in 2QFY14 decreased by \$43,000, or 27.7%, to \$12,000 in 2QFY14 from \$55,000 in 2QFY13. This is due to lower interest income, and lower currency exchange gains in 2QFY14 compared with 2QFY13. In addition 2QFY14 did not include sub-lease income of \$15K, which was included in 2QFY13.

Provision for Income Taxes

Comparison of Six Months Ended February 28, 2014 and 2013.

The following table sets forth our condensed statements of operations (in thousands) and the percentages that such items bear to net sales(because of rounding, numbers may not foot):

	Six Months Ended			
	02/28/14		02/28/13	
Net sales	\$5,722	100.0%	\$5,408	100.0%
Cost of sales	941	16.4	885	16.3
Gross profit	4,782	83.6	4,523	83.6
Selling, general and administrative	2,175	38.0	1,786	33.0
Research and development	516	9.0	428	7.9
Total operating expenses	2,691	47.0	2,214	40.9
Income from operations	2,091	36.6	2,309	42.7
Other income	45	0.7	159	2.9
Income from operations before taxes	2,136	37.3	2,468	45.6
(Provision for) income taxes	(641)	(11.2)	(819)	(15.1)
Net income	\$1,495	26.1%	\$1,649	30.5%

Net Sales

Net sales increased \$314,000 or 5.8%, to \$5,722,000 in the first 6 months of fiscal 2014 (“6moFY14”) from \$5,408,000 in the first 6 months of fiscal 2013 (“6moFY13”). The increase in revenues is due to an approximately \$512,000 increase in software sales. Service revenues, such as collaboration, analytical studies, and workshop/training activities decreased by \$197,000.

Cost of Sales

Cost of sales increased by \$56,000, or 6.2%, to \$941,000 in 6moFY14 from \$885,000 in 6moFY13. As a percentage of revenue, cost of sales in 6moFY14 was approximately the same as 6moFY13 increasing by 0.1% to 16.4%. A significant portion of cost of sales for pharmaceutical software products is the systematic amortization of capitalized software development costs. Amortization cost increased approximately \$25,000, or 6.9%, in 6moFY14 compared with 6moFY13. Royalty expense, another significant portion of cost of sales, increased approximately \$4,000, or 1.1%, in 6moFY14 compared with 6moFY13. We pay a royalty on the core GastroPlus software licenses but not on its optional modules. We also pay royalties to Accelrys on a portion of the ADMET Predictor Metabolism Module.

Gross Profit

Gross profit increased \$259,000, or 5.7%, to \$4,782,000 in 6moFY14 from \$4,523,000 in 6moFY13. We attribute this increase to increased revenue outweighing increased cost of sales.

Selling, General and Administrative Expenses

Selling, general and administrative (SG&A) expenses increased \$389,000, or 21.8%, to \$2,175,000 in 6moFY14 from \$1,786,000 in 6moFY13.

The major changes in SG&A expenses for 6moFY14 vs 6moFY13 were:

- Commission expense – increased by \$66K, we incurred increased commissions to our Japanese and Chinese dealers as we recorded significantly increased sales in our Asian markets
- Marketing labor costs – increased by \$21K, substantive employee time was incurred in conjunction with updating of training materials, trade shows and visitation of our Asian dealers
- Travel expenses - increased \$49K as the company strategically increased its presence at a number of trade shows and conferences in 6moFY14. In addition, a higher percentage of travel was at international destinations
- Bonus expense - increased by \$30K, due to the changes in 2014 compensation plan for the company’s Chief Executive Officer (see Notes to Financial statements above)
- Professional fees – increased by \$29K, primarily due to costs associated with review of proxy issues and legal issues associated with the company’s amendment of its 2007 Stock Option Plan
- Investor relations – increased by \$20K, this is due to a change in stock transfer agents which occurred in the 3rd quarter of FY13
- Salaries and wages – increased \$88K due to annual salary review increases and some duplicated salaries associated with the transition of the company’s CFO. In addition the Life Science staff spent more time on G&A activities in 6moFY14 compared to 6moFY13, resulting in more expense allocated to SG&A

Research and Development

We incurred approximately \$1,250,000 of research and development costs during 6moFY14. Of this amount, \$733,000 was capitalized and \$516,000 was expensed. In 6moFY13 we incurred \$1,010,000 of research and development costs, of which \$582,000 was capitalized and \$428,000 was expensed. The increase of \$240,000, or 23.7%, in total research and development expenditures from 6moFY13 to 6moFY14 was due to expansion of staff and increases in salaries and stock based compensation for existing employees, in addition the company incurred \$26K of costs associated with its NCE initiative (See NCE discussion in Business section above).

Other income (expense)

Net other income decreased by \$114,000, or 71.7%, to \$45,000 in 6moFY14 from \$159,000 in 6moFY13. This is due to the lower interest income and lower currency exchange gain in 6moFY14 compared with 6moFY13. In addition 6moFY14 did not include any sub-lease income, while \$31K was included in 6moFY13.

Provision for Income Taxes

Provision for income taxes decreased by \$178,000, or 21.7%, to \$641,000 in 6moFY14 from \$819,000 in 6moFY13 due to the decrease in income before taxes. The Company’s effective tax rate was 30% and differs from statutory rates for the quarter mainly due to R&D tax credits recognized during the period.

Income from Continuing Operations

Net income from continuing operations decreased by \$154,000, or 9.3%, to \$1,495,000 in 6moFY14 from \$1,649,000 in 6moFY13. We attribute this decrease to increased research and development costs and increased operating expenses.

Liquidity and Capital Resources

Our principal sources of capital have been cash flows from our operations. We have achieved continuous positive operating cash flow over the last eight fiscal years. We believe that our existing capital and anticipated funds from operations will be sufficient to meet our anticipated cash needs for working capital and capital expenditures for the foreseeable future. Thereafter, if cash generated from operations is insufficient to satisfy our capital requirements, we may open a revolving line of credit with a bank, or we may have to sell additional equity or debt securities or obtain expanded credit facilities. In the event such financing is needed in the future, there can be no assurance that such financing will be available to us, or, if available, that it will be in amounts and on terms acceptable to us. If cash flows from operations became insufficient to continue operations at the current level, and if no additional financing was obtained, then management would restructure the Company in a way to preserve its pharmaceutical business while maintaining expenses within operating cash flows.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Our risk from exposure to financial markets is limited to foreign exchange variances and fluctuations in interest rates. We may be subject to some foreign exchange risks. Most of our business transactions are in U.S. dollars, although we generate significant revenues from customers overseas. The exception is that we have been compensated in Japanese yen by Japanese customers and PRC Yuan by Chinese customers. In the future, if foreign currency transactions increase significantly, then we may mitigate this effect through foreign currency forward contracts whose market-to-market gains or losses are recorded in "Other Income or expense" at the time of the transaction. To date, exchange rate exposure has not resulted in a material impact.

Item 4. Controls and Procedures

We are responsible for maintaining disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Disclosure controls and procedures are controls and other procedures designed to ensure that the information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure. In designing and evaluating disclosure controls and procedures, management recognizes

that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

Based on management's evaluation (with the participation of our chief executive officer and chief financial officer) of our disclosure controls and procedures as required by Rule 13a-15 under the Exchange Act, our principal executive officer and principal financial officer have concluded that our disclosure controls and procedures were effective.

Management's Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal controls over financial reporting, as defined in Exchange Act Rule 13a-15(f). Our internal controls over financial reporting are designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of condensed financial statements for external purposes in accordance with generally accepted accounting principles.

No changes were made in our internal controls over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) of the Exchange Act) during our most recent fiscal quarter that have materially affected or are reasonably likely to materially affect, our internal controls over financial reporting.

Our management, including our CEO and CFO, does not expect that our disclosure controls or internal controls over financial reporting will prevent all errors or all instances of fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within our company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple errors or mistakes. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and any design may not succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with policies or procedures. Because of the inherent limitation of a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

Part II. Other Information

Item 1. Legal Proceedings

The Company is not a party to any legal proceedings and is not aware of any pending legal proceedings of any kind.

Item
1A. Risk Factors

Not applicable.

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

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits

<u>EXHIBIT</u>	<u>DESCRIPTION</u>
<u>NUMBER</u>	
3.1	Articles of Incorporation of the Company. (5)
3.2	Amended and Restated Bylaws of the Company. (5)
4.1	Articles of Incorporation of the Company. (incorporated by reference to Exhibit 3.1 hereof)
4.2	Bylaws of the Company. (incorporated by reference to Exhibit 3.2 hereof)
4.3	Form of Common Stock Certificate (1)
4.4	Share Exchange Agreement (1)
10.1	The Company's 1996 Stock Option Plan (the "Option Plan") and forms of agreements relating thereto (1)
10.2	Exclusive License Software Agreement by and between the Company and Therapeutic Systems Research Laboratories dated June 30, 1997. (2)
10.3	The Company's 2007 Stock Option Plan. (3)
10.4	Notice of Election to Extend Term of Lease by and between the Company and Crest Development LLC formerly Freeway Ventures LLC, dated July 29, 2010.(4)
10.5	Employment Agreement by and between the Company and Walter S. Woltosz, dated as of July 22, 2011. (5) (†)
10.6	Employment Agreement by and between the Company and Walter S. Woltosz, dated as of August 22, 2013. (6) (†)
10.3	The Company's Amended 2007 Stock Option Plan. (7).
31.1	Section 302 – Certification of the Principal Executive Officer. (7)
31.2	Section 302 – Certification of the Principal Financial Officer. (7)
32.1	Section 906 – Certification of the Chief Executive Office and Chief Financial Officer. (7)
101.INS	XBRL Instance Document.
101.SCH	XBRL Taxonomy Extension Schema Document.
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document.
101.LAB	XBRL Taxonomy Extension Label Linkbase Document.
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document.

- (1) Incorporated by reference to the Company's Registration Statement on Form SB-2 (Registration No. 333-6680) filed on March 25, 1997.
- (2) Incorporated by reference to the Company's Form 10-KSB for the fiscal year ended August 31, 1997.
- (3) Incorporated by reference to the Company's Form 10-K for the fiscal year ended August 31, 2009.
- (4) Incorporated by reference to the Company's Form 10-K for the fiscal year ended August 31, 2010.
- (5) Incorporated by reference to the Company's Form 10-K for the fiscal year ended August 31, 2011.
- (6) Incorporated by reference to the Company's Form 8-K filed September 22, 2011.
- (7) Filed herewith

