SIMULATIONS PLUS INC
Form 10-Q
July 14, 2015
SECURITIES AND EXCHANGE COMMISSION

**Washington, DC 20549**

FORM 10-Q

[X] Quarterly Report Pursuant to Section 13 or 15(d) of the Security Exchange Act of 1934 for the quarterly period ended **May 31, 2015**

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**

(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 [X] 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 [X] No [ ]

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

| | |
|---|---|
| [ ] Large accelerated filer | [ ] Accelerated filer |
| [ ] Non-accelerated filer (Do not check if a smaller reporting company) | [X] 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 [X]

The number of shares outstanding of the registrant's common stock, par value $0.001 per share, as of July 14, 2015 was 16,892,117; no shares of preferred stock were outstanding.

**Simulations Plus, Inc.**

**FORM 10-Q**

**For the Quarterly Period Ended May 31, 2015**

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**PART I. FINANCIAL INFORMATION**

**PART I. FINANCIAL INFORMATION**

Item 1. Condensed Financial Statements

**SIMULATIONS PLUS, INC.**

**CONDENSED CONSOLIDATED BALANCE SHEETS**

**As of**

| | (Unaudited) May 31, 2015 | (Audited) August 31, 2014 |
|---|---|---|
| ASSETS | | |
| Current assets | | |
| Cash and cash equivalents | $6,428,596 | $8,614,929 |
| Accounts receivable, net of allowance for doubtful accounts of $0 | 3,990,467 | 1,708,158 |
| Revenues in excess of billings | 924,793 | 158,914 |
| Prepaid income taxes | – | 748,359 |
| Prepaid expenses and other current assets | 269,776 | 188,160 |
| Deferred income taxes | 209,705 | 114,846 |
| Total current assets | $11,823,337 | $11,533,366 |
| Long-term assets | | |
| Capitalized computer software development costs, net of accumulated amortization of $7,358,012 and $6,609,283 | $3,880,162 | $3,452,541 |
| Property and equipment, net (note 3) | 420,629 | 95,242 |
| Intellectual property, net of accumulated amortization of $649,375 and $193,750 | 5,425,625 | 5,881,250 |
| Other intangible assets net of accumulated amortization of $110,625 | 1,539,375 | – |
| Goodwill | 4,789,248 | – |
| Other assets | 34,082 | 18,445 |
| Total assets | $27,912,458 | $20,980,844 |
| | | |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Current liabilities | | |
| Accounts payable | $133,126 | $130,547 |
| Accrued payroll and other expenses | 427,750 | 340,709 |
| Accrued bonuses to officer | 72,000 | 120,000 |
| Income taxes payable | 178,894 | – |
| Other current liabilities | 19,859 | 19,859 |
| Current portion - Contracts payable (note 4) | 750,000 | 750,000 |
| Billings in excess of revenues | 93,122 | – |
| Deferred revenue | 42,168 | 30,370 |
| Total current liabilities | $1,716,919 | $1,391,485 |

| | | |
|---|---|---|
| Long-term liabilities | | |
| Deferred income taxes | $3,510,899 | $2,375,874 |
| Payments due under Contracts payable (note 4) | 2,854,404 | 1,750,000 |
| Other long-term liabilities | 13,239 | 28,134 |
| Total liabilities | $8,095,461 | $5,545,493 |
| | | |
| Commitments and contingencies (note 5) | | |
| | | |
| Shareholders' equity (note 6) | | |
| Preferred stock, $0.001 par value 10,000,000 shares authorized no shares issued and outstanding | $– | $– |
| Common stock, $0.001 par value 50,000,000 shares authorized 16,887,117 and 16,349,955 shares issued and outstanding | $5,358 | $4,821 |
| Additional paid-in capital | 9,643,394 | 6,085,427 |
| Retained earnings | 10,168,245 | 9,345,103 |
| Total shareholders' equity | $19,816,997 | $15,435,351 |
| | $– | – |
| Total liabilities and shareholders' equity | $27,912,458 | $20,980,844 |

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

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**SIMULATIONS PLUS, INC.**

**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

**For the three and nine months ended May 31,**

**(Unaudited)**

| | Three months ended | | Nine months ended | |
|---|---|---|---|---|
| | 2015 | 2014 | 2015 | 2014 |
| Net Revenues | $5,942,082 | $3,740,567 | $14,602,464 | $9,463,059 |
| Cost of revenues | 1,115,402 | 227,600 | 3,238,796 | 1,168,219 |
| Gross margin | 4,826,680 | 3,512,967 | 11,363,668 | 8,294,840 |
| Operating expenses | | | | |
| Selling, general, and administrative | 1,624,610 | 1,204,312 | 5,303,792 | 3,378,950 |
| Research and development | 348,285 | 234,685 | 981,633 | 750,808 |
| Total operating expenses | 1,972,895 | 1,438,997 | 6,285,425 | 4,129,758 |
| Income from operations | 2,853,785 | 2,073,970 | 5,078,243 | 4,165,082 |
| Other income (expense) | | | | |
| Interest income | 4,391 | 8,017 | 13,394 | 25,000 |
| Gain(loss) on currency exchange | (35,632) | 7,340 | (78,107) | 35,477 |
| Total other income (expense) | (31,241) | 15,357 | (64,713) | 60,477 |
| Income from operations before provision for income taxes | 2,822,544 | 2,089,327 | 5,013,530 | 4,225,559 |
| Provision for income taxes | (970,122) | (781,778) | (1,661,972) | (1,422,991) |
| Net Income | $1,852,422 | $1,307,549 | $3,351,558 | $2,802,568 |
| Earnings per share | | | | |
| Basic | $0.11 | $0.08 | $0.20 | $0.17 |
| Diluted | $0.11 | $0.08 | $0.20 | $0.17 |
| Weighted-average common shares outstanding | | | | |
| Basic | 16,862,128 | 16,193,976 | 16,847,191 | 16,117,198 |
| Diluted | 17,073,155 | 16,455,078 | 17,070,334 | 16,361,695 |

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

**SIMULATIONS PLUS, INC.**

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

**For the nine months ended May 31,**

**(Unaudited)**

| | 2015 | 2014 |
|---|---|---|
| Cash flows from operating activities | | |
| Net income | $3,351,558 | $2,802,568 |
| Adjustments to reconcile net income to net cash provided by operating activities | | |
| Depreciation and amortization of property and equipment | 168,585 | 35,730 |
| Amortization of capitalized computer software development costs | 748,730 | 584,237 |
| Amortization of Intellectual property | 566,250 | 30,625 |
| Stock-based compensation | 230,501 | 103,498 |
| Deferred income taxes | 377,666 | 1,349,585 |
| (Increase) decrease in | | |
| Accounts receivable | (1,347,791) | (1,229,485) |
| Revenues in excess of billings | (368,170) | – |
| Prepaid income taxes | 748,359 | (644,945) |
| Prepaid expenses and other assets | 7,106 | 72,993 |
| Increase (decrease) in | | |
| Accounts payable | (56,838) | 31,345 |
| Accrued payroll and other expenses | (357,397) | 38,255 |
| Accrued bonus | (48,000) | 30,000 |
| Billings in excess of revenues | (253,318) | – |
| Accrued income taxes | 178,894 | – |
| Other liabilities | (14,895) | (14,894) |
| Deferred revenue | 11,796 | 145,444 |
| Net cash provided by operating activities | $3,943,036 | 3,334,956 |
| | | |
| Cash flows from investing activities | | |
| Purchases of property and equipment | (35,620) | (21,339) |
| Purchases of intellectual property | – | (2,500,000) |
| Cash used to purchase Cognigen | (2,080,000) | – |
| Cash received in acquisition | 190,184 | – |
| Capitalized computer software development costs | (976,350) | (1,051,700) |
| Net cash provided by (used in) investing activities | (2,901,786) | (3,573,039) |
| | | |
| Cash flows from financing activities | | |
| Payment of Dividends | (2,528,416) | (2,258,688) |
| Payments on Contracts Payable | (750,000) | |
| Proceeds from the exercise of stock options | 50,833 | 75,445 |
| Net cash (used in) financing activities of continuing operations | (3,227,583) | (2,183,243) |

| | | |
|---|---|---|
| Net increase (decrease) in cash and cash equivalents | (2,186,333) | (2,421,326) |
| Cash and cash equivalents, beginning of year | 8,614,929 | 10,179,298 |
| Cash and cash equivalents, end of period | $6,428,596 | $7,757,972 |
| | | |
| Supplemental disclosures of cash flow information | | |
| Interest paid | $– | $– |
| Income taxes paid | $320,707 | $572,192 |
| | | |
| Non-Cash Investing and Financing Activities | | |
| Stock issued for acquisition of Cognigen Corporation | $3,277,170 | $– |
| Creation of contract liability for acquisition of Cognigen Corporation | $1,854,404 | $– |
| Purchase of intellectual property with shares and notes payable | $– | $3,500,000 |

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

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**Simulations Plus, Inc.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

May 31, 2015 and 2014

(Unaudited)

Note 1: GENERAL

This report on Form 10-Q for the quarter ended May 31, 2015, should be read in conjunction with the Company's annual report on Form 10-K for the year ended August 31, 2014, filed with the Securities and Exchange Commission ("SEC") on November 28, 2014. As contemplated by the SEC under Article 8 of Regulation S-X, the accompanying financial statements and footnotes have been condensed and therefore do not contain all disclosures required by generally accepted accounting principles. The interim financial data are unaudited; however, in the opinion of Simulations Plus, Inc. ("we", "our", "us"), the interim data 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.

Organization

Simulations Plus, Inc. was incorporated on July 17, 1996. On September 2, 2014, Simulations Plus, Inc. acquired all outstanding equity interests of Cognigen Corporation ("Cognigen") pursuant to the terms of the Merger Agreement and Cognigen became a wholly owned subsidiary of Simulations Plus, Inc. (collectively, the "Company").

Note 2: SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

The consolidated financial statements include the accounts of Simulations Plus, Inc. and, as of September 2, 2014, its wholly owned subsidiary, Cognigen Corporation. All significant intercompany accounts and transactions are eliminated in consolidation.

Estimates

Our condensed 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. Actual results could differ from those estimates. Significant accounting policies for us include revenue recognition, accounting for capitalized computer software development costs, valuation of stock options, and accounting for income taxes.

Revenue Recognition

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

As a byproduct of ongoing improvements and upgrades for the new programs and new modules of software, some modifications are provided to customers who have already licensed 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. Certain of the Company's software products are housed and supported on the Company's computer networks. Software revenues for those products are including in income over the life of the contract.

We recognize revenue from collaboration research and revenue from grants equally over their terms. For contract revenues based on actual hours incurred we recognize revenues when the work is performed. For fixed price contracts, we recognize contract study and other contract revenues 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 credit worthiness, 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 programs MedChem Designer™ and MembranePlus™, and we do not foresee an end-of-life for any of them at this point). Amortization of software development costs amounted to $748,730 and $584,237 for the nine months ended May 31, 2015 and 2014, respectively, and amortization of software development costs was $258,679 and $200,585 for the three months ended May 31, 2015 and 2014, 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.

Intangible Assets and Goodwill

The Company performs valuations of assets acquired and liabilities assumed on each acquisition accounted for as a business combination and recognizes the assets acquired and liabilities assumed at their acquisition date fair value. Acquired intangible assets include customer relationships, software, trade name, and non-compete agreements. The Company determines the appropriate useful life by performing an analysis of expected cash flows based on historical experience of the acquired businesses. Intangible assets are amortized over their estimated useful lives using the straight-line method, which approximates the pattern in which the majority of the economic benefits are expected to be consumed.

Goodwill represents the excess of the cost of an acquired entity over the fair value of the acquired net assets. Goodwill is not amortized, instead it is tested for impairment annually or when events or circumstances change that would indicate that goodwill might be impaired. Events or circumstances that could trigger an impairment review include, but are not limited to, a significant adverse change in legal factors or in the business climate, an adverse action or assessment by a regulator, unanticipated competition, a loss of key personnel, significant changes in the manner of the Company's use of the acquired assets or the strategy for the Company's overall business, significant negative industry or economic trends or significant under-performance relative to expected historical or projected future results of operations.

Goodwill is tested for impairment at the reporting unit level, which is one level below or the same as an operating segment. As of May 31, 2015, the Company determined that it has two reporting units, Simulations Plus and Cognigen Corporation. When testing goodwill for impairment, the Company first performs a qualitative assessment to determine whether it is necessary to perform step one of a two-step annual goodwill impairment test for each reporting unit. The Company is required to perform step one only if it concludes that it is more likely than not that a reporting unit's fair value is less than its carrying value. Should this be the case, the first step of the two-step process is to identify whether a potential impairment exists by comparing the estimated fair values of the Company's reporting units with their respective book values, including goodwill. If the estimated fair value of the reporting unit exceeds book value, goodwill is considered not to be impaired, and no additional steps are necessary. If, however, the fair value of the reporting unit is less than book value, then the second step is performed to determine if goodwill is impaired and to measure the amount of impairment loss, if any. The amount of the impairment loss is the excess of the carrying amount of the goodwill over its implied fair value. The estimate of implied fair value of goodwill is primarily based on an estimate of the discounted cash flows expected to result from that reporting unit, but may require valuations of certain internally generated and unrecognized intangible assets such as the Company's software, technology, patents and trademarks. If the carrying amount of goodwill exceeds the implied fair value of that goodwill, an impairment loss is recognized in an amount equal to the excess.

As of May 31, 2015, the entire balance of goodwill was attributed to the Company's Cognigen Corporation reporting unit. Intangible assets subject to amortization are reviewed for impairment whenever events or circumstances indicate that the carrying amount of these assets may not be recoverable. The Company has not recognized any impairment charges during the periods ended May 31, 2015 and 2014.

Reconciliation of Goodwill for the period ended May 31, 2015:

| | |
|---|---|
| **Balance, August 31, 2014** | $– |
| Addition | 4,789,248 |
| Impairments | – |
| **Balance, May 31, 2015** | $4,789,248 |

Other Intangible Assets

The following table summarizes other intangible assets as of May 31, 2015:

| | Amortization Period | Acquisition Value | Accumulated Amortization | Net book value |
|---|---|---|---|---|
| Customer relationships | Straight line 8 years | $1,100,000 | $ 103,125 | $996,875 |
| Trade Name-Cognigen | None | 500,000 | 0 | 500,000 |

| | | | | |
|---|---|---|---|---|
| Covenants not to compete | Straight line 5 years | 50,000 | 7,500 | 42,500 |
| | | $1,650,000 | $ 110,625 | $1,539,375 |

Amortization expense for the three and nine months ended May 31, 2015 was $36,875 and $110,625, respectively.

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Business Acquisitions

The Company accounted for the acquisition of Cognigen using the purchase method of accounting where the assets acquired and liabilities assumed are recognized based on their respective estimated fair values. The excess of the purchase price over the estimated fair values of the net assets acquired is recorded as goodwill. Determining the fair value of certain acquired assets and liabilities is subjective in nature and often involves the use of significant estimates and assumptions, including, but not limited to, the selection of appropriate valuation methodology, projected revenue, expenses and cash flows, weighted average cost of capital, discount rates, estimates of advertiser and publisher turnover rates and estimates of terminal values. Business acquisitions are included in the Company's consolidated financial statements as of the date of the acquisition.

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 May 31, 2015 for assets and liabilities measured at fair value on a recurring basis:

| | **Level I** | **Level II** | **Level III** | **Total** |
|---|---|---|---|---|
| Cash and cash equivalents | $6,428,596 | $ – | $ – | $6,428,596 |
| Total | $6,428,596 | $ – | $ – | $6,428,596 |

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 that 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 nine months periods ended May 31, 2015 and 2014 was $5,625 and was $1,875 for each three-month period ended May 31, 2015 and 2014. Accumulated amortization as of May 31, 2015 was $24,375.

On May 15, 2014, we entered into a termination and non-assertion agreement with TSRL, Inc., pursuant to which the parties agreed to terminate an exclusive software licensing agreement entered into between the parties in 1997. As a result, the company obtained a perpetual right to use certain source code and data, and TSRL relinquished any rights and claims to any GastroPlus products and to any claims to royalties or other payments under that 1997 agreement. We agreed to pay TSRL total consideration of $6,000,000, which is being amortized over 10 years under the straight-line method. Amortization expense for the nine months ended May 31, 2015 and 2014 was $450,000 and $25,000 respectively. Amortization expense for the three months ended May 31, 2015 and 2014 was $150,000 and $25,000 respectively. Accumulated amortization as of May 31, 2015 was $625,000. (See Note 4).

Total amortization expense for intellectual property agreements for the nine months ended May 31, 2015 and 2014 was $455,625 and $30,625, respectively. Total amortization expense for intellectual property agreements for the three months ended May 31, 2015 and 2014 was $151,875 and $26,875, respectively. Accumulated amortization as of May 31, 2015 was $649,375.

Earnings per Share

We report earnings per share (EPS) in accordance with FASB ASC 260-10. Basic EPS is computed by dividing income available to common shareholders by the weighted-average number of common shares available. Diluted EPS is computed similar to basic EPS, 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 EPS for the three and nine months ended May 31, 2015 and 2014 were as follows:

| | Three month ended | Nine month ended |
|---|---|---|

| | 05/31/2015 | 05/31/2014 | 05/31/2015 | 05/31/2014 |
|---|---|---|---|---|
| Numerator: | | | | |
| Net income attributable to common shareholders | $1,852,422 | $1,307,549 | $3,351,558 | $2,802,568 |
| Denominator: | | | | |
| Weighted-average number of common shares outstanding during the period | 16,862,128 | 16,193,976 | 16,847,191 | 16,117,198 |
| Dilutive effect of stock options | 211,027 | 261,102 | 223,143 | 244,497 |
| Common stock and common stock equivalents used for diluted EPS | 17,073,155 | 16,455,078 | 17,070,334 | 16,361,695 |

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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 $230,501 and $103,498 for the nine months ended May 31, 2015 and 2014, respectively, and was $79,877 and $32,411 for the three months ended May 31, 2015 and 2014, respectively. This expense is included in the condensed consolidated statements of operations as Selling, General and Administrative (SG&A), and Research and Development expense.

Recently Issued Accounting Pronouncements

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 adopted this standard during fiscal 2015 and believe that it did not have a significant effect on our financial position or results of operation.

In May 2014, FASB issued Accounting Standards Update (ASU) No. 2014-09, Revenue from Contracts with Customers. The standard will eliminate the transaction- and industry-specific revenue recognition guidance under current U.S. GAAP and replace it with a principles-based approach for determining revenue recognition. ASU 2014-09 is effective for annual and interim periods beginning after December 15, 2017. Early adoption is permitted for years beginning after December 15, 2016. The revenue recognition standard is required to be applied retrospectively, including any combination of practical expedients as allowed in the standard. We are evaluating the impact, if any, of the adoption of ASU 2014-09 to our financial statements and related disclosures. The Company has not yet selected a transition method nor has it determined the effect of the standard on its ongoing financial reporting.

Note 3: Property and Equipment

Property and equipment as of May 31, 2015 consisted of the following:

| | |
|---|---|
| Equipment | $426,555 |
| Computer equipment | 123,234 |
| Furniture and fixtures | 188,778 |
| Leasehold improvements | 103,599 |

| | |
|---|---|
| Sub total | 842,166 |
| Less: Accumulated depreciation and amortization | (421,537) |
| Net Book Value | $420,629 |

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NOTE 4: CONTRACTS PAYABLE

<u>TSRL</u>

Pursuant to the termination and non-assertion agreement with TSRL (See note 2), the Company will pay TSRL $2,500,000 over a three-year period. The payment schedule, by year, is below.

<u>Cognigen</u>

On September 2, 2014, the Company acquired Cognigen Corporation (See note 11). As part of the consideration, the Company agreed that within three business days following the two-year anniversary of July 23, 2014 (the date of the Merger Agreement), and subject to any offsets, the Company will pay the former shareholders of Cognigen a total of $1,800,000, comprised of $720,000 of cash and the issuance of 170,014 shares of stock.

Future payments under the Agreements, which are non-interest-bearing, are due as follows:

| **Twelve month Period ending May 31** | TSRL | Cognigen | Total |
|---|---|---|---|
| 2016 | 750,000 | 0 | 750,000 |
| 2017 | 1,000,000 | 1,854,404 | 2,854,404 |
| Total | $1,750,000 | $1,854,404 | $3,604,404 |
| Less Current portion | (750,000 ) | – | (750,000 ) |
| Contract payable, net of current portion | $1,000,000 | $1,854,404 | $2,854,404 |

Note 5: COMMITMENTS AND CONTINGENCIES

<u>Employment Agreement</u>

On August 22, 2013, the Company entered into an employment agreement with its Chief Executive Officer that expired in August 2014. The employment agreement provided for an annual base salary of $300,000 per year, and a performance bonus in an amount equal to 5% of the Company's net income before taxes of the previous fiscal year, not to exceed $60,000. The agreement also provided Employee stock options, exercisable for five years, to purchase ten (10) 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 20,000 options over the term of the agreement. The Company may terminate the agreement upon 30 days written notice if termination is without cause. The Company's only obligation would be to pay its President the greater of a) 12 months' salary or b) the remainder of the term of the employment agreement from the date of notice of termination. 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.

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

Effective September 1, 2014, the Company entered into a new Employment Agreement with Walter S. Woltosz to serve as Chief Executive Officer of the Company (the "Woltosz Employment Agreement"). The Woltosz Employment Agreement has a one-year term. Under the terms of the Woltosz Employment Agreement, Mr. Woltosz is required to devote a minimum of 60% of his productive time to the position of Chief Executive Officer of the Company. He will receive annual compensation of $180,000, be eligible to receive up to 12,000 Company stock options under the 2007 Simulations Plus, Inc. Stock Option Plan, as determined by the Company's Board of Directors, and shall be paid an annual performance bonus of up to 5% of the Company's net income before taxes, not to exceed $36,000. A copy of the Woltosz Employment Agreement was filed as an attachment to the 8-K filed with the Securities and Exchange Commission on September 4, 2014.

On September 2, 2014, Thaddeus H. Grasela, Jr., Ph.D., was appointed President of the Company and its wholly owned subsidiary Cognigen, and the Company and Cognigen have entered into an Employment Agreement with Dr. Grasela (the "Grasela Employment Agreement"), which has a three-year term. Pursuant to the Grasela Employment Agreement, Dr. Grasela will receive an annual base salary of $250,000, will be eligible to receive Company stock options under the 2007 Simulations Plus, Inc., Stock Option Plan as determined by the Company's Board of Directors, and will be eligible to receive an annual performance bonus in an amount not to exceed 10% of salary, to be determined by the Compensation Committee of the Company's Board of Directors.

License Agreement

The Company executed a royalty agreement with Accelrys, Inc. (the original agreement was entered into with Symyx Technologies in March 2010; Symyx Technologies later merged with Accelrys, Inc.) for access to their Metabolite Database for developing our Metabolite Module within ADMET Predictor™. The module was renamed the Metabolism Module when we released ADMET Predictor version 6 on April 19, 2012. Under this agreement, we pay a royalty of 25% of revenue derived from the sale of the Metabolism/Metabolite module to Accelrys. In 2014, Dassault Systemes of France acquired Accelrys and the company now operates under the name Biovia. Under this agreement for the nine months ended May 31, 2015 and 2014 we incurred royalty expense of $58,187 and $32,680, respectively and for the three months ended May 31, 2015 and 2014, we incurred royalty expense of approximately $23,197 and $8,613, respectively.

Litigation

Except as described below, we are not a party to any legal proceedings and are not aware of pending legal proceedings of any kind.

In June 2014, the Company was served with a complaint in a civil action entitled Sherri Winslow v. Incredible Adventures, Inc., et al. (Los Angeles Superior Court Case No. BC545789) alleging wrongful death and seeking unspecified damages arising out of a May 18, 2012 plane crash in the State of Nevada. The Company's Chief Executive Officer owns the subject aircraft and is also a named defendant. The complaint alleged that the Company was the owner of the subject aircraft. The Company denies all material allegations against it, including that it owns or has ever owned any interest in the subject aircraft. On November 25, 2014, the plaintiff and the Company signed a stipulation of dismissal pursuant to which the plaintiff agreed to dismiss the Company without prejudice. If the plaintiff does not discover evidence during a nine month period to and including August 31, 2015 that justifies bringing the Company back into the litigation, the Company will prepare a dismissal with prejudice to be signed on behalf of the plaintiff.

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Note 6: SHAREHOLDERS' EQUITY

Dividend

The Board of Directors 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 |
|---|---|---|---|---|
| 11/8/2013 | 11/15/2013 | 16,073,894 | $0.04 | $642,956 |
| 2/17/2014 | 2/24/2014 | 16,149,460 | $0.05 | $807,473 |
| 5/09/2014 | 5/16/2014 | 16,165,171 | $0.05 | $808,259 |
| 8/4/2014 | 8/11/2014 | 16,337,955 | $0.05 | $816,897 |
| **Total** | | | | **$3,075,585** |

The Board of Directors has also declared cash dividends during fiscal year 2015. 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 |
|---|---|---|---|---|
| 11/7/2014 | 11/14/2014 | 16,841,114 | $0.05 | $842,056 |
| 1/26/2015 | 2/2/2015 | 16,852,117 | $0.05 | $842,606 |
| 5/11/2015 | 5/18/2015 | 16,875,117 | $0.05 | $843,754 |
| **Total** | | | | **$2,528,416** |

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 May 31, 2015, employees hold Qualified ISO to purchase 752,500 shares of common stock at exercise prices ranging from $1.00 to $6.85, which were granted prior to May 31, 2015.

| Transactions in FY15 | Number of Options | Weighted-Average Exercise Price Per Share | Weighted-Average Remaining Contractual Life |
|---|---|---|---|
| Outstanding, August 31, 2014 | 798,500 | $ 4.59 | 6.27 |
| Granted | 17,000 | $ 6.85 | |
| Exercised | (39,500 ) | $ 1.29 | |
| Cancelled/Forfeited | (23,500 ) | $ 6.85 | |
| Outstanding, May 31, 2015 | 752,500 | $ 4.75 | 5.73 |
| Exercisable, May 31, 2015 | 345,500 | $ 2.52 | 2.70 |

The fair value of the options, including both ISO and NQSO options, granted during the nine months ended May 31, 2015 is estimated at $44,987. 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 Fiscal quarter ended May 31, 2015: dividend yield of 2.92%, pre-vest forfeiture rate of 6.23%, expected volatility of 49.55%, risk-free interest rate of 2.23%, and expected life of 6.90 years.

Non-Qualified Stock Options (Non-Qualified ISO)

As of May 31, 2015, the outside members of the Board of Directors hold options to purchase 35,600 shares of common stock at exercise prices ranging from $1.67 to $6.85, which were granted prior to May 31, 2015.

| Transactions in FY15 | Number of Options | Weighted-Average Exercise Price Per Share | Weighted-Average Remaining Contractual Life |
|---|---|---|---|
| Outstanding, August 31, 2014 | 56,600 | $ 4.82 | 7.96 |
| Granted | 0 | $ 0.00 | |
| Exercised | (6,503 ) | $ 3.28 | |
| Cancelled/Forfeited | (14,497 ) | $ 4.97 | |
| Outstanding, May 31, 2015 | 35,600 | $ 5.05 | 7.13 |
| Exercisable, May 31, 2015 | 19,000 | $ 4.29 | 5.72 |

The weighted-average remaining contractual life of options outstanding issued under the Plan, both Qualified ISO and Non-Qualified SO, was 5.72 years at May 31, 2015. The exercise prices for the options outstanding at May 31, 2015 ranged from $1.00 to $6.85, and the information relating to these options is as follows:

| Exercise Price | | Awards Outstanding | | | Awards Exercisable | | |
|---|---|---|---|---|---|---|---|
| Low | High | Quantity | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price | Quantity | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price |
| $1.00 | $1.50 | 163,000 | 3.02 years | $1.03 | 163,000 | 3.21 years | $1.03 |
| $1.51 | $3.00 | 8,600 | 4.91 years | $2.37 | 8,600 | 4.91 years | $2.37 |
| $3.01 | $4.50 | 133,500 | 2.11 years | $3.25 | 131,700 | 2.04 years | $3.24 |
| $4.51 | $6.00 | 128,000 | 3.60 years | $5.47 | 57,200 | 3.46 years | $5.42 |
| $6.01 | $6.85 | 355,000 | 9.17 years | $6.84 | 4,000 | 2.25 years | $6.68 |
| **TOTAL** | | **788,100** | **5.79 years** | **$4.76** | **364,500** | **2.86 years** | **$2.61** |

NOTE 7: RELATED PARTY TRANSACTIONS

As of May 31, 2015, included in bonus expenses to officers was $72,000, of which $45,000 was accrued bonus representing an estimated quarterly amount of bonus payable to the Corporate Secretary, Virginia Woltosz, as part of the terms of the sale of Words+ to Simulations Plus in 1996, and $27,000 accrued bonus representing an estimated quarterly amount of bonus payable to the Chief Executive Officer, Walter Woltosz, as part of his current employment agreement.

NOTE 8: CONCENTRATIONS AND UNCERTAINTIES

Revenue concentration shows that international sales accounted for 39.5% and 53% of net sales for the nine months ended May 31, 2015 and 2014, respectively. Three customers accounted for 8% (a dealer account in Japan representing various customers), 7%, and 5% of sales for the nine months ended May 31, 2015, compared with three customers accounting for 14% (a dealer account in Japan representing various customers), 9%, and 5% of sales for the nine months ended May 31, 2014.

Accounts receivable concentration shows that two customers comprise 18% and 16% (a dealer account in Japan representing various customers), respectively, of accounts receivable at May 31, 2015, compared to three customers that comprised 23%, 18% (a dealer account in Japan representing various customers), and 10% of accounts receivable at May 31, 2014.

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. Consolidation and downsizing in the pharmaceutical industry could have an impact on our revenues and earnings going forward.

NOTE 9: SEGMENT AND Geographic Reporting

We account for segments and geographic revenues in accordance with guidance issued by the FASB. Our reportable segments are strategic business units that offer different products and services.

Results for each segment and consolidated results are as follows for the three and nine months ended May 31, 2015 (in thousands):

Three months ended May 31, 2015

| | Simulations Plus, Inc. | Cognigen Corporation* | Eliminations | Total |
|---|---|---|---|---|
| Net Revenues | $ 4,541 | $ 1,401 | | $5,942 |
| Income (loss) from operations before income taxes | $ 2,445 | $ 377 | | $2,822 |
| Total assets | $ 26,336 | $ 8,814 | $ (7,238 ) | $27,912 |
| Capital expenditures | $ 7 | $ 10 | | $17 |
| Capitalized software costs | $ 193 | $ 53 | | $246 |
| Depreciation and Amortization | $ 413 | $ 91 | | $504 |

Nine months ended May 31, 2015

| | Simulations Plus, Inc. | Cognigen Corporation* | Eliminations | Total |
|---|---|---|---|---|
| Net Revenues | $ 10,795 | $ 3,807 | | $14,602 |
| Income (loss) from operations before income taxes | $ 4,386 | $ 627 | | $5,013 |
| Total assets | $ 26,336 | $ 8,814 | $ (7,238 ) | $27,912 |
| Capital expenditures | $ 23 | $ 14 | | $37 |
| Capitalized software costs | $ 860 | $ 116 | | $976 |
| Depreciation and Amortization | $ 1,211 | $ 273 | | $1,484 |

*Cognigen Corporation was acquired on September 2, 2014.

In addition, the Company allocates revenues to geographic areas based on the locations of its customers. Geographical revenues for the three months and nine months ended May 31, 2015 and 2014 were as follows (in thousands):

Three months ended May 31, 2015

| | Europe | Asia | | Total |
|---|---|---|---|---|

| | North America | | | South America | |
|---|---|---|---|---|---|
| Simulations Plus, Inc. | $ 2,239 | $1,287 | $1,003 | $ 12 | $4,541 |
| Cognigen Corporation * | $ 1,401 | $0 | $0 | $ 0 | $1,401 |
| Total | $ 3,640 | $1,287 | $1,003 | $ 12 | $5,942 |

Nine months ended May 31, 2015

| | North America | Europe | Asia | South America | Total |
|---|---|---|---|---|---|
| Simulations Plus, Inc. | $ 5,029 | $3,201 | $2,552 | $ 13 | $10,795 |
| Cognigen Corporation * | $ 3,807 | – | – | – | $3,807 |
| Total | $ 8,836 | $3,201 | $2,552 | $ 13 | $14,602 |

*Cognigen Corporation was acquired on September 2, 2014

Three and nine months ended May 31, 2014**

| | North America | Europe | Asia | South America | Total |
|---|---|---|---|---|---|
| Three Months | $ 2,350 | $672 | $719 | $ 0 | $3,741 |
| Nine Months | $ 4,480 | 2,684 | 2,273 | $ 26 | $9,463 |

** Does not include Cognigen Corporation acquired on September 2, 2014

Note 10: 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 $179,591 and $89,784 for the nine months ended May 31, 2015 and 2014, respectively, and $56,745 and $28,028 for the three months ended May 31, 2015 and 2014, respectively.

Note 11: ACQUISITION/MERGER WITH COGNIGEN CORPORATION

On July 23, 2014, the Company entered into an Agreement and Plan of Merger (the "Merger Agreement") with Cognigen Corporation ("Cognigen"). On September 2, 2014, the Company consummated the acquisition of all outstanding equity interests of Cognigen pursuant to the terms of the Merger Agreement, with Cognigen merging with and into a newly formed, wholly owned subsidiary of the Company. We believe the combination of Simulations Plus and Cognigen provides substantial future potential based on the complementary strengths of each of the companies.

Under the terms of the Merger Agreement, as described below, the Company will pay the former shareholders of Cognigen total consideration of $7,000,000, consisting of $2,800,000 of cash and $4,200,000 worth of newly issued, unregistered shares of the Company's common stock.

On September 2, 2014, the Company paid the former shareholders of Cognigen a total of $5,200,000, comprised of cash in the amount of $2,080,000 and the issuance of 491,159 shares of the Company's common stock valued at $3,120,000 (under the terms of the Merger Agreement a price of approximately $6.35 dollars per share was used based upon the volume-weighted average closing price of the Company's shares of common stock for the 30-consecutive-trading-day period ending two trading days prior to September 2, 2014). The actual stock price at September 2, 2014 was $6.67, so the total value of the stock issued was approximately $3,277,000. The Merger Agreement provides for a two-year market standoff period in which the newly issued shares may not be sold by the recipients thereof.

Within three business days following the two-year anniversary of July 23, 2014 (the date of the Merger Agreement) and subject to any offsets, the Company will pay the former shareholders of Cognigen a total of $1,800,000, comprised of $720,000 of cash and the issuance of 170,014 shares of stock valued at $1,080,000 under the formula described above.

The Merger Agreement provided for a targeted working capital adjustment to be made 120 days after the closing date.

Under the acquisition method of accounting, the total estimated purchase price is allocated to Cognigen's tangible and intangible assets and liabilities based on its estimated fair values at the date of the completion of the acquisition (September 2, 2014). The following table summarizes the preliminary allocation of the purchase price for Cognigen:

| | |
|---|---|
| Assets acquired, including accounts receivable of $934,000 and estimated Contracts receivable of $530,000 | $1,524,389 |
| Fixed assets acquired | 458,351 |
| Estimated value of software acquired | 200,000 |
| Estimated value of Intangibles acquired (Customer Lists, trade name etc.) | 1,600,000 |
| Working Capital Adjustment | (26,707) |
| Current Liabilities assumed | (644,499) |
| Goodwill | 4,789,248 |
| Estimated Deferred income taxes | (662,500) |
| Total Consideration | $7,238,282 |

Goodwill has been provided in the transaction based on estimates of future earnings of this subsidiary including anticipated synergies associated with the positioning of the combined company as a leader in model-based drug development. Based on the structure of the transaction, the Company does not anticipate benefiting from any tax deductions in future periods for recognized goodwill.

The accounting for this acquisition has not been completed, as further valuations and analysis is required to establish beginning fair market values and the implication on deferred taxes. The amounts shown are provisional, and do not include any adjustments for charges that will result from integration activities related to the acquisition. Additional assets or liabilities may be recorded that could affect the amounts. During the measurement period, any such adjustments to provisional amounts would increase or decrease goodwill. Adjustments that occur after the end of the measurement period will be recognized in the post-combination current period operations.

Consolidated supplemental Pro Forma information

The following consolidated supplemental pro forma information assumes that the acquisition of Cognigen took place on September 1, 2013 for the income statements fo