

ARI NETWORK SERVICES INC /WI

Form 10QSB

June 14, 2005

**Table of Contents**

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-QSB**

(Mark One)

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

For the quarterly period ended April 30, 2005

TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE EXCHANGE ACT

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

Commission file number 000-19608

**ARI Network Services, Inc.**

(Exact name of small business issuer as specified in its charter)

WISCONSIN

39-1388360

State or other jurisdiction of  
incorporation or organization)

(IRS Employer Identification No.)

11425 W. Lake Park Drive, Milwaukee, Wisconsin 53224  
(Address of principal executive office)

Issuer's telephone number (414) 973-4300

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

YES  NO

As of June 10, 2005, there were 6,063,659 shares of the registrant's shares outstanding.

Transitional Small Business Disclosure Format (check one).

YES  NO

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**ARI Network Services, Inc.**

FORM 10-QSB

FOR THE THREE MONTHS ENDED APRIL 30, 2005

INDEX

**PART I FINANCIAL INFORMATION**

	<u>Page</u>
Item 1 Financial statements	
<u>Condensed balance sheets April 30, 2005 and July 31, 2004</u>	3-4
<u>Condensed statements of operations for the three and nine months ended April 30, 2005 and 2004</u>	5
<u>Condensed statements of cash flows for the nine months ended April 30, 2005 and 2004</u>	6
<u>Notes to unaudited condensed financial statements</u>	7-8
<u>Item 2 Management's discussion and analysis or plan of operation</u>	9-17
<u>Item 3 Controls and procedures</u>	18

**PART II OTHER INFORMATION**

<u>Item 2 Unregistered sales of equity securities and use of proceeds</u>	18
<u>Item 6 Exhibits</u>	18
<u>Signatures</u>	19
<u>Section 302 Certification of Chief Executive Officer</u>	
<u>Section 302 Certification of Chief Financial Officer</u>	
<u>Section 906 Certification of Chief Executive Officer</u>	
<u>Section 906 Certification of Chief Financial Officer</u>	

**Table of Contents****ITEM 1. FINANCIAL STATEMENTS**

**ARI Network Services, Inc.**  
**Balance Sheets**  
*(In thousands, except share and per share data)*  
*(Unaudited)*

<b>ASSETS</b>	<b>April 30 2005</b>	<b>July 31 2004</b>
Current assets:		
Cash	\$ 3,632	\$ 3,357
Trade receivables, less allowance for doubtful accounts of \$86 at April 30, 2005 and \$44 at July 31, 2004	759	1,121
Prepaid expenses and other	148	187
Total current assets	4,539	4,665
Equipment and leasehold improvements:		
Computer equipment	4,812	4,607
Leasehold improvements	73	73
Furniture and equipment	1,518	1,491
	6,403	6,171
Less accumulated depreciation and amortization	5,820	5,630
Net equipment and leasehold improvements	583	541
Other assets	37	15
Capitalized software product costs	11,142	10,203
Less accumulated amortization	9,650	9,233
Net capitalized software product costs	1,492	970
<b>Total Assets</b>	<b>\$ 6,651</b>	<b>\$ 6,191</b>

**Table of Contents**

**ARI Network Services, Inc.**  
**Balance Sheets**  
*(In thousands, except share and per share data)*  
*(Unaudited)*

<b>LIABILITIES AND SHAREHOLDERS EQUITY (DEFICIT)</b>	<b>April 30 2005</b>	<b>July 31 2004</b>
Current liabilities:		
Current portion of notes payable	\$ 1,000	\$ 1,000
Accounts payable	208	260
Deferred revenue	5,337	5,453
Accrued payroll and related liabilities	949	951
Accrued sales, use and income taxes	182	489
Other accrued liabilities	696	564
Current portion of capital lease obligations	6	10
<b>Total current liabilities</b>	<b>8,378</b>	<b>8,727</b>
Long term liabilities:		
Notes payable (net of discount)	2,495	3,306
Accrued payroll and related liabilities	568	495
Other long term liabilities	211	211
Capital lease obligations		3
<b>Total long term liabilities</b>	<b>3,274</b>	<b>4,015</b>
Shareholders' equity (deficit):		
Cumulative preferred stock, par value \$.001 per share, 1,000,000 shares authorized; 0 shares issued and outstanding at April 30, 2005 and July 31, 2004, respectively		
Common stock, par value \$.001 per share, 25,000,000 shares authorized; 6,012,582 and 5,923,034 shares issued and outstanding at April 30, 2005 and July 31, 2004, respectively	5	5
Common stock warrants and options	36	36
Additional paid-in-capital	93,731	93,625
Accumulated deficit	(98,773)	(100,217)
<b>Total shareholders' equity (deficit)</b>	<b>(5,001)</b>	<b>(6,551)</b>
<b>Total Liabilities and Shareholders' Equity (Deficit)</b>	<b>\$ 6,651</b>	<b>\$ 6,191</b>

*See notes to unaudited condensed financial statements.*

Note: The balance sheet at July 31, 2004 has been derived from the audited balance sheet at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements.



**Table of Contents**

**ARI Network Services, Inc.**  
**Statements of Operations**  
*(In thousands, except per share data)*  
*(Unaudited)*

	<b>Three months ended</b>		<b>Nine months ended</b>	
	<b>April 30</b>		<b>April 30</b>	
	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>
Net revenues:				
Subscriptions, support and other services fees	\$ 2,534	\$ 2,263	\$ 7,358	\$ 6,812
Software licenses and renewals	552	590	1,686	1,783
Professional services	373	505	994	1,341
	3,459	3,358	10,038	9,936
Operating expenses:				
Cost of products and services sold:				
Subscriptions, support and other services fees	186	98	612	382
Software licenses and renewals *	153	470	452	1,390
Professional services	134	306	264	646
	473	874	1,328	2,418
Depreciation and amortization (exclusive of amortization of software products included in cost of products and services sold)	67	38	190	110
Customer operations and support	265	249	784	823
Selling, general and administrative	1,805	1,696	5,259	5,212
Software development and technical support	487	399	1,353	1,102
Operating expenses before amounts capitalized	3,097	3,256	8,914	9,665
Less capitalized portion	(192)	(144)	(498)	(331)
Net operating expenses	2,905	3,112	8,416	9,334
Operating income	554	246	1,622	602
Other income (expense):				
Interest expense	(49)	(55)	(140)	(200)
Other, net	3	(11)	25	25
Total other expense	(46)	(66)	(115)	(175)
Income before provision for income taxes	508	180	1,507	427
Income tax expense	(13)		(63)	
Net income	\$ 495	\$ 180	\$ 1,444	\$ 427
Average common shares outstanding:				
Basic	6,008	5,861	5,974	5,812
Diluted	6,598	6,115	6,564	6,066

Net income per share:				
Basic	\$ 0.08	\$ 0.03	\$ 0.24	\$ 0.07
Diluted	\$ 0.08	\$ 0.03	\$ 0.22	\$ 0.07

*See notes to unaudited condensed financial statements.*

\* Includes amortization of software products of \$143, \$435, \$417 and \$1,323 for the three months ended April 30, 2005 and 2004 and the nine months ended April 30, 2005 and 2004, respectively, and excludes other depreciation and amortization shown separately



**Table of Contents**

**ARI Network Services, Inc.**  
**Statements of Cash Flows**  
*(In thousands)*  
*(Unaudited)*

	<b>Nine months ended</b>	
	<b>April 30</b>	
	<b>2005</b>	<b>2004</b>
<b>Operating activities</b>		
Net income	\$ 1,444	\$ 427
Adjustments to reconcile net income to net cash provided by Operating activities:		
Amortization of software products	417	1,323
Amortization of deferred financing costs, debt discount and excess carrying value over face amount of notes payable	(58)	(42)
Depreciation and other amortization	190	110
Stock issued as contribution to 401(k) plan	37	37
Net change in receivables, prepaid expenses and other current assets	376	215
Net change in accounts payable, deferred revenue, accrued liabilities and other long term liabilities	(272)	(370)
Net cash provided by operating activities	2,134	1,700
<b>Investing activities</b>		
Purchase of equipment and leasehold improvements	(232)	(106)
Purchase of assets related to acquisitions		(108)
Software product costs capitalized	(939)	(331)
Net cash used in investing activities	(1,171)	(545)
<b>Financing activities</b>		
Payments under notes payable	(750)	(500)
Payments of capital lease obligations	(7)	(19)
Debt issuance costs incurred		(20)
Proceeds from issuance of common stock	69	11
Net cash used in financing activities	(688)	(528)
Net increase in cash	275	627
Cash at beginning of period	3,357	2,120
Cash at end of period	\$ 3,632	\$ 2,747
Cash paid for interest	\$ 197	\$ 353
Cash paid for income taxes	\$ 55	\$

**Noncash investing and financing activities**

Issuance of common stock in connection with deferred executive compensation	\$	\$ 130
Issuance of common stock in connection with acquisitions		37
Exchange of equity to debt		1,000

*See notes to unaudited condensed financial statements.*

**Table of Contents**

**Notes to Condensed Financial Statements**  
**(Unaudited)**  
**April 30, 2005**

**1. BASIS OF PRESENTATION**

The accompanying unaudited financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for fiscal year end financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and nine months ended April 30, 2005 are not necessarily indicative of the results that may be expected for the fiscal year ending July 31, 2005. For further information, refer to the financial statements and footnotes thereto included in the Company's annual report on Form 10-KSB for the year ended July 31, 2004.

**2. BASIC AND DILUTED NET INCOME PER SHARE**

Basic net income per common share is computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted net income per common share is computed by dividing net income by the weighted average number of common shares outstanding during the period and reflects the potential dilution that could occur if all of the Company's outstanding stock options and warrants that are in the money were exercised (calculated using the treasury stock method). The following table is a reconciliation of the weighted average number of common shares and equivalents outstanding in the calculation of basic and diluted net income per common share (in thousands) for the periods indicated.

	Three months ended		Nine months ended	
	April 30		April 30	
	2005	2004	2005	2004
Weighted average common shares outstanding	6,008	5,861	5,974	5,812
Dilutive effect of stock options and warrants	590	254	590	254
Diluted weighted average common shares outstanding	6,598	6,115	6,564	6,066

**3. STOCK-BASED COMPENSATION**

The Company has stock-based compensation plans. SFAS No. 148 Accounting for Stock-Based Compensation Transition and Disclosure requires companies with stock-based compensation plans to disclose the pro forma effect of stock-based compensation on earnings and earnings per share. The following table sets forth the effect on earnings and earnings per share (in thousands, except per share data) of stock-based compensation had the cost been determined based upon the fair value at the grant date for awards under the plan using the Black-Scholes valuation method.

	Three months ended		Nine months ended	
	April 30		April 30	
	2005	2004	2005	2004
Net income, as reported	\$ 495	\$ 180	\$ 1,444	\$ 427
Stock-based compensation using the fair value method	(93)	(18)	(229)	(53)

Pro forma net income	\$ 402	\$ 162	\$ 1,215	\$ 374
Net income per share Basic as reported	\$ 0.08	\$ 0.03	\$ 0.24	\$ 0.07
Basic pro forma	\$ 0.07	\$ 0.03	\$ 0.20	\$ 0.06
Diluted as reported	\$ 0.08	\$ 0.03	\$ 0.22	\$ 0.07
Diluted pro forma	\$ 0.06	\$ 0.03	\$ 0.19	\$ 0.06

#### 4. NOTES PAYABLE

On April 24, 2003, the Company restructured its debt. In exchange for its previously outstanding securities, the Company issued to a group of investors, in aggregate, \$500,000 in cash, unsecured notes in the amount of \$3.9 million and warrants for 250,000 common shares, exercisable at \$1.00 per share. The interest rate on the notes is the prime interest rate plus 2% (effective rate of 7.75% as of April 30, 2005). The notes (in aggregate) are payable in \$200,000 quarterly installments commencing March 31, 2004 through December 31, 2005 and \$300,000 quarterly installments commencing March 31, 2006 until paid in full. The notes do not contain any financial covenants, but the Company is restricted from permitting certain liens on its assets. In addition, in the event of payment default that is not cured within ninety (90) days, Taglich Brothers, Inc., one of the note holders, has the right to appoint one designee to the Company's Board of Directors. The warrants were estimated to have a value of \$36,000, of which the unamortized amount reduces the carrying amount of the debt.

In accordance with SFAS No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings, the exchange of the previously outstanding securities for \$500,000 in cash, the notes and the warrants was accounted for as a troubled debt

**Table of Contents**

restructuring and no gain was recorded. Instead the liability in excess of the future cash payments, which was originally approximately \$322,000, remains on the balance sheet as long term debt and is being amortized as a reduction of interest expense over the life of the notes.

On August 7, 2003, the Company purchased from WITECH Corporation 1,025,308 shares of the Company's common stock, 30,000 common stock warrants and 20,350 shares of series A Preferred Stock for \$200,000 at closing and an \$800,000 promissory note which is payable quarterly through September 30, 2007, at the prime interest rate plus 2% (effective rate of 7.75% as of April 30, 2005).

**5. SHAREHOLDER RIGHTS PLAN**

On August 7, 2003, the Company adopted a Shareholder Rights Plan designed to protect the interests of common shareholders from an inadequate or unfair takeover, but not affect a takeover proposal which the Board of Directors believes is fair to all shareholders. Under the Shareholder Rights Plan adopted by the Board of Directors, all shareholders of record on August 18, 2003 received one Preferred Share Purchase Right for each share of common stock they owned. These Rights trade in tandem with the common stock until and unless they are triggered. Should a person or group acquire more than 10% of ARI's common stock (or if an existing holder of 10% or more of the common stock were to increase its position by more than 1%), the Rights would become exercisable for every shareholder except the acquirer that triggered the exercise. The Rights, if triggered, would give the other shareholders the ability to purchase additional stock of ARI at a substantial discount. The rights will expire on August 18, 2013, and can be redeemed by the Company for \$0.01 per Right at any time prior to a person or group becoming a 10% shareholder.

**6. CLAIM FOR INDEMNIFICATION**

On November 5, 2004, the Company received a letter on behalf of one of its customers asserting a warranty claim and/or a claim for indemnity with respect to a complaint filed against the customer for patent infringement in the United States District Court for the Eastern District of Texas. In connection with the case, the customer has identified three other suppliers as potential indemnitors as well. The customer is one of several primarily large, multinational corporate defendants alleged to have violated patents purporting to cover an Electronic Proposal Preparation System (U.S. Patent No. 5,615,342) and/or Computer-Assisted Parts Sales Method (U.S. Patent No. 5,367,627). The customer has denied any and all allegations of patent infringement in the lawsuit. If the Company can assist its customer in its defense, management intends to do so. At the same time, ARI denies any responsibility, warranty or indemnification to the customer with respect to the complaint and intends to vigorously defend itself in this matter should that become necessary.

**Table of Contents**

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION**

**Results of Operations**

Total revenue increased from \$3,358,000 for the three months ended April 30, 2004 to \$3,459,000 for the three months ended April 30, 2005 and from \$9,936,000 for the nine months ended April 30, 2004 to \$10,038,000 for the nine months ended April 30, 2005. The change consisted of an increase in recurring revenues from the Company's catalog products in the North American sector of the Equipment Industry, partially offset by a decrease in revenues from the Non-North American sector of the Equipment Industry and the Non-equipment Industry. Earnings increased from \$180,000, or \$0.03 per share for the quarter ended April 30, 2004 to \$495,000 or \$0.08 per share for the quarter ended April 30, 2005 and from \$427,000 or \$0.07 per share for the nine months ended April 30, 2004 to \$1,444,000 or \$0.24 per share for the nine months ended April 30, 2005 primarily due to decreased software amortization expense and increased revenue. Management believes that the Company will have modest revenue growth and continue to be profitable for the remainder of fiscal 2005.

**Critical Accounting Policies and Estimates**

*General*

The Company's discussion and analysis of its financial condition and results of operations are based upon its financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, the Company evaluates its estimates, including those related to customer contracts, bad debts, capitalized software product costs, financing instruments, revenue recognition and other accrued expenses. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions and are subject to change in the near term.

The Company believes the following critical accounting policies affect its more significant judgments and estimates used in the preparation of its financial statements.

*Revenue Recognition*

Revenue for use of the network and for information services is recognized in the period such services are utilized. Revenue from annual or periodic maintenance fees, license and license renewal fees and catalog subscription fees is recognized ratably over the period the service is provided. Arrangements that include acceptance terms beyond the Company's standard terms are not recognized until acceptance has occurred. If collectibility is not considered probable, revenue is recognized when the fee is collected. Arrangements that include professional services are evaluated to determine whether those services are essential to the functionality of other elements of the arrangement. When professional services are not considered essential, the revenue allocable to the professional services is recognized as the services are performed. When professional services are considered essential, revenue under the arrangement is recognized pursuant to contract accounting using the percentage-of-completion method with progress-to-completion measured based upon labor hours incurred. When the current estimates of total contract revenue and contract cost indicate a loss, a provision for the entire loss on the contract is made. Revenue on arrangements with customers who are not the ultimate users (resellers) is deferred if there is any contingency on the ability and intent of the reseller to sell such software to a third party.

*Bad Debts*

The Company maintains an allowance for doubtful accounts for estimated losses resulting from the inability of its customers to make required payments. The Company currently reserves for most amounts due over 90 days, unless there is reasonable assurance of collectibility. If the financial condition of the Company's customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

*Use of Estimates*

The preparation of the Company's financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates and are subject to change in the near term.

*Impairment of Long-Lived Assets*

Equipment and leasehold improvements and capitalized software product costs are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. If the sum of the expected undiscounted cash flows is less than the carrying value of the related asset or group of assets, a loss is recognized for the difference between the fair value and carrying value of the asset or group of assets.

**Table of Contents***Debt Instruments*

The Company valued debt discounts for Common Stock Warrants and Options granted in consideration for Notes Payable using the Black-Scholes valuation method. Non-cash interest expense is recorded for the amortization of the debt discount over the term of the debt.

*Stock-Based Compensation*

The Company accounts for its employee stock option plans under the recognition and measurement principles of Accounting Principles Board ( APB ) Opinion No. 25, Accounting for Stock Issued to Employees, and related Interpretations. Under APB Opinion No. 25, no stock-based compensation is reflected in net income (loss), as all options granted under the plans had an exercise price equal to the market value of the underlying common stock on the date of grant and the related number of shares granted is fixed at that point in time.

**Revenues**

The Company is a leading provider of electronic parts catalogs and related technology and services to increase sales and profits for dealers in the manufactured equipment market. The Company currently provides 83 catalogs of manufactured equipment from 70 manufacturers to over 28,000 dealers in more than 100 countries in 12 segments of the worldwide manufactured equipment market including outdoor power, power sports, motorcycles, agricultural equipment, recreation vehicles, marine, construction, floor maintenance, auto and truck parts after-market, and others, primarily in North America, Europe and Australia. Collectively, dealers and distributors have over 86,000 catalog subscriptions. The Company supplies three types of software and services: (1) robust Web and CD-ROM interactive electronic parts catalogs, (2) dealer marketing services including template-based website services and technology-enabled direct mail services and (3) communication or transaction services. The Company's primary product line is electronic cataloging; the other products are supplementary offerings that leverage its position in the catalog market.

The following table sets forth certain Catalog, Customer and Subscription information by region derived from the Company's financial and customer databases. The number of distinct distributors and dealers is estimated because some subscriptions are distributed by third parties (including manufacturers), which may or may not inform ARI of the distributors and/or dealers to which the subscriptions are distributed. Because the estimating methodology is still being refined, comparisons to prior quarters may or may not be indicative of business trends.

**Catalog, Customer and Subscription Information by Region**  
(As of April 30, 2005)

	<b>Distinct Catalogs</b>	<b>Distinct Manufacturers</b>	<b>Subscriptions</b>	<b>Distinct Distributors (Estimated)</b>	<b>Distinct Dealers (Estimated)</b>
North American	75	59	72,546	100	19,684
Non-North American	70	11	13,554	22	8,614
Included in both Regions	(62)				
<b>Total</b>	<b>83</b>	<b>70</b>	<b>86,100</b>	<b>122</b>	<b>28,298</b>

Catalog= A separately sold and/or distributed parts catalog. A manufacturer may have more than one catalog. More than one brand or distinct product line may be included in a



catalog.

**Distinct Manufacturer=** A single independent manufacturer, not owned by another manufacturer, served by ARI. Distinct manufacturers are included in the region they most serve even if they have catalogs in both regions.

**Subscription=** A single catalog subscribed to by a single dealer or distributor. A dealer or distributor may subscribe to more than one catalog.

**Distinct Distributor=** A single independent distributor, not owned by another distributor, served by ARI. A distributor generally buys from manufacturers and sells to dealers.

**Distinct Dealer=** A single independent servicing dealer, not owned by another dealer, served by ARI.

As part of its historical business practice, the Company continues to provide electronic transaction services to the North American agribusiness industry. As the Company focuses on its core businesses in the Equipment industry, the percentage of revenues coming from the non-equipment industry is expected to continue to decline during fiscal 2005.

Management reviews the Company's recurring vs. non-recurring revenue in the aggregate and within the North American Equipment, non-North American Equipment and non-Equipment industries and by product category within the Equipment Industry.

**Table of Contents**

The following tables set forth, for the periods indicated, certain revenue information derived from the Company's unaudited financial statements.

**Revenue by Industry Sector**  
(In thousands)

Industry Sector:	Three months ended April 30		Percent Change	Nine months ended April 30		Percent Change
	2005	2004		2005	2004	
<b>Equipment Industry</b>						
North American Recurring	\$ 2,644	\$ 2,495	6%	\$ 7,809	\$ 7,278	7%
Non-recurring	449	439	2%	1,159	1,174	(1%)
Subtotal	3,093	2,934	5%	8,968	8,452	6%
Non-North American Recurring	227	250	(9%)	654	834	(22%)
Non-recurring	12	34	(64%)	12	168	(93%)
Subtotal	239	284	(16%)	666	1,002	(34%)
Total Equipment Industry Recurring	2,871	2,745	5%	8,463	8,112	4%
Non-recurring	461	473	(2%)	1,171	1,342	(13%)
Subtotal	3,332	3,218	4%	9,634	9,454	2%
<b>Non-equipment Industry</b>						
Recurring	127	140	(9%)	404	482	(16%)
Non-recurring						
Subtotal	127	140	(9%)	404	482	(16%)
<b>Total Revenue</b>						
Recurring	2,998	2,885	4%	8,867	8,594	3%
Non-recurring	461	473	(2%)	1,171	1,342	(13%)
Grand Total	\$ 3,459	\$ 3,358	3%	\$ 10,038	\$ 9,936	1%

**Revenue by Product in the Equipment Industry**  
(In thousands)

Product:	Three months ended April 30		Percent Change	Nine months ended April 30		Percent Change
	2005	2004		2005	2004	
<b>Equipment Industry</b>						
Catalog and related products Recurring	\$ 2,759	\$ 2,669	3%	\$ 8,116	\$ 7,789	4%
Non-recurring	461	456	1%	1,171	1,318	(11%)
Subtotal	3,220	3,125	3%	9,287	9,107	2%

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Communications Recurring	112	76	47%	347	323	7%
Non-recurring		17	(100%)		24	(100%)
Subtotal	112	93	20%	347	347	0%
Total Equipment Industry	\$ 3,332	\$ 3,218	4%	\$ 9,634	\$ 9,454	2%

## **Table of Contents**

Recurring revenues are derived from catalog subscription fees, catalog data update fees, software maintenance and support fees, software license renewals, network traffic and support fees and other miscellaneous subscription fees. Non-recurring revenues are derived from initial software licenses and professional services fees. Recurring revenue, as a percentage of total revenue, was 88% for the nine months ended April 30, 2005 compared to 86% for the same period last year. This ratio is expected to fluctuate from quarter to quarter and year to year, depending on the nature, size and timing of new business.

### *Equipment Industry*

The Equipment Industry has been a growing percentage of the Company's revenue over the past five years and is composed of several vertical markets including outdoor power, power sports, motorcycles, recreation vehicles, marine, construction, floor maintenance, agricultural equipment, auto and truck parts after-market and others primarily in North America, Europe and Australia. Management's strategy is to expand the Company's electronic parts catalog software and services business with dealers in the existing vertical markets and the manufacturers and distributors whose products they sell and service, add supplemental products for existing customers, and then expand to other similar markets in the future. Revenues in the Equipment Industry increased, as a percentage of total revenues, from 95% for the nine months ended April 30, 2004 to 96% for the nine months ended April 30, 2005.

### *North American*

Recurring revenues in the North American Equipment Industry increased for the three and nine month periods ended April 30, 2005, compared to the same periods last year, primarily due to an increase in the revenue of subscription renewals from the Company's catalog products and services. Non-recurring revenues in the North American Equipment Industry increased slightly for the three month period ended April 30, 2005, compared to the same period last year. Non-recurring revenues in the North American Equipment Industry decreased for the nine month period ended April 30, 2005, compared to the same period last year, primarily due to fewer large customization projects during the period as the Company sells a larger number of smaller deals, requiring less customization.

### *Non-North American*

Recurring revenues in the non-North American Equipment Industry decreased for the three and nine month periods ended April 30, 2005, compared to the same periods last year, primarily due to the loss of a customer in the power generation market and the discontinuation of a legacy microfiche publishing application. Non-recurring revenues in the non-North American Equipment Industry decreased for the three and nine month periods ended April 30, 2005, compared to the same periods last year, primarily due to no new sales. Management expects revenues in the Non-North American Equipment Industry to improve slightly for the remainder of fiscal 2005, as the Company invests in a new dealer-centric model similar to that used in its North American operations, and expects to show more significant improvements in fiscal 2006.

### *Catalog and Related Products*

Recurring revenues from the Company's catalog and related products in the Equipment Industry increased for the three and nine month periods ended April 30, 2005, compared to the same periods last year, primarily due to an increase in the Company's revenue from new products, from new catalog customers and an increase in the volume of catalogs subscribed to by dealers. Non-recurring revenues from the Company's catalog and related products in the Equipment Industry increased marginally for the three months ended April 30, 2005 compared to the same period last year. Non-recurring revenues from the Company's catalog and related products in the Equipment Industry decreased for the nine month period ended April 30, 2005, compared to the same period last year, primarily due to less professional service revenues from customization projects, particularly in the non-North American Industry. Management expects

recurring catalog and related revenues, which have a higher margin than revenues from professional services, to continue to increase in the North American Equipment Industry, and non-recurring catalog and related revenues in this industry to increase slightly for the remainder of fiscal 2005.

*Communications Products*

Revenues from the Company's communications products increased for the three month period ended April 30, 2005, compared to the same period last year, primarily due to fluctuations in network traffic revenues but remained the same for the nine month period ended April 30, 2005. The Company has focused the business primarily on its catalog products. Management expects that revenues from communications products will be a declining percentage of total revenue for the remainder of fiscal 2005 and fiscal 2006.

*Non-Equipment Industry Business*

The Company's business outside of the Equipment Industry includes sales of electronic communication services to the agricultural inputs industry. Revenues in this business have decreased for the three and nine month periods ended April 30, 2005, compared to the same periods last year, because an industry association introduced a competitive offering to our database management services. As a result, many of the agricultural inputs industry participants did not renew their contracts for database management services, which were \$6,000 for the nine month period ended April 30, 2005 compared to \$72,000 for the nine

**Table of Contents**

month period ended April 30, 2004 and approximately \$500,000 on an annual basis. The Company continues to provide electronic communication services to the agricultural inputs industry, but management expects these revenues, as a percentage of total revenues, to continue to decline for the remainder of fiscal 2005.

**Cost of Products and Services Sold**

The following table sets forth, for the periods indicated, certain information regarding revenue and cost of products and services sold which is derived from the Company's unaudited financial statements.

**Cost of Products and Services Sold as a Percent of Revenue by Revenue Type**  
(*In thousands*)

	Three months ended		Percent Change	Nine months ended		Percent Change
	2005	2004		2005	2004	
Subscriptions, support and other services fees						
Revenue	\$ 2,534	\$ 2,263	12%	\$ 7,358	\$ 6,812	8%
Cost of revenue	186	98	89%	612	382	60%
Cost of revenue as a percent of revenue	7%	4%		8%	6%	
Software licenses and renewals						
Revenue	552	590	(6%)	1,686	1,783	(5%)
Cost of revenue	153	470	(67%)	452	1,390	(67%)
Cost of revenue as a percent of revenue	28%	80%		27%	78%	
Professional services						
Revenue	373	505	(26%)	994	1,341	(26%)
Cost of revenue	134	306	(56%)	264	646	(59%)
Cost of revenue as a percent of revenue	36%	61%		27%	48%	
Total						
Revenue	\$ 3,459	\$ 3,358	3%	\$ 10,038	\$ 9,936	1%
Cost of revenue	473	874	(46%)	1,328	2,418	(45%)
Cost of revenue as a percent of revenue	14%	26%		13%	24%	

Cost of subscriptions, support and other services fees consists primarily of telecommunication costs, catalog production and replication costs and distribution costs. Cost of subscriptions, support and other services fees as a percentage of revenue increased for the three and nine month periods ended April 30, 2005, compared to the same periods last year primarily due to an increase in catalog production and replication costs absorbed by the Company as part of a strategy to acquire additional catalog titles to sell to dealers, which was included in cost of professional services prior to fiscal 2005. Management expects gross margins, as a percent of revenue from subscriptions, support and other services fees, to vary slightly from quarter to quarter, depending on the timing of catalog update shipments.

Cost of software licenses and renewals consists primarily of amortization of software products, software royalties and reseller commissions. Cost of software license and renewals as a percentage of revenue decreased significantly for the

three and nine month periods ended April 30, 2005, compared to the same periods last year, primarily due to lower software amortization costs, as the software product costs of PartSmart™, acquired in fiscal 1999, became fully amortized in May, 2004. Gross margins from software licenses and renewals will fluctuate from quarter to quarter based on the level of revenue, while costs remain relatively the same since amortization of software is not related to the level of revenue generated from software license and renewals. Management expects software amortization costs to increase slightly from the current level for the remainder of the year as the Company releases new products, but to remain well below last year.

Cost of professional services consists of customization and catalog production labor. Cost of professional services as a percentage of revenue decreased for the three and nine month periods ended April 30, 2005, compared to the same periods last year, primarily due to the reclassification of catalog production labor that is not directly billed to the manufacturer to cost of subscriptions, where the Company realizes revenue for this service. These costs had previously not been segregated from catalog production labor which was billed to the manufacturer. Management expects cost of professional services to fluctuate from quarter to quarter depending on the mix of services sold and on the Company's performance towards the contracted amount for customization projects.

**Table of Contents****Operating Expenses**

The following table sets forth, for the periods indicated, certain operating expense information derived from the Company's unaudited financial statements.

**Operating Expenses**  
(In thousands)

	Three months ended April 30		Percent Change	Nine months ended April 30		Percent Change
	2005	2004		2005	2004	
Cost of products and services sold	\$ 473	\$ 874	(46%)	\$ 1,328	\$ 2,418	(45%)
Customer operations and support	265	249	6%	784	823	(5%)
Selling, general and administrative	1,805	1,696	6%	5,259	5,212	1%
Software development and technical support	487	399	22%	1,353	1,102	23%
Less capitalized portion	(192)	(144)	33%	(498)	(331)	50%
Depreciation and amortization	67	38	76%	190	110	73%
Net operating expenses	\$ 2,905	\$ 3,112	(7%)	\$ 8,416	\$ 9,334	(10%)

Customer operations and support consists primarily of server room operations, software maintenance agreements for the Company's core network and customer support costs. Customer operations and support costs increased for the three month period ended April 30, 2005, compared to the same period last year, primarily due to the timing of postage and shipping costs and temporary consulting costs in the network and support area. Customer operations and support costs decreased for the nine month period ended April 30, 2005, compared to the same period last year, primarily due to reduced customer operations and support costs for the agricultural inputs industry and continued server room cost reductions. Management expects customer operations and support costs to continue at relatively the same level for the remainder of fiscal 2005.

Selling, general and administrative expenses (SG&A) increased for the three and nine month periods ended April 30, 2005, compared to the same periods last year, primarily due to increased consulting costs related to Sarbanes-Oxley Section 404 compliance offset in part by the reduction of an accrual in the first half of the year for costs related to a sales tax audit. SG&A, as a percentage of revenue remained approximately the same at 52% for the nine month periods ended April 30, 2004 and April 30, 2005. Management expects SG&A costs as a percentage of revenue to increase compared to the previous year for the remainder of fiscal 2005 due to investments in new product marketing and the reorganizing of the non-North American business.

The Company's technical staff (in-house and contracted) performs both software development and technical support as well as software customization and data conversion services for customer applications. Therefore, management expects fluctuations between software customization and data conversion services and development and technical support expenses quarter to quarter, as the mix of development and customization activities will change based on customer requirements. Software development and technical support costs increased for the three and nine month periods ended April 30, 2005, compared to the same periods last year, primarily due to a shift in resources from cost of sales to software development in the first quarter of fiscal 2005. Management expects software development and technical support costs to continue to be higher than the previous year for the remainder of fiscal 2005 as we invest in



new products.

Capitalized software product costs represented 37% of software development and technical support for the nine month period ended April 30, 2005, compared to 30% for the same period last year. Capitalized software product costs fluctuate from quarter to quarter depending on the deployment of the Company's resources between early stage research, software development available for capitalization, data conversion, customer customizations and maintenance and technical support. Management expects that capitalized software product costs will continue to be higher than the previous year for the remainder of fiscal 2005, because of planned product development investments.

Depreciation and amortization expense increased for the three and nine month periods ended April 30, 2005, compared to the same periods last year as the Company made investments in computer equipment. Management expects depreciation and amortization to continue to be higher than the previous year for the remainder of fiscal 2005.

#### **Other Items**

Net income increased from \$427,000 for the nine month period ended April 30, 2004, to \$1,444,000 for the nine month period ended April 30, 2005. The increase in net income is primarily due to the decrease in software amortization expense. Management expects to continue to generate positive earnings and cash flows for the remainder of fiscal 2005, although there can be no assurance that this will occur.

**Table of Contents**

Interest expense includes both cash and non-cash interest. Cash interest paid or accrued for payment was approximately \$201,000 and \$246,000 for the nine month periods ended April 30, 2005 and 2004, respectively. In addition, approximately \$61,000 and \$46,000 of excess debt principal, a non-cash item, was amortized to offset interest expense for the nine month periods ended April 30, 2005 and 2004, respectively.

On November 19, 2003, pursuant to its option exchange program, the Company accepted for cancellation options to purchase 319,186 shares of common stock, representing approximately 29% of the options that were eligible for exchange in the offer. Subject to and in accordance with the terms of the offer, the Company issued, on May 21, 2004, replacement options to purchase 245,944 shares of the Company's common stock in exchange for the options cancelled in the offer.

**Acquisitions**

Since December 1995, the Company has had a formal business development program aimed at identifying, evaluating and closing acquisitions that augment and strengthen the Company's market position, product offerings, and personnel resources. Since the program's inception, five acquisitions have been completed, four of which were fully integrated into the Company's operations prior to fiscal year 2000.

On October 27, 2003, the Company acquired the technology and customer base of VertX Commerce Corporation (VertX). ARI had been reselling the VertX software under the brand name WebsiteSmart<sup>®</sup>. The acquisition did not have a material impact on the Company's financial statements.

The business development program is still an important component of the Company's long-term growth strategy and the Company expects to continue to pursue it aggressively.

**Liquidity and Capital Resources**

The following table sets forth, for the periods indicated, certain information reconciling earn/burn rate to the Company's unaudited financial statements.

**Earn/Burn Rate**  
*(In thousands)*

	Three months ended		Percent Change	Nine months ended		Percent Change
	April 30			April 30		
	2005	2004		2005	2004	
Net cash provided by operating activities	\$ 820	\$ 443	85%	\$ 2,134	\$ 1,700	26%
Net increase (decrease) in receivables, prepaid expenses and other current assets	77	272	(72%)	(376)	(215)	75%
Net (increase) decrease in accounts payable, deferred revenue and accrued liabilities	(208)	(75)	177%	272	370	(26%)
Net cash used in investing activities	(272)	(173)	57%	(1,171)	(545)	115%
Earn/burn rate	\$ 417	\$ 467	(11%)	\$ 859	\$ 1,310	(34%)

Net cash provided by operating activities increased for the three and nine month periods ended April 30, 2005, compared to the same periods last year, primarily due to the increase in net income. The effect of net changes in working capital is dependent on the timing of payroll and other cash disbursements, accruals and the timing of invoices and may vary significantly from quarter to quarter. Net cash used in investing activities increased for the three and nine month periods ended April 30, 2005, compared to the same periods last year, primarily due to the acquisition of software purchased from a third party in the first quarter of fiscal 2005 that will be incorporated into a new ARI product (WarrantySmart™) and increased in-house capitalized software product costs. Management expects the earn/burn rate to continue to be less than the prior year for the remainder of fiscal 2005, as the Company invests in marketing and the development of new software products.

At April 30, 2005, the Company had cash of approximately \$3,632,000 compared to approximately \$3,357,000 at July 31, 2004.

**Table of Contents**

The following table sets forth, for the periods indicated, certain information related to the Company's debt derived from the Company's unaudited financial statements.

**Debt Schedule**  
(In thousands)

	April 30 2005 (Unaudited)	July 31 2004 (Audited)	Net Change
Note payable to WITECH:			
Current portion of note payable	200	200	
Long term portion of note payable	300	450	(150)
Total note payable to WITECH	500	650	(150)
Notes payable to New Holders:			
Current portion of notes payable	800	800	
Long term portion of notes payable	2,100	2,700	(600)
Total face value of notes payable to New Holders	2,900	3,500	(600)
Carrying value in excess of face amount of notes payable	115	182	(67)
Debt discount (common stock warrants and options)	(20)	(26)	6
Total carrying value of notes payable to New Holders	2,995	3,656	(661)
Total debt	\$ 3,495	\$ 4,306	\$ (811)

On April 24, 2003, the Company restructured its debt. In exchange for previously outstanding debt and securities, the Company issued to a group of investors, in aggregate, \$500,000 in cash, unsecured notes in the amount of \$3.9 million and warrants for 250,000 common shares, exercisable at \$1.00 per share. The interest rate on the notes is prime plus 2% (effective rate of 7.75% as of April 30, 2005). The notes (in aggregate) are payable in \$200,000 quarterly installments commencing March 31, 2004 through December 31, 2005 and \$300,000 quarterly installments commencing March 31, 2006 until paid in full. The notes do not contain any financial covenants, but the Company is restricted from permitting certain liens on its assets. In addition, in the event of payment default that is not cured within ninety (90) days, Taglich Brothers, Inc., one of the note holders, has the right to appoint one designee to the Company's Board of Directors. The warrants were estimated to have a value of \$36,000, of which the unamortized amount reduces the carrying amount of the debt.

On August 8, 2003, the Company repurchased from WITECH Corporation 1,025,308 shares of Common Stock, a warrant to purchase 30,000 shares of Common Stock at \$.24 per share, and 20,350 shares of Series A Preferred Stock with an approximate face value plus accrued and undeclared dividends of \$3.5 million. The Company paid \$200,000 in cash and issued a four-year note for \$800,000, payable quarterly and bearing interest at prime plus 2% (effective rate of 7.75% as of April 30, 2005). The note does not contain any financial covenants.

On July 9, 2004, the Company entered into a line of credit with Bank One, N.A. which permits the Company to borrow an amount equal to 80% of the book value of all eligible accounts minus \$75,000, up to \$500,000, and bears interest at prime rate. Eligible accounts include certain non-foreign accounts receivable which are less than 90 days from the invoice date. The line of credit terminates July 9, 2005, and is secured by substantially all of the Company's

assets. The line of credit limits repurchases of common stock, the payment of dividends, liens on assets and new indebtedness, and requires the Company to meet minimum net worth and debt service coverage financial covenants. As of June 10, 2005, the Company had not borrowed on the line of credit.

Management believes that funds generated from operations will be adequate to fund the Company's operations, investments and debt payments for the foreseeable future, although additional financing may be necessary if the Company were to complete a large acquisition or to make a large investment in its business.

**Table of Contents**

The following table sets forth, for the periods indicated, certain information reconciling earnings before interest, taxes, depreciation and amortization to the Company's unaudited financial statements.

**Earnings before Interest, Taxes, Depreciation and Amortization**  
(in thousands)

	Three months ended			Nine months ended		
	April 30		Percent Change	April 30		Percent Change
	2005	2004		2005	2004	
Net income	\$ 495	\$ 180	175%	\$ 1,444	\$ 427	238%
Plus: Interest	49	55	(11%)	140	200	(30%)
Amortization of software products	143	435	(67%)	417	1,323	(68%)
Other depreciation and amortization	67	38	76%	190	110	73%
Income tax expense	13		100%	63		100%
Earnings before interest, taxes, depreciation and amortization	\$ 767	\$ 708	8%	\$ 2,254	\$ 2,060	9%

Earnings before interest, taxes, depreciation and amortization ( EBITDA ) increased for the three and nine month periods ended April 30, 2005, compared to the same periods last year, primarily due to the increase in revenue. Management believes that EBITDA will continue at the same level for the remainder of fiscal 2005, as the Company invests in the future.

This Management's Discussion and Analysis or Plan of Operation discloses EBITDA (earnings before interest and other taxes, depreciation and amortization) and cash from operations and investment before changes in working capital (earn/burn rate), each of which may be considered a non-GAAP financial measure. Generally, a non-GAAP financial measure is a numerical measure of a company's performance, financial position or cash flows that either excludes or includes amounts that are not normally excluded or included in the most directly comparable measure calculated and presented in accordance with accounting principles generally accepted in the United States. In order to fully assess the Company's financial results, management believes that EBITDA and earn/burn rate are appropriate measures of evaluating operating performance and liquidity, respectively. EBITDA is a commonly used measurement of financial performance. In addition, management believes EBITDA is helpful in understanding period-over-period operating results separate and apart from items that may, or could, have a disproportionate impact on the Company's results of operations in any particular period. The Company believes that cash from operations and investment before changes in working capital items (earn/burn rate) is helpful in determining and measuring the amount of cash generated from the Company's business, separate and apart from changes caused by changes in working capital items, which, over several periods, tend to offset each other. However, these measures should be considered in addition to, and not as a substitute for operating income, cash flows or other measures of financial performance prepared in accordance with generally accepted accounting principles and may not necessarily be comparable to similarly titled measures of other companies.

**Forward Looking Statements**

Certain statements contained in this Form 10-QSB are forward looking statements including revenue growth, future cash flows and cash generation and sources of liquidity. Expressions such as believes, anticipates, expects, and similar expressions are intended to identify such forward looking statements. Several important factors can cause actual

results to materially differ from those stated or implied in the forward looking statements. Such factors include, but are not limited to the factors listed on exhibit 99.1 of the Company's annual report on Form 10-KSB for the year ended July 31, 2004, which is incorporated herein by reference. The forward-looking statements are made only as of the date hereof, and the Company undertakes no obligation to publicly release the result of any revisions to these forward-looking statements.

**Table of Contents**

**ITEM 3. CONTROLS AND PROCEDURES**

ARI maintains a set of disclosure controls and procedures that are designed to ensure that information required to be disclosed by it in the reports filed by it under the Securities Exchange Act of 1934, as amended ( Exchange Act ) is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. ARI carried out an evaluation, under the supervision and with the participation of its management, including its Chief Executive Officer and its Chief Financial Officer, of the effectiveness of the design and operation of its disclosure controls and procedures pursuant to Rule 13a-15 of the Exchange Act. Based on that evaluation, ARI's Chief Executive Officer and its Chief Financial Officer concluded that ARI's disclosure controls and procedures are effective as of April 30, 2005.

There have been no changes in ARI's internal control over financial reporting identified in connection with the evaluation discussed above that occurred during the quarter ended April 30, 2005 that have materially affected, or are reasonably likely to materially affect, ARI's internal control over financial reporting.

**PART II OTHER INFORMATION**

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

During the quarter ended April 30, 2005, the Company did not sell any equity securities which were not registered under the Securities Act or repurchase any of its equity securities.

**ITEM 6. EXHIBITS**

- 31.1 Section 302 Certification of Chief Executive Officer.
- 31.2 Section 302 Certification of Chief Financial Officer.
- 32.1 Section 906 Certification of Chief Executive Officer.
- 32.2 Section 906 Certification of Chief Financial Officer.



**Table of Contents**

**SIGNATURES**

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

ARI Network Services, Inc.  
(Registrant)

Date: June 14, 2005

/s/ Brian E. Dearing  
Brian E. Dearing, Chairman of the Board  
and Chief Executive Officer

/s/ Timothy Sherlock  
Timothy Sherlock, Chief Financial Officer