ARI NETWORK SERVICES INC /WI
Form 10QSB
June 14, 2005

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-QSB

(Mark One)

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

For the quarterly period ended April 30, 2005

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

For the transition period from _________________ to __________________

Commission file number 000-19608

ARI Network Services, Inc.

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

WISCONSIN	39-1388360
State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

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

Issuer s telephone number (414) 973-4300

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

YES **ü** NO

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

Transitional Small Business Disclosure Format (check one).

YES NO **ü**

ARI Network Services, Inc.

FORM 10-QSB

FOR THE THREE MONTHS ENDED APRIL 30, 2005

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ITEM 1. FINANCIAL STATEMENTS

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

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

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

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

See notes to unaudited condensed financial statements.

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

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

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

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

See notes to unaudited condensed financial statements.

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

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

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

Noncash investing and financing activities		
Issuance of common stock in connection with deferred executive compensation	$	$ 130
Issuance of common stock in connection with acquisitions		37
Exchange of equity to debt		1,000

See notes to unaudited condensed financial statements.

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

1. **BASIS OF PRESENTATION**

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

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

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

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

3. STOCK-BASED COMPENSATION

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

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

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

4. NOTES PAYABLE

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

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

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

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

5. SHAREHOLDER RIGHTS PLAN

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

6. CLAIM FOR INDEMNIFICATION

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

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

Results of Operations

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

Critical Accounting Policies and Estimates

General

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

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

Revenue Recognition

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

Bad Debts

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

Use of Estimates

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

Impairment of Long-Lived Assets

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

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Debt Instruments

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

Stock-Based Compensation

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

Revenues

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

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

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

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

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

		catalog.
Distinct Manufacturer	=	A single independent manufacturer, not owned by another manufacturer, served by ARI. Distinct manufacturers are included in the region they most serve even if they have catalogs in both regions.
Subscription	=	A single catalog subscribed to by a single dealer or distributor. A dealer or distributor may subscribe to more than one catalog.
Distinct Distributor	=	A single independent distributor, not owned by another distributor, served by ARI. A distributor generally buys from manufacturers and sells to dealers.
Distinct Dealer	=	A single independent servicing dealer, not owned by another dealer, served by ARI.

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

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

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

Revenue by Industry Sector
(In thousands)

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