

ARI NETWORK SERVICES INC /WI

Form 10QSB

June 19, 2007

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

(Mark One)

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

**For the quarterly period ended April 30, 2007**

**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 offices)

Issuer's telephone number (414) 973-4300

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

YES  NO

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

YES  NO

As of June 10, 2007 there were 6,620,605 shares of the registrant's common stock outstanding.

Transitional Small Business Disclosure Format (check one).

YES  NO

**ARI Network Services, Inc.**  
FORM 10-QSB  
FOR THE NINE MONTHS ENDED APRIL 30, 2007  
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**ARI Network Services, Inc.**  
**Consolidated Balance Sheets**  
*(In thousands, except share and per share data)*  
*(Unaudited)*

|  | <b>April 30<br/>2007</b> | <b>July 31<br/>2006</b> |
|--|--------------------------|-------------------------|
| <b>ASSETS</b>  |                          |                         |
| Current assets:  |                          |                         |
| Cash and cash equivalents  | \$ 1,468                 | \$ 3,584                |
| Trade receivables, less allowance for doubtful accounts of \$120 and \$103 at April 30, 2007 and July 31, 2006, respectively | 1,137                    | 885                     |
| Work in Process  | 206                      | 163                     |
| Prepaid expenses and other   | 491                      | 254                     |
| Deferred income taxes  | 675                      | 675                     |
| <b>Total Current Assets</b>  | <b>3,977</b>             | <b>5,561</b>            |
| Equipment and leasehold improvements:  |                          |                         |
| Computer equipment   | 5,221                    | 5,084                   |
| Leasehold improvements   | 128                      | 116                     |
| Furniture and equipment  | 2,495                    | 2,057                   |
|  | 7,844                    | 7,257                   |
| Less accumulated depreciation and amortization   | 6,550                    | 6,275                   |
| <b>Net equipment and leasehold improvements</b>  | <b>1,294</b>             | <b>982</b>              |
| Deferred income taxes  | 1,419                    | 1,419                   |
| Goodwill   | 875                      |                         |
| Other assets   | 1,201                    | 6                       |
| Capitalized software product costs   | 12,381                   | 11,557                  |
| Less accumulated amortization  | 10,686                   | 10,089                  |
| <b>Net capitalized software product costs</b>  | <b>1,695</b>             | <b>1,468</b>            |
| <b>Total Assets</b>  | <b>\$ 10,461</b>         | <b>\$ 9,436</b>         |

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

|   | <b>April 30<br/>2007</b> | <b>July 31<br/>2006</b> |
|---|--------------------------|-------------------------|
| <b>LIABILITIES AND SHAREHOLDERS EQUITY (DEFICIT)</b>  |                          |                         |
| Current liabilities:  |                          |                         |
| Current portion of notes payable  | \$ 1,184                 | \$ 1,400                |
| Accounts payable  | 671                      | 500                     |
| Deferred revenue  | 5,470                    | 5,616                   |
| Accrued payroll and related liabilities   | 983                      | 1,006                   |
| Accrued sales, use and income taxes   | 26                       | 38                      |
| Accrued vendor specific liabilities   |                          | 104                     |
| Other accrued liabilities   | 455                      | 254                     |
| Current portion of capital lease obligations  | 20                       |                         |
| <b>Total Current Liabilities</b>  | <b>8,809</b>             | <b>8,918</b>            |
| Long term liabilities:  |                          |                         |
| Notes payable (net of discount)   | 558                      | 580                     |
| Long term payroll related   | 202                      | 202                     |
| Other long term liabilities   | 33                       | 48                      |
| Capital lease obligations   | 9                        |                         |
| <b>Total Long Term Liabilities</b>  | <b>802</b>               | <b>830</b>              |
| Shareholders' equity (deficit):   |                          |                         |
| Cumulative preferred stock, par value \$.001 per share, 1,000,000 shares authorized;<br>no shares issued and outstanding at April 30, 2007 and July 31, 2006, respectively            |                          |                         |
| Common stock, par value \$.001 per share, 25,000,000 shares authorized; 6,618,405<br>and 6,202,529 shares issued and outstanding at April 30, 2007 and July 31, 2006,<br>respectively | 7                        | 6                       |
| Common stock warrants and options   | 144                      | 36                      |
| Additional paid-in-capital  | 94,623                   | 93,838                  |
| Accumulated deficit   | (93,924)                 | (94,192)                |
| <b>Total Shareholders' Equity (Deficit)</b>   | <b>850</b>               | <b>(312)</b>            |
| <b>Total Liabilities and Shareholders' Equity (Deficit)</b>   | <b>\$ 10,461</b>         | <b>\$ 9,436</b>         |

*See notes to unaudited condensed consolidated financial statements.*

Note: The balance sheet at July 31, 2006 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.**  
**Consolidated Statements of Operations**  
*(In thousands, except per share data)*  
*(Unaudited)*

|   | <b>Three months ended</b> |             | <b>Nine months ended</b> |             |
|---|---------------------------|-------------|--------------------------|-------------|
|   | <b>April 30</b>           |             | <b>April 30</b>          |             |
|   | <b>2007</b>               | <b>2006</b> | <b>2007</b>              | <b>2006</b> |
| Net revenues:   |                           |             |                          |             |
| Subscriptions, support and other services fees  | \$ 2,916                  | \$ 2,621    | \$ 8,333                 | \$ 7,733    |
| Software licenses and renewals  | 547                       | 498         | 1,665                    | 1,531       |
| Professional services   | 638                       | 434         | 1,297                    | 1,302       |
|   | 4,101                     | 3,553       | 11,295                   | 10,566      |
| Cost of products and services sold:   |                           |             |                          |             |
| Subscriptions, support and other services fees  | 282                       | 265         | 888                      | 653         |
| Software licenses and renewals *  | 253                       | 168         | 655                      | 490         |
| Professional services   | 296                       | 81          | 418                      | 276         |
|   | 831                       | 514         | 1,961                    | 1,419       |
| Gross Margin  | 3,270                     | 3,039       | 9,334                    | 9,147       |
| Operating expenses:   |                           |             |                          |             |
| Depreciation and amortization (exclusive of amortization of software products included in cost of products and services sold) | 203                       | 104         | 419                      | 278         |
| Customer operations and support   | 298                       | 273         | 842                      | 855         |
| Selling, general and administrative   | 2,491                     | 1,862       | 6,577                    | 5,561       |
| Software development and technical support  | 450                       | 344         | 1,178                    | 924         |
| Net operating expenses  | 3,442                     | 2,583       | 9,016                    | 7,618       |
| Operating income (loss)   | (172)                     | 456         | 318                      | 1,529       |
| Other income (expense):   |                           |             |                          |             |
| Interest expense  | (40)                      | (45)        | (110)                    | (144)       |
| Other, net  | 16                        | 46          | 77                       | 94          |
| Total other income (expense)  | (24)                      | 1           | (33)                     | (50)        |
| Income (loss) before provision for income taxes   | (196)                     | 457         | 285                      | 1,479       |
| Income tax benefit (provision)  | (9)                       | 1,008       | (17)                     | 1,008       |
| Net income (loss)   | \$ (205)                  | \$ 1,465    | \$ 268                   | \$ 2,487    |

Average common shares outstanding:

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|  |           |         |         |         |
|--|-----------|---------|---------|---------|
| Basic  | 6,444     | 6,175   | 6,320   | 6,152   |
| Diluted  | 6,844     | 6,621   | 6,720   | 6,598   |
| Basic and diluted net income (loss) per share: |           |         |         |         |
| Basic  | \$ (0.03) | \$ 0.24 | \$ 0.04 | \$ 0.40 |
| Diluted  | \$ (0.03) | \$ 0.22 | \$ 0.04 | \$ 0.38 |

*See notes to unaudited condensed consolidated financial statements.*

\* Includes amortization of software products of \$213, \$161, \$598 and \$458 respectively and excluding other depreciation and amortization shown separately



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

|   | <b>Nine months ended<br/>April 30</b> |             |
|---|---------------------------------------|-------------|
|   | <b>2007</b>                           | <b>2006</b> |
| <b>Operating activities</b>   |                                       |             |
| Net income  | \$ 268                                | \$ 2,487    |
| Adjustments to reconcile net income to net cash provided by operating activities:                                   |                                       |             |
| Amortization of capitalized software products   | 598                                   | 458         |
| Amortization of deferred financing costs, debt discount and excess carrying value over face amount of notes payable | (22)                                  | (44)        |
| Depreciation and other amortization   | 419                                   | 278         |
| Stock based compensation related to stock options   | 109                                   |             |
| Deferred income taxes   |                                       | (1,038)     |
| Stock issued as contribution to 401(k) plan   | 42                                    | 21          |
| Net change in receivables, prepaid expenses and other current assets  | (428)                                 | (335)       |
| Net change in accounts payable, deferred revenue, accrued liabilities and long term liabilities                     | 61                                    | (70)        |
| Net cash provided by operating activities   | 1,047                                 | 1,757       |
| <b>Investing activities</b>   |                                       |             |
| Purchase of equipment and leasehold improvements  | (629)                                 | (494)       |
| Purchase of assets related to acquisitions, net of cash acquired  | (1,179)                               |             |
| Software product costs capitalized  | (247)                                 | (468)       |
| Net cash used in investing activities   | (2,055)                               | (962)       |
| <b>Financing activities</b>   |                                       |             |
| Payments under notes payable  | (1,145)                               | (850)       |
| Payments on capital lease obligations   |                                       | (4)         |
| Proceeds from issuance of common stock  | 37                                    | 60          |
| Net cash used in financing activities   | (1,108)                               | (794)       |
| Net increase (decrease) in cash and cash equivalents  | (2,116)                               | 1           |
| Balance at beginning of period  | 3,584                                 | 3,651       |
| Balance at end of period  | \$ 1,468                              | \$ 3,652    |
| Cash paid for interest  | \$ 137                                | \$ 190      |
| Cash paid for income taxes  | \$ 20                                 | \$          |

**Noncash investing and financing activities**

|   |    |     |    |
|---|----|-----|----|
| Redemption of common stock in connection with exercise of stock options | \$ | \$  | 54 |
| Issuance of common stock in connection with acquisition                 |    | 707 |    |
| Debt issued in connection with acquisition                              |    | 700 |    |
| Debt assumed in connection with acquisition                             |    | 37  |    |
| Accrued liabilities related to acquisition                              |    | 175 |    |
| Stock based compensation related to stock options                       |    | 109 |    |

*See notes to unaudited condensed consolidated financial statements.*

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**Notes to Condensed Consolidated Financial Statements  
(Unaudited)  
April 30, 2007**

**1. BASIS OF PRESENTATION**

The accompanying unaudited consolidated 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, 2007 are not necessarily indicative of the results that may be expected for the fiscal year ending July 31, 2007. 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, 2006.

The financial statements include the accounts of ARI Network Services, Inc. and its wholly owned subsidiary, ARI Europe B.V. All intercompany transactions and balances have been eliminated.

The functional currency of the Company's subsidiary in the Netherlands is the Euro; accordingly, monetary assets and liabilities are translated into United States dollars at the rate of exchange existing at the end of the period, and non-monetary assets and liabilities are translated into United States dollars at historical exchange rates. Income and expense amounts, except for those related to assets translated at historical rates, are translated at the average exchange rates during the period. Adjustments resulting from the remeasurement of the financial statements into the functional currency are charged or credited to income.

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

Basic net income per common share is computed by dividing net income by the basic 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<br>April 30 |       | Nine months ended<br>April 30 |       |
|--|--------------------------------|-------|-------------------------------|-------|
|  | 2007                           | 2006  | 2007                          | 2006  |
| Weighted average common shares outstanding   | 6,444                          | 6,175 | 6,320                         | 6,152 |
| Dilutive effect of stock options and warrants  | 400                            | 446   | 400                           | 446   |
| Diluted weighted average common shares outstanding   | 6,844                          | 6,621 | 6,720                         | 6,598 |
| Options that could potentially dilute net income per share in the future that are not included in the computation of diluted net income per share, as their impact is antidilutive | 319                            | 225   | 319                           | 225   |

**3. 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.

The Company adopted SFAS 123R using the modified prospective method. Under this transition method, compensation cost recognized in fiscal 2007 includes: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of August 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123 and (b) compensation cost for all share-based payments granted subsequent to August 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R. Results for prior periods have not been restated. Compensation cost for options will be recognized in earnings, net of estimated forfeitures, on a straight-line basis over the requisite service period. There were no capitalized stock-based compensation costs at April 30, 2007. Total stock compensation expense recognized by the Company during the three and nine month periods ended April 30, 2007 was \$40,702 and \$109,520. As of April 30, 2007, there was \$195,682 of total unrecognized compensation cost related to nonvested options granted under the plans.

The Company used the Black-Scholes model to value stock options granted. Expected volatility is based on historical volatility of the Company's stock. The expected life of options granted represents the period of time that options granted are expected to be outstanding. The risk-free rate for periods within the contractual term of the options is based on the U.S. Treasury yields in effect at the time of grant.

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As stock-based compensation expense recognized in our results for the three and nine months ended April 30, 2007 is based on awards ultimately expected to vest, the amount has been reduced for estimated forfeitures. SFAS 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based on our historical experience. Prior to fiscal year 2007, we accounted for forfeitures as they occurred for the purposes of our pro forma information under SFAS 123.

The fair value of each option grant is estimated using the assumptions in the following table:

|                         | Three months ended |          | Nine months ended |          |
|-------------------------|--------------------|----------|-------------------|----------|
|                         | April 30,          |          | April 30,         |          |
|                         | 2007               | 2006     | 2007              | 2006     |
| Expected life (years)   | 10 years           | 10 years | 10 years          | 10 years |
| Risk-free interest rate | 4.88%              | 4.00%    | 4.88%             | 4.00%    |
| Expected volatility     | 124%               | 124%     | 124%              | 124%     |
| Expected dividend yield | 0%                 | 0%       | 0%                | 0%       |

The following table illustrates the effect on net income and earnings per share as if the Company had accounted for stock-based compensation in accordance with SFAS 123R for the:

|   | Three months ended | Nine months ended |
|---|--------------------|-------------------|
|   | April 30,          | April 30,         |
|   | 2006               | 2006              |
| Net income as reported  | \$ 1,465           | \$ 2,487          |
| Stock-based compensation expense determined under fair value based method for options | (85)               | (247)             |
| Pro forma net income  | \$ 1,380           | \$ 2,240          |
| Pro forma net income per share basic  | \$ .22             | \$ .36            |
| Pro forma net income per share diluted  | \$ .21             | \$ .34            |

**Employee Stock Purchase Plans**

The Company's 1992 Employee Stock Purchase Plan had 62,500 shares of common stock reserved for issuance, and all 62,500 shares have been issued. The Company's 2000 Employee Stock Purchase Plan has 175,000 shares of common stock reserved for issuance, and 148,781 of the shares have been issued as of April 30, 2007. All employees of the Company, other than executive officers, with nine months of service are eligible to participate. Shares may be purchased at the end of a specified period at the lower of 85% of the market value at the beginning or end of the specified period through accumulation of payroll deductions, not to exceed 5,000 shares per employee per year.

**Stock Option Plans**

On November 19, 2003, pursuant to its option exchange program, the Company accepted for cancellation from all stock option plans old options to purchase 319,186 shares of common stock, representing approximately 29% of the shares of common stock underlying all old options that were eligible for exchange in the offer. Subject to and in accordance with the terms of the offer, the Company issued, on the new option grant date, May 21, 2004, new options to purchase 245,944 shares of the Company's common stock from the 2000 Stock Option Plan in exchange for the old options cancelled in the offer. The new options were 50% vested immediately and of the remaining options, 25% vested on July 31, 2005 and 25% vested on July 31, 2006.

**1991 Stock Option Plan**

The Company's 1991 Stock Option Plan was terminated on August 14, 2001, except as to outstanding options. Options granted under the 1991 Plan may be either: (a) options intended to qualify as incentive stock options under Section 422 of the Internal Revenue Code of 1986, as amended (the Code), or (b) nonqualified stock options.

Any incentive stock option that was granted under the 1991 Plan could not be granted at a price less than the fair market value of the stock on the date of grant (or less than 110% of the fair market value in the case of holders of 10% or more of the voting stock of the Company). Nonqualified stock options were allowed to be granted at the exercise price established by the Compensation Committee, which could be less than, equal to or greater than the fair market value of the stock on the date of grant.

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Each option granted under the 1991 Plan is exercisable for a period of ten years from the date of grant (five years in the case of a holder of more than 10% of the voting stock of the Company) or such shorter period as determined by the Compensation Committee and shall lapse upon the expiration of said period, or earlier upon termination of the participant's employment with the Company.

At its discretion, the Compensation Committee may require a participant to be employed by the Company for a designated number of years prior to exercising any options. The Committee may also require a participant to meet certain performance criteria, or that the Company meet certain targets or goals, prior to exercising any options. Changes in option shares under the 1991 Plan during the:

|                                    | Options | Three months ended<br>April 30, 2007 |                                    |                                 | Options | Nine months ended<br>April 30, 2007 |                                    |                                 |
|------------------------------------|---------|--------------------------------------|------------------------------------|---------------------------------|---------|-------------------------------------|------------------------------------|---------------------------------|
|                                    |         | Wt-Avg<br>Exercise<br>Price          | Remaining<br>Contractual<br>Period | Aggregate<br>Intrinsic<br>Value |         | Wt-Avg<br>Exercise<br>Price         | Remaining<br>Contractual<br>Period | Aggregate<br>Intrinsic<br>Value |
| Outstanding at beginning of period | 145,686 | \$2.27                               | 2.34                               | \$13,125                        | 146,686 | \$2.28                              | 2.85                               | \$13,125                        |
| Granted                            |         |                                      |                                    |                                 |         |                                     |                                    |                                 |
| Exercised                          |         |                                      |                                    |                                 |         |                                     |                                    |                                 |
| Forfeited                          |         |                                      |                                    |                                 | (1,000) | \$3.25                              |                                    |                                 |
| Outstanding at end of period       | 145,686 | \$2.27                               | 2.09                               | \$13,125                        | 145,686 | \$2.27                              | 2.09                               | \$13,125                        |
| Exercisable at end of period       | 145,686 | \$2.27                               | 2.09                               | \$13,125                        | 145,686 | \$2.27                              | 2.09                               | \$13,125                        |

The range of exercise prices for options outstanding at April 30, 2007 was \$2.00 to \$9.06.

*1993 Director Stock Option Plan*

The Company's 1993 Director Stock Option Plan ( Director Plan ) has expired and is terminated except for outstanding options. The Director Plan originally had 150,000 shares of common stock reserved for issuance to nonemployee directors. Options under the Director Plan were granted at the fair market value of the stock on the grant date. Each option granted under the Director Plan is exercisable one year after the date of grant and cannot be exercised later than ten years from the date of grant.

Changes in option shares under the Director Plan during the:

|                                    | Options | Three months ended<br>April 30, 2007 |                                    |                                 | Options | Nine months ended<br>April 30, 2007 |                                    |                                 |
|------------------------------------|---------|--------------------------------------|------------------------------------|---------------------------------|---------|-------------------------------------|------------------------------------|---------------------------------|
|                                    |         | Wt-Avg<br>Exercise<br>Price          | Remaining<br>Contractual<br>Period | Aggregate<br>Intrinsic<br>Value |         | Wt-Avg<br>Exercise<br>Price         | Remaining<br>Contractual<br>Period | Aggregate<br>Intrinsic<br>Value |
| Outstanding at beginning of period | 1,313   | \$2.65                               | 3.72                               | \$152                           | 1,313   | \$2.65                              | 3.97                               | \$152                           |
| Granted                            |         |                                      |                                    |                                 |         |                                     |                                    |                                 |
| Exercised                          |         |                                      |                                    |                                 |         |                                     |                                    |                                 |
| Forfeited                          |         |                                      |                                    |                                 |         |                                     |                                    |                                 |
| Outstanding at end of period       | 1,313   | \$2.65                               | 3.22                               | \$152                           | 1,313   | \$2.65                              | 3.22                               | \$152                           |
|                                    | 1,313   | \$2.65                               | 3.22                               | \$152                           | 1,313   | \$2.65                              | 3.22                               | \$152                           |

Exercisable at end  
of period

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

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**Table of Contents***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<br>April 30, 2007 |                              |                |                                 | Nine months ended<br>April 30, 2007 |                              |      |                                 |
|------------------------------------|--------------------------------------|------------------------------|----------------|---------------------------------|-------------------------------------|------------------------------|------|---------------------------------|
|                                    | Options                              | Wt-Avg                       |                | Aggregate<br>Intrinsic<br>Value | Options                             | Wt-Avg                       |      | Aggregate<br>Intrinsic<br>Value |
| Exercise Price                     |                                      | Remaining Contractual Period | Exercise Price |                                 |                                     | Remaining Contractual Period |      |                                 |
| 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<br>April 30, 2007 |                              | Nine months ended<br>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

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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<br>April 30, 2007 |          | Nine months ended<br>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

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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 |            | Nine months ended |            |
|---|--------------------|------------|-------------------|------------|
|   | April 30           |            | 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

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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<br>Manufacturers | Subscriptions | Distinct<br>Distributors<br>(Estimated) | Distinct<br>Dealers<br>(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)      |                           |               |   |                                    |
| <b>Total</b>             | <b>99</b> | <b>70</b>                 | <b>72,661</b> | <b>157</b>                              | <b>24,697</b>                      |

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

Distinct Manufacturer A single independent manufacturer, not owned by another manufacturer, served by ARI.

= Distinct manufacturers are included in the region they most serve even if they have catalogs in both regions.

Subscription =

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

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

Distinct Dealer ~~A~~ single independent servicing dealer, not owned by another dealer, served by ARI. As part of its historical business practice, the Company continues to provide 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)**

|                                     | <b>Three months<br/>ended<br/>April 30</b> |             | <b>Percent<br/>Change</b> | <b>Nine months ended<br/>April 30</b> |             | <b>Percent<br/>Change</b> |
|-------------------------------------|--|-------------|---------------------------|---------------------------------------|-------------|---------------------------|
|                                     | <b>2007</b>                                | <b>2006</b> |                           | <b>2007</b>                           | <b>2006</b> |                           |
| <b>North American</b>               |  |             |                           |                                       |             |                           |
| 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%                        |
| <b>Rest of the World</b>            |  |             |                           |                                       |             |                           |
| Catalog subscriptions               | 257  | 195         | 32%                       | 727                                   | 579         | 26%                       |
| Catalog professional services       | 81   | 15          | 440%                      | 145                                   | 101         | 44%                       |
| Subtotal                            | 338  | 210         | 61%                       | 872                                   | 680         | 28%                       |
| <b>Total Revenue</b>                |  |             |                           |                                       |             |                           |
| 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.

**Table of Contents****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<br>April 30 |         |       | Nine months ended<br>April 30 |          | %<br>Chg |
|---|--------------------------------|---------|-------|-------------------------------|----------|----------|
|   | 2007                           | 2006    | % Chg | 2007                          | 2006     |          |
| 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<br>April 30 |         |       | Nine months ended<br>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)*

|  | <b>Three months<br/>ended<br/>April 30</b> |             |              | <b>Nine months ended<br/>April 30</b> |             |              |
|--|--|-------------|--------------|---------------------------------------|-------------|--------------|
|  | <b>2007</b>                                | <b>2006</b> | <b>% Chg</b> | <b>2007</b>                           | <b>2006</b> | <b>% Chg</b> |
| 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.

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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)

|  | <b>April 30<br/>2007<br/>(Unaudited)</b> | <b>July 31<br/>2006<br/>(Audited)</b> | <b>Net<br/>Change</b> |
|--|--|---------------------------------------|-----------------------|
| 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.

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**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, successor 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

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