SIMULATIONS PLUS INC
Form 10-Q
July 10, 2017

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Security Exchange Act of 1934 for the quarterly period ended **May 31, 2017**

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 No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company.

See the definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act (Check one):

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

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

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

The number of shares outstanding of the registrant's common stock, par value $0.001 per share, as of July 10, 2017 was 17,245,346; no shares of preferred stock were outstanding.

Simulations Plus, Inc.

FORM 10-Q

For the Quarterly Period Ended May 31, 2017

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Part I. Financial Information

Item 1. Condensed Consolidated Financial Statements

SIMULATIONS PLUS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

ASSETS	(Unaudited) May 31, 2017	(Audited) August 31, 2016
Current assets		
Cash and cash equivalents	$8,248,197	$8,030,284
Accounts receivable, net of allowance for doubtful accounts of $0	5,010,589	3,009,517
Revenues in excess of billings	1,130,154	694,131
Prepaid income taxes	241,540	555,486
Prepaid expenses and other current assets	304,408	410,811
Total current assets	14,934,888	12,700,229
Long-term assets		
Capitalized computer software development costs, net of accumulated amortization of $9,477,930 and $8,613,487	4,077,144	4,013,127
Property and equipment, net (note 3)	257,552	256,381
Intellectual property, net of accumulated amortization of $1,864,375 and $1,408,750	4,210,625	4,666,250
Other intangible assets net of accumulated amortization of $405,625 and $295,000	1,244,375	1,355,000
Goodwill	4,789,248	4,789,248
Other assets	34,082	34,082
Total assets	$29,547,914	$27,814,317
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable	$211,645	$108,111
Accrued payroll and other expenses	647,203	481,610
Accrued bonuses to officers	45,750	121,000
Other current liabilities	–	8,274
Current portion - Contracts payable (note 4)	–	1,000,000
Billings in excess of revenues	313,399	230,100
Deferred revenue	48,964	176,422
Total current liabilities	1,266,961	2,125,517
Long-term liabilities		
Deferred income taxes	3,055,465	2,956,206

Total liabilities	4,322,426	5,081,723
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 17,242,510 and 17,225,478 shares issued and outstanding	7,244	7,227
Additional paid-in capital	11,816,573	11,376,007
Retained earnings	13,401,671	11,349,360
Total shareholders' equity	25,225,488	22,732,594
	$–	–
Total liabilities and shareholders' equity	$29,547,914	$27,814,317

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, 2017 and 2016

	Three months ended (Unaudited)		Nine months ended (Unaudited)	
	2017	2016	2017	2016
Net Revenues	$6,748,518	$6,012,193	$17,872,044	$16,014,539
Cost of revenues	1,444,764	1,194,815	4,334,699	3,541,903
Gross margin	5,303,754	4,817,378	13,537,345	12,472,636
Operating expenses				
Selling, general, and administrative	1,954,871	1,680,707	5,766,563	5,079,985
Research and development	253,799	348,427	952,635	1,161,124
Total operating expenses	2,208,670	2,029,134	6,719,198	6,241,109
Income from operations	3,095,084	2,788,244	6,818,147	6,231,527
Other income (expense)				
Interest income	4,663	4,553	13,548	13,507
Gain (loss) on currency exchange	(14,913)	7,733	5,573	(35,490)
Total other income (expense)	(10,250)	12,286	19,121	(21,983)
Income before provision for income taxes	3,084,834	2,800,530	6,837,268	6,209,544
Provision for income taxes	(1,004,805)	(891,191)	(2,199,914)	(2,048,383)
Net Income	$2,080,029	$1,909,339	$4,637,354	$4,161,161
Earnings per share				
Basic	$0.12	$0.11	$0.27	$0.24
Diluted	$0.12	$0.11	$0.27	$0.24
Weighted-average common shares outstanding				
Basic	17,241,891	17,028,634	17,233,470	17,000,228
Diluted	17,585,528	17,227,540	17,454,864	17,219,835

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, 2017 and 2016

	(Unaudited) 2017	2016
Cash flows from operating activities		
Net income	$4,637,354	$4,161,161
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization of property and equipment	116,348	148,442
Amortization of capitalized computer software development costs	864,443	735,579
Amortization of Intellectual Property	566,250	566,250
Stock-based compensation	355,365	234,616
Deferred income taxes	99,259	(4,910)
(Increase) decrease in		
Accounts receivable	(2,001,072)	(2,988,866)
Revenues in excess of billings	(436,023)	(244,772)
Prepaid income taxes	313,946	(108,690)
Prepaid expenses and other assets	106,403	93,554
Increase (decrease) in		
Accounts payable	103,534	(24,411)
Accrued payroll and other expenses	165,593	81,212
Accrued bonus	(75,250)	(30,250)
Billings in excess of revenues	83,299	5,911
Accrued income taxes	–	(43,602)
Other liabilities	(8,274)	(14,894)
Deferred revenue	(127,458)	182,321
Net cash provided by operating activities	4,763,717	2,748,651
Cash flows used in investing activities		
Purchases of property and equipment	(117,519)	(32,317)
Capitalized computer software development costs	(928,460)	(815,582)
Net cash used in investing activities	(1,045,979)	(847,899)
Cash flows used in financing activities		
Payment of dividends	(2,585,043)	(2,552,175)
Payments on Contracts Payable	(1,000,000)	(750,000)
Proceeds from the exercise of stock options	85,218	129,831
Net cash used in financing activities	(3,499,825)	(3,172,344)
Net increase (decrease) in cash and cash equivalents	217,913	(1,271,592)
Cash and cash equivalents, beginning of year	8,030,284	8,551,275
Cash and cash equivalents, end of period	$8,248,197	$7,279,683

Supplemental disclosures of cash flow information		
Income taxes paid	$1,765,189	$2,186,159

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

Simulations Plus, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

May 31, 2017 and 2016

(Unaudited)

NOTE 1: GENERAL

This report on Form 10-Q for the quarter ended May 31, 2017, should be read in conjunction with the Company's annual report on Form 10-K for the year ended August 31, 2016, filed with the Securities and Exchange Commission (“SEC”) on November 14, 2016. As contemplated by the SEC under Article 8 of Regulation S-X, the accompanying consolidated financial statements and footnotes have been condensed and therefore do not contain all disclosures required by generally accepted accounting principles. The interim financial data are unaudited; however, in the opinion of Simulations Plus, Inc. ("we", "our", "us"), the interim data includes all adjustments, consisting only of normal recurring adjustments, necessary for a fair statement of the results for the interim periods. Results for interim periods are not necessarily indicative of those to be expected for the full year.

Organization

Simulations Plus, Inc. (“Simulations Plus”, “Lancaster”) was incorporated on July 17, 1996. On September 2, 2014, Simulations Plus, Inc. acquired all of the outstanding equity interests of Cognigen Corporation (“Cognigen”, “Buffalo”) and Cognigen became a wholly owned subsidiary of Simulations Plus, Inc. (collectively, “Company”, “we”, “us”, “our”), pursuant to the terms of that certain Agreement and Plan of Merger, dated as of July 23, 2014, by and between Simulations Plus and Cognigen (the “Merger Agreement”).

Subsequent to May 31, 2017, on June 1, 2017 the Company acquired 100% of the stock of DILIsym Systems, Inc.

Lines of Business

The Company designs and develops pharmaceutical simulation software to promote cost-effective solutions to a number of problems in pharmaceutical research and in the education of pharmacy and medical students, and it provides consulting services to the pharmaceutical and chemical industries. The Company is also exploring developing software applications for defense and for health care outside of the pharmaceutical industry.

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

The consolidated financial statements include the accounts of Simulations Plus, Inc. and 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.

Reclassifications

Certain numbers in the prior year have been reclassified to conform to the current year's presentation.

Revenue Recognition

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

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

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

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

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 creditworthiness, and changes in customer payment terms when making estimates of the collectability of the Company's trade accounts receivable balances. If we determine that the financial conditions of any of its customers deteriorated, whether due to customer-specific or general economic issues, an increase in the allowance may be made. Accounts receivable are written off when all collection attempts have failed.

Capitalized Computer Software Development Costs

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

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

Amortization of capitalized software development costs is calculated on a product-by-product basis on the straight-line method over the estimated economic life of the products (not to exceed five years, although all of our current software products have already been on the market for 7-15 years except for our newest PKPlus™ program, and we do not foresee an end-of-life for any of them at this point). Amortization of software development costs amounted to $290,567 and $241,042 for the three months ended May 31, 2017 and 2016 and $864,443 and $735,579 for the nine months ended May 31, 2017 and 2016, 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.

Goodwill and indefinite-lived assets

Goodwill and indefinite-lived assets are not amortized, but are evaluated for impairment annually or when indicators of a potential impairment are present. Our impairment testing of goodwill is performed separately from our impairment testing of indefinite-lived intangibles. The annual evaluation for impairment of goodwill and indefinite-lived intangibles is based on valuation models that incorporate assumptions and internal projections of expected future cash flows and operating plans.

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.

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.

We follow guidance issued by the FASB with regard to our accounting for uncertainty in income taxes recognized in the financial statements. Such guidance prescribes a recognition threshold of more likely than not and a measurement process for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. In making this assessment, a company must determine whether it is more likely than not that a tax position will be sustained upon examination, based solely on the technical merits of the position and must assume that the tax position will be examined by taxing authorities. Our policy is to include interest and penalties related to unrecognized tax benefits in income tax expense. Interest and penalties totaled $ -0- and $-0- for fiscal year 2017 and 2016, respectively. We file income tax returns with the IRS and various state jurisdictions and India.

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 three-month periods ended May 31, 2017 and 2016 was $1,875, and was $3,750 for each of the nine-month periods ended May 31, 2017 and 2016. Accumulated amortization as of May 31, 2017 and August 31, 2016 was $39,375 and $33,750, respectively.

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 paid TSRL total consideration of $6,000,000, which is being amortized over 10 years under the straight-line method. Amortization expense for each of the three-month periods ended May 31, 2017 and 2016 was $150,000 and was $450,000 for each of the nine-month periods ended May 31, 2017 and 2016. Accumulated amortization as of May 31, 2017 and August 31, 2016 was $1,825,000 and $1,375,000, respectively.

Total amortization expense for intellectual property agreements for the three months ended May 31, 2017 and 2016 was $151,875, and total amortization expense for the nine months ended May 31, 2017 and 2016 was $455,625. Accumulated amortization as of May 31, 2017 was $1,864,375 and $1,408,750 as of August 31, 2016.

Intangible assets

The Company acquired certain intangible assets as part of the acquisition of Cognigen Corporation on September 2, 2014. The following table summarizes those intangible assets as of May 31, 2017:

	Amortization Period	Acquisition Value	Accumulated Amortization	Net book value
Customer relationships	Straight line 8 years	$1,100,000	$ 378,125	$721,875
Trade Name-Cognigen	None	500,000	–	500,000
Covenants not to compete	Straight line 5 years	50,000	27,500	22,500
		$1,650,000	**$ 405,625**	**$1,244,375**

Amortization expense for each of the three-and nine-month periods ended May 31, 2017 and 2016 was $36,875 and $110,625, respectively. According to policy in addition to normal amortization, these assets are tested for impairment as needed.

Earnings per Share

We report earnings per share in accordance with FASB ASC 260-10. Basic earnings per share is computed by dividing income available to common shareholders by the weighted-average number of common shares available. Diluted earnings per share is computed similar to basic earnings per share except that the denominator is increased to include the number of additional common shares that would have been outstanding if the potential common shares had been issued and if the additional common shares were dilutive. The components of basic and diluted earnings per share for the three and nine months ended May 31, 2017 and 2016 were as follows:

	Three months ended		Nine months ended	
	5/31/2017	5/31/2016	5/31/2017	5/31/2016
Numerator:				
Net income attributable to common shareholders	$2,080,029	$1,909,339	$4,637,354	$4,161,161
Denominator:				
Weighted-average number of common shares outstanding during the period	17,241,891	17,028,634	17,233,470	17,000,228
Dilutive effect of stock options	343,637	198,906	221,394	219,607
	17,585,528	17,227,540	17,454,864	17,219,835

Common stock and common stock equivalents used for diluted earnings per share

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 with FASB ASC 718-10, amortized on a straight-line basis over the options’ vesting period. Stock-based compensation was $142,879 and $114,367 for the three months ended May 31, 2017 and 2016 respectively and $355,365 and $234,616 or the nine months ended May 31, 2017 and 2016, respectively. This expense is included in the condensed consolidated statements of operations as Selling, General, and Administration (SG&A), and Research and Development expense.

Recently Issued Accounting Pronouncements

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.

In November 2015, the FASB issued ASU No 2015-17, Income Taxes (Topic 740). The amendments in ASU 2015-17 change the requirements for the classification of deferred taxes on the balance sheet. Currently, GAAP requires an entity to separate deferred income tax liabilities and assets into current and noncurrent amounts in a classified statement of financial position. To simplify the presentation of deferred income taxes, the amendments in this ASU require that deferred tax liabilities and assets be classified as noncurrent in a classified statement of financial position. The pronouncement is effective for fiscal years and interim periods within those fiscal years beginning after December 15, 2016. Earlier application is permitted for all entities as of the beginning of an interim or annual reporting period. The Company early adopted ASU No. 2015-17 because it reduced complexity while maintaining the usefulness of the information. The retrospective application resulted in a reclassification of the current deferred tax asset at August 31, 2016 now being presented against the long term deferred tax liability.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842), which supersedes existing guidance on accounting for leases in "Leases (Topic 840)" and generally requires all leases to be recognized in the consolidated balance sheet. ASU 2016-02 is effective for annual and interim reporting periods beginning after December 15, 2018; early adoption is permitted. The provisions of ASU 2016-02 are to be applied using a modified retrospective approach. The Company is currently evaluating the impact of the adoption of this standard on its consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09, Improvements to Employee Share-Based Payment Accounting. This ASU affects entities that issue share-based payment awards to their employees. The ASU is designed to simplify several aspects of accounting for share-based payment award transactions that include - the income tax consequences, classification of awards as either equity or liabilities, classification on the statement of cash flows, and forfeiture rate calculations. ASU 2016-09 will become effective for the Company in the first quarter of fiscal 2019. Early adoption is permitted in any interim or annual period. The Company early adopted ASU No. 2016-09. The adoption had no material impact on the Company’s financial statements.

NOTE 3: Property and Equipment

Property and equipment as of May 31, 2017 consisted of the following:

Equipment	$572,871
Computer equipment	230,229
Furniture and fixtures	127,857
Leasehold improvements	103,599
Sub total	1,034,556
Less: Accumulated depreciation and amortization	(777,004)
Net Book Value	$257,552

NOTE 4: CONTRACTS PAYABLE

TSRL

Pursuant to the termination and nonassertion agreement with TSRL (See note 2), the Company paid TSRL $2,500,000 over a three-year period. The final payment of $1,000,000 was made in April 2017.

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NOTE 5: COMMITMENTS AND CONTINGENCIES

Employment Agreements

CEO Employment Agreement

In August 2014, we entered into an employment agreement with Mr. Woltosz for his services as our Chief Executive Officer, which was effective September 1, 2014 and continued until August 31, 2015 (the "September 2014 Agreement"). Under the terms of this employment agreement, Mr. Woltosz was required to devote a minimum of 60% of his productive time to performing the duties as our Chief Executive Officer. The agreement provided for an annual base salary of $180,000, an annual performance bonus of up to 5% of the Company's net income before taxes of the previous fiscal year, not to exceed $36,000, and the grant of an option to purchase six shares of the Company's common stock for each $1,000 of net income before taxes that the Company earns at the end of each fiscal year (up to a maximum of 12,000 shares over the term of the agreement) with an exercise price equal to 10% over the market value per share as of the date of grant. In August 2015 this agreement was renewed for another year on the same terms. Under his current employment agreement, we agreed to provide Mr. Woltosz, at 60% of our actual costs, with such health insurance and other benefits which are appropriate to his office and position, adequate to the performance of his duties and not inconsistent with that which we customarily provide to our other management employees. We also agreed to reimburse him for customary, ordinary, and necessary business expenses incurred in connection with the rendering of services. The agreement also provides that we may terminate the agreement without cause upon thirty (30) days written notice, and that upon any such termination our only obligation to Mr. Woltosz would be for a payment equal to the greater of (i) 12 months of salary or (ii) the amount of salary for the remainder of the term of the agreement from the date of notice of termination. Further, the agreement provides that we may terminate the agreement for "cause" (as defined in the agreement) and that our only obligation to Mr. Woltosz upon any such termination would be limited to the payment of Mr. Woltosz' salary and benefits through and until the effective date of any such termination. On July 9, 2015, the Company entered into a new employment agreement with Mr. Woltosz for another year on the same terms as the September 2014 agreement. A copy of this agreement was filed as an exhibit to the Current Form on Form 8-K filed with the Securities and Exchange Commission on July 15, 2015. On August 8, 2016 the Company entered into a new employment agreement for another year on the same terms as the September 2014 agreement. A copy of this agreement was filed as an exhibit to the Current Form on Form 8-K filed with the Securities and Exchange Commission on August 11, 2016.

President's employment agreement

On September 2, 2014, Thaddeus H. Grasela, Jr., Ph.D., was appointed President of the Company and its wholly owned subsidiary Cognigen (also known as the Buffalo Division of the Company). The Company and Cognigen have entered into an Employment Agreement with Dr. Grasela (the "Grasela Employment Agreement") that has a three-year term. Pursuant to the Grasela Employment Agreement, Dr. Grasela receives an annual base salary of $250,000, is eligible to receive Company stock options under the 2007 Simulations Plus, Inc. Stock Option Plan, as determined by the Board, and is 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 Board. The Compensation Committee awarded Dr. Grasela a $25,000 performance bonus in each of September 2015 and September 2016 for the 2015 and 2016 fiscal years, respectively.

License Agreement

The Company executed a royalty agreement with Accelrys, Inc. (“Accelrys”) (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. We incurred royalty expense of $35,494 and $44,485, respectively, and for the three months ended May 31, 2017 and 2016, respectively and $108,587 and $95,323 for the nine months ended May 31, 2017 and 2016, respectively.

Income taxes

Our federal income tax returns for fiscal year 2012 thru 2015 are open for audit, and our state tax returns for fiscal year 2011 through 2015 remain open for audit. In addition our California tax return for the fiscal year 2007 and fiscal year 2008 remains open with regard to R&D tax credits as a result of a previous audit for which we received a letter from the California Franchise Tax Board stating that an audit will not be conducted for those years at this time; however it may be subject to future audit. In 2015 the Company was informed that the IRS was auditing the Company’s tax return for 2014. This audit was completed during FY2016; there were no changes as a result of the audit.

Litigation

We are not a party to any legal proceedings and are not aware of any 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 owned the subject aircraft and is also a named defendant. The complaint alleged that the Company was the owner of the subject aircraft. The Company denied all material allegations against it, including that it owns or has ever owned any interest in the subject aircraft.

In June 2017, the Plaintiff settled the case with certain of the Defendants; the case was dismissed on June 20, 2017. The Company incurred no liability as part of the settlement and has been dismissed with prejudice.

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NOTE 6: SHAREHOLDERS' EQUITY

Dividend

The Company's Board of Directors declared cash dividends during fiscal years 2017 and 2016. The details of the dividends paid are in the following tables:

FY2017

Record Date	Distribution Date	Number of Shares Outstanding on Record Date	Dividend per Share	Total Amount
11/10/2016	11/17/2016	17,226,478	$0.05	$861,324
1/30/2017	2/6/2017	17,233,758	$0.05	$861,688
5/08/2017	5/15/2017	17,240,626	$0.05	$862,031
Total				**$2,585,043**

FY2016

Record Date	Distribution Date	Number of Shares Outstanding on Record Date	Dividend per Share	Total Amount
11/09/2015	11/16/2015	16,996,001	$0.05	$849,800
1/29/2016	02/05/2016	17,018,001	$0.05	$850,900
5/02/2016	5/09/2016	17,029,051	$0.05	$851,475
8/11/2016	8/18/2016	17,221,978	$0.05	$861,099
Total				**$3,413,274**

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. This plan terminated in February 2017 by its term.

On December 23, 2016 the Board of Directors adopted, and on February 23, 2017 the shareholders approved, the 2017 Equity Incentive Plan under which a total of 1,000,000 shares of common stock has been reserved for issuance. This plan will terminate in December 2026.

Qualified Incentive Stock Options (Qualified ISO)

As of May 31, 2017 employees hold Qualified ISO to purchase 1,272,692 shares of common stock at exercise prices ranging from $1.00 to $10.06.

Transactions in FY17	Number of Options	Weighted-Average Exercise Price Per Share	Weighted-Average Remaining Contractual Life
Outstanding, August 31, 2016	894,750	$ 7.54	7.72
Granted	404,582	$ 10.05	
Exercised	(9,892)	$ 7.00	
Cancelled/Forfeited	(16,748)	$ 9.24	
Outstanding, May 31, 2017	**1,272,692**	**$ 8.32**	**7.82**
Exercisable, May 31, 2017	359,000	$ 5.96	5.18

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Non-Qualified Stock Options (Non-Qualified ISO)

As of May 31, 2017 the outside members of the Board of Directors and certain employees hold non-qualified options to purchase 47,168 shares of common stock at exercise prices ranging from $4.46 to $10.06.

Transactions in FY17	Number of Options	Weighted-Average Exercise Price Per Share	Weighted-Average Remaining Contractual Life
Outstanding, August 31, 2016	52,750	$ 6.88	8.07
Granted	17,418	$ 10.05	
Exercised	(9,500)	$ 5.88	
Cancelled/Forfeited	(13,500)	$ 7.43	
Outstanding, May 31, 2017	**47,168**	**$ 8.10**	**8.61**
Exercisable, May 31, 2017	13,000	$ 5.78	6.90

The weighted-average remaining contractual life of options outstanding issued under the Plan, both Qualified ISO and Non-Qualified SO, was 7.85 years at May 31, 2017. The exercise prices for the options outstanding at May 31, 2017 ranged from $1.00 to $10.06, 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	67,000	1.85 years	$ 1.00	67,000	1.85 years	$ 1.00
$3.01	$4.50	20,000	1.10 years	$ 3.16	20,000	1.10 years	$ 3.16
$4.51	$6.00	70,000	1.66 years	$ 5.52	70,000	1.66 years	$ 5.52
$6.01	$7.50	341,040	7.28 years	$ 6.86	136,620	7.30 years	$ 6.86
$7.51	$9.00	10,000	9.25 years	$ 8.62	–	–	$ –
$9.01	$10.06	811,820	9.26 years	$ 9.89	78,380	8.79 years	$ 9.72
		1,319,860	**7.85 years**	**$ 8.32**	**372,000**	**5.24 years**	**$ 5.96**

NOTE 7: RELATED PARTY TRANSACTIONS

As of May 31, 2017, included in bonus expenses to officers was $45,750, of which $27,000 was an accrued bonus representing an estimated amount of bonus payable to our Chief Executive Officer, Walter Woltosz as part of his current employment agreement, and $18,750 accrued bonus representing as estimated amount of bonus payable to our President, Thaddeus Grasela as part of his current employment agreement.

May 1, 2017, Dr. Daniel Weiner was appointed as a member of the Board of Directors of the Company. Dr. Weiner also served on the Board of Directors of DILIsym. Immediately prior to the closing of the acquisition discussed in Subsequent Event Note 11, Dr. Weiner owned 5,000 shares of DILIsym's common stock (less than one percent of DILIsym's outstanding shares). At the closing of the Acquisition, Dr. Weiner received approximately $29,000 in cash consideration of the sale of his shares of DILIsym to the Company and may receive up to an additional $35,000 upon any payment of the holdback consideration and/or Earn-out Payments.

NOTE 8: CONCENTRATIONS AND UNCERTAINTIES

Revenue concentration shows that international sales accounted for 34% and 43.8% of net sales for the nine months ended May 31, 2017 and 2016, respectively. Three customers accounted for 8%, 6% (a dealer account in Japan representing various customers), and 5% of sales for the nine months ended May 31, 2017. Four customers accounted for 8% (a dealer account in Japan representing various customers), 6%, 5% and 5% of sales for the nine months ended May 31, 2016.

Accounts receivable concentrations shows that three customers comprised 14%, 12% (a dealer account in Japan representing various customers), and 8% of accounts receivable at May 31, 2017 compared to two customers comprising 15% and 11% (a dealer account in Japan representing various customers) at May 31, 2016.

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, 2017 and 2016 (in thousands):

Three months ended May 31, 2017

	Lancaster	Buffalo	Eliminations	Total
Net revenues	$ 4,948	$ 1,801		$ 6,749
Income (loss) from operations	2,681	414		3,095
Identifiable assets	27,428	9,358	$ (7,238)	29,548
Capital expenditures	12	0		12
Capitalized software costs	278	66		344
Depreciation and amortization	422	92		514

Three months ended May 31, 2016

	Lancaster	Buffalo	Eliminations	Total
Net Revenues	$ 4,664	$ 1,348		$ 6,012
Income (loss) from operations	2,577	211		2,788
Total assets	26,532	9,504	$ (7,238)	28,798
Capital expenditures	3	27		30
Capitalized software costs	222	48		270
Depreciation and Amortization	381	98		479

Nine months ended May 31, 2017

	Lancaster	Buffalo	Eliminations	Total
Net Revenues	$ 12,685	$ 5,187		$ 17,872
Income (loss) from operations	5,739	1,079		6,818
Total assets	27,428	9,358	$ (7,238)	29,548
Capital expenditures	37	80		117
Capitalized software costs	809	120		929
Depreciation and Amortization	1,261	286		1,547

Nine months ended May 31, 2016

	Lancaster	Buffalo	Eliminations	Total

Net Revenues	$ 11,722	$ 4,293		$ 16,015
Income (loss) from operations	5,471	760		6,232
Total assets	26,532	9,504	$ (7,238)	28,798
Capital expenditures	4	28		32
Capitalized software costs	678	138		816
Depreciation and Amortization	1,171	279		1,450

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, 2017 and 2016 were as follows (in thousands):

Three months ended May 31, 2017

	North America	Europe	Asia	South America	Total
Lancaster	$ 2,533	$ 1,144	$ 1,271	$ 0	$ 4,948
Buffalo	1,801	0	0	0	1,801
Total	$ 4,334	$ 1,144	$ 1,271	$ 0	$ 6,749

Three months ended May 31, 2016

	North America	Europe	Asia	South America	Total
Lancaster	$ 2,444	$ 1,247	$ 973	$ 0	$ 4,664
Buffalo	1,348	0	0	0	1,348
Total	$ 3,792	$ 1,247	$ 973	$ 0	$ 6,012

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Nine months ended May 31, 2017

	North America	Europe	Asia	South America	Total
Lancaster	$6,261	$3,201	$3,222	$ 1	$12,685
Buffalo	5,187	–	–	–	5,187
Total	$11,448	$3,201	$3,222	$ 1	$17,872

Nine months ended May 31, 2016

	North America	Europe	Asia	South America	Total
Lancaster	$ 5,237	$3,651	$2,833	$ 1	$11,722
Buffalo	4,293	–	–	–	4,293
Total	$ 9,530	$3,651	$2,833	$ 1	$16,015

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 $64,233 and $61,028 for the three months ended May 31, 2017 and 2016 respectively and $179,123 and $168,654 for the nine months ended May 31, 2017 and 2016, respectively.

NOTE 11: SUBSEQUENT EVENTS

On May 1, 2017, Simulations Plus, Inc. entered into a Stock Purchase Agreement (the "Agreement") with DILIsym Services, Inc., a North Carolina corporation ("DILIsym"), the shareholders of DILIsym (the "DILIsym Shareholders") and Brett A. Howell, the representative of the DILIsym Shareholders (the "DILIsym Shareholders Representative"), each, a "Party," and collectively, the "Parties."

On June 1, 2017, the Company consummated the acquisition of all outstanding capital stock of DILIsym pursuant to the terms of the Agreement and DILIsym became a wholly owned subsidiary of the Company (the "Acquisition"). Under the terms of the Agreement, the Company: (1) paid to the DILIsym Shareholders Five Million Dollars ($5,000,000) payable at the closing of the Acquisition (the "Closing") subject to certain adjustments and holdbacks as provided in the Agreement and as more fully described below; and (2) will pay to the DILIsym Shareholders certain earn-out payments, to be measured by the adjusted earnings of DILIsym before income taxes, payable following the Closing, as more particularly described below and in the Agreement:

a) On June 1, 2017, the Company paid the DILIsym Shareholders total cash consideration of $4,515,982; which such amount included $515,982 in working capital left in DILIsym's accounts in excess of the amount required under the Agreement,

b) At the holdback release date, eighteen months from the Closing and subject to any offsets, the Company will pay $1,000,000 of holdback consideration; and

c) In addition, the Company may pay up to an additional $5,000,000 in Earn-out Payments over the 3 years following the Closing if and when such Earn-out Payments become due and payable, and subject to certain offsets as provided in the Agreement, according to the Agreement.

The Company is currently in the process of preparing information for, and assessing the accounting treatment of the transaction.

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

Forward-Looking Statements

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

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

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

38,938

$

41,387

Interest expense

24,712

15,687

11,644

11,896

14,661

Net interest income

30,844

28,893

28,380

27,042

26,726

Provision for loan losses

760

1,091

588

1,000

1,075

Other income

13,380

12,518

11,639

12,255

10,394

Other expense

28,423

25,385

25,139

24,530

24,006

Income before income taxes

15,041

14,935

14,292

13,767

12,039

Income tax expense

5,032

5,128

4,541

4,674

4,005

Net income

$
10,009

$
9,807

$
9,751

$
9,093

$
8,034

Per Common Share Data (1)

Basic earnings per share

$
2.31

$
2.22

$

2.17

$

1.92

$

1.60

Diluted earnings per share

2.27

2.16

2.13

1.88

1.58

Dividends per common share

.52

.50

.45

.43

.33

Book value per common share

17.68

16.47

15.53

15.02

13.97

Capital Ratios

Total capital to risk-weighted assets

10.91

%

11.87
%

11.71
%

10.61
%

10.35
%
Tier 1 capital to risk-weighted assets

10.10
%

11.14
%

10.94
%

9.83
%

9.64
%
Tier 1 capital to average assets

7.56
%

8.55
%

7.99
%

7.18
%

6.62
%
Financial Ratios

Net interest margin

3.51
%

3.70

%

3.75
%

3.75
%

3.99
%
Return on average assets

1.07
%

1.18
%

1.20
%

1.17
%

1.11
%
Return on average common equity

13.31
%

13.64
%

14.24
%

13.11
%

11.82
%
Dividend payout ratio

22.51
%

22.55
%

20.92

%

22.57
%

20.92
%
Average equity to average assets

8.01
%

8.64
%

8.44
%

8.94
%

9.36
%
Allowance for loan losses as a percent of total loans

0.81
%

0.73
%

0.77
%

0.80
%

0.74
%
Year End Balances

Total assets

$
980,559

$
850,573

$
826,728

$

793,981

$

776,240

Net loans

717,692

631,707

590,539

547,647

489,071

Total deposits

770,595

649,069

650,240

614,992

613,452

Total equity

75,786

72,326

69,154

70,595

66,807

Average Balances

Total assets

$

938,784

$

832,752

$

811,061

$

776,072

$

727,986

Net loans

686,069

606,064

568,271

520,962

479,957

Total deposits

737,344

650,116

638,445

611,982

573,670

Total equity

75,174

71,911

68,459

69,349

67,989

(1) All share and per share data have been restated to reflect the 3-for-2 stock splits effective July 16, 2004.

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ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis is intended to provide a better understanding of the consolidated financial condition and results of operations of the Company and its subsidiaries for the years ended December 31, 2006, 2005 and 2004. This discussion and analysis should be read in conjunction with the consolidated financial statements, related notes and selected financial data appearing elsewhere in this report.

Forward-Looking Statements

This report contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, such as discussions of the Company's pricing and fee trends, credit quality and outlook, liquidity, new business results, expansion plans, anticipated expenses and planned schedules. The Company intends such forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995, and is including this statement for purposes of these safe harbor provisions. Forward-looking statements, which are based on certain assumptions and describe future plans, strategies and expectations of the Company, are identified by use of the words "believe," "expect," "intend," "anticipate," "estimate," "project," or similar expressions. Actual results cou differ materially from the results indicated by these statements because the realization of those results is subject to many uncertainties including: changes in interest rates, general economic conditions, legislative/regulatory changes, monetary and fiscal policies of the U.S. Government, including policies of the U.S. Treasury and the Federal Reserve Board, the quality or composition of the loan or investment portfolios, demand for loan products, deposit flows, competition, demand for financial services in the Company's market area and accounting principles, policies and guidelines. These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements. Further information concerning the Company and its business, including additional factors that could materially affect the Company's financial results, is included in Item 1A of this Annual Report on Form 10-K captioned "Risk Factors" and elsewhere in the filing and the Company's other filings with the Securities and Exchange Commission.

For the Years Ended December 31, 2006, 2005, and 2004

Overview

This overview of management's discussion and analysis highlights selected information in this document and may not contain all of the information that is important to you. For a more complete understanding of trends, events, commitments, uncertainties, liquidity, capital resources, and critical accounting estimates, you should carefully read this entire document. These have an impact on the Company's financial condition and results of operations.

Net income was $10.01 million, $9.81 million, and $9.75 million and diluted earnings per share was $2.27, $2.16, and $2.13 for the years ended December 31, 2006, 2005, and 2004, respectively. The increase in net income in 2006 was primarily the result of higher net interest income and greater non-interest income. The increase in earnings per share in 2006 was the result of improved net income and a decrease in the number of shares outstanding due to share repurchases made through the Company's stock buy-back program. During 2006, the Company acquired 172,820 shares for a total investment of $7,152,000. The following table shows the Company's annualized performance ratios for the years ended December 31, 2006, 2005 and 2004:

	2006	**2005**	**2004**
Return on average assets	1.07%	1.18%	1.20%
Return on average equity	13.31%	13.64%	14.24%
Average equity to average assets	8.01%	8.64%	8.44%

Total assets at December 31, 2006, 2005, and 2004 were $980.6 million, $850.6 million, and $826.7 million, respectively. The increase in net assets was primarily the result of the acquisition of Peoples during the second quarter of 2006. Net loan balances increased to $715.5 million at December 31, 2006, from $631.7 million and $590.5 million at December 31, 2005 and 2004, respectively. The increase in 2006 of $83.8 million or 13.3% was due to the acquisition of $55.8 million of total net loans acquired from Peoples in the second quarter of 2006 and also to an increase in commercial real estate loans. Total deposit balances increased $121.5 million to $770.6 million at December 31, 2006 from $649.1 million at December 31, 2005 and $650.2 million at December 31, 2004. The increase in 2006 was primarily due to the acquisition of $108.1 million of deposits acquired from Mansfield.

Net interest margin, defined as net interest income divided by average interest-earning assets, was 3.51% for 2006, 3.70% for 2005 and 3.75% for 2004. The decrease in net interest margin is attributable to a greater increase in borrowing and deposit rates compared to the increase in interest-earning asset rates. This is primarily due to the inversion of the interest rate yield curve where rates on short-term financial instruments have increased faster than rates on longer-term instruments.

Net interest income increased from $28.4 million in 2004 to $28.9 million in 2005 and to $30.8 million in 2006. This increase was the result of management's business development efforts that led to higher levels of average interest-earning assets of $756.8 million in 2004, $781.7 million in 2005 and $877.1 million in 2006. This growth offset the factors previously mentioned which led to margin compression and led to higher levels of net interest income. The ability of the Company to continue to grow net interest income is largely dependent on management's ability to succeed in its overall business development efforts. Management expects these efforts to continue but will not compromise credit quality and prudent management of the maturities of interest-earning assets and interest-paying liabilities in order to achieve growth. Non-interest income increased to $13.4 million in 2006 compared to $12.5 million in 2005 and $11.6 million in 2004. The primary reasons for this increase of $.9 million or 6.9% were increases in trust revenues, insurance commissions and ATM and bankcard service fees during 2006 compared to 2005.

Non-interest expenses increased $3 million, to $28.4 million in 2006 compared to $25.4 million in 2005 and $25.1 million in 2004. The primary factor in the increase was due to additional salaries and benefits expense as a result of the acquisition of Mansfield, merit increases for continuing employees and $178,000 of additional compensation expense related to the vesting of stock options recorded in 2006 in accordance with the provisions of SFAS 123R.

Following is a summary of the factors that contributed to the changes in net income (in thousands):

		2006 vs 005		**2005 vs 2004**
Net interest income	$	1,951	$	513
Provision for loan losses		331		(503)
Other income, including securities transactions		862		879
Other expenses		(3,038)		(246)
Income taxes		96		(587)
Increase in net income	$	202	$	56

Credit quality is an area of importance to the Company and the level of nonperforming loans and net charge-offs remained below peer banks in 2006. Year-end total nonperforming loans did not change materially with $3.7 million at December 31, 2006 compared to $3.5 million at December 31, 2005 and $3.1 million at December 31, 2004. The Company's provision for loan losses was $760,000 for 2006 compared to $1,091,000 for 2005. During the year, a decline in credit quality of commercial loans of four borrowers secured by business assets and mortgage real estate loans of a single borrower resulted in charges to the allowance for loan losses of $543,000 and accounted for the majority of the provision increase. At December 31, 2006, the composition of the loan portfolio remained similar to 2005. Loans secured by both commercial and residential real estate comprised 71% of the loan portfolio as of December 31, 2006 and 2005.

The Company's capital position remains strong and the Company has consistently maintained regulatory capital ratios above the "well-capitalized" standards. The Company's Tier 1 capital ratio to risk weighted assets ratio at December 31, 2006, 2005, and 2004 was 10.10%, 11.14%, and 10.94%, respectively. The Company's total capital to risk weighted assets ratio at December 31, 2006, 2005, and 2004 was 10.91%, 11.87%, and 11.71%, respectively. The decrease in 2006 was primarily the result of an increase in risk-weighted assets and a decrease in tier I capital due to the acquisition of Mansfield. This was partially offset by the issuance of trust preferred securities by First Mid-Illinois Statutory Trust II ("Trust II"), which qualify as Tier I capital for the Company under Federal Reserve Board guidelines. The Trust invested the proceeds of the issuance in junior subordinated debentures of the Company. The increase in 2005 was primarily the result of an increase in retained earnings due to the Company's increase in net income.

The Company's liquidity position remains sufficient to fund operations and meet the requirements of borrowers, depositors, and creditors. The Company maintains various sources of liquidity to fund its cash needs. See "Liquidity" herein for a full listing of its sources and anticipated significant contractual obligations.

The Company enters into financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include lines of credit, letters of credit and other commitments to extend credit. The total outstanding commitments at December 31, 2006, 2005 and 2004 were $131.9 million, $117.8 million and $94.2 million, respectively. See Note 12 - "Disclosure of Fair Values of Financial Instruments" and Note 18 - "Commitments and Contingent Liabilities" herein for further information.

Critical Accounting Policies

The Company has established various accounting policies that govern the application of accounting principles generally accepted in the United States in the preparation of the Company's financial statements. The significant accounting policies of the Company are described in the footnotes to the consolidated financial statements. Certain accounting policies involve significant judgments and assumptions by management that have a material impact on the carrying value of certain assets and liabilities; management considers such accounting policies to be critical accounting policies. The judgments and assumptions used by management are based on historical experience and other factors, which are believed to be reasonable under the circumstances. Because of the nature of the judgments and assumptions made by management, actual results could differ from these judgments and assumptions, which could have a material impact on the carrying values of assets and liabilities and the results of operations of the Company.

The Company believes the allowance for loan losses is the critical accounting policy that requires the most significant judgments and assumptions used in the preparation of its consolidated financial statements. In estimating the allowance for loan losses, management utilizes historical experience, as well as other factors, including the effect of changes in the local real estate market on collateral values, the effect on the loan portfolio of current economic indicators and their probable impact on borrowers, and increases or decreases in nonperforming and impaired loans. Changes in these factors may cause management's estimate of the allowance to increase or decrease and result in adjustments to the Company's provision for loan losses. See "Loan Quality and Allowance for Loan Losses" and Note 1 - "Summary of Significant Accounting Policies" herein for a detailed description of the Company's estimation process and methodology related to the allowance for loan losses.

Mergers and Acquisitions

On May 1, 2006, the Company completed the acquisition, for $24 million in cash, of all of the outstanding common stock of Mansfield and its wholly-owned subsidiary, Peoples, with locations in Mansfield, Mahomet and Weldon, Illinois, in order to expand its market presence in this area. The Company financed the purchase price through a dividend of $5 million from First Mid Bank, an issuance of $10 million of trust preferred securities and a $9.5 million draw on the Company's line of credit with The Northern Trust Company. Following the completion of the acquisition during the third quarter of 2006, Mansfield merged with and into Peoples and Peoples merged with and into First Mid Bank. Following the completion of these mergers, Mansfield and Peoples ceased to exist and Peoples' operations were merged into First Mid Bank's.

The transaction has been accounted for as a purchase, and the results of operations of Mansfield and Peoples since the acquisition date have been included in the consolidated financial statements. See Note 20 - "Acquisitions" herein for further information.

Results of Operations

Net Interest Income

The largest source of operating revenue for the Company is net interest income. Net interest income represents the difference between total interest income earned on earning assets and total interest expense paid on interest-bearing liabilities. The amount of interest income is dependent upon many factors, including the volume and mix of earning assets, the general level of interest rates and the dynamics of changes in interest rates. The cost of funds necessary to support earning assets varies with the volume and mix of interest-bearing liabilities and the rates paid to attract and retain such funds.

The Company's average balances, interest income and expense and rates earned or paid for major balance sheet categories are set forth in the following table (dollars in thousands):

	Year Ended December 31, 2006			Year Ended December 31, 2005			Year Ended December 31, 2004		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
ASSETS									
Interest-bearing deposits	$ 628	$ 31	4.94%	$ 1,330	$ 40	3.01%	$ 4,729	$ 75	1.59%
Federal funds sold	5,517	276	5.00%	9,184	285	3.10%	8,813	103	1.17%
Investment securities									
Taxable	161,351	7,490	4.64%	140,972	5,313	3.77%	143,568	4,860	3.39%
Tax-exempt (1)	17,900	771	4.31%	19,435	871	4.48%	26,814	1,193	4.45%
Loans (2) (3)	691,726	46,988	6.79%	610,781	38,071	6.23%	572,836	33,793	5.90%
Total earning assets	877,122	55,556	6.33%	781,702	44,580	5.70%	756,760	40,024	5.29%
Cash and due from banks	18,974			17,828			18,870		
Premises and equipment	16,082			15,115			15,692		
Other assets	32,263			22,824			24,304		
Allowance for loan losses	(5,657)			(4,717)			(4,565)		
Total assets	$ 938,784								