NUVEEN PREFERRED CONVERTIBLE INCOME FUND
Form N-Q
November 29, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM N-Q

QUARTERLY SCHEDULE OF PORTFOLIO HOLDINGS OF REGISTERED MANAGEMENT INVESTMENT COMPANY

Investment Company Act file number 811-21293

Nuveen Preferred and Convertible Income Fund
(Exact name of registrant as specified in charter)

333 West Wacker Drive, Chicago, Illinois 60606
(Address of principal executive offices) (Zip code)

Jessica R. Droeger Vice President and Secretary
333 West Wacker Drive, Chicago, Illinois 60606
(Name and address of agent for service)

Registrant's telephone number, including area code: 312-917-7700

Date of fiscal year end: 12/31

Date of reporting period: 09/30/05

Form N-Q is to be used by management investment companies, other than small business investment companies registered on Form N-5 (§§ 239.24 and 274.5 of this chapter), to file reports with the Commission, not later than 60 days after the close of the first and third fiscal quarters, pursuant to rule 30b1-5 under the Investment Company Act of 1940 (17 CFR 270.30b1-5). The Commission may use the information provided on Form N-Q in its regulatory, disclosure review, inspection, and policymaking roles.

A registrant is required to disclose the information specified by Form N-Q, and the Commission will make this information public. A registrant is not required to respond to the collection of information contained in Form N-Q unless the Form displays a currently valid Office of Management and Budget (OMB) control number. Please direct comments concerning the accuracy of the information collection burden estimate and any suggestions for reducing the burden to the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. The OMB has reviewed this collection of information under the clearance requirements of 44 U.S.C. § 3507.

Item 1. Schedule of Investments

Nuveen Preferred and Convertible Income Fund (JPC)
Portfolio of Investments (Unaudited)
September 30, 2005

Shares	Description[1]

Shares	Description[1]
	COMMON STOCKS - 0.3% (0.2% of Total Investments)
	IT Services - 0.1%
54,275	Acxiom Corporation
	Software - 0.2%
102,711	Computer Associates International Inc.
	Total Common Stocks (cost $3,706,175)

Shares	Description[1]
	$25 Par (or similar) SECURITIES - 51.2% (34.8% of Total Investmen
	Automobiles - 0.1%
88,694	Ford Motor Company, Series F (CORTS)
	Capital Markets - 4.9%
17,900	Bear Stearns Capital Trust III
500	BNY Capital Trust IV, Series E
301,800	BNY Capital Trust V, Series F
129,800	Compass Capital Trust III
9,900	CSFB USA, Series 2002-10 (SATURNS)
29,000	First Union Capital II, Series II (CORTS)
41,500	First Union Institutional Capital II (CORTS)
13,100	Goldman Sachs Group Inc., Series 2003-06 (SATURNS)
39,600	Goldman Sachs Group Inc., Series 2004-4 (CORTS)
526,388	Lehman Brothers Holdings Capital Trust III, Series K
2,400	Lehman Brothers Holdings Capital Trust IV, Series L
109,800	Merrill Lynch Capital Trust
29,900	Merrill Lynch Capital Trust II
29,000	Merrill Lynch Preferred Capital Trust
119,200	Merrill Lynch Preferred Capital Trust IV
228,800	Merrill Lynch Preferred Capital Trust V
23,300	Morgan Stanley (PPLUS)
67,100	Morgan Stanley Capital Trust II
365,739	Morgan Stanley Capital Trust III
717,800	Morgan Stanley Capital Trust IV
22,400	Washington Mutual Capital Trust I, Series 2001-22, Class A-1 (CORTS)
	Commercial Banks - 8.8%
170,000	Abbey National plc
92,400	Abbey National plc, Series B
16,600	Abbey National plc, Series B
37,900	ABN AMRO Capital Fund Trust V
2,500	ABN AMRO North America, Series L, 144A (a)
69,900	ASBC Capital I
68,185	BAC Capital Trust I
136,755	BAC Capital Trust II

284,700	BAC Capital Trust III
59,750	Banco Santander
63,400	Banco Totta & Acores Finance, Series A
207,400	Banesto Holdings, Series A, 144A
81,700	Bank One Capital Trust VI
35,200	BankNorth Capital Trust II
15,100	BBVA Preferred Capital Ltd., Series B
62,200	Chittenden Capital Trust I
107,000	Cobank ABC, 144A (a)
84,400	Comerica Capital Trust I
306,079	Fleet Capital Trust VII
337,300	Fleet Capital Trust VIII
773,900	HSBC Finance Corporation
15,500	KeyCorp, Series 2001-7 (CORTS)
25,400	KeyCorp, Series B (CORTS)
156,700	National Commerce Capital Trust II
32,900	National Westminster Bank plc, Series A
32,200	PNC Capital Trust
21,400	Regions Finance Trust I
175,000	Royal Bank of Scotland Group plc, Series L
91,395	Royal Bank of Scotland Group plc, Series N
77,700	SunTrust Capital Trust IV
58,200	SunTrust Capital Trust V
71,100	USB Capital Trust III
189,300	USB Capital Trust IV
70,300	USB Capital Trust V
344,300	USB Capital Trust VI
33,400	VNB Capital Trust I
9,100	Wells Fargo Capital Trust IV
77,235	Wells Fargo Capital Trust V
14,700	Wells Fargo Capital Trust VI
225,700	Wells Fargo Capital Trust VII
80,200	Zions Capital Trust B
	Computers & Peripherals - 0.1%
14,100	IBM Inc. (CORTS)
21,000	IBM Inc., Series 2001-1 (SATURNS)
3,900	IBM Inc., Trust Certificates, Series 2001-2
5,300	IBM Trust III (CORTS)
	Consumer Finance - 0.1%
27,800	Household Capital Trust VI
39,200	Household Capital Trust VII
	Diversified Financial Services - 5.8%
190,000	CIT Group Incorporated, Series A (a)
15,200	CIT Group Incorporated (CORTS)
215,900	Citigroup Capital Trust IX
79,500	Citigroup Capital Trust VII
355,200	Citigroup Capital Trust VIII
4,800	Citigroup Capital Trust XI

4,700	Citigroup Capital X
33,200	Citigroup Inc., Series F (a)
94,000	Citigroup Inc., Series G (a)
59,300	Citigroup Inc., Series H (a)
64,600	Citigroup Inc., Series M (a)
5,400	General Electric Capital Corporation
33,100	General Electric Capital Corporation
3,800	General Electric Capital Corporation (CORTS)
769,075	ING Group NV
560,618	ING Group NV
16,800	ING Group NV
30,000	JPM Capital Trust (CORTS)
52,200	JPMorgan Chase & Company (PCARS)
395,367	JPMorgan Chase Capital Trust X
22,800	JPMorgan Chase Capital Trust XVI
47,200	JPMorgan Chase Trust, Series 2002-6, Class A (SATURNS)

COMPETITION

In our pharmaceutical software and services business, we compete against a number of established companies that provide screening, testing and research services, and products that are not based on simulation software. There are also software companies whose products do not compete directly, but are sometimes closely related. Our competitors in this field include some companies with financial, personnel, research and marketing resources that are greater than ours. Management believes there is currently no significant competitive threat to GastroPlus or DDDPlus, however, one could be developed in time. MedChem Studio and ADMET Predictor/ADMET Modeler operate in a more competitive environment. Several other companies presently offer simulation or modeling software, or simulation-software-based services, to the pharmaceutical industry.

Major pharmaceutical companies conduct drug discovery and development efforts through their internal development staffs and through outsourcing some of this work. Smaller companies need to outsource a greater percentage of this research. Thus, we compete not only with other software suppliers, but also with the in-house development teams at some of the larger pharmaceutical companies.

Although competitive products exist, both new licenses and license renewals for GastroPlus have continued to grow in spite of this competition. We believe that we enjoy a dominant market share in this segment.

We believe the key factors in competing in this field are our ability to develop industry-leading simulation and modeling software and related products and services to effectively predict activities and ADMET-related behaviors of new drug-like compounds, to design new molecules with acceptable activity and ADMET properties, to develop and maintain a proprietary database of results of physical experiments that will serve as a basis for simulated studies and empirical models, to attract and retain a highly skilled scientific and engineering team, and to develop and maintain relationships with research and development departments of pharmaceutical companies, universities and government agencies.

We are actively seeking acquisitions to expand the pharmaceutical software and services business. Earlier attempts to acquire other companies have not been successful either in arriving at mutually agreeable terms and conditions, or because of adverse conditions discovered during our comprehensive due diligence process.

WORDS+

PRODUCTS

Our wholly owned subsidiary, Words+, has been focused on introducing and improving augmentative and alternative communication and computer access software and devices for people with disabilities for over 30 years. The introduction of EyeProTM, an eyegaze product, in 2010 increased our revenue and marketshare. Eyegaze technology allows people to operate a computer or communication device by simply looking at the screen, and has been a major breakthrough for people with severe disabilities. In 2011, we added the EyePro GS to our eyegaze product line. The EyePro GS uses proprietary technology developed by Words+, where our other EyePro products use third party eyegaze technology that we bundle into our products. EyePro GS was released near the end of FY 2011. We also introduced the Conversa CV and CVX and upgraded most products to Windows 7. The Conversa is our line of tablet-based communication devices. The Conversa CV and CVX are based on Windows tablets with flip screens that allow them to convert between tablet and notebook formats.

MARKETING AND DISTRIBUTION

We market augmentative and alternative communication products through a network of employee representatives and independent dealers and resellers. Webinars and remote interaction using web-based evaluation, setup and training, introduced in 2009, have become standard parts of our operation. We have continued to see an increase in the number of family members, caregivers, teachers, and aides attending the live and recorded webinars. This is a significant change in the speech pathologist-to-patient relationship, and allows the speech pathologists' professional experience and advice to extend beyond the therapy session to achieve more effective results for their clients. It has also allowed our sales force to spend less time training and more time selling, and allows us to recruit, train and support resellers who are less experienced in assistive technology.

We currently have 33 sales representatives worldwide: 1 salaried sales manager, 11 independent distributors and 6 independent resellers in the U.S., and 15 sales representatives overseas – 3 in Australia, and 1 each in New Zealand, Canada, The Netherlands, France, Ireland, Italy, Israel, Japan, Korea, Mexico, Malaysia, and Taiwan. We also have 3 inside support persons, who answer e-mails and telephone inquiries on our toll-free telephone line and who provide customer and technical support. Additional outside salespersons and independent dealers and resellers are being actively recruited.

We direct our marketing efforts to speech pathologists, occupational therapists, rehabilitation engineers, special education teachers, disabled persons and relatives of disabled persons. We maintain a mailing list of over 10,000 people made up of these professionals, consumers and relatives, and we mail various marketing materials to this list. These materials include our catalog of products and announcements regarding new and enhanced products.

We participate in industry conferences held worldwide that are attended by speech pathologists, occupational and physical therapists, special education teachers, parents and consumers. We and others in the industry demonstrate our products at these conferences and present technical papers that describe the application of our technologies and research studies on the effectiveness of our products. Words+ attended five major national conferences in 2011, and several more specialized national conferences, such as TEDPA (the national conference for specialized telecommunication equipment distribution program) and the American Occupational Therapist Association national conference. We responded to calls for papers and presented five different professional sessions during these conferences. We also advertise in selected publications and websites of interest to persons in this market.

We estimate that for approximately 62% of our sales of augmentative and alternative communication ("AAC") software and hardware, purchases are funded primarily by third parties such as Medicaid, Medicare and private insurance. Telecommunication equipment distribution programs, school special education budgets, vocational rehabilitation, the Veterans Administration and other governmental programs, private purchases and charitable assistance account for most of the other purchases. Medicare provides coverage for augmentative communication devices.

Our personnel provide advice and assistance to customers and prospective customers on obtaining third-party financial assistance for purchasing our products. Third-party funding grew slowly for the first 20 years of operation; however, the addition of Medicare coverage for AAC devices in 2001 resulted in significant increases in third-party funding in recent years. Our Medicare/Medicaid and other third-party-funded sales have grown, with the majority of total sales are now funded by a third party. Medicare/Medicaid sales are subject to funding caps that limit the amounts paid for our products, and payment by some agencies can be slow, making this market segment somewhat more difficult than others. Collection of accounts receivable has been a significant problem from certain state Medicaid agencies, Medicaid, and private insurance. Our financial reporting includes allowances for bad debts that are based on assumptions that we will collect a historical percentage of accounts receivable that fall in different aging categories: less than 6 months, 6-12 months, 12-24 months, and over 24 months. Although we may not give up on any of the invoices that are included in the allowances for bad debts, we recognize that responsible financial reporting requires us to be conservative in these estimates.

PRODUCTION

Disability software products are either loaded onto computer hard disk drives by our employees or copied to CD-ROM or memory cards. Most software customers also buy their notebook personal computers from us, which we purchase at wholesale prices and resell at a markup. We purchase microprocessors that are part of dedicated devices such as MessageMates™. We design our cases, printed circuit boards, labels and other components of products such as SAM Communicator™ and our popular Conversa™ Sound Pack. We outsource the extrusion, machining and manufacturing of certain components. All final assembly and testing operations are done by our employees at our facility.

Our products are shipped from our Lancaster, California facility either directly to the customer or to the salesperson, dealer or reseller. Historically for major products, the outside salesperson, dealer or reseller either delivers the product or visits the customer after delivery to provide training. In our remote interactive sales and delivery model, an increasing number of deliveries are being completed utilizing internet with video support for setup, and webinars plus individual live video interaction for training.

COMPETITION

The AAC industry in which we operate is highly competitive and some of our competitors have greater financial and personnel resources than ours. The industry is made up of about six major competitors including Words+, and a number of smaller ones. Following the introduction of EyePro and other products to complement our current catalog, we are now focused on developing new products in-house.

We believe that the competition in this industry is based primarily on the quality of products, quality of customer training and technical support, and quality and size of sales forces. Price is a competitive factor that has traditionally not been as important to the purchaser or recommender as obtaining the product most suited to the customer’s needs, along with strong after-sale support. However, there has been significant downward pricing pressure due to the increasing popularity of extremely low-priced communication apps available on the popular Apple iPod and iPad, particularly in the past year. This is a change in our industry leading to a new category of low-cost technology, private payers, different service delivery expectations, and adverse affects on some traditional purchasers such as schools. To meet this challenge, we have been exploring lower cost solutions that compete in the iPod and iPad space, and different pricing and payment options to add to the cost-cutting, web-based remote delivery, training and support services we began in 2009. This remains a significant challenge and opportunity for us that we will continue to focus on.

We believe that we are a leader in the industry in developing and producing some of the most technologically advanced products and in providing quality customer training and technical support. We believe that the potential exists for significant increases in the sales of our disability products; however, there are few barriers to entry in the form of proprietary or patented technology or trade secrets in this industry. While we believe that cost of product development and the need for specialized knowledge and experience in this industry would present some barrier to entry for new competition, other companies may enter this industry, including companies with substantially greater financial resources than ours. Furthermore, companies already in this industry may increase their market share through increased technology development and marketing efforts.

TRAINING AND TECHNICAL SUPPORT

Customer training and technical support are important factors in customer satisfaction for both our pharmaceutical and disability products, and we believe we are an industry leader in providing customer training and technical support in both of our business areas. For pharmaceutical software, we provide in-house seminars at customers' sites. These seminars often serve as initial training in the event the potential customer decides to license or evaluate our software. Technical support is provided after the sale in the form of on-site training (at customer's expense), web meeting, telephone, fax, and e-mail assistance to users during the customer's license period. We have used Internet meetings extensively to provide demonstrations and customer assistance, resulting in rapid response to requests worldwide and reducing our travel time and expenses.

For disability products, our salesperson, dealer or reseller historically provided initial training to the customer for major systems -- typically two to four hours. This training is typically provided not only to the user of the product but also to speech pathologists, occupational therapists, rehabilitation engineers, teachers, parents and others who will assist the user. This initial training for the purchase of full systems is often provided as a part of the price of the product. Additional training and service calls are available for a fee. Live and recorded webinars introduced last year have significantly changed our service delivery model, making it more accessible to people who need training, and reducing the amount of time our sales force spends traveling and providing on-site, one-on-one training and support. Our salespeople still visit in person whenever appropriate, but the professional on-line training and support have greatly reduced this need. Feedback from surveys and increasing webinar attendance indicate improved customer satisfaction with our products and service delivery. The remote service delivery model that we have already implemented is becoming an expectation in our industry.

Technical support for both pharmaceutical software and disability products is provided by our life sciences team and our inside sales and support staff based at our headquarters facilities in Lancaster, California. We provide free telephone support offering unlimited toll-free numbers in the U.S. and Canada, and e-mail and web-based support for all of our pharmaceutical software and disability products worldwide. Technical support for pharmaceutical software products is minimal, averaging a few person-hours per month. Technical support for Words+ products varies from none for most customers to as much as several hours for others.

RESEARCH AND DEVELOPMENT

We believe that our ability to grow and remain competitive in our markets is strongly dependent on significant investment into research and development (“R&D”). R&D activities include both enhancement of existing products and development of new products. Development of new products and adding functionality to existing products are capitalized in accordance with Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) 985-20. R&D expenditures were approximately $1,846,000 during fiscal year 2011, of which $911,000 was capitalized. R&D

expenditures during fiscal year 2010 were approximately $1,857,000, of which $887,000 was capitalized.

Our pharmaceutical business R&D activities during fiscal year 2011 were focused on improving our ADMET Predictor/ADMET Modeler, MedChem Studio, MedChem Designer and GastroPlus products.

Our R&D activities for our Words+ subsidiary were focused on development of our new EyePro GS eye gaze product line, extension of the family of tablet-computer-based systems called Conversa, and two new hardware development projects that we are not ready to announce at this time.

EMPLOYEES

As of August 31, 2011, we employed 38 full-time and 1 part-time employees, including 20 in research and development, 5 in marketing and sales, 8 in administration and accounting and 6 in production. Currently 16 employees hold Ph.D.s and 1 is a Ph.D. candidate in their respective science or engineering disciplines. Additionally, 3 employees hold one or more Master's degrees. Most of the senior management team and Board of Directors hold graduate degrees. We believe that our future success will depend, in part, on our ability to continue to attract, hire and retain qualified personnel. The competition for such personnel in the pharmaceutical industry and in the augmentative and alternative communication device and computer software industry is intense. None of our employees is represented by a labor union, and we have never experienced a work stoppage. We believe that our relations with our employees are good. As noted earlier, we have signed an agreement to sell our Words+ subsidiary and expect to complete the transaction by November 30, 2011. After that date, assuming the transaction is completed, our number of employees will be reduced to approximately 25, of which all but four have advanced degrees. We continue to seek additions to our Life Sciences team.

PATENTS

We own two patents that were acquired as part of our acquisition of certain assets of Bioreason, Inc. We primarily protect our intellectual property through copyrights and trade secrecy. Our intellectual property consists primarily of source code for computer programs and data files for various applications of those programs in both the pharmaceutical software and the disability products businesses. In the disability products business, electronic device schematics, mechanical drawings, and design details are also intellectual property. The expertise of our technical staff is a considerable asset closely related to intellectual property, and attracting and retaining highly qualified scientists and engineers is essential to our business.

EFFECT OF GOVERNMENT REGULATIONS

Our pharmaceutical software products are tools used in research and development and are neither approved nor approvable by the FDA or other government agencies.

Most of our Words+ products for the disabled are funded by Medicare or Medicaid, schools, the Veteran's Administration, and other insurance programs. Changes in government regulations regarding the allowability of augmentative communication aids and other assistive technology under such funding could affect our business; however, as noted earlier, Words+ is expected to be sold by November 30, 2011.

Costs and Effects of Compliance with Environmental Laws

Federal, state and local laws and regulations regarding the discharge of harmful materials into the environment may have an impact on the Company. Words+ is involved in manufacturing of Augmentative Communication Devises which uses laptop computers, and minor electronic assembly that might have a material adverse effect on the environment. However, the Company's exposure to environmental laws is not expected to be any more significant than any other similar type of business. Any new laws or regulations with regard to the environment that affect businesses in general are likely to result in additional compliance costs, and could result in additional operating restrictions. These costs could affect our future business operations. Words+ incurred environmental fee of $288 and $292 in FY11 and FY10, respectively, and electronic waste recycling fee of $466 and $16 in FY11 and FY10, respectively.

ITEM 1A – RISK FACTORS

Not applicable because the Company is a smaller reporting company.

ITEM 1B – UNRESOLVED STAFF COMMENTS

Not applicable.

ITEM 2 –PROPERTIES

We lease approximately 13,500 square feet of space in Lancaster, California. The original agreement had a five-year term with two (2), three-(3) year options to extend. Since the original five-year term expired in February 2011, we have exercised the first of the two (2), three-year options. The base rent started at the rate of $18,445 per month plus common area maintenance fees. The base rental rate increases at 4% annually and currently it is $21,578 per month, plus common area maintenance fees. We believe that this facility is sufficient for our current needs and growth for the foreseeable future.

In connection with the sale of our Words+ subsidiary to Prentke Romich Company, we expect to temporarily lease a portion of this space to PRC on a prorated basis. After January 1, 2012, we expect that portion to be reduced, providing additional room for growth of the Simulations Plus staff, which has been reaching its limits within the space available prior to the pending sale of Words+.

ITEM 3 – LEGAL PROCEEDINGS

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

ITEM 4 – [REMOVED AND RESERVED]

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PART II

ITEM 5 – MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our Common Stock is currently traded on the NASDAQ Stock Market (NASDAQ) under the symbol "SLP". According to the records of our transfer agent, we had approximately 56 shareholders of record and approximately 1,540 beneficial owners as of August 31, 2011. The following table sets forth the low and high sale prices for our Common Stock as listed on the NASDAQ for the last two fiscal years. We have not paid cash dividends on our Common Stock to date. Any determination as to the payment of dividends will be at the discretion of our Board of Directors and will depend among other things, on our financial condition, results of operations, capital requirements and such other factors as the Board of Directors deems relevant.

On October 23, 2008, our board of directors authorized a share repurchase program enabling the buyback of up to $2.5 million in shares during a 12-month period beginning Monday, October 27, 2008. The actual repurchase started on December 2, 2008; therefore the board of directors extended it through December 1, 2009 in order to have a full 12-month period. The Company opened an account with Morgan Stanley Smith Barney for the purchase of such securities. Funds for any stock purchases are drawn from the Company's cash reserves. The Company repurchased 1,026,483 shares at an average price of $1.3823 per share prior to December 1, 2009.

On January 10, 2010, the board of directors authorized a second share repurchase program (Phase II) effective as of February 15, 2010. The renewed program enabled the Company to buy back up to one million shares during a 12-month period. Under the Phase II program, the Company has purchased 996,248 shares at an average price of $2.8041 per share from April 2010 to February 2011.

There is currently no share repurchase program pending, and the Company made no repurchases of its securities within the fourth quarter of the fiscal year covered by this report.

The following table shows low and high sales price for the last eight fiscal quarters.

	Low Sales Price	High Sales Price
FY11:		
Quarter ended August 31, 2011	2.76	3.47
Quarter ended May 31, 2011 .	2.68	3.27
Quarter ended February 28, 2011	2.42	3.69
Quarter ended November 30, 2010	2.40	3.50
FY10:		
Quarter ended August 31, 2010	2.04	2.52
Quarter ended May 31, 2010	1.67	2.50
Quarter ended February 28, 2010	1.35	1.72
Quarter ended November 30, 2009	1.32	1.79

EQUITY COMPENSATION PLAN INFORMATION

The following table provides a summary of Equity Compensation Plan Information.

Equity Compensation Plan Information (1)

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	957,636	$ 1.39	412,000
Equity compensation plans not approved by security holders	0	0	0
Total	957,636		412,000

(1) The Company is authorized to issue stock options under the following compensation arrangement:

a. 4,000 shares per year per person to Directors as a part of their annual stipends.

b. 50 shares for each $1,000 of net income before taxes at the end of each fiscal year (up to a maximum of 120,000 options) to CEO over the term of his current employment agreement

ITEM 6 – SELECTED FINANCIAL DATA

Not applicable because the Company is a smaller reporting company.

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

The following discussion and analysis should be read in conjunction with the Consolidated Financial Statements and related notes included in this Annual Report on Form 10-K.

Management Overview

Fiscal year 2011 was a record year comprised of three record quarters. We believe the continued growth of our pharmaceutical software and services business segment is the result of increasing adoption of simulation and modeling software tools such as those we produce, as well as the expertise we offer as consultants to assist companies involved in the research and development of new medicines, which has resulted in a continuing series of study contracts with pharmaceutical companies ranging from several of the largest in the world to a number of medium-sized and smaller companies in the U.S. and Europe.

During FY11 we released major upgrades to three of our four pharmaceutical software offerings, and a new software product called MedChem Designer. Our financial performance enabled us to continue to increase our cash deposits, remain debt-free, and continue to invest in the aggressive marketing and sales activities we began in early 2009 in order to reach a wider customer base.

We have not been successful in identifying and completing any acquisitions during this reporting period in spite of a number of investigations and due diligence activities. In every case, either our due diligence activities revealed undesirable aspects of the potential acquisition, or terms and conditions agreeable to both sides were not able to be reached. It is our intent to continue to search for acquisition opportunities that would be compatible with our current businesses and that would be immediately accretive, i.e., adding to both revenues and earnings.

We have used some of our cash to repurchase shares of our common stock because we believe that reducing the number of fully diluted shares provides greater value to our shareholders than receiving a low interest rate on our cash deposits, and because we believe that our cash deposits after such repurchases remain sufficient to accomplish any reasonable potential acquisitions as well as to maintain sufficient cash reserves to ensure meeting operational needs for the foreseeable future. Although there are no stock repurchase programs pending, the board of directors may consider additional repurchases at any time at prices and under conditions set by the board.

Our Words+ subsidiary's net income increased despite of the decline in sales due to reducing expenses. We developed and released our own new EyePro eyegaze system in August 2011; however, the continued poorer performance of this business unit caused us to agree to sell Words+ in November 2011, as previously discussed.

If the sale of Words+ is closed in November 2011, its net sales and income will be reported as discontinued operations going forward. The net sales and income for the last 3 years of Words+ operations are followings.

	Net Sales	Net Income (or loss)
FY09	$2,842,000	$(87,000)
FY10	3,091,000	(82,000)
FY11	2,981,000	72,000

Results of Operations

The following sets forth selected items from our statements of operations (in thousands) and the percentages that such items bear to net sales for the fiscal years ended August 31, 2011 ("FY11") and August 31, 2010 ("FY10").

	FY11		FY10	
Net sales	$ 11,720	100.0%	$ 10,712	100.0%
Cost of sales	2,879	24.6	2,546	23.8
Gross profit	8,841	75.4	8,166	76.2
Selling, general, and administrative	4,305	36.7	4,325	40.4
Research and development	935	8.0	970	9.1
Total operating expenses	5,240	44.7	5,295	49.5
Income from operations	3,601	30.7	2,871	26.7
Interest income	92	0.8	101	0.9
Interest expense	-	-	(1	