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SIMULATIONS PLUS INC  
Form 10QSB  
January 14, 2004

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549

FORM 10-QSB

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended November 30, 2003 or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1937

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 000-21665

SIMULATIONS PLUS, INC.  
(Name of small business issuer in its charter)

CALIFORNIA  
(State or other jurisdiction of  
Incorporation or Organization)

95-4595609  
(I.R.S. Employer  
identification No.)

1220 W. AVENUE J  
LANCASTER, CA 93534-2902  
(Address of principal executive offices including zip code)

(661) 723-7723  
(Issuer's telephone number, including area code)

NOT APPLICABLE  
(Former Name, Former Address and Former Fiscal Year,  
if Changed Since Last Report)

Check whether the issuer: (1) filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No   
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The number of shares outstanding of the Issuer's common stock, par value \$0.001 per share, as of January 14, 2004, was 3,439,374.

SIMULATIONS PLUS, INC.  
FORM 10-QSB  
FOR THE QUARTERLY PERIOD ENDED NOVEMBER 30, 2003

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SIMULATIONS PLUS, INC. AND SUBSIDIARY  
CONSOLIDATED BALANCE SHEET  
AT NOVEMBER 30, 2003  
(Unaudited)

ASSETS

CURRENT ASSETS

Cash and cash equivalents (Note 2)	\$ 351,067
Accounts receivable, net of allowance for doubtful accounts of \$26,180 and present value discount of \$30,513	1,281,720
Inventory (Note 3)	236,410

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Prepaid expenses and other current assets	21,631	
Total current assets	1,890,828	
LONG TERM RECEIVABLES, net of present value discount of \$29,165	270,835	
CAPITALIZED COMPUTER SOFTWARE DEVELOPMENT COSTS, net of accumulated amortization of \$1,847,166 (Note 4)	369,581	
PROPERTY AND EQUIPMENT, net (Note 5)	74,621	
DEFERRED TAX (Note 6)	1,291,110	
OTHER ASSETS	10,890	
TOTAL ASSETS	\$ 3,907,865	
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES		
Accounts payable	\$ 174,046	
Accrued payroll and other expenses	283,906	
Accrued warranty and service costs	39,159	
Current portion of deferred revenue	11,416	
Other current liabilities (Note 7)	2,726	
Total current liabilities	511,253	
DEFERRED REVENUE	28,547	
OTHER LONG TERM LIABILITIES (Note 7)	5,451	
Total liabilities	545,251	
COMMITMENTS AND CONTINGENCIES (Note 7)	--	
SHAREHOLDERS' EQUITY (Note 8)		
Preferred stock, \$0.001 par value 10,000,000 shares authorized no shares issued and outstanding	--	
Common stock, \$0.001 par value 20,000,000 shares authorized 3,439,374 shares issued and outstanding	3,440	
Additional paid-in capital	4,696,676	
Accumulated deficit	(1,337,502)	
Total shareholders' equity	3,362,614	
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$ 3,907,865	

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

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SIMULATIONS PLUS, INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF OPERATIONS  
FOR THE THREE MONTHS ENDED NOVEMBER 30,  
(Unaudited)

	2003	2002
NET SALES	\$ 1,138,733	\$ 1,077,515
COST OF SALES	351,746	332,798
GROSS PROFIT	786,987	744,717
OPERATING EXPENSES		
Selling, general, and administrative	605,823	502,881
Research and development	143,393	109,598
Total operating expenses	749,216	612,479
INCOME FROM OPERATIONS	37,771	132,238
OTHER INCOME (EXPENSE)		
Interest income	20,487	15
Interest expense	(366)	(1,540)
Total other income (expense)	20,121	(1,525)
INCOME BEFORE BENEFIT FROM (PROVISION FOR) INCOME TAXES	57,892	130,713
BENEFIT FROM (PROVISION FOR) INCOME TAXES		
Provision for income tax	(11,173)	--
Change in valuation allowance	--	--
Total benefit from (provision for) income taxes	(11,173)	--
NET INCOME	\$ 46,719	\$ 130,713
BASIC EARNINGS PER SHARE	\$ 0.01	\$ 0.04
Diluted earnings per share	\$ 0.01	\$ 0.04
WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING BASIC	3,417,202	3,408,331

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DILUTED 4,128,092 3,430,768  
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The accompanying notes are an integral part of these financial statements.

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SIMULATIONS PLUS, INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
FOR THE THREE MONTHS ENDED NOVEMBER 30,  
(Unaudited)

	2003	2002
	-----	-----
<hr style="border-top: 1px dashed black;"/>		
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 46,719	\$ 130,713
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization of property and equipment	8,060	9,932
Amortization of capitalized software development costs	52,552	35,550
(Increase) decrease in		
Accounts receivable	140,788	50,168
Inventory	(44,571)	(47,417)
Other assets	44,382	7,275
Increase (decrease) in		
Accounts payable	(962)	(13,604)
Accrued expenses	5,097	(11,684)
Accrued payroll for officers	--	(58,333)
Accrued bonuses to officers	(133,538)	(54,057)
Accrued warranty and service costs	(5,571)	4,503
Deferred revenue	(6,454)	11,546
	-----	-----
Net cash provided by operating activities	106,502	64,592
	-----	-----
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchases of property and equipment	(2,970)	(27,029)
Capitalized computer software development costs	(48,209)	(18,352)
	-----	-----
Net cash used in investing activities	(51,179)	(45,381)
	-----	-----
CASH FLOWS FROM FINANCING ACTIVITIES		
Payments on capitalized lease obligations	(1,787)	(3,610)
Proceeds from the exercise of stock options	36,798	--
	-----	-----
Net cash provided by (used in)		

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financing activities	35,011	(3,610)
	-----	-----
Net increase (decrease) in cash and cash equivalents	\$ 90,334	\$ 15,601
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	260,733	36,072
	-----	-----
CASH AND CASH EQUIVALENTS, END OF QUARTER	\$ 351,067	\$ 51,673
	=====	=====
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION		
INTEREST PAID	\$ 366	\$ 1,540
	=====	=====
INCOME TAXES PAID	\$ 47,000	\$ 1,600
	=====	=====

SUPPLEMENTAL SCHEDULE OF NON-CASH TRANSACTIONS

Minolta copier with a zero book value was traded-in for a new Ricoh copier/printer. The remaining obligation of \$8,177 was assumed by the lessor of Ricoh copier/printer in the exchange for a higher per print cost.

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

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SIMULATIONS PLUS, INC.  
NOTES TO CONDENSED FINANCIAL STATEMENTS  
(Unaudited)

Note 1: GENERAL

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As contemplated by the Securities and Exchange Commission under Item 310(b) of Regulation S-B, 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"), the interim data include 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.

ESTIMATES

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

Note 2: CASH AND CASH EQUIVALENTS

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We maintain cash deposits at banks located in California. Deposits at each bank are insured by the Federal Deposit Insurance Corporation up to \$100,000. As of November 30, 2003, the uninsured portions aggregated to \$246,000. We have not experienced any losses in such accounts and we believe we are not exposed to any significant credit risk on cash and cash equivalents.

### Note 3: INVENTORY

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Inventory is stated at the lower of cost (first-in, first-out basis) or market, and consists of computers and peripheral computer equipment.

### Note 4: CAPITALIZED COMPUTER SOFTWARE DEVELOPMENT COSTS

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Software development costs are capitalized in accordance with Statement of Financial Accounting Standards ("SFAS") No. 86, "Accounting for the Cost of Computer Software to be Sold, Leased, or Otherwise 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 revenue, estimated economic life, and changes in software and hardware technologies. Capitalized software development costs are comprised primarily of salaries and the purchase of existing software to be used in our software products.

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Amortization of capitalized software development costs is provided on a product-by-product basis on the straight-line method over the estimated economic life of the products, not exceeding three years. Management periodically compares estimated net realizable value by product with the amount of software development costs capitalized for that product to ensure the amount capitalized is recoverable through revenues. Any excess of development costs to expected net realizable value is expensed at that time.

### Note 5: FURNITURE AND EQUIPMENT

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Furniture and equipment as of November 30, 2003 consisted of the following:

Equipment	\$ 137,690
Computer equipment	287,032
Furniture and fixtures	52,704
Leasehold improvements	38,215
	-----
	515,641
Less accumulated depreciation	(441,020)
	-----
	\$ 74,621
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### Note 6: INCOME TAX

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The Company utilizes SFAS No. 109 "Accounting for Income Taxes," which requires

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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.

### Note 7: OTHER LIABILITIES

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We lease certain facilities for our corporate and operations offices under a non-cancelable operating lease agreement that expires in September 2005. During the first fiscal quarter of 2004 (FY04), we agreed to a 3-year non-cancelable operating lease for a printer/copier. In this agreement, we traded in the previous copier with an additional per charge per print for the new printer/copier. Accordingly, the remaining balance on the lease of the previous copier will be amortized over the term of the lease. The equipment that was traded in had a book value of zero (the original cost of \$37,967 with accumulated depreciation of \$37,967) at the time of transaction.

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### Note 8: STOCKHOLDERS' EQUITY

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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") pursuant to which a total of 250,000 shares of common stock were 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 500,000. In February 2000, the shareholders approved the number of shares to be granted under the Option Plan to be 1,000,000 shares. Furthermore, in December 2000, the shareholders approved an increase in number of shares that may be granted under the Option Plan to 1,250,000. The Option Plan terminates in 2006, subject to earlier termination by the Board of Directors.

As of November 30, 2003, 1,093,035 shares have been issued and outstanding to various employees at an exercise price equal to the fair market value of our stock price at the date of each grant, with five-year vesting periods. Also, in accordance with the by-laws of the corporation, a total of 7,206 shares have been issued to the Board of Directors at exercise prices ranging from \$1.20 to \$5.25, with a three-year vesting period. At the end of the first fiscal quarter of 2004, 33,343 options have been exercised by employees.

### Note 9: EARNINGS PER SHARE

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Effective February 28, 1998, we adopted SFAS No. 128 "Earnings Per Share."

### Note 10: REVENUE RECOGNITION



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We recognize revenues related to software licenses and software maintenance in accordance with the American Institute of Certified Public Accountants ("AICPA") Statements of Position No. 97-2, "Software Revenue Recognition." Product revenue is recorded at the time of shipment, net of estimated allowances and returns. Post-contract customer support ("PCS") obligations are insignificant; therefore, revenue for PCS is recognized at the time of shipment, and the costs of providing such support services are accrued and amortized over the obligation period. Ongoing improvements and upgrades of any significance are infrequent and minimal in nature and timing. We provide additional training and service calls to our customers for a fee. We recognize revenues from these activities at the time the training or service call is provided. The Company believes its history of collections with its existing customers is sufficient to overcome the presumption that revenue should be recognized in time with the expected cash collections, and has therefore recognized the entire license fee, net of an applicable discount, at the time of the software's release and acceptance by the customer.

Note 11: LINE OF BUSINESS

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For internal reporting purposes, management segregates the Company into two divisions. Results for each division and consolidated results are as follows for the three months ended November 30, 2003 and 2002:

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	November 30, 2003		
	Simulations Plus, Inc.	Words +, Inc.	Eliminations
Net Sales	642,293	496,440	
Income (loss)			
from operations	135,148	(97,377)	
Identifiable assets	4,189,068	651,521	(963,279)
Capital expenditures	0	2,970	
Depreciation and amortization	3,957	4,103	
	-----		
	November 30, 2002		
	Simulations Plus, Inc.	Words +, Inc.	Eliminations
Net Sales	506,619	570,896	
Income (loss)			
from operations	162,385	(30,147)	
Identifiable assets	1,642,942	735,227	(786,704)
Capital expenditures	0	27,029	
Depreciation and amortization	4,539	5,393	

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Note 12: SUBSEQUENT EVENT

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On December 23, 2003, Words+, Inc., the Company's subsidiary, has purchased all of the rights, title, and interest in the Say-it! SAM augmentative communication device developed by SAM Communications, LLC, for 35,000 shares of Simulations Plus restricted common stock. The value of this technology acquisition was recorded at \$4.65 per share; equal to the closing price of the Company's stock on the date the agreement was signed. Its costs are capitalized in accordance with SFAS No. 86 (see Note 4) and amortized over the estimated economic life of the product, not exceeding three years.

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

### FORWARD-LOOKING STATEMENTS

CERTAIN STATEMENTS IN THIS QUARTERLY REPORT ON FORM 10-KSB, OR THE "REPORT," ARE "FORWARD-LOOKING STATEMENTS." THESE FORWARD-LOOKING STATEMENTS INCLUDE, BUT ARE NOT LIMITED TO, STATEMENTS ABOUT THE PLANS, OBJECTIVES, EXPECTATIONS AND INTENTIONS OF SIMULATIONS PLUS, INC., A CALIFORNIA CORPORATION (REFERRED TO IN THIS REPORT AS THE "COMPANY") AND OTHER STATEMENTS CONTAINED IN THIS REPORT THAT ARE NOT HISTORICAL FACTS. FORWARD-LOOKING STATEMENTS IN THIS REPORT OR HEREAFTER INCLUDED IN OTHER PUBLICLY AVAILABLE DOCUMENTS FILED WITH THE SECURITIES AND EXCHANGE COMMISSION, OR THE "COMMISSION," REPORTS TO THE COMPANY'S STOCKHOLDERS AND OTHER PUBLICLY AVAILABLE STATEMENTS ISSUED OR RELEASED BY THE COMPANY INVOLVE KNOWN AND UNKNOWN RISKS, UNCERTAINTIES AND OTHER FACTORS WHICH COULD CAUSE THE COMPANY'S ACTUAL RESULTS, PERFORMANCE (FINANCIAL OR OPERATING) OR ACHIEVEMENTS TO DIFFER FROM THE FUTURE RESULTS, PERFORMANCE (FINANCIAL OR OPERATING) OR ACHIEVEMENTS EXPRESSED OR IMPLIED BY SUCH FORWARD-LOOKING STATEMENTS. SUCH FUTURE RESULTS ARE BASED UPON MANAGEMENT'S BEST ESTIMATES BASED UPON CURRENT CONDITIONS AND THE MOST RECENT RESULTS OF OPERATIONS. WHEN USED IN THIS REPORT, THE WORDS "EXPECT," "ANTICIPATE," "INTEND," "PLAN," "BELIEVE," "SEEK," "ESTIMATE" AND SIMILAR EXPRESSIONS ARE GENERALLY INTENDED TO IDENTIFY FORWARD-LOOKING STATEMENTS, BECAUSE THESE FORWARD-LOOKING STATEMENTS INVOLVE RISKS AND UNCERTAINTIES. THERE ARE IMPORTANT FACTORS THAT COULD CAUSE ACTUAL RESULTS TO DIFFER MATERIALLY FROM THOSE EXPRESSED OR IMPLIED BY THESE FORWARD-LOOKING STATEMENTS, INCLUDING THE COMPANY'S PLANS, OBJECTIVES, EXPECTATIONS AND INTENTIONS AND OTHER FACTORS.

THE FOLLOWING DISCUSSION AND ANALYSIS SHOULD BE READ IN CONJUNCTION WITH THE CONSOLIDATED FINANCIAL STATEMENTS AND RELATED NOTES INCLUDED ELSEWHERE IN THIS REPORT.

GENERAL

BUSINESS

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Simulations Plus, Inc. (the "Company" or "Simulations Plus", or "we" or "our") and its wholly owned subsidiary, Words+, Inc. ("Words+") produce two types of products: (1) Simulations Plus, incorporated in 1996, develops and produces modeling and simulation software for use in pharmaceutical research and for education, and also provides contract research services to the pharmaceutical industry, and (2) Words+, founded in 1981, produces computer software and

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specialized hardware for use by persons with disabilities, as well as a personal productivity software program called Abbreviate! for the retail market.

### DESCRIPTION OF SIMULATION AND MODELING SOFTWARE

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The development of simulation software involves (1) understanding the underlying science of the process to be simulated, (2) breaking the process down into the lowest practical level of sub-processes which can be represented mathematically, (3) developing mathematical equations for each of these sub-processes, and (4)

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programming the equations into computer subroutines. Software subroutines are then integrated into the overall simulation program, with appropriate coordination between modules and design of a user-friendly interface for inputs and outputs. The predictions of the simulations are compared to known results in order to calibrate the software. The types of simulation software we produce are based on the equations of chemistry and physics that describe or "model" the behavior of things in the real world.

### PRODUCTS

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Our GastroPlus(TM) pharmaceutical software simulates how drugs are absorbed in the human body and in animals. The simulation has equations for the movement of the drug through the gastrointestinal tract, how fast it dissolves in the stomach and intestines, whether it is converted to a different molecular form by chemical reactions or by metabolism by enzymes in the gastrointestinal tract, and how fast it is absorbed through the intestinal wall into the blood stream. If some additional inputs are provided, it also simulates the amount of drug in the blood plasma versus time. With an optional module called PDPlus(TM), the program can also simulate how a drug affects the body, such as reducing pain, reducing blood pressure, or reducing depression. Adverse side effects can also be simulated.

We believe GastroPlus is the "gold standard" for simulation of oral drug absorption in the pharmaceutical industry. In addition to pharmaceutical companies, recent sales have included a number of drug delivery companies (companies that design the tablet or capsule for a drug compound that was developed by another company). Although these companies are considerably smaller than the pharmaceutical giants, they can save cost and time through accurate simulations of their drug delivery technologies. We believe this part of the industry, which includes hundreds of companies, represents major growth potential for GastroPlus.

In 1998, we signed a License Agreement with Therapeutic Systems Research Laboratories, Inc. ("TSRL"), Ann Arbor, Michigan, to obtain exclusive rights to TSRL's technology and database, including data from nearly 60 laboratory experiments to measure the intestinal permeability of drug compounds in human and/or rat. As a part of this License Agreement, we are also entitled to ongoing consulting assistance in the development and further enhancement of the GastroPlus absorption simulation model from TSRL staff, including Dr. Gordon Amidon. We believe that the strategic advantage of exclusive access to TSRL's database, technology and expertise, combined with our own expertise in absorption, pharmacokinetics, and pharmacodynamics simulation, have resulted in GastroPlus becoming the de facto standard for oral drug absorption simulation and analysis within the pharmaceutical industry. We are aware that other

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companies have developed competitive software; however, based on customer feedback, we believe there is no significant competitive threat for GastroPlus at this time. We believe that the addition of the Metabolism and Transporter Module last year, the recently released PDPlus module, and ongoing upgrades of the core simulation are advances in the state-of-the-art of oral drug absorption, pharmacokinetics, and pharmacodynamics analysis. The PBPKPlus module now in development will further extend the utility of GastroPlus within the industry. Our recognized expertise in oral absorption and pharmacokinetics is

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evidenced by the fact that our staff members have been invited speakers at over 30 prestigious scientific meetings worldwide in the past two years, and they continue to be invited to present at a variety of meetings worldwide. We also conduct contracted studies for customers who prefer to have studies run by our scientists rather than to license our software and train someone to use it.

In addition to simulation software, we produce software that consists of statistically significant models (equations) that predict various properties of chemical compounds from just their molecular structures. When drug companies try to find new drugs, they search through thousands or millions of potential molecular structures (combinations of atoms arranged in different ways to make molecules) to find a good molecule. In order for a new molecule to become an approved drug, it must have acceptable values for certain properties, such as solubility (how much can be dissolved in a glass of water), permeability (how well it gets absorbed through the intestinal wall), and others.

Our QMPRPlus(TM) program provides estimates for several important properties of new drug-like molecules with only their structures as input. Recent developments have included adding a prediction of the percent of a new drug that would be absorbed at dose levels of 1, 10, 100, and 1000 milligrams, and the addition of the prediction of ionization constants ("pKa's") for molecules, which tells chemists whether the molecules will ionize (add or give up hydrogen atoms) in the body. Ionization has a major effect on some other properties, like solubility.

GastroPlus and QMPRPlus are used by almost every major and a number of smaller pharmaceutical companies in the U.S., Europe, and Japan. The number of customers continues to grow each year. Our revenue growth reflects the cumulative effect of new license sales added to annual license renewals from the previous year.

QMPRchitect (TM) was released in July of 2003. This program is used to generate the predictive models used in QMPRPlus. With QMPRchitect, scientists can use their own experimental data for a set of molecules to create a new predictive model. For example, if a company had some experimental data for solubility for 500 new molecules that were somewhat similar to each other (called a "chemical series"), they could use QMPRchitect to make a predictive model for solubility that would be a good predictor for other molecules in the same series. In the past, we have needed 2-3 months to produce equivalent models. With QMPRchitect, the time is usually reduced to a few hours or days.

We continue to enhance GastroPlus, QMPRPlus, and QMPRchitect, and we are also developing new core products to add to our catalog of software for pharmaceutical research.

In addition to our pharmaceutical software, we also produce a set of award-winning science experiment simulations (computer programs for Windows and Macintosh computers) for middle school and high school students under the

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umbrella name of FutureLab(TM). These simulations incorporate the equations of chemistry and physics for each experiment (optics, electrical circuits, gravity, universal gravitation, ideal gases, etc.), and allow students to design and conduct their own experiments in a virtual laboratory environment. Although development of FutureLab software was discontinued in 1998, low-level sales have continued through distributors in the U.S., U.K. Australia, and New Zealand.

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### CONTRACT RESEARCH SERVICES

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We offer contract research services to the pharmaceutical industry in the area of gastrointestinal absorption, pharmacokinetics, and related technologies. These studies provide us an additional source of revenue, as well as a means to introduce our software products to new customers. These studies are also beneficial to us to validate and enhance our products by studying actual data in the pharmaceutical industry. A services contract with a major pharmaceutical company was signed last year. This company has numerous software licenses, but desires additional consultation assistance from our scientists for certain complex simulation problems.

### PHARMACEUTICAL SIMULATIONS SOFTWARE PRODUCT DEVELOPMENT

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In the area of simulation software for pharmaceutical research, we are developing additional modules for GastroPlus, QMPRPlus, and QMPRchitect. Although all of our development work cannot be disclosed for competitive reasons, some of our development efforts include:

#### (1) PBPKPlus(TM) Module

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The PBPKPlus Module for GastroPlus is in early development. This module will enable researchers to predict the amount of drug that reaches different body tissues and organs. This is an important new capability because it opens up the market to researchers who deal in later stage clinical trials, and who routinely perform PBPK (physiologically based pharmacokinetic) and PD (pharmacodynamic) analyses. Until now, these analyses were performed using models that treated absorption and its related processes with simplified models - often so simplified that calculations were in error. With PBPKPlus integrated with the sophisticated absorption model in GastroPlus, researchers will be able to perform more accurate simulations and analyses to better understand how a drug moves from the blood into different tissues and organs. Without the ability to predict these effects, clinical trial costs can soar when trials must be repeated to determine proper dosing levels. We expect to release this additional-cost module later this fiscal year.

#### (2) Multiple Particle Size Dissolution Model

-----

The current dissolution model in GastroPlus uses a single "effective" particle size. While this model has represented most tablets, capsules, and suspensions we have dealt with to date reasonably well, formulation researchers know that real dosage forms do not consist of particles that are all one size. Instead, there is a distribution of particle sizes from smaller than the average size to larger than the average size. Smaller particles dissolve faster than larger particles. For some drugs, this results in dissolution behavior that is not well

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modeled with a single effective particle size. This new model will allow formulation researchers to assess the effects of different particle size distributions on dissolution and absorption.

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### (3) DDDPlus(TM)

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The DDDPlus (Dose Disintegration and Dissolution Plus) project originally began in 2000, and proceeded at a slow pace until 2003, in between other higher priority projects. DDDPlus will simulate how different tablets and capsules disintegrate and dissolve during in vitro (in the laboratory) experiments. The program will include the effects of changing formulation excipients (additives that are not the active drug). This tool will be a valuable asset for formulation scientists as they search for optimum formulations that provide desirable properties at minimum cost.

### (4) QMPRPlus(TM) upgrades

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We continue to add new molecular descriptors and new predicted ADMET properties to QMPRPlus(TM). Last year we completed the development of two new, additional-cost modules, one for predicting ionization constants ("pKa Module") and one for predicting the fraction of a dose that will be absorbed at dose levels of 1, 10, 100, and 1000 milligrams ("Fraction Absorbed Module"). Other enhancements have been included to allow the program to account for a wider variety of molecular features ("descriptors") to be used in its mathematical models.

### DISABILITY PRODUCT DEVELOPMENT

-----  
Our wholly owned subsidiary, Words+, Inc. has been an industry technology leader for over 22 years in introducing and improving augmentative and alternative communication and computer access software and devices for disabled persons and intends to continue to be at the forefront of the development of new products. We will continue to enhance our major software products, E Z Keys and Talking Screen, as well as our growing line of hardware products. We will also consider acquisitions of other products, businesses and companies that are complementary to its existing augmentative and alternative communication and computer access business lines. We recently announced the purchase of the Say-it! SAM technologies from SAM Communications, LLC of San Diego, which gives us our smallest, lightest augmentative communication system based on a Compaq iPAQ personal digital assistant (PDA). PDA-based communication devices have been very successful in the augmentative communication market, and this acquisition has enabled us to move into this market segment faster and at lower cost than developing the product ourselves.

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### RESULTS OF OPERATIONS

COMPARISON OF THREE MONTHS ENDED NOVEMBER 30, 2003 AND 2002.

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

	Three Months Ended		
	11/30/03		11/30/03
Net sales	\$ 1,139	100%	\$ 1,078
Cost of sales	352	30.9	333
Gross profit	787	69.1	745
Selling, general and administrative	606	53.2	503
Research and development	143	12.6	110
Total operating expenses	749	65.8	613
Income from operations	38	3.3	132
Other income (expenses)	20	1.8	(1)
Net income before taxes	58	5.1	131
Provision for income taxes	11	1.0	--
Net income	\$ 47	4.1%	\$ 131

### NET SALES

Consolidated net sales increased \$61,000, or 5.7%, to \$1,139,000 in the first fiscal quarter of 2004 (FY04) from \$1,078,000 in the first fiscal quarter of 2003 (FY03). Simulations Plus, Inc.'s sales from pharmaceutical and educational software increased approximately \$136,000, or 26.8%; however, our Words+, Inc. subsidiary's sales decreased approximately \$75,000, or 13.1%, for the quarter. Much of the increase in our pharmaceutical software sales is attributable to the exercise of an option under the large multi-year order we received during the 4th quarter of FY03 for an additional geographic location. This option added a fifth site for the modified "ADME Partners" program under that license agreement, which provides virtually unlimited licenses for the use of our GastroPlus(TM), QMPRPlus(TM), and QMPRchitect(TM) software products with all optional modules. Management attributes the decrease in Words+ sales primarily to the low sales of TuffTalker Plus, which declined approximately \$27,000, or 67%, compared to the same period of the previous year and some decline in software sales. Management attributes these declines primarily due to heavy competition in picture-based communication systems.

### COST OF SALES

Consolidated cost of sales increased \$19,000, or 5.7%, to \$352,000 in the first fiscal quarter of FY04 from \$333,000 in the first fiscal quarter of FY03. The percentage of cost of sales in the first fiscal quarter of FY04 is the same as the first fiscal quarter of FY03. For Simulations Plus, cost of sales increased \$22,000, or 41.4%. A significant portion of cost of sales is the systematic amortization of capitalized software development costs, which increased \$15,000, or 50.3%, and an increase in royalty expense of \$7,000, or 30.3% which represents royalty payments to TSRL. The change in percentage of cost of sales

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between the first fiscal quarter of FY04 and FY03 is an increase of 1.4%, 12.1%

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in FY04 and 10.9% in FY03. Management attributes this slight increase in percentage of cost of sales primarily to a proportional increase in amortization of capitalized software development costs compared to sales.

For Words+, cost of sales decreased \$5,000, or 2.0%. The change in percentage of cost of sales between the first fiscal quarter of FY04 and FY03 was an increase of 6.0%. Management attributes the percentage increase in cost of sales for Words+ primarily to the fact that the percentage of sales generated by products with higher profit margins, such as software, was less than products with lower profit margins, such as computer-based systems.

### GROSS PROFIT

Consolidated gross profit increased \$42,000, or 5.6%, to \$787,000 in the first quarter of FY04 from \$745,000 in the first quarter of FY03. Management attributes this increase to a significant increase in pharmaceutical software sales, resulting in approximately 25% increase in gross profit for these sales. This increase outweighed a decrease in gross profit generated by Words+ products.

### SELLING, GENERAL AND ADMINISTRATIVE EXPENSES

Consolidated selling, general and administrative expenses increased \$103,000, or 20.5%, to \$606,000 in the first fiscal quarter of FY04 from \$503,000 in the first fiscal quarter of FY03. For Simulations Plus, selling, general and administrative expenses increased \$119,000, or 65.6%. The major increases in expenses were in the categories of other taxes due to sales to foreign countries, a transfer of administrative personnel wages from Words+ to Simulations Plus for internal tracking purposes, investor relation's fees which began in the last fiscal quarter of last year, and payroll-related expenses such as health insurance and 401(k) matching contributions. These increases outweighed small decreases in dues/subscriptions, employee benefits, and depreciation.

For Words+, expenses decreased \$16,000, or 4.9%, due to a transfer of administrative personnel wages from Words+ to Simulations Plus for internal tracking purposes, contract labor, technical service costs, recruiting expense, and utilities. These decreases outweighed increases in selling expense, such as commission to sales reps and travel expense, dues/subscriptions, insurance, and telephone.

### RESEARCH AND DEVELOPMENT

We incurred approximately \$191,000 of research and development costs for both companies during the first quarter of FY04. Of this amount, \$48,000 was capitalized and \$143,000 was expensed. In the first quarter of FY03, we incurred \$128,000 of research and development costs, of which \$18,000 was capitalized and \$110,000 was expensed. The increase of \$63,000, or 49.2% in research and development expenditure from the first quarter of FY03 to the first quarter of FY04 was due to staff expansion and salary increases.

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### OTHER INCOME (EXPENSE)

Interest income in the first quarter of FY04 increased by \$20,000 due primarily to the amortization of present value discount on long-term receivables.

### PROVISION FOR INCOME TAXES

Although the Company had a Net Operating Loss (NOL) carried forward which was applied to the Company's Federal income tax liability, the State of California suspended the NOL carry forward for two years beginning with fiscal years that began after January 2002, resulting in a \$11,000 tax due to the state of California for the first quarter FY04.

### NET INCOME

Consolidated net income before tax for the three months' operations decreased by \$84,000, or 64.1%, to \$47,000 in the first quarter of FY04 compared to \$131,000 in the first quarter of FY03. Management attributes this decrease in profit primarily to the increases in cost of sales, selling, general and administrative expenses, research and development expenses and provision for income taxes, which outweighed increases in sales and other income.

### CRITICAL ACCOUNTING POLICIES

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Our consolidated 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. Critical accounting policies for us include revenue recognition, accounting for capitalized software development costs, and accounting for income taxes.

### REVENUE RECOGNITION

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We account for the licensing of software in accordance with American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 97-2, "SOFTWARE REVENUE RECOGNITION". The application of SOP 97-2 requires judgment, including whether a software arrangement includes multiple elements, and if so, whether vendor-specific objective evidence (VSOE) of fair value exists for those elements.

The end users receive certain elements of our products over a period of time. These elements include free post-delivery telephone support and the right to receive unspecified upgrades/enhancements. In accordance with SOP 97-2, we have evaluated these agreements and we have recognized the entire license fee on the date the software is delivered to and accepted by the customer. In order to recognize the fee in this manner, we have met all the criteria required, including:

- o The Post Contract Customer Support ("PCS") fee is included in the initial licensing fee,
- o The PCS included with the license is for one year or less,
- o The estimated cost of providing the PCS during the arrangement is insignificant, and
- o Unspecified upgrades/enhancements during the PCS arrangements have been and are expected to continue to be minimal and infrequent.

Changes to the elements in a software arrangement, the ability to identify VSOE

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for those elements, the fair value of the respective elements, the costs associated with providing PCS and changes to a product's estimated life cycle could materially impact the amount of earned and unearned revenue. Judgment is also required to assess whether future releases of certain software represent new products or upgrades and enhancements to existing products.

From time to time, we offer certain customers three-year contracts with extended payment terms. SOP 97-2 requires us to evaluate these contracts to determine if they qualify for recognition of revenue in a manner similar to our one-year contracts. On these contracts, we evaluate the collection and concession history with these customers and products to overcome the presumption that revenue should be recognized in line with cash collections. To date, we have recognized these contracts on delivery to and acceptance by the customer of the product. Substantial judgment is required in evaluating the relevant history and contract economics of these extended contracts, and could materially impact recorded revenue and unearned revenue in our financial statements.

### CAPITALIZED SOFTWARE DEVELOPMENT COSTS

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Capitalized computer software development costs are capitalized in accordance with SFAS No. 86, "Accounting for the Cost of Computer Software to be Sold, Leased, or Otherwise 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 including, but not limited to, technological feasibility, anticipated future gross revenues, estimated economic life, and changes in software and hardware technologies. Any changes to these estimates could materially impact the amount of amortization expense, research and development expense recognized in the consolidated statement of operations and the amount recognized as capitalized software development costs in the consolidated balance sheet.

### INCOME TAXES

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SFAS No. 109, "ACCOUNTING FOR INCOME TAXES", establishes financial accounting and reporting standards for the effect of income taxes. The objectives of accounting for income taxes are to recognize the amount of taxes payable or refundable for the current year and deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity's financial statements or tax returns. Judgment is required in assessing the future tax consequences of events that have been recognized in our financial statements or tax returns. Fluctuations in the actual outcome of these future tax consequences could materially impact our financial position or our results of operations.

During the year ended August 31, 2003, we recognized significant income tax benefit from the release of a previously recorded reserve for deferred tax assets. The evaluation of the deferred tax assets is based on our history of generating taxable profits and our projections of future profits as well as expected future tax rates to determine if the realization of the deferred tax asset is more-likely-than-not. Significant judgment is required in these evaluations, and differences in future results from our estimates, could result in a material differences in the realizability of these assets.

### LIQUIDITY AND CAPITAL RESOURCES

The Company's principal sources of capital have been cash flows from its operations and a bank line of credit. The Company has available a \$500,000 revolving line of credit from a bank. Interest is payable on a monthly basis at the bank's prime rate plus 1.5%. At November 30, 2003, the outstanding balance under the revolving line of credit was zero. The revolving line of credit is

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secured by the Company's assets, consisting of tangible personal property (except goods in transit), is personally guaranteed by the Company's President, and expires in May 2004.

The Company believes that existing capital and anticipated funds from operations will be sufficient to meet its anticipated cash needs for working capital and capital expenditures for the foreseeable future. Thereafter, if cash generated from operations is insufficient to satisfy the Company's capital requirements, the Company 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 the Company, or, if available, that it will be in amounts and on terms acceptable to the Company. 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 and disability businesses while maintaining expenses within operating cash flows.

### Item 3. Controls and Procedures

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- (a) EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES. As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Exchange Act Rule 13a-14. Based upon that evaluation, the Chief Executive Officer and Director of Finance concluded that the Company's disclosure controls and procedures are effective

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in timely alerting them to material information relating to the Company required to be included in the Company's periodic SEC filings.

- (b) CHANGES IN INTERNAL CONTROLS OVER FINANCIAL REPORTING. There was no change in Company's internal control over financial reporting during the Company's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's Internal control over financial reporting.

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## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

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In the normal course of business, the Company is subject to various lawsuits and claims. The Company believes that the final outcomes of

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these matters, either individually or in the aggregate, will not have a material effect on the financial statements. The Company is not involved in any such litigation at this time.

Item 2. Changes in Securities

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None.

Item 3. Defaults Upon Senior Securities

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None.

Item 4. Submission of Matters to a Vote of Security Holders

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None.

Item 5. Other Information

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None.

Item 6. Exhibits and Reports on form 8-K

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(a) Exhibits:

- 31.1-2 Certification of Chief Executive Officer and Chief Financial Officer
- 99.1 Press release dated December 12, 2003. (Incorporated by reference to the Company's Form 8-K filed on December 12, 2003.)
- 99.1 Press release dated December 29, 2003. (Incorporated by reference to the Company's Form 8-K filed on December 29, 2003.)

(b) Reports on Form 8-K

On December 12, 2003, Simulations Plus, Inc. issued a press release announcing preliminary revenue for the fiscal quarter ending November 30, 2003. Following the press release, Form 8-K was filed on December 12, 2003.

On December 29, 2003, Simulations Plus, Inc. issued a press release announcing that its Words+, Inc. subsidiary had purchased all of the rights, title, and interest in the Say-it! SAM augmentative communication device developed by SAM Communications, LLC for 35,000 shares of Simulations Plus restricted common stock.

SIGNATURE

In accordance with Section 13 or 15 (d) of the Securities Exchange Act of 1934, the Registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Lancaster, State of California, on January 14, 2004.

Simulations Plus, Inc.

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Date: January 14, 2004

By: /s/ MOMOKO BERAN

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Momoko Beran  
Chief Financial Officer