CHINA YUCHAI INTERNATIONAL LTD
Form 20-F
August 08, 2006

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SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 20-F

o **REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR 12(g) OF THE SECURITIES EXCHANGE ACT OF 1934**

OR

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

For the fiscal year ended December 31, 2005

OR

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

For the transition period from __________ to __________

o **SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Date of event requiring this shell company report __________

Commission file number 1-13522

China Yuchai International Limited
(Exact Name of Registrant as Specified in Its Charter)

N/A	Bermuda
(Translation of Registrant s Name Into English)	(Jurisdiction of Incorporation or Organization)

16 Raffles Quay #26-00
Hong Leong Building
Singapore 048581
65-6220-8411
(Address and Telephone Number of Principal Executive Offices)

Securities registered or to be registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, par value US$0.10 per share	The New York Stock Exchange

Securities registered or to be registered pursuant to Section 12(g) of the Act:
None
(Title of Class)

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act:
None
(Title of Class)

Indicate the number of outstanding shares of each of the issuer s classes of capital or common stock as of the close of the period covered by the annual report.

As of December 31, 2005, 37,267,673 shares of common stock, par value US$0.10 per share, and one special share, par value US$0.10, were issued and outstanding.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No þ

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934. Yes o No þ

Note Checking the box above will not relieve any registrant required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 from their obligations under those Sections.

Indicate by check mark whether the registrant: (1) has 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 filing requirements for the past 90 days. Yes o No þ

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

Large accelerated filer o Accelerated filer þ Non-accelerated filer o

Indicate by check mark which financial statement item the registrant has elected to follow. Item 17 o Item 18 þ

If this report is an annual report, indicate by check mark if the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ

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Certain Definitions and Supplemental Information

All references to China , PRC and the State in this Annual Report are references to the People s Republic of China. Unless otherwise specified, all references in this Annual Report to U.S. dollars , dollars , US$ or $ are to United States dollars; all references to Renminbi or Rmb are to Renminbi, the legal tender currency of China; and all references to S$ are to Singapore dollars, the legal tender of Singapore. Unless otherwise specified, translation of amounts from Renminbi to U.S. dollars for the convenience of the reader has been made in this Annual Report at the rate of Rmb 8.0702 = US$1.00, the rate quoted by the People s Bank of China on December 30, 2005. No representation is made that the Renminbi amounts or Singapore dollar amounts could have been, or could be, converted into U.S. dollars at rates specified herein or any other rate.

The consolidated financial statements of China Yuchai International Limited, its subsidiaries and affiliates are presented in Renminbi. All consolidated financial statements of the Company presented herein have been prepared in conformity with accounting principles generally accepted in the United States of America (US GAAP). Totals presented in this Annual Report may not correctly total due to rounding of numbers.

As used in this Annual Report, unless the context otherwise requires, the terms the Company , CYI , we , us , our , our company refer to China Yuchai International Limited, its subsidiaries and affiliates. All references herein to Yuchai are to Guangxi Yuchai Machinery Company Limited, its consolidated subsidiaries and affiliates and, prior to its incorporation in July 1992, to the machinery business of its predecessor, Guangxi Yulin Diesel Engine Factory (Yulin Diesel), which was founded in 1951 and became a state-owned enterprise in 1959. In the restructuring of Yulin Diesel in July 1992, its other businesses were transferred to Guangxi Yuchai Machinery Holdings Company, also sometimes referred to as Guangxi Yuchai Machinery Group Company Limited (the State Holding Company), which became a shareholder of Yuchai. In addition, TCL refers to Thakral Corporation Ltd and LKN refers to LKN-Primefield Limited, each of which are minority investees of the Company.

As of December 31, 2005, 37,267,673 shares of common stock, par value US$0.10 per share of the Company (Common Stock), and one special share, par value US$0.10, of the Company were issued and outstanding. The weighted average common shares outstanding during the year is 36,459,635. Unless otherwise indicated herein, all percentage share amounts with respect to the Company are based on the weighted average number of shares of 36,459,635 for 2005.

Cautionary Statements with Respect to Forward-Looking Statements

The Company wishes to caution readers that the forward-looking statements contained in this Annual Report, which include all statements which, at the time made, address future results of operations, are based upon the Company s interpretation of factors affecting the business and operations of the Company. The Company believes the following important factors, among others, in some cases have affected, and in the future could affect, the Company s actual consolidated results and could cause the Company s actual consolidated results for 2006, and beyond, to differ materially from those described in any forward-looking statements made by, or on behalf of, the Company:

- political, economic and social conditions in China, including the Chinese government s specific policies with respect to foreign investment, economic growth, inflation and the availability of credit, particularly to the extent such current or future conditions and policies affect the truck and diesel engine industries and markets in China, the Company s diesel engine customers, the demand, sales volume and sales prices for the Company s diesel engines and the Company s levels of accounts receivable;

- the effects of competition in the diesel engine market on the demand, sales volume and sales prices for the Company s diesel engines;

- the Company s ability to collect and control its levels of accounts receivable;

- the Company s dependence on the Dongfeng Automobile Company and other major diesel truck manufacturers controlled by or affiliated with the Dongfeng Automobile Company;

the Company s ability to successfully manufacture and sell its 4108, 4110, 4110Q, 4110ZQ, 4112, 6105, 6108, 6112, 6L/6M (formerly referred to as 6113) heavy-duty diesel engines and any new products;

the Company s ability to finance its working capital and capital expenditure requirements, including obtaining any required external debt or other financing;

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the effects of inflation on the Company s financial condition and results of operations, including the effects on Yuchai s costs of raw materials and parts and labor costs;

the Company s ability to successfully implement the reorganization agreement which it entered into with Yuchai and Coomber Investments Limited (Coomber) on April 7, 2005 (the Reorganization Agreement), as amended in December 2005, relating to the implementation of the restructuring contemplated in the earlier agreement dated July 19, 2003 between the Company and Yuchai with respect to the Company s investment in Yuchai (the July 2003 Agreement);

the Company s ability to control Yuchai and consolidate Yuchai s financial results;

the effects of China s political, economic and social conditions on the Company s financial condition, results of operations, business or prospects;

the effects of uncertainties in the Chinese legal system, which could limit the legal protections available to foreign investors, including with respect to the enforcement of foreign judgments in China; and

the impact on the Company s business and results of operations as a result of China s membership with the World Trade Organization (WTO).

Incorporation by Reference

This Annual Report on Form 20-F shall be deemed to be incorporated by reference in the Prospectus, dated March 24, 2004, included in the Registration Statement (File No. 333-111106) on Form F-3 of the Company and to be a part thereof from the date on which this Annual Report is filed, to the extent it is not superseded by documents or reports subsequently filed or furnished.

PART I

ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS.

Not Applicable.

ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE.

Not Applicable.

ITEM 3. KEY INFORMATION.

Selected Financial Data

The selected financial information set forth below should be read in conjunction with, and is qualified in its entirety by reference to, Item 5. Operating and Financial Review and Prospects and the Company s audited consolidated financial statements and the notes thereto included in this Annual Report. The consolidated financial statements of the Company are prepared in conformity with US GAAP.

The Company s main operating asset is its 76.4% ownership interest in Yuchai. As a result, the Company s financial condition and results of operations depend primarily upon Yuchai s financial condition and results of operations, and the implementation of the Reorganization Agreement with respect to the restructuring of the Company s investment in Yuchai, described elsewhere herein (see Item 4. Information on the Company Recent Developments and Item 8. Financial Information Legal Proceedings).

On February 7, 2005, the board of directors of the Company announced its approval of the implementation of a business expansion and diversification plan by the Company. Pursuant to this plan, the Company has looked for new business opportunities to seek to reduce its financial dependence on Yuchai, which has historically been the Company s main operating asset.

In March 2005, the Company completed an acquisition of approximately 14.99% of TCL, a China-focused electronics distribution company, for approximately S$30.9 million (approximately $18.9 million, based on an exchange rate of S$1.637 to US$1.00). The Company subsequently increased its minority stake in TCL, and as of December 31, 2005 the Company s shareholding in TCL was

15.99%. The Company has also recently invested in LKN, a company primarily engaged in the business of investment holding and hospitality-related businesses, pursuant to the Company s business expansion and diversification plan.

In February 2006, the Company acquired debt and equity in LKN for an aggregate consideration of approximately S$131.6 million (approximately $81.2 million, based on an exchange rate of S$1.62 to US$1.00), divided into 191,413,465 ordinary shares representing approximately 29.13% of the total number of ordinary shares in issue; 123,010,555 redeemable convertible preference shares in the capital of LKN; and approximately S$129.4 million (approximately US$79.9 million, based on an exchange rate of S$1.62 to US$1.00) in principal amount of outstanding secured non-convertible bonds issued by LKN. For further information on the TCL and LKN minority investments, see Item 4. Information on the Company History and Development Minority Investments .

The selected balance sheet data as of December 31, 2004 and 2005 and the statement of income data and cash flow statement data of the Company set forth below for the years ended December 31, 2003, 2004 and 2005 are derived from the consolidated financial statements of the Company included in this Annual Report, which have been audited by KPMG, Independent Registered Public Accounting Firm (the Consolidated Financial Statements). The selected balance sheet data of the Company set forth below as of December 31, 2001, 2002 and 2003 and the statement of income data and cash flow statement data for the years ended December 31, 2001 and 2002 are derived from the consolidated financial statements of the Company, which have been audited by KPMG, but which are not included in this Annual Report.

	As of and for the Year Ended December 31,					
	2001	**2002**	**2003**	**2004**	**2005**	**2005**
	Rmb	**Rmb**	**Rmb**	**Rmb**	**Rmb**	**US$(3)**
			(in thousands)			
Statement of Income Data:						
Revenues, net	1,783,329	3,513,047	4,569,950	5,582,095	5,829,431	722,340
Gross profit	599,926	1,141,967	1,377,156	1,575,209	1,302,385	161,382
Research and development costs	(44,721)	(75,532)	(94,594)	(136,960)	(123,876)	(15,350)
Provision for uncollectible loans to a related party					(205,000)	(25,402)
Operating income	295,115	640,307	721,411	779,929	168,692	20,903
Income before income taxes and minority interests	269,189	625,450	696,906	753,854	117,242	14,528
Income tax benefit/(expense)	63,584	(83,242)	(112,924)	(105,165)	(20,875)	(2,587)
Income before minority interests	332,773	542,208	583,982	648,689	96,367	11,941
Minority interests in income of consolidated subsidiaries	(82,386)	(129,775)	(145,800)	(157,292)	(27,880)	(3,455)
Net income	250,387	412,433	438,182	491,397	68,487	8,486
	7.09	11.67	12.40	13.90	1.88	0.23

Basic and diluted earnings per common share						
Weighted average number of shares	35,340	35,340	35,340	35,340	36,460	36,460
Balance Sheet Data (at year end):						
Working capital[(1)]	1,100,462	1,340,832	1,031,830	1,402,226	959,401	118,882
Goodwill	212,636	212,636	212,636	212,636	212,636	26,348
Total assets	3,262,868	3,985,459	4,033,632	5,384,248	6,613,785	819,532

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	As of and for the Year Ended December 31,					
	2001	**2002**	**2003**	**2004**	**2005**	**2005**
	Rmb	**Rmb**	**Rmb**	**Rmb**	**Rmb**	**US$(3)**
			(in thousands)			
Long-term bank loans, excluding current instalments	180,000	50,000		100,000	50,000	6,196
Minority interests	420,545	487,491	544,526	724,311	685,514	84,944
Common stock	30,349	30,349	30,349	30,349	31,945	3,958
Stockholders equity	1,805,045	2,161,903	1,991,687	2,483,084	2,667,041	330,480
Statement of Cash Flows Data:						
Net cash provided by operating activities	59,273	659,500	1,075,274	589,608	242,674	30,070
Capital expenditures(2)	43,043	174,850	372,775	552,902	515,359	63,860
Depreciation and amortization	113,680	118,872	125,519	132,789	139,720	17,313

(1) Current assets (including cash) less current liabilities.

(2) Purchase of property, plant and equipment, lease prepayment and payment for construction in progress.

(3) The Company s functional and reporting currency is Renminbi, and the translation of amounts from Renminbi to U.S. dollars is solely for the convenience of the reader. Translation of amounts from Renminbi to

U.S. dollars has been made at the rate of Rmb 8.0702 = US$1.00, the rate quoted by the People s Bank of China at the close of business on December 30, 2005. No representation is made that the Renminbi amounts could have been, or could be, converted into U.S. dollars at that rate or at any other rate prevailing on December 30, 2005 or any other date.

Dividends

The following table sets forth a five-year summary of dividends paid by the Company to its shareholders and by Yuchai to the Company, respectively:

Period	Dividend paid by the Company to its shareholders (per share)	Dividend Paid by Yuchai to the Company[1] (in thousands)
2001	US$0.02	Rmb 72,284 (US$8,720)
2002	US$0.19	Rmb 245,766 (US$29,694)[2]
2003	US$2.08	Rmb 61,433 (US$7,422)
2004	US$0.39	Rmb 231,309 (US$27,906)[3]
2005	US$ Nil	Rmb 72,282 (US$8,957)[4]

(1) Dividends paid by Yuchai to the Company, as well as to other shareholders of Yuchai, were declared in Renminbi and paid in U.S. dollars (as shown in the parentheses)

based on the exchange rates at local designated foreign exchange banks on the respective payment dates. For dividends paid for 2001, 2002, 2003, 2004 and 2005, the exchange rate used was Rmb 8.2894 = US$1.00, Rmb 8.2767 = US$1.00, Rmb 8.2767 = US$1.00, Rmb 8.2765 = US$1.00 and Rmb 8.0702 = US$1.00, respectively.

(2) The dividends declared for 2002 by Yuchai were paid to the Company in 2003 following execution of the July 2003 Agreement.

(3) The dividends declared for 2004 by Yuchai were paid to the Company in 2005 following execution of the Reorganization Agreement.

(4) On June 26, 2006, Yuchai has declared dividends to all

shareholders in respect of the financial year ended December 31, 2005 and the amount attributable to the Company is Rmb 72.3 million (US$9.0 million). This dividend was received by the Company on July 28, 2006.

Historical Exchange Rate Information

On June 30, 2006, the noon buying rate was Rmb 7.9943 = US$1.00.

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The following tables set forth certain information concerning exchange rates between Renminbi and U.S. dollars for the periods indicated:

	Noon Buying Rate[1] (Rmb per US$1.00)	
Period	**High**	**Low**
December 2005	8.0808	8.0702
January 2006	8.0702	8.0596
February 2006	8.0616	8.0415
March 2006	8.0505	8.0167
April 2006	8.0248	8.0040
May 2006	8.0300	8.0005
June 2006	8.0225	7.9943
July 2006	8.0018	7.9690

	Noon Buying Rate[1] (Rmb per US$1.00)			
Period	**Period End**	**Average**	**High**	**Low**
2001	8.2766	8.2772	8.2786	8.2763
2002	8.2800	8.2772	8.2800	8.2765
2003	8.2767	8.2771	8.2800	8.2765
2004	8.2765	8.2768	8.2774	8.2764
2005	8.0702	8.1734	8.2765	8.0702
2006 (through July 31, 2006)	7.9690	8.0200	8.0702	7.9690

(1) The noon buying rate in New York for cable transfers payable in foreign currencies as certified for customs purposes by the Federal Reserve Bank of New York. Since April 1994, the noon buying rate has been based on the rate quoted by the People s Bank of China. As a result, since April 1994, the noon buying

rate and the People s Bank of China rate have been substantially similar. The People s Bank of China rate at the end of 2005 was Rmb 8.0702, compared with Rmb 8.1734 for the noon buying rate (average).

(2) Determined by averaging the rates on the last business day of each month during the relevant period.

Risk Factors

Risks relating to our company and our business

Our financial condition, results of operations, business and prospects may be adversely affected if we are unable to implement the Reorganization Agreement.

Our main operating asset is our ownership interest in Yuchai, and our primary source of cash flow continues to be our share of the dividends, if any, paid by Yuchai and investment earnings thereon. As a result of the agreement reached with Yuchai and its related parties pursuant to the July 2003 Agreement, we discontinued legal and arbitration proceedings initiated by us in May 2003 relating to difficulties with respect to our investment in Yuchai. In furtherance of the terms of the July 2003 Agreement, we, Yuchai and Coomber entered into the Reorganization Agreement in April 2005, as amended in December 2005, and agreed on a restructuring plan for our company intended to be beneficial to our shareholders (see Item 4. Information on the Company Recent Developments). No assurance can be given as to when the corporate governance requirements relating to Yuchai and the restructuring plan in respect of our ownership of Yuchai, both as contemplated by the Reorganization Agreement, will be fully implemented, or that implementation of the Reorganization Agreement will effectively resolve all of the difficulties faced by us with respect to our investment in Yuchai.

In addition, the Reorganization Agreement contemplates the continued implementation of our business expansion and diversification plan adopted in February 2005. One of the goals of this business expansion and diversification plan is to reduce our financial dependence on Yuchai. Thus far, we have acquired strategic stakes in TCL and LKN (see Item 3. Key Information and Item 4. Information on the Company Recent Developments). Nonetheless, no assurance can be given that we will be able to successfully expand and diversify our business. We may also not be able to continue to identify suitable acquisition opportunities, or secure funding to consummate such acquisitions or successfully integrate such acquired businesses within our operations. Any failure to implement the terms of the Reorganization Agreement, including our continued expansion and diversification, could have a material adverse effect on our financial condition, results of operations, business or prospects.

We have and may continue to experience disagreements and difficulties with the Chinese Shareholders in Yuchai.

Although we own 76.4% of Yuchai s shares, and believe we have proper legal ownership of our investment and a controlling financial interest in Yuchai, in the event there is a dispute with Yuchai s Chinese Shareholders regarding our investment in Yuchai we may have to rely on the Chinese legal system for remedies. The Chinese legal system may not be as effective as compared to other more developed countries such as the United States (see Risks relating to Mainland China The Chinese legal system embodies uncertainties which could limit the legal protections available to foreign investors). We have in the past experienced problems from time to time in obtaining assistance and cooperation of Yuchai s Chinese Shareholders in the daily management and operation of Yuchai. We have in the past also experienced problems from time to time in obtaining the assistance and cooperation of the State Holding Company in dealing with other various matters, including the implementation of corporate governance procedures, the payment of dividends, the holding of Yuchai board meetings and the resolution of employee-related matters. Examples of these problems are described elsewhere in this Annual Report. The July 2003 Agreement and the Reorganization Agreement are intended to resolve certain issues relating to our share ownership in Yuchai and the continued corporate governance and other difficulties which we have had with respect to Yuchai. As part of the terms of the Reorganization Agreement, Yuchai agreed that it would seek the requisite shareholder approval prior to entering into any material transactions (including any agreements or arrangements with parties related to Yuchai or any of its shareholders) and that it would comply with its governance requirements. Yuchai also acknowledged and affirmed CYI s continued rights as majority shareholder to direct the management and policies of Yuchai through Yuchai s board of directors. However, no assurance can be given that disagreements and difficulties with Yuchai s management and/or Yuchai s Chinese Shareholders will not recur, including implementation of the Reorganization Agreement, corporate governance matters or related party transactions (such as, for example, the Rmb 205.0 million loan from Yuchai to Yuchai Marketing and Logistics Company, see Note 5 to our company s Consolidated Financial Statements appearing elsewhere herein). Such disagreements and difficulties could ultimately have a material adverse impact on the company s consolidated financial position, results of operations and cash flows.

Our exposure to the Dongfeng Group has had, and could continue to have, a material adverse effect on our business, financial condition and results of operation.

Our sales are concentrated among the Dongfeng Group, which includes the Dongfeng Automobile Company, one of the largest state-owned automobile companies in China, and other major diesel truck manufacturers controlled by or affiliated with the Dongfeng Automobile Company. In 2005, the Dongfeng Group accounted for 19.8% of our gross sales, out of which sales to our two largest customers, Liuzhou Dongfeng Automobile and Hubei Dongfeng Automobile, accounted for 12.3%. Although we consider our relationships with the Dongfeng Group to be good, the loss of one or more of the companies within the Dongfeng Group as a customer would have a material adverse effect on our financial condition, results of operations, business or prospects.

In addition, we are dependent on the purchases made by the Dongfeng Group and have exposure to their liquidity arising from the high level of accounts receivable from them. We cannot assure you that the Dongfeng Group will be able to repay all the money they owe to us. In addition, the Dongfeng Group may not be able to continue purchasing the same volume of products from our company, which would reduce our overall sales volume.

The Dongfeng Group also competes with us in the diesel engine market in China. Although we believe that the companies within the Dongfeng Group generally make independent purchasing decisions based on end-user preferences, we cannot assure you that truck manufacturers affiliated with the Dongfeng Automobile Company will not preferentially purchase diesel engines manufactured by companies within the Dongfeng Group over those manufactured by us.

Competition in China from other diesel engine manufacturers may adversely affect our financial condition, results of operations, business or prospects.

The diesel engine industry in China is highly competitive. We compete with many other domestic companies, most of which are state-owned enterprises. Some of our competitors have formed joint ventures with or have technology assistance relationships with foreign diesel engine manufacturers or foreign engine design consulting firms and use foreign technology that is more advanced than ours. We expect competition to intensify as a result of:

- improvements in competitors products;

increased production capacity of competitors;

increased utilization of unused capacity by competitors; and

price competition.

In addition, if import restrictions on motor vehicles and motor vehicle parts are reduced, foreign competition could increase significantly. See Risks relating to Mainland China The admission of China into the WTO could lead to increased foreign competition .

In the medium-duty diesel engine market, our 6108 medium-duty engine, introduced in 1997, has been competing with the 6110 medium-duty engine offered by our competitors. We cannot assure you, however, that we will be able to maintain or improve our current market share or develop new markets for our medium-duty diesel engines. Based on current industry trends, there is a perceived shift in the market demand from medium-duty engines to heavy-duty diesel engines. Therefore, we would expect declining sales volume of our 6108 medium-duty engines in the coming years. In 2005, we experienced lower unit sales volume of 6108 medium-duty engines due principally to the effects of the general credit tightening by banks in China.

In the heavy-duty diesel engine market, we introduced the 6112 heavy-duty engine in late 1999. Due to a delay in the commercial production of the 6112 engine; however, we were not able to benefit from the competitive advantages of an early entry into the domestic market for heavy-duty engines. Moreover, the market for heavy-duty diesel engines in China is price-sensitive. We commenced engine development of the 6L heavy-duty engine (formerly referred to as 6113) in 2003, with a rated power ranging from 280 to 350 horsepower, and we also introduced the 6M heavy-duty engine family for heavy-duty trucks and passenger buses, with a rated power ranging from 280 to 390 horsepower, in 2004. We had limited initial sales of 963 and 818 units of the 6L and 6M engines, respectively, in 2004. We sold 782 units of the 6L engines and 3,471 units of the 6M engines in 2005. We cannot assure you that our 6112, 6L or 6M heavy-duty engines will be able to compete successfully in the heavy-duty diesel engine market in China with the existing producers or any new entrants.

In the light-duty diesel engine market, our 4108, 4110 and 4112 light-duty engines introduced in 2000 were met with weak consumer demand due to strong competition and a high pricing structure. The 4F diesel engine is a four-cylinder, four-stroke engines with a rated power ranging from 90 to 115 horsepower. Yuchai s first sales of the 4F engines occurred in March 2005 and sold 4,510 units in 2005. Yuchai expects growth of this new engine to strengthen over the few years and become a significant contributor to sales growth for Yuchai. Yuchai produced 7,009 units of the 4F engines in 2005 and embarked upon major capital expenditures to increase the production capacity to 50,000 units per year by 2007. The expansion is expected to enable Yuchai to enter into light duty diesel engines market for light duty trucks and buses. Although there had been an increase in sales of our 4-Series engines in 2003, 2004 and 2005, this has been primarily due to the average selling price of the 4-Series engines being lower than the medium and heavy-duty diesel engines, thereby making the 4-Series more affordable to the buyers especially due to the credit tightening by banks in China. Accordingly, we cannot assure you that we will be able to continue to improve our market share for light-duty diesel engines, and we may, in the future, decide to cease production of one or more of the models we are currently producing.

Our long-term business prospects will depend largely upon our ability to develop and introduce new or improved products at competitive prices. Our competitors in the diesel engine markets may be able to introduce new or improved engine models that are more favorably received by customers. Competition in the end-use markets, mainly the truck market, may also lead to technological improvement and advances that render our current products obsolete at an earlier than expected date, in which case we may have to depreciate or impair our production equipment more rapidly than planned. Failure to introduce, or delays in the introduction of, new or improved products at competitive prices could have a material adverse effect on our financial condition, results of operations, business or prospects.

Our financial condition, results of operations, business or prospects may be adversely affected to the extent we are unable to continue our sales growth or adequately manage our growth.

We have achieved consistent growth in net sales during the last four fiscal years, with net sales increasing by 22.0% to Rmb 5,582.1 million in 2004 and by 4.4% to Rmb 5,829.4 million in 2005. We cannot assure you that we can continue to increase our net sales or maintain our present level of net sales. For example, during 2005, we have increased production capacity to approximately 290,000 units after the completion of our second foundry and the new 6L and 6M heavy-duty engines lines, and we may not be able to increase our net sales commensurate with our increased levels of production capacity. Moreover, our future growth is dependent in large part on factors beyond our control, such as continued economic growth in China.

In addition, we cannot assure you that we will be able to properly manage any future growth, including:

obtaining the necessary supplies;

hiring and training skilled production workers and management personnel;

manufacturing and delivering products for increased orders in a timely manner;

maintaining quality standards and prices; and

controlling production costs.

Furthermore, we have acquired in the past, and may acquire in the future, equity interests in engine parts suppliers and logistics and marketing companies. If we are unable to effectively manage or assimilate these acquisitions, our financial condition, results of operations, business or prospects could be adversely affected. See Item 4. Information on the Company Business Overview Manufacturing .

The diesel engine business in China is dependent in large part on the performance of the Chinese economy, as well as Chinese government policy. As a result, our financial condition, results of operations, business and prospects could be adversely affected by slowdowns in the Chinese economy, as well as Chinese government policies that de-emphasize the use of diesel engines.

During periods of economic expansion, the demand for trucks, construction machinery and other applications of diesel engines generally increases. Conversely, during economic slowdowns the diesel engine industry is generally adversely affected by a decline in demand. As a result, the performance of the Chinese economy will likely affect, to a significant degree, our financial condition, results of operations, business and prospects. For example, the various austerity measures taken by the Chinese government from time to time to regulate economic growth and control inflation have in prior periods significantly weakened demand for trucks in China, and may have a similar effect in the future. In particular, austerity measures that restrict access to credit and slow the rate of fixed investment (including infrastructure development) adversely affect demand for, and production of, trucks and other commercial vehicles. These adverse market conditions, together with increased competition in the diesel engine market, result in various degrees of financial and marketing difficulties for diesel engine producers, including our company.

The business and prospects for the diesel engine industry, and thus the business and prospects of our company, may also be adversely affected by Chinese government policy. For example, in 1998, the Chinese government announced a major initiative to boost consumer demand through investments in infrastructure projects and increased availability of bank credit. As a result, demand for trucks and other commercial vehicles, and thus demand for diesel engines, continued to increase from 2002 to 2004. In 2005, truck and the commercial vehicles declined by approximately 1.0%. However, we cannot assure you that the Chinese government will not change its policy in the future to de-emphasize the use of diesel engines, and any such change will adversely affect our financial condition, results of operations, business or prospects. For example, the Chinese government has recently announced measures to avoid overheating in certain sectors of the economy, which may include tight bank lending policies and increases in bank interest rates (see Risks relating to Mainland China Adverse changes in the economic policies of the Chinese government could have a material adverse effect on the overall economic growth of Mainland China, which could reduce the demand for our products and adversely affect our competitive position).

If we are not able to continuously improve our existing engine products and develop new diesel engine products, we may become less competitive, and our financial condition, results of operations, business and prospects will be adversely affected.

As the Chinese automotive industry continues to develop, we will have to continuously improve our existing engine products and develop new diesel engine products in order to remain competitive. As a result, our long-term business prospects will largely depend upon our ability to develop and introduce new or improved products at competitive prices. Future products may utilize different technologies and may require knowledge of markets that we do not currently possess. Moreover, our competitors may be able to introduce new or improved engine models that are more favorably received by customers than our products. Any failure by our company to introduce, or any delays in the introduction of, new or improved products at competitive prices could have a material adverse effect on our financial condition, results of operations, business or prospects.

We may be unable to obtain sufficient financing to fund our capital requirements, which could limit our growth potential.

We believe that our cash from operations, together with any necessary borrowings, will provide sufficient financial resources to meet our projected capital and other expenditure requirements. If we have underestimated our capital requirements or overestimated our future cash flows, additional financing may be required. Financing may not be available to us on acceptable terms or at all. Our ability to obtain external financing is subject to various uncertainties, including our results of operations, financial condition and cash flow, economic, political and other conditions in Mainland China, the Chinese government s policies relating to foreign currency borrowings and the condition of the Chinese and international capital markets. If adequate capital is not available, our financial condition, results of operations, business and prospects could be adversely affected.

Our controlling shareholder s interests may differ from those of our other shareholders.

Our parent company is Hong Leong Asia Ltd., or HLA, which indirectly owns 7,913,769, or 21.2%, of the outstanding shares of our common stock, as well as a special share that entitles it to elect a majority of our directors. HLA controls us through its wholly-owned subsidiary, Hong Leong (China) Limited, or HLC, and through HL Technology Systems Pte Ltd, or HLT, a wholly-owned subsidiary of HLC. HLT owns approximately 21.0% of the outstanding shares of our common stock and is the registered holder of our special share since December 1994. HLA also owns through another wholly-owned subsidiary, Well Summit Investments Limited, approximately 0.2% of the outstanding shares of our common stock since May 2005. HLA is a member of the Hong Leong group of companies. Prior to August 2002, we were controlled by Diesel Machinery (BVI) Limited, or DML, which, until its dissolution, was a holding company controlled by HLC and was the prior owner of our special share. Through HLT s stock ownership and various agreements among shareholders, HLA is able to effect most corporate transactions without the concurrence of any of our other shareholders. See Item 7. Major Shareholders and Related Party Transactions Related Party Transactions Shareholders Agreement . In addition, our shareholders do not have cumulative voting rights. We cannot assure you that HLA s actions will be in the best interests of our other shareholders. See also Item 6. Directors, Senior Management and Employees Compensation Yuchai .

We may experience a change of control as a result of offerings of shares by our controlling shareholders.

As described above, HLT, a subsidiary of HLA, owns 7,831,169 shares of our common stock, as well as our special share. In March 2004, HLT and Coomber, each registered shares for offer and sale from time to time on a shelf registration statement which we filed on their behalf pursuant to a registration rights agreement. If HLT reduces its shareholding to less than 7,290,000 shares of our common stock as a result of such offering, our Bye-Laws provide that the special share held by HLT will cease to carry any rights, and HLA may as a result cease to have control over us. See Item 7. Major Shareholders and Related Party Transactions Major Shareholders The Special Share . We believe that our only other significant shareholder is Coomber. If HLT sells all of the shares being registered for sale by HLT in such offering, HLT will cease to own any of our shares. As a result, we cannot determine what control arrangements will arise as a result of such offering (including changes in our management arising therefrom), or assess what effect those control arrangements may have, if any, on our financial condition, results of operations, business, prospects or share price.

We could be exposed to the impact of interest rates and foreign currency movements with respect to our future borrowings. In addition, a devaluation of the Renminbi will increase the Renminbi cost of repaying our foreign currency denominated indebtedness and, therefore, could adversely affect our financial condition, results of operations, business or prospects.

We may use borrowings from time to time to supplement our working capital requirements and to finance our business expansion and diversification plans (See also Item 5. Operating and Financial Review and Prospects Liquidity and Capital Resources). A portion of our borrowings may be structured on a floating rate basis and denominated in U.S. dollars or other foreign currencies. An increase in interest rates, or fluctuations in exchange rates between the Renminbi and other currencies, may increase our borrowing costs or the availability of funding and could affect our financial condition, results of operations, business or prospects. In particular, our financial condition, results of operations, business or prospects could be adversely affected by a devaluation of the Renminbi.

The value of the Renminbi is subject to changes in Chinese government policies and to international economic and political developments. Since 1994, the conversion of Renminbi into foreign currencies, including U.S. dollars, has been based on rates set by the People s Bank of China. The official exchange rate for the conversion of Renminbi into U.S. dollar has generally been stable during the past ten years. On July 21, 2005, China reformed its foreign exchange regime by moving into a managed floating exchange rate system based on market supply and demand with reference to a basket of currencies. Renminbi would no longer be pegged to the U.S. dollar. From that day to December 31, 2005, Renminbi appreciated about 2.5% against the U.S. dollar, and has appreciated slightly further since then. Substantially all of our operating revenue is denominated in Renminbi, while a major portion of our capital expenditures is denominated in U.S. dollars and Euros. An appreciation of Renmimbi against the U.S. dollar and other currencies would also result in foreign currency translation losses for financial reporting purposes when we translate our U.S. dollar or other foreign currency denominated financial assets into Renmimbi, as Renmimbi is our reporting currency. Since we may not be able to hedge effectively against Renminbi devaluations, future movements in the exchange rate of Renminbi and other currencies could have an adverse effect on our financial condition and results of operations.

We may be adversely affected by environmental regulations.

We are subject to Chinese national and local environmental protection regulations which currently impose fees for the discharge of waste substances, require the payment of fines for pollution, and provide for the closure by the Chinese government of any facility that fails to comply with orders requiring us to cease or improve upon certain activities causing environmental damage. Due to the nature of our business, we produce certain amounts of waste water, gas, and solid waste materials during the course of our production. We believe our environmental protection facilities and systems are adequate for us to comply with the existing national, provincial, and local environmental protection regulations. However, Chinese national, provincial, or local authorities may impose additional or more stringent regulations which would require additional expenditure on environmental matters or changes in our processes or systems.

Our insurance coverage may not be adequate to cover risks related to our production and other operations.

The amount of our insurance coverage for our buildings and equipment is at cost which could be less than replacement value, and we have no plans to increase the coverage. The amount of our insurance coverage for our inventory is at book value which could be less than replacement value, and we also have no plans to increase this coverage. In accordance with what we believe is customary practice among industrial equipment manufacturers in China, we insure only high risk assets, such as production property and equipment and certain inventory. However, our underinsurance of other properties, facilities and inventory in accordance with this Chinese practice exposes us to substantial risks so that in the event of a major accident, our insurance recovery may be inadequate. We do not currently carry third party liability insurance to cover claims in respect of bodily injury, property or environmental damage arising from accidents on our property or relating to our operations. We also do not carry business interruption insurance as such coverage is not customary in China. Losses incurred or payments required to be made by us which are not fully insured could have a material adverse effect on our financial condition.

The market price for our common stock may be volatile.

In recent periods, there has been volatility in the market price for our common stock. The market price could fluctuate substantially in the future in response to a number of factors, including:

- our interim operating results;
- the public s reaction to our press releases and announcements and our filings with the Securities and Exchange Commission, or SEC;
- changes in financial estimates or recommendations by stock market analysts regarding us, our competitors or other companies that investors may deem comparable;
- operating and stock price performance of our competitors or other companies that investors may deem comparable;
- changes in general economic conditions;
- future sales of our common stock in the public market, or the perception that such sales could occur;
- the announcement by us or our competitors of a significant acquisition; and
- increases in labor and other costs.

Recent market activity of our stock price on the New York Stock Exchange, or NYSE, has been unpredictable. See Item 9. The Offer and Listing below. We cannot assure you that such volatility in the trading price and volume for our shares will stabilize in the future. In addition, in recent years, the stock market in general has experienced extreme price and volume fluctuations. This volatility has had a significant effect on the market prices of securities issued by many companies for reasons unrelated to their operating performance. These broad market fluctuations may materially adversely affect our stock price.

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Risks relating to Mainland China

Substantially all of our assets are located in Mainland China, and substantially all of our revenue is derived from our operations in Mainland China. Accordingly, our financial condition, results of operations, business or prospects are subject, to a significant degree, to economic, political and legal developments in Mainland China. The economic system of Mainland China differs from the economies of most developed countries in many respects, including government investment, the level of development, control of capital investment, control of foreign exchange and allocation of resources.

Adverse changes in the economic

Outstanding at end of period

1,313	$2.65	3.22		1,313	$2.65	3.22	

Exercisable at end of period

1,313	$2.65	3.22	$152	1,313	$2.65	3.22	$152

The range of exercise prices for options outstanding at April 30, 2007 was $2.00 to $3.56.

2000 Stock Option Plan

The Company s 2000 Stock Option Plan (2000 Plan) has 1,450,000 shares of common stock authorized for issuance. Options granted under the 2000 Plan may be either: (a) options intended to qualify as incentive stock options under Section 422 of the Code, or (b) nonqualified stock options.

Any incentive stock option that is granted under the 2000 Plan may not be granted at a price less than the fair market value of the stock on the date of the grant (or less than 110% of the fair market value in the case of a participant who is a 10% shareholder of the Company within the meaning of Section 422 of the Code). Nonqualified stock options may be granted at the exercise price established by the Compensation Committee.

Each incentive stock option granted under the 2000 Plan is exercisable for a period of not more than ten years from the date of grant (five years in the case of a participant who is 10% shareholder of the Company). Nonqualified stock options do not have this restriction.

Eligible participants include current and prospective employees, nonemployee directors, consultants or other persons who provide services to the Company and whose performance, in the judgment of the Compensation Committee or management of the Company, can have a significant effect on the success of the Company.

Changes in option shares under the 2000 Plan during the:

	Three months ended April 30, 2007				Nine months ended April 30, 2007			
	Options	Wt-Avg Exercise Price	Wt-Avg Remaining Contractual Period	Aggregate Intrinsic Value	Options	Wt-Avg Exercise Price	Wt-Avg Remaining Contractual Period	Aggregate Intrinsic Value
Outstanding at beginning of period	1,082,850	$1.43	7.10	$688,028	1,054,350	$1.35	7.27	$814,975
Granted	750	$1.53			111,000	$2.02		
Exercised	(13,750)	$0.75			(34,126)	$0.48		
Forfeited	(25,374)	$1.38			(86,748)	$1.43		
Outstanding at end of period	1,044,476	$1.44	6.85	$654,011	1,044,476	$1.44	6.85	$654,011
Exercisable at end of period	802,080	$1.34	6.32	$588,159	802,080	$1.34	6.32	$588,159

Changes in non-vested option shares under the 2000 Plan during the:

	Three months ended April 30, 2007		Nine months ended April 30, 2007	
	Options	Wt-Avg Grant Date Fair Value	Options	Wt-Avg Grant Date Fair Value
Non-vested at beginning of period	265,238	$ 1.74	188,799	$ 1.59
Granted	750	$ 1.96	111,000	$ 2.02
Vested				
Forfeited	(23,592)	$ 1.27	(57,403)	$ 1.60
Non-vested at end of period	242,396	$ 1.79	242,396	$ 1.79

The range of exercise prices for options outstanding at April 30, 2007 was $0.15 to $2.74.

4. ACQUISITIONS

On January 26, 2007, the Company purchased all of the outstanding stock of OC-NET, Inc. (OC-NET). OC-NET, a privately held corporation in Cypress, CA, provided website development and hosting services to the Power Sports market (which includes motorcycles, All Terrain Vehicles, snowmobiles and personal watercraft), as well as certain customers outside the Power Sports market. Consideration for the acquisition included approximately $1.1 million in cash, 350,000 shares of the Company s common stock, $700,000 in debt to the sellers and future contingent payments totaling up to $400,000.

The purchase price of this acquisition has been allocated to specific assets and liabilities acquired based on the fair value of those identified tangible and intangible assets and liabilities as determined by an independent valuation. These include capitalized software to be amortized over 4 years and intangibles related to customer relationships and assembled and trained workforce to be amortized over 5 years as well as goodwill. In addition, the final purchase price will be determined upon the settlement of the contingencies outlined in the Stock Purchase Agreement. As noted above, a total of $400,000 of the total purchase price is subject to contingencies. Of this amount, the Company has included $150,000 of the contingent payments in the preliminary purchase price based on the likelihood of the contingencies being met. The remaining $250,000 of contingent payments have not been included in the preliminary purchase price, as they relate to meeting sales targets to a specified customer over the twelve month period following the date of acquisition. The Company will continually evaluate the likelihood of realization on this portion of the contingent payments and make the necessary adjustments to the purchase price and the ultimate allocation to the identified intangible assets.

In connection with the Acquisition, the Company entered into an employment agreement with Robert Hipp (the Employment Agreement) to serve as a Marketing/Business Development Manager for the Company. The term of the Employment Agreement is two years.

The foregoing description of the Purchase Agreement and the transactions contemplated thereby is qualified in its entirety by reference to the Purchase Agreement, attached as Exhibit 2.1 of Form 8-K, dated January 29, 2007 and Form 8-K/A dated April 13, 2007, and incorporated herein by reference. The acquisition was accounted for under the purchase method; accordingly, its results are included in the financial statements of the Company from the date of acquisition.

The following unaudited pro forma results of operations for the nine months ended April 30, 2007 assume the acquisition of the
OC-Net business occurred at the beginning of that period:

Pro Forma Results
(in thousands, except per share data)

	Three months ended April 30, 2007		Nine months ended April 30, 2007	
	2007	2006	2007	2006
Revenues	$ 4,101	$ 3,889	$ 11,954	$ 11,431
Net income (loss)	$ (205)	$ 1,486	$ 20	$ 2,347
Net income (loss) per basic share	$ (.03)	$ .23	$ 0.00	$ .36
Net income (loss) per diluted share	$ (.03)	$ .21	$ 0.00	$ .33

This pro forma information does not purport to be indicative of the results that actually would have been obtained if the combined operations had been conducted during the periods presented and is not intended to be a projection of future results.

5. NOTES PAYABLE

On April 24, 2003, the Company restructured its debt. In exchange for previously outstanding securities, the Company issued to a group of investors (collectively, the New Holders), in aggregate, $500,000 in cash, new unsecured notes in the amount of $3.9 million (the New Notes) and new warrants for 250,000 common shares, exercisable at $1.00 per share (the New Warrants). The interest rate on the New Notes is prime plus 2%, adjusted quarterly (effective rate of 10.25% as of April 30, 2007). The New Notes 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 New 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 New Holders, has the right to appoint one designee to the Company s Board of Directors. The New 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 New Notes and the New Warrants was accounted for as a troubled debt restructuring and no gain was recorded. Instead the liability in excess of the future cash flows to the New Holders, which was originally approximately $322,000, remains on the balance sheet as a long term debt and is being amortized as a reduction of interest expense over the life of the New 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 in $50,000 quarterly installments through September 30, 2007 at the prime interest rate plus 2%, adjusted quarterly (effective rate of 10.25% as of April 30, 2007). The note does not contain any financial covenants.

The Company issued $700,000 of notes in connection with the OC-Net acquisition. The interest rate on the notes is prime plus 2%, adjusted quarterly (effective rate of 10.25% as of April 30, 2007) and is payable in quarterly principal installments of $58,333 commencing March 31, 2007 through April 30, 2010. The notes do not contain any financial covenants.

6. 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 (a 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 the Company 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 the Company 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.

7. INCOME TAXES

The provision for income taxes is composed of the following (in thousands):

	Three months ended April 30		Nine months ended April 30	
	2007	2006	2007	2006
Current:				
Federal	$ 140	$ 145	$ 323	$ 493
State	32	46	83	108
Deferred		(1,000)		(1,000)
Utilization of net operating loss carryforwards	(163)	(199)	(389)	(609)
Income tax (benefit) provision	$ 9	$ (1,008)	$ 17	$ (1,008)

Provision for income taxes is based on taxes payable under currently enacted tax laws and an analysis of temporary differences between the book and tax bases of our assets and liabilities, including various accruals, allowances, depreciation and amortization. The tax effect of these temporary differences and the estimated tax benefit from tax net operating losses are reported as deferred tax assets and liabilities in the balance sheet. An assessment of the likelihood that net deferred tax assets will be realized from future taxable income is performed on a quarterly basis. To the extent that management believes it is more likely than not that some portion, or all, of the deferred tax asset will not be realized, a valuation allowance is established. Because the ultimate realizability of deferred tax assets is highly subject to the outcome of future events, the amount established as a valuation allowance is a significant estimate that is subject to change in the near future. The change in the valuation allowance during a period is reflected with a corresponding increase or decrease in the tax provision in the statement of operations. Because of the uncertainty of long-term future economic conditions, the estimated future utilization of deferred net tax assets is based on twelve quarters of projections. The Company made no change in its estimated valuation allowance this quarter.

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

Results of Operations

Total revenue increased $548,000 or 15% for the three month period ended April 30, 2007 and $729,000 or 7% for the nine month period ended April 30, 2007, compared to the same periods last year, primarily due to an increase in revenues from the Company s newly acquired marketing services product and to organic growth in the previously existing marketing services business. Operating income decreased $628,000 or 138% for the three month period ended April 30, 2007 and $1,211,000 or 79% for the nine month period ended April 30, 2007, compared to the same periods last year, primarily due to increased expenses associated with the acquisition, developing and marketing of new products and lower gross margins generated by some of those products. Earnings decreased from net income of $1,465,000 or $0.24 per basic share for the three months ended April 30, 2006 to net loss of $205,000 or $0.03 per basic share for the three months ended April 30, 2007 and decreased from $2,487,000 or $0.40 per basic share for the nine months ended April 30, 2006 to $268,000 or $0.04 per basic share for the nine months ended April 30, 2007. Management expects revenue growth to continue over the prior year in the fourth quarter of the year, primarily due to revenues generated by the newly acquired OC-Net business and the Company s marketing services, at least partially offset by increased operating expenses over the prior year.

During fiscal year 2007, the Company plans to continue to focus on the same four growth initiatives as last year: (1) maintaining and enhancing the current catalog business; (2) growing the marketing services business; (3) changing to a dealer-direct business model in Europe; and (4) making selected synergistic acquisitions.

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, among others, 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.

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 (including transaction fees) and for information services is recognized in the period such services are utilized. Revenue from annual or periodic maintenance fees, hosting fees, license and license renewal fees and catalog subscription fees is recognized ratably over the period the service is provided. Revenue under arrangements that include acceptance terms beyond the Company s standard terms is 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 under 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. Amounts invoiced to customers prior to recognition as revenue as discussed above are reflected in the accompanying balance sheets as deferred revenue.

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 about accrued expenses that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Legal Provisions

The Company is periodically involved in legal proceedings arising from contracts, patents or other matters in the normal course of business. The Company reserves for any material estimated losses if the outcome is reasonably certain, in accordance with the provisions of SFAS No. 5 Accounting for Contingencies .

Impairment of Long-Lived Assets

Equipment and leasehold improvements, capitalized software product costs, goodwill, customer lists, and other identifiable intangible assets 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.

Cash and Cash Equivalents

The Company s investment policy, as approved by the Board of Directors, is designed to provide preservation of capital, adequate liquidity to meet projected cash requirements, optimum yields in relationship to risk, market conditions and tax considerations and minimum risk of principal loss through diversified short and medium term investments. Eligible investments included direct obligations of the U.S. Treasury, obligations issued or guaranteed by the U.S. government, certain time deposits, certificates of deposits issued by commercial banks, money market mutual funds, asset backed securities and municipal bonds. The Company s current investments include money market funds.

Debt Instruments

The Company valued debt discounts for Common Stock Warrants 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.

Deferred Tax Asset

The tax effect of the temporary differences between the book and tax bases of assets and liabilities and the estimated tax benefit from tax net operating losses are reported as deferred tax assets and liabilities in the balance sheet. An assessment of the likelihood

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that net deferred tax assets will be realized from future taxable income is performed. Because the ultimate realizability of deferred tax assets is highly subject to the outcome of future events, the amount established as valuation allowances is considered to be a significant estimate that is subject to change in the near term. To the extent a valuation allowance is established or there is a change in the allowance during a period, the change is reflected with a corresponding increase or decrease in the tax provision in the statement of operations.

Stock-Based Compensation

Effective August 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standard No. 123R, Share-Based Payment, (SFAS 123R) for its stock option and stock purchase plans. The Company previously accounted for these plans under the recognition and measurement principles of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, (APB 25) and related interpretations and disclosure requirements established by Statement of Financial Accounting Standard No. 123, Accounting for Stock-Based Compensation, (SFAS 123), as amended by Statement of Financial Accounting Standard No. 148, Accounting for Stock-Based Compensation Transition and Disclosure.

Revenues

The Company is a leading provider of technology-enabled services (including electronic parts catalogs and marketing services) that help to increase sales and profits for dealers, distributors and manufacturers in the manufactured equipment market. The Company currently provides 99 catalogs of manufactured equipment from 70 manufacturers to over 24,000 dealers in approximately 89 countries in about a dozen segments of the worldwide manufactured equipment market including outdoor power, power sports, motorcycles, recreation vehicles, marine, construction, agricultural equipment, auto and truck parts after-market and others, primarily in the U.S., Canada, Europe and Australia. Collectively, dealers and distributors have over 72,000 catalog subscriptions. The Company supplies three types of software and services: (1) robust Web and CD-ROM interactive electronic parts catalogs, (2) marketing services including both custom and template-based website services and technology-enabled direct mail services and (3) communication or transaction services. The Company s primary product lines at present are electronic parts catalogs and marketing services . Management s strategy is to expand the Company s electronic parts catalog and marketing services business with dealers in the existing vertical markets, expand to other similar markets, and execute on the four growth initiative strategies previously mentioned.

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 the Company of the distributors and/or dealers to which the subscription is distributed.

Catalog, Customer and Subscription Information by Region
(As of April 30, 2007)

	Catalogs	Distinct Manufacturers	Subscriptions	Distinct Distributors (Estimated)	Distinct Dealers (Estimated)
North America	89	63	65,912	92	21,055
Rest of World	52	7	6,749	65	3,642
Included in both Regions	(42)				
Total	99	70	72,661	157	24,697

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 dealer and distributor communication services to the U.S. and Canadian agribusiness industry. As the Company focuses on its core businesses in the Equipment industry, revenues in the non-equipment industry are expected to continue to decline as a percentage of total revenues during fiscal 2007.

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

Revenue by Location and Service
(In Thousands)

	Three months ended April 30 2007	Three months ended April 30 2006	Percent Change	Nine months ended April 30 2007	Nine months ended April 30 2006	Percent Change
North American						
Catalog subscriptions	$ 2,503	$ 2,562	-2%	$ 7,711	$ 7,721	0%
Catalog professional services	329	418	-21%	923	1,212	-24%
Marketing service subscriptions	536	147	265%	1,047	322	225%
Marketing professional services	230		100%	230		100%
Dealer & distributor communications	165	216	-24%	512	631	-19%
Subtotal	3,763	3,343	13%	10,423	9,886	5%
Rest of the World						
Catalog subscriptions	257	195	32%	727	579	26%
Catalog professional services	81	15	440%	145	101	44%
Subtotal	338	210	61%	872	680	28%
Total Revenue						
Catalog subscriptions	2,760	2,757	0%	8,438	8,300	2%
Catalog professional services	410	433	-5%	1,068	1,313	-19%
Marketing service subscriptions	536	147	265%	1,047	322	225%
Marketing professional services	230		100%	230		100%
Dealer & distributor communications	165	216	-24%	512	631	-19%
Total	$ 4,101	$ 3,553	15%	$ 11,295	$ 10,566	7%

North America

Catalog Subscriptions

North American catalog subscription revenues are derived from software license fees, license renewal fees, software maintenance and support fees, catalog subscription fees, and other miscellaneous subscription fees charged to dealers, distributors and manufacturers for the use of the Company s catalog products in the United States and Canada. Catalog subscription revenues decreased for the three and nine months ended April 30, 2007, compared to the same periods last year, primarily due to decreased bulk sales to manufacturers of the Company s CD-Rom catalog products. Catalog subscription renewals from the Company s North American customers were over 85% for the nine months ended April 30, 2007.

Catalog Professional Services

Revenues from the Company s North American catalog professional services are derived from software customization labor, data conversion labor, data conversion replication fees, travel and shipping fees primarily charged to manufacturers and distributors in the United States and Canada. Revenues from catalog professional services in North America decreased for the three and nine month periods ended April 30, 2007, compared to the same periods last year, primarily due to lower customization labor charged for the deployment of new web-based manufacturer databases.

Marketing Service Subscriptions

Revenues from the Company s North American marketing service subscriptions are derived from start-up and access fees charged to dealers for Website Smart and Website Smart Pro , commissions on on-line sales through Website Smart Pro and set-up and postage fees for ARI MailSmart in the United States and Canada. Revenues from marketing services in North America increased, for the three and nine month periods ended April 30, 2007, compared to the same periods last year, primarily due to sales of Website Smart , MailSmart and the Company s recently acquired Website Smart Pro . The sales increases are a result of the Company s investments in sales and marketing for the marketing services business. Revenues from Website Smart Pro are included in Marketing services beginning January 27, 2007.

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Marketing Professional Services

Revenues from the Company s North American marketing professional services are derived from website customization labor primarily charged to manufacturers, distributors and other customers in the United States. Revenues from marketing services in North America for the three and nine month periods ended April 30, 2007, resulted from customization of websites related to contracts acquired with OC-Net.

Dealer and Distributor Communications

Revenues from dealer and distributor communications are derived from license renewal fees, software maintenance, customization labor and other communication fees charged for dealers and distributors to communicate with manufacturers in the manufactured equipment industry and the agricultural inputs industry. Dealer and distributor communication revenues decreased for the three and nine month periods ended April 30, 2007, compared to the same periods last year, primarily due to a decline in the base of customers as the Company focused the business primarily on its catalog and marketing services products.

Rest of the World

Catalog Subscriptions

Catalog subscription revenues from the rest of the world are derived from software license fees, license renewal fees, software maintenance and support fees, catalog subscription fees, and other miscellaneous subscription fees charged to dealers, distributors and manufacturers for the use of the Company s catalog products. Catalog subscription revenues for the rest of the world increased for the three and nine month periods ended April 30, 2007, compared to the same periods last year, primarily due to the amortization of revenue from a large Harley Davidson deal closed in the fourth quarter of fiscal 2006 and a large sale to a Korean manufacturer in the first quarter of fiscal 2007. The increase in Rest of World revenues in fiscal 2007 should not be interpreted as an indicator that our challenges in the European market are behind us. The number of new subscriptions purchased directly by dealers has declined, compared to the same period last year.

Catalog Professional Services

Revenues from the Company s rest of the world catalog professional services are derived from software customization labor, data conversion labor, data conversion replication fees, travel and shipping fees primarily charged to manufacturers that do not reside in North America. Revenues from catalog professional services in the rest of the world increased, for the three and nine month periods ended April 30, 2007, compared to the same periods last year, primarily due customization labor charged to the manufacturer located in Korea.

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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 April 30			Nine months ended April 30		
	2007	**2006**	**% Chg**	**2007**	**2006**	**% Chg**
Catalog subscriptions						
Revenue	$2,760	$2,757	0%	$ 8,438	$ 8,300	2%
Cost of revenue	286	289	(1%)	859	827	4%
Cost of revenue as a percent of revenue	10%	10%		10%	10%	
Catalog professional services						
Revenue	410	433	(5%)	1,068	1,313	(19%)
Cost of revenue	210	119	77%	448	338	33%
Cost of revenue as a percent of revenue	51%	27%		42%	26%	
Marketing services subscriptions						
Revenue	536	147	265%	1,047	322	225%
Cost of revenue	244	75	225%	511	155	230%
Cost of revenue as a percent of revenue	45%	51%		49%	48%	
Marketing professional services						
Revenue	230		100%	230		100%
Cost of revenue	75		100%	75		100%
Cost of revenue as a percent of revenue	33%	0%		33%	0%	
Dealer and distributor communications						
Revenue	165	216	(24%)	512	631	(19%)
Cost of revenue	16	31	(49%)	68	99	(31%)
Cost of revenue as a percent of revenue	10%	14%		13%	16%	
Total						
Revenue	$4,101	$3,553	15%	$11,295	$10,566	7%
Cost of revenue	831	514	62%	1,961	1,419	38%
	20%	14%		17%	13%	

Cost of revenue as a
percent of revenue

Cost of revenue for catalog subscriptions consists primarily of reseller fees, software amortization costs, catalog replication and distribution costs. Cost of catalog subscriptions as a percentage of revenue remained relatively stable for the three and nine month periods ended April 30, 2007, compared to the same periods last year. Management expects gross margins, as a percent of revenue from catalog subscriptions, to vary slightly from quarter to quarter due to the timing of data shipments.

Cost of revenue for catalog professional services consists of customization and catalog production labor. Cost of professional services as a percentage of revenue increased for the three and nine month periods ended April 30, 2007, compared to the same periods last year, primarily due to an increase in non-billable professional services and costs for customizations done by a third party for software sold to a Korean customer. Management expects cost of catalog professional services to fluctuate from quarter to quarter depending on the mix of services sold, the nature of manufacturer data conversion contracts, and the Company s performance towards the contracted amount for customization projects.

Cost of revenue for marketing service subscriptions consists primarily of website setup labor, software amortization costs, postcards and distribution costs. Cost of marketing services as a percentage of revenue decreased for the three month period ended April 30, 2007, compared to the same period last year, primarily due to increased sales from the Company s Website products, which have a higher margin than MailSmart . By contrast, cost of marketing services as a percentage of revenue increased for the nine month period ended April 30, 2007, compared to the same period last year, primarily due to an increase in the percentage of sales represented by MailSmart in the first half of the year, which has a lower margin than the other marketing services offered. Management expects gross margins, as a percent of revenue from marketing services, to fluctuate from quarter to quarter depending on the mix of products and services sold.

Cost of revenues for marketing professional services consists of website customization labor. Cost of marketing professional services increased for the three and nine month periods ended April 30, 2007, compared to the same periods last year, due to new

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contracts acquired with OC-Net. Management expects cost of marketing professional services to fluctuate from quarter to quarter depending on the Company s performance towards the contracted amount for customization projects and the actual labor rates negotiated in customer contracts.

Cost of revenue for dealer and distributor communications consists primarily of telecommunication costs, royalties and software customization labor. Cost of dealer and distributor communications as a percentage of revenue decreased for the three and nine month periods ended April 30, 2007, compared to the same periods last year, primarily due to a decrease in telecommunication costs and software customization labor. Management expects gross margins, as a percent of revenue from dealer and distributor communications, to be relatively consistent from quarter to quarter.

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			Nine months ended April 30		
	2007	2006	% Chg	2007	2006	% Chg
Customer operations and support	$ 298	$ 273	9%	$ 842	$ 855	(2%)
Selling, general and administrative	2,491	1,862	34%	6,577	5,561	18%
Software development and technical support	450	344	31%	1,178	924	27%
Depreciation and amortization	203	104	95%	419	278	51%
Net operating expenses	$3,442	$2,583	33%	$9,016	$7,618	18%

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, 2007, compared to the same period last year, primarily due to an increase in temporary help used to provide technical support for the Company s new release of its catalog product and decreased for the nine month period ended April 30, 2007, compared to the same period last year, primarily due to the reduction of temporary help used in the data conversion operations. Management expects customer operations and support costs to decrease slightly, compared to the prior year, for the remainder of fiscal 2007.

Selling, general and administrative expenses (SG&A) increased for the three and nine month periods ended April 30, 2007, compared to the same periods last year, as the Company invested in continued sales and marketing initiatives in the North American market, acquisition integration costs associated with OC-Net, continuing operating costs for the new California location and costs related to the SFAS123R expensing of stock options. SG&A, as a percentage of revenue, increased from 53% for the nine month period ended April 30, 2006 to 58% for the nine month period ended April 30, 2007. Management expects SG&A costs to continue to be higher than the previous year for the remainder of fiscal 2007 as the Company continues its sales and marketing initiatives and to recognize the costs of stock options under SFAS123R.

The Company s technical staff (in-house and contracted) performs software development, technical support, software customization and data conversion services for customer applications. Management expects fluctuations from quarter to quarter, as the mix of development and customization activities will change based on customer requirements even if the total technical staff cost remains relatively constant. Software development and technical support costs increased for the three and nine month periods ended April 30, 2007, compared to the same periods last year, primarily due to continued expenses related to the deployment of the new catalog software released in the first quarter of fiscal 2007 and operating costs associated with the new California location. Management expects software development and technical support costs to continue to be higher than the previous year for the remainder of fiscal 2007 as the Company supports its new catalog and marketing services products.

Depreciation and amortization expense increased for the three and nine month periods ended April 30, 2007, compared to the same periods last year primarily due to the amortization of new software and equipment and the amortization of intangible assets associated with the OC-Net acquisition. Management expects depreciation and other amortization to increase for the remainder of fiscal 2007, compared to the prior year, as the Company continues to invest in software and equipment to operate the business and amortize other intangible assets.

Other Items

Earnings decreased from net income of $1,465,000 and $2,487,000 for the three and nine month periods ended April 30, 2006 to net loss of $205,000 and net income of $268,000 for the three and nine month periods ended April 30, 2007, respectively. The

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Company s decrease in earnings was primarily due to an increase in technical support costs and sales expenses associated with its new products and sales initiatives, acquisition integration costs and a $1 million deferred tax benefit recognized in the third quarter of fiscal 2006.

Management has undertaken a number of actions to enhance gross margins and reduce operating expenses. These actions include selective price increases and initiatives to reduce third party expenses along with consolidating similar functions across the company.

Interest expense includes both cash and non-cash interest. Interest paid was approximately $45,000 and $137,000 for the three and nine month periods ended April 30, 2007, and $83,000 and $190,000 for the three and nine month periods ended April 30, 2006, respectively. In addition, excess debt principal was amortized to offset interest expense by approximately $9,000 and $22,000 for the three and nine month periods ended April 30, 2007 and $13,000 and $29,000 for the three and nine month periods ended April 30, 2006, respectively.

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, six business acquisitions and one software asset acquisition have been completed, five of which were fully integrated into the Company s operations prior to fiscal year 2006.

Most recently, the Company completed the acquisition of OC-Net, as described in Note 4 to the Consolidated 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 cash flow information derived from the Company s unaudited financial statements.

Cash Flow Information
(In thousands)

	Three months ended April 30			**Nine months ended April 30**		
	2007	**2006**	**% Chg**	**2007**	**2006**	**% Chg**
Net income	$ (205)	$ 1,465	(114%)	$ 268	$ 2,487	(89%)
Amortization of software products	213	161	32%	598	458	31%
Amortization of deferred finance costs and debt discount	11	(13)	185%	(22)	(44)	(50%)
Depreciation and other amortization	203	104	95%	419	278	51%
Stock based compensation related to stock options	41		100%	109		100%
Deferred income taxes		(1,038)	100%		(1,038)	100%
Stock issued as contribution to 401(k) plan				42	21	100%
Net change in working capital	506	195	160%	(367)	(405)	9%
Net cash provided by operating activities	769	874	(12%)	1,047	1,757	(40%)
Net cash used in investing activities	(501)	(452)	(11%)	(2,055)	(962)	(114%)
	(439)	(354)	(24%)	(1,108)	(794)	(40%)

Net cash used in financing activities									
Net change in cash	$	(171)	$	68	(351%)	$	(2,116)	$	1	(2,117%)

Net cash provided by operating activities decreased for the three and nine month periods ended April 30, 2007, compared to the same periods last year, primarily due to the decrease in operating 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, 2007, compared to the same periods last year, primarily due to the purchase of OC-Net.

At April 30, 2007, the Company had cash and cash equivalents of approximately $1,468,000 compared to approximately $3,584,000 at July 31, 2006.

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 2007 (Unaudited)	July 31 2006 (Audited)	Net Change
Note payable to WITECH:			
Current portion of note payable	$ 100	$ 200	$ (100)
Long term portion of note payable		50	(50)
Total note payable to WITECH	100	250	(150)
Notes payable to New Holders:			
Current portion of notes payable	800	1,200	(400)
Long term portion of notes payable		500	(500)
Total face value of notes payable to New Holders	800	1,700	(900)
Carrying value in excess of face amount of notes payable	8	42	(34)
Debt discount (common stock warrants and options)	(4)	(12)	8
Total carrying value of notes payable to New Holders	804	1,730	(926)
Debt related to acquisition of OC-Net, Inc.:			
Current portion of note payable	234		233
Long term portion of note payable	408		409
Long term cash holdback	150		150
	792		792
Total debt	$ 1,696	$ 1,980	$ (284)

On April 24, 2003, the Company restructured its debt. In exchange for previously outstanding debt and securities, the Company issued to the New Holders, in aggregate, $500,000 in cash, New Notes in the amount of $3.9 million and New Warrants for 250,000 common shares, exercisable at $1.00 per share. The interest rate on the New Notes is prime plus 2%, adjusted quarterly (effective rate of 10.25% as of April 30, 2007). The New Notes 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 New 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 New Holders, has the right to appoint one designee to the Company s Board of Directors. The New 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%, adjusted quarterly (effective rate of 10.25% as of April 30, 2007). The note does not contain any financial covenants.

On January 26, 2007, the Company purchased all of the outstanding stock of OC-Net. Consideration for the acquisition included $700,000 in debt to the sellers and future contingent payments totaling up to $400,000. The notes to the sellers are payable quarterly and bear interest at prime plus 2%, adjusted quarterly (effective rate of 10.25% as of April 30, 2007). The notes do 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 receivable plus 45% of the value of all eligible open renewal orders (provided the renewal rate is at least 85%) minus $75,000, up to $1,000,000, 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, 2008, 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. As of April 30, 2007, there were no borrowings 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 material acquisition or to make a large investment in its business.

Off-Balance Sheet Arrangements

As reported in Footnote 4 - Acquisitions, there is an unrecorded contingent payment of $250,000 related to meeting sales targets to a specified customer over the twelve month period following the date of the OC-Net acquisition.

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, 2006, 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.

ITEM 3. CONTROLS AND PROCEDURES

The Company 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. The Company 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, the Company s Chief Executive Officer and its Chief Financial Officer concluded that the Company s disclosure controls and procedures are effective as of April 30, 2007.

There have been no changes in the Company s internal control over financial reporting identified in connection with the evaluation discussed above that occurred during the quarter ended April 30, 2007 that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

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PART II OTHER INFORMATION

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

During the quarter ended April 30, 2007 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

10.1 Amendment to Credit Agreement dated May 10, 2007, between the Company and JPMorgan Chase Bank, NA, successor by merger to Bank One, NA.

10.2 Note Modification Agreement dated May 10, 2007, between the Company and JPMorgan Chase Bank, NA, successsor by merger to Bank One, NA.

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.

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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 19, 2007

/s/ Brian E. Dearing

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

/s/ Timothy Sherlock

Timothy Sherlock, Chief Financial Officer