

ARI NETWORK SERVICES INC /WI

Form 10QSB

June 14, 2004

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-QSB

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

For the quarterly period ended April 30, 2004

OR

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

For the transition period from to

Commission file number 000-19608

ARI Network Services, Inc.

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

WISCONSIN

39- 1388360

(State or other jurisdiction
of
incorporation or
organization)

(IRS Employer
Identification No.)

11425 W. Lake Park Drive, Milwaukee, Wisconsin 53224

(Address of principal executive office)

Issuer's telephone number (414) 973-4300

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of The Exchange Act during the past twelve 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 ninety days.

YES (X) NO ()

Transitional Small Business Disclosure Format (check one).

YES () NO (X)

As of June 10, 2004, there were 5,923,034 shares of the registrant's shares outstanding.

ARI Network Services, Inc.

FORM 10-QSB

FOR THE THREE MONTHS ENDED APRIL 30, 2004

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(In thousands, except share and per share data)
(Unaudited)

| | April 30 2004 | July 31 2003 |
|--|--------------------------|-------------------------|
| | <u> </u> | <u> </u> |
| ASSETS | | |
| Current assets: | | |
| Cash | \$ 2,747 | \$2,120 |
| Trade receivables, less allowance for doubtful accounts of \$110 at April 30, 2004 and \$98 at July 31, 2003 | 856 | 1,088 |
| Prepaid expenses and other | 137 | 115 |
| | <u> </u> | <u> </u> |
| Total current assets | 3,740 | 3,323 |
| Equipment and leasehold improvements: | | |
| Computer equipment | 4,480 | 4,475 |
| Leasehold improvements | 73 | 73 |
| Furniture and equipment | 1,473 | 1,372 |
| | <u> </u> | <u> </u> |
| | 6,026 | 5,920 |
| Less accumulated depreciation and amortization | 5,584 | 5,474 |
| | <u> </u> | <u> </u> |
| Net equipment and leasehold improvements | 442 | 446 |
| Other assets | 16 | 0 |
| Capitalized software product costs | 10,075 | 9,602 |
| Less accumulated amortization | 9,044 | 7,721 |
| | <u> </u> | <u> </u> |
| Net capitalized software product costs | 1,031 | 1,881 |
| | <u> </u> | <u> </u> |
| Total Assets | \$ 5,229 | \$5,650 |
| | <u> </u> | <u> </u> |

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

| | April 30 2004 | July 31 2003 |
|---|--------------------------|-------------------------|
| | <hr/> | <hr/> |
| LIABILITIES AND SHAREHOLDERS EQUITY (DEFICIT) | | |
| Current liabilities: | | |
| Current portion of notes payable | \$ 1,000 | \$ 400 |
| RFC financed receivables facility | | 346 |
| Accounts payable | 196 | 401 |
| Deferred revenue | 5,364 | 5,280 |
| Accrued payroll and related liabilities | 955 | 1,088 |
| Other accrued liabilities | 709 | 601 |
| Current portion of capital lease obligations | 12 | 20 |
| | <hr/> | <hr/> |
| Total current liabilities | 8,236 | 8,136 |
| Long term liabilities: | | |
| Notes payable (net of discount) | 3,623 | 3,769 |
| Other long term liabilities | 553 | 559 |
| Capital lease obligations | 5 | 16 |
| | <hr/> | <hr/> |
| Total long term liabilities | 4,181 | 4,344 |
| Shareholders' equity (deficit): | | |
| Cumulative preferred stock, par value \$.001 per share, 1,000,000 shares authorized; 0 and 20,350 shares issued and outstanding at April 30, 2004 and July 31, 2003, respectively | | |
| Common stock, par value \$.001 per share, 25,000,000 shares authorized; 5,921,034 and 6,645,191 shares issued and outstanding at April 30, 2004 and July 31, 2003, respectively | 5 | 6 |
| Common stock warrants and options | 36 | 141 |
| Additional paid-in-capital | 93,616 | 94,295 |
| Accumulated deficit | (100,845) | (101,272) |
| | <hr/> | <hr/> |
| Total shareholders' equity (deficit) | (7,188) | (6,830) |
| | <hr/> | <hr/> |
| Total Liabilities and Shareholders' Equity (Deficit) | \$ 5,229 | \$ 5,650 |
| | <hr/> | <hr/> |

See notes to unaudited condensed financial statements.

Note: The balance sheet at July 31, 2003 has been derived from the audited balance sheet at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements.

Table of Contents**ARI Network Services, Inc.**

Statements of Operations
(In thousands, except per share data)
(Unaudited)

| | Three months ended | | Nine months ended | |
|---|---------------------------|-------------------|--------------------------|-------------------|
| | April 30 | | April 30 | |
| | 2004 | 2003 | 2004 | 2003 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Net revenues: | | | | |
| Subscriptions, support and other services fees | \$2,263 | \$2,137 | \$6,812 | \$ 6,168 |
| Software licenses and renewals | 590 | 608 | 1,783 | 1,713 |
| Professional services | 505 | 509 | 1,341 | 1,521 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| | 3,358 | 3,254 | 9,936 | 9,402 |
| Operating expenses: | | | | |
| Cost of products and services sold: | | | | |
| Subscriptions, support and other services fees | 98 | 152 | 382 | 453 |
| Software licenses and renewals * | 470 | 455 | 1,390 | 1,328 |
| Professional services | 306 | 242 | 646 | 586 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| | 874 | 849 | 2,418 | 2,367 |
| Depreciation and amortization (exclusive of amortization of software products included in cost of products and services sold) | 38 | 52 | 110 | 164 |
| Customer operations and support | 249 | 290 | 823 | 912 |
| Selling, general and administrative | 1,696 | 2,157 | 5,212 | 5,359 |
| Software development and technical support | 399 | 363 | 1,102 | 1,239 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Operating expenses before amounts capitalized | 3,256 | 3,711 | 9,665 | 10,041 |
| Less capitalized portion | (144) | (86) | (331) | (369) |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Net operating expenses | 3,112 | 3,625 | 9,334 | 9,672 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Operating income | 246 | (371) | 602 | (270) |
| Other expense: | | | | |
| Interest expense | (55) | (291) | (200) | (970) |
| Other, net | (11) | 8 | 25 | (34) |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Total other expense | (66) | (283) | (175) | (1,004) |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |

| | | | | |
|------------------------------------|-------------------|-------------------|-------------------|-------------------|
| Net income (loss) | \$ 180 | \$ (654) | \$ 427 | \$ (1,274) |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Average common shares outstanding: | | | | |
| Basic | 5,861 | 6,581 | 5,812 | 6,449 |
| Diluted | 6,115 | 6,581 | 6,066 | 6,449 |
| Net income (loss) per share: | | | | |
| Basic | \$ 0.03 | \$ (0.10) | \$ 0.07 | \$ (0.20) |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Diluted | \$ 0.03 | \$ (0.10) | \$ 0.07 | \$ (0.20) |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |

See notes to unaudited condensed financial statements.

* Includes amortization of software products of \$435, \$440, \$1,323 and \$1,304 and excludes other depreciation and amortization shown separately

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

| | Nine months ended April 30 | |
|---|---------------------------------------|-------------|
| | 2004 | 2003 |
| Operating activities | | |
| Net income (loss) | \$ 427 | \$(1,274) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | |
| Amortization of software products | 1,323 | 1,304 |
| Amortization of deferred financing costs, debt discount and excess carrying value over face amount of notes payable | (42) | 701 |
| Depreciation and other amortization | 110 | 164 |
| Interest expense converted to subordinated debt | | 229 |
| Stock issued as consideration to vendor | | 44 |
| Stock issued as contribution to 401(k) plan | 37 | |
| Net change in receivables, prepaid expenses and other current assets | 215 | 403 |
| Net change in accounts payable, deferred revenue, accrued liabilities and other long term liabilities | (370) | 194 |
| | 1,700 | 1,765 |
| Investing activities | | |
| Purchase of equipment and leasehold improvements | (106) | (42) |
| Purchase of assets related to acquisitions | (108) | |
| Software product costs capitalized | (331) | (369) |
| | (545) | (411) |
| Financing activities | | |
| Borrowings under notes payable | | 58 |
| Payments under notes payable | (500) | (634) |
| Payments of capital lease obligations | (19) | (125) |
| Debt issuance costs incurred | (20) | |
| Proceeds from issuance of common stock | 11 | 44 |
| | (528) | (657) |
| Net increase in cash | 627 | 697 |
| Cash at beginning of period | 2,120 | 879 |
| | \$2,747 | \$ 1,576 |
| Cash at end of period | \$2,747 | \$ 1,576 |

| | | |
|------------------------|-------------------|-------------------|
| Cash paid for interest | \$ 353 | \$ 65 |
| | <u> </u> | <u> </u> |

Noncash investing and financing activities

| | | |
|--|-------|-------|
| Capital lease obligations incurred for computer equipment | \$ | \$ 15 |
| Issuance of common stock in connections with deferred executive compensation | 130 | |
| Issuance of common stock in connection with acquisitions | 37 | |
| Issuance of common stock in connection with restructuring of debt | | 36 |
| Conversion of accrued interest to subordinated debt | | 493 |
| Exchange of equity to debt | 1,000 | |

See notes to unaudited condensed financial statements.

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Notes to Condensed Financial Statements
(Unaudited)
April 30, 2004

1. BASIS OF PRESENTATION

The accompanying unaudited financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for fiscal year end financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three months ended April 30, 2004 are not necessarily indicative of the results that may be expected for the fiscal year ending July 31, 2004. For further information, refer to the financial statements and footnotes thereto included in the Company's annual report on Form 10-K for the year ended July 31, 2003.

2. BASIC AND DILUTED NET INCOME (LOSS) PER SHARE

Basic net income(loss) per common share is computed by dividing net income(loss) by the weighted average number of common shares outstanding during the period. Diluted net income per common share is computed by dividing net income by the weighted average number of common shares outstanding during the period and reflects the potential dilution that could occur if all of the Company's outstanding stock options and warrants that are in the money were exercised (calculated using the treasury stock method). The effect of dilutive stock options and warrants on net loss per common share is antidilutive in fiscal 2003 and therefore not computed. The following table is a reconciliation of the weighted average number of common shares and equivalents outstanding (in thousands), which are used in the calculation of basic and diluted net income (loss) per common share for the periods indicated.

| | Three months ended April 30 | | Nine months ended April 30 | |
|--|--|-------------|---------------------------------------|-------------|
| | 2004 | 2003 | 2004 | 2003 |
| Weighted average common shares outstanding | 5,861 | 6,581 | 5,812 | 6,449 |
| Dilutive effect of stock options and warrants | 254 | | 254 | |
| Diluted weighted average common shares outstanding | 6,115 | 6,581 | 6,066 | 6,449 |

3. STOCK-BASED COMPENSATION

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

Nine months ended

| | Three months ended | | | |
|--|-------------------------------|-------------|-----------------|-------------|
| | April 30 | | April 30 | |
| | 2004 | 2003 | 2004 | 2003 |
| Net income (loss), as reported | \$ 180 | \$ (654) | \$ 427 | \$ (1,274) |
| Stock-based compensation using the fair value method | (20) | (21) | (59) | (60) |
| Pro forma net income (loss) | \$ 160 | \$ (675) | \$ 368 | \$ (1,334) |
| Net income (loss) per share | | | | |
| Basic - as reported | \$0.03 | \$(0.10) | \$0.07 | \$ (0.20) |
| Basic - pro forma | \$0.03 | \$(0.10) | \$0.06 | \$ (0.21) |
| Diluted - as reported | \$0.03 | \$(0.10) | \$0.07 | \$ (0.20) |
| Diluted - pro forma | \$0.03 | \$(0.10) | \$0.06 | \$ (0.21) |

4. NOTES PAYABLE

On April 27, 2000, the Company issued and sold to RGC International Investors, LDC (RGC) (i) a convertible subordinated Debenture (the Debenture) in the amount of \$4,000,000 due on April 27, 2003, (ii) warrants to purchase 600,000 shares of Common Stock at a price of \$6 per share (the Warrants) expiring April 27, 2005, and (iii) an Investment Option to purchase 800,000 shares of Common Stock at a price of \$6 per share (the Investment Option) which expired on October 27, 2001.

In September 2002, RGC transferred the Debenture and the Warrants to ARI Network Services Partners (which is not in any way affiliated with the Company), Dolphin Offshore Partners, LP and SDS Merchant Fund, LP. (the Transferees).

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On April 24, 2003, the Company restructured the foregoing instruments. In exchange for the Debenture and the Warrants, the Company issued to a group of investors affiliated with the Transferees (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). In addition, the Transferees assigned to the Company all their rights and claims against RGC. The interest rate on the New Notes is the prime interest rate plus 2%. 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 original Warrants and Investment Options were estimated using a Black Scholes valuation model to have a value of \$2,354,000, and 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 Debenture plus accrued interest and the Warrants 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%.

5. SHAREHOLDER RIGHTS PLAN

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

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**MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL
CONDITION AND RESULTS OF OPERATIONS**

Results of Operations

Total revenue for the quarter ended April 30, 2004 increased \$104,000 or 3% compared to the same period last year, primarily due to an increase in recurring revenues from the Company's catalog products in the Equipment Industry. Earnings increased from a net loss of \$654,000, or \$0.10 per share for the quarter ended April 30, 2003 to net income of \$180,000 or \$0.03 per share for the quarter ended April 30, 2004. Management believes that the Company will have modest revenue growth and continue to be profitable for the remainder of fiscal 2004, although there can be no assurance that this will occur. See Forward Looking Statements.

Critical Accounting Policies and Estimates

General

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

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

Revenue Recognition

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

Bad Debts

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

Use of Estimates

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

Debt Instruments

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

Table of Contents*Impairment of Long-Lived Assets*

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

Stock-Based Compensation

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

Revenues

The Company is a leading provider of electronic catalog-enabled business solutions for sales, service and life cycle product support in the manufactured equipment market. The Company currently provides 76 catalogs of manufactured equipment for 60 manufacturers to over 24,000 dealers in more than 100 countries in 12 segments of the worldwide manufactured equipment market including outdoor power, power sports, recreation vehicles, auto and truck parts aftermarket, marine, construction, floor maintenance and others. Collectively, dealers and distributors have over 88,000 catalog subscriptions. The Company supplies three types of software and services: robust Web and CD-ROM interactive electronic parts catalogs, template-based website services and communication or transaction services. The Company's primary product line is electronic cataloging; the other products are supplementary offerings that leverage its position in the catalog market.

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

Catalog, Customer and Subscription Information by Region
(As of April 30, 2004)

| | Catalogs | Distinct Manufacturers | Subscriptions | Distinct Distributors (Estimated) | Distinct Dealers (Estimated) |
|--------------------------|-----------------|-----------------------------------|----------------------|--|---|
| North American | 69 | 52 | 70,744 | 117 | 18,899 |
| Non-North American | 71 | 8 | 17,929 | 17 | 6,000 |
| Included in both Regions | (64) | | | | |
| Total | 76 | 60 | 88,673 | 134 | 24,899 |

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

in a catalog.

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

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

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

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

As part of its historical business practice, the Company continues to provide electronic directory and transaction services to the U.S. and Canadian agribusiness industry. As the Company focuses on its core businesses in the Equipment industry, the percentage of revenues coming from the non-equipment industry is expected to continue to decline during fiscal 2004.

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

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

Revenue by Industry Sector
(In thousands)

| | Three months ended | | Percent Change | Nine months ended | | Percent Change |
|-------------------------------|--------------------|--------------|-------------------|-------------------|--------------|-------------------|
| | April 30 2004 | 2003 | | April 30 2004 | 2003 | |
| Industry Sector: | | | | | | |
| Equipment Industry | | | | | | |
| North American | | | | | | |
| Recurring | \$2,495 | \$2,313 | 8% | \$7,278 | \$6,398 | 14% |
| Non-recurring | 439 | 449 | (2%) | 1,174 | 1,262 | (7%) |
| | <u>2,934</u> | <u>2,762</u> | | <u>8,452</u> | <u>7,660</u> | |
| Subtotal | | | 6% | | | 10% |
| Non-North American | | | | | | |
| Recurring | 250 | 264 | (5%) | 834 | 748 | 12% |
| Non-recurring | 34 | 42 | (20%) | 168 | 193 | (13%) |
| | <u>284</u> | <u>306</u> | | <u>1,002</u> | <u>941</u> | |
| Subtotal | | | (7%) | | | 6% |
| Total Equipment Industry | | | | | | |
| Recurring | 2,745 | 2,577 | 7% | 8,112 | 7,146 | 14% |
| Non-recurring | 473 | 491 | (4%) | 1,342 | 1,455 | (8%) |
| | <u>3,218</u> | <u>3,068</u> | | <u>9,454</u> | <u>8,601</u> | |
| Subtotal | | | 5% | | | 10% |
| Non-equipment Industry | | | | | | |
| Recurring | 140 | 176 | (20%) | 482 | 755 | (36%) |
| Non-recurring | | 10 | (100%) | | 46 | (100%) |
| | <u>141</u> | <u>186</u> | | <u>482</u> | <u>801</u> | |
| Subtotal | | | (25%) | | | (40%) |
| Total Revenue | | | | | | |
| Recurring | 2,885 | 2,753 | 5% | 8,594 | 7,901 | 9% |
| Non-recurring | 473 | 501 | (6%) | 1,342 | 1,501 | (11%) |
| | <u>3,358</u> | <u>3,254</u> | | <u>9,936</u> | <u>9,402</u> | |
| Grand Total | | | 3% | | | 6% |

Revenue by Product in the Equipment Industry
(In thousands)

| | Three months ended | | Percent Change | Nine months ended | | Percent Change |
|---------------------------|--------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| | April 30 2004 | 2003 | | April 30 2004 | 2003 | |
| Product: | | | | | | |
| Equipment Industry | | | | | | |
| Catalog and related | | | | | | |
| Recurring | \$2,669 | \$2,475 | 8% | \$7,789 | \$6,819 | 14% |
| Non-recurring | 456 | 480 | (5%) | 1,318 | 1,432 | (8%) |
| | <u> </u> | <u> </u> | | <u> </u> | <u> </u> | |
| Subtotal | 3,125 | 2,955 | 6% | 9,107 | 8,251 | 10% |
| Communications | | | | | | |
| Recurring | 76 | 102 | (25%) | 323 | 327 | (1%) |
| Non-recurring | 17 | 11 | 55% | 24 | 23 | 4% |
| | <u> </u> | <u> </u> | | <u> </u> | <u> </u> | |
| Subtotal | 93 | 113 | (18%) | 347 | 350 | (1%) |
| | <u> </u> | <u> </u> | | <u> </u> | <u> </u> | |
| Total Equipment Industry | \$3,218 | \$3,068 | 5% | \$9,454 | \$8,601 | 10% |
| | <u> </u> | <u> </u> | | <u> </u> | <u> </u> | |

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Recurring revenues are derived from catalog subscription fees, catalog data update fees, software maintenance and support fees, software license renewals, network traffic and support fees and other miscellaneous subscription fees. Non-recurring revenues are derived from initial software licenses and professional services fees. Recurring revenue, as a percentage of total revenue, was 86% for the nine months ended April 30, 2004 compared to 84% for the same period last year. Management believes that the relationship of approximately three quarters recurring revenue to one quarter non-recurring revenue establishes an appropriate level of base revenue while the Company continues to add new sales to drive future increases in recurring revenue. If the manufacturing sector of the economy improves in the future, the percentage of recurring revenue may be slightly lower, indicating a higher amount of new business. This ratio is expected to fluctuate from quarter to quarter and year to year, depending on the nature, size and timing of new business.

Equipment Industry

The Equipment Industry has been a growing percentage of the Company's revenue over the past five years and is composed of several vertical markets including outdoor power, power sports, motorcycles, recreation vehicles, auto and truck parts after-market, farm equipment, marine, construction, floor maintenance and others primarily in the U.S., Canada, Europe and Australia. Management's strategy is to expand the Company's electronic parts catalog software and services business with manufacturers and distributors and their dealers in the existing vertical markets, add supplemental products for existing customers, and then expand to other similar markets in the future. Revenues in the Equipment Industry increased, as a percentage of total revenues, from 91% for the nine months ended April 30, 2003 to 95% for the nine months ended April 30, 2004.

North American

Recurring revenues in the North American Equipment Industry increased for the three and nine month periods ended April 30, 2004, compared to the same periods last year, primarily due to an increase in the base revenue of subscription renewals from the Company's catalog products. Non-recurring revenues in the North American Equipment Industry decreased for the three and nine month periods ended April 30, 2004, compared to the same periods last year, primarily due to fewer large customization projects because of the decline in the manufacturing sector of the economy.

Non-North American

Recurring revenues in the non-North American Equipment Industry decreased for the three month period ended April 30, 2004, compared to the same period last year, primarily due to the loss of a major customer representing approximately \$25,000 a quarter. Recurring revenues in the non-North American Equipment Industry increased for the nine month period ended April 30, 2004, compared to the same period last year primarily due to fluctuations in USD revenue because of the euro exchange rate. Non-recurring revenues in the non-North American Equipment Industry decreased for the three and nine month periods ended April 30, 2004, compared to the same periods last year, primarily due to fewer customization projects. Management expects revenues in the Non-North American Equipment Industry to continue at the same level or to decline for the remainder of fiscal 2004, until the economy improves.

Catalog and Related Products

Recurring revenues from the Company's catalog and related products in the Equipment Industry increased for the three and nine month periods ended April 30, 2004, compared to the same periods last year, primarily due to an increase in the Company's base revenue from new catalog customers and an increase in the volume of catalogs purchased by dealers. Management expects recurring catalog and related revenues to continue at the same level or higher in the North American Equipment Industry for the remainder of fiscal 2004, as the Company continues to focus attention

and resources on its catalog products, but non-recurring catalog and related revenue growth may be delayed until the economy improves.

Communications Products

Revenues from the Company's communications products decreased for the three month period ended April 30, 2004, compared to the same period last year, primarily due to fluctuations in network traffic revenues and remained relatively the same for the nine month period ended April 30, 2004, compared to the same period last year. The Company has focused the business primarily on its catalog products. Management expects revenues from communications products will be a declining percentage of total revenue for the remainder of fiscal 2004.

Non-Equipment Industry Business

The Company's business outside of the Equipment Industry includes sales of database management and electronic communication services to the agricultural inputs industry. Revenues in this business have decreased for the three and nine month periods ended April 30, 2004, compared to the same periods last year because an industry association introduced a competitive offering to our database management services. As a result, many of the agricultural inputs industry participants did not renew their contracts for database management services, which were approximately \$500,000 on an annual basis and expire

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each December. The Company continues to provide electronic communication services to the agricultural inputs industry, but management expects these revenues, as a percentage of total revenues, to continue to decline for the remainder of fiscal 2004.

Cost of Products and Services Sold

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

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

| | Three months ended | | Percent Change | Nine months ended | | Percent Change |
|--|--------------------|---------|-------------------|-------------------|---------|-------------------|
| | April 30 | | | April 30 | | |
| | 2004 | 2003 | | 2004 | 2003 | |
| Subscriptions, support and other services fees | | | | | | |
| Revenue | \$2,263 | \$2,137 | 6% | \$6,812 | \$6,168 | 10% |
| Cost of revenue | 98 | 152 | (36%) | 382 | 453 | (16%) |
| Cost of revenue as a percent of revenue | 4% | 7% | | 6% | 7% | |
| Software licenses and renewals | | | | | | |
| Revenue | 590 | 608 | (3%) | 1,783 | 1,713 | 4% |
| Cost of revenue | 470 | 455 | 3% | 1,390 | 1,328 | 5% |
| Cost of revenue as a percent of revenue | 80% | 75% | | 78% | 78% | |
| Professional services | | | | | | |
| Revenue | 505 | 509 | (1%) | 1,341 | 1,521 | (12%) |
| Cost of revenue | 306 | 242 | 26% | 646 | 586 | 10% |
| Cost of revenue as a percent of revenue | 61% | 48% | | 48% | 39% | |
| Total | | | | | | |
| Revenue | \$3,358 | \$3,254 | 3% | \$9,936 | \$9,402 | 6% |
| Cost of revenue | 874 | 849 | 3% | 2,418 | 2,367 | 2% |
| Cost of revenue as a percent of revenue | 26% | 26% | | 24% | 25% | |

Cost of subscriptions, support and other services fees consists primarily of telecommunications and catalog replication and distribution costs. Cost of subscriptions, support and other services fees as a percentage of revenue decreased for the three and nine month periods ended April 30, 2004, compared to the same periods last year primarily due to increased catalog subscriptions and decreased telecommunications costs and distribution costs related to shipping updated catalog subscriptions. Management expects gross margins, as a percent of revenue from subscriptions, support and other services fees, to vary slightly from quarter to quarter, depending on the timing of catalog update shipments.

Cost of software licenses and renewals consists primarily of amortization of software products, royalties and software distribution costs. Cost of software license and renewals as a percentage of revenue increased for the three month period ended April 30, 2004, compared to the same period last year, and remained relatively the same for the nine month period ended April 30, 2004, compared to the same period last year, primarily due to fluctuations in revenues from software licenses and renewals while software amortization costs increased slightly. Gross margins from software licenses and renewals will fluctuate from quarter to quarter based on the level of revenue, while costs remain relatively the same as amortization of software is not related to the level of revenue generated from software license

and renewals. Management expects software amortization costs to decrease significantly in the fourth quarter, as the initial software product cost of PartSmart acquired in fiscal 1999, becomes fully amortized. Amortization expense for PartSmart was \$346,000 in the third quarter and will be approximately \$110,000 in the fourth quarter.

Cost of 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, 2004, compared to the same periods last year, primarily due to an increase in catalog production of data bases requested by dealers that are not billed to the manufacturer on a time and materials basis (revenues from these databases are included in subscriptions, support and other services fees) and, for the nine month periods, the reversal of an accrual for contracted project work in excess of the contract amount in the first quarter of fiscal 2003. Management expects cost of professional services to fluctuate from quarter to quarter depending on the mix of services sold and on the Company's performance towards the contracted amount for customization projects.

Table of Contents**Operating Expenses**

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

Operating Expenses
(In thousands)

| | Three months ended | | Percent Change | Nine months ended | | Percent Change |
|--|--------------------|----------------|-------------------|-------------------|----------------|-------------------|
| | April 30 | | | April 30 | | |
| | 2004 | 2003 | | 2004 | 2003 | |
| Cost of products and services sold | \$ 874 | \$ 849 | 3% | \$2,418 | \$2,367 | 2% |
| Customer operations and support | 249 | 290 | (14%) | 823 | 912 | (10%) |
| Selling, general and administrative | 1,696 | 2,157 | (21%) | 5,212 | 5,359 | (3%) |
| Software development and technical support | 399 | 363 | 10% | 1,102 | 1,239 | (11%) |
| Less capitalized portion | (144) | (86) | 67% | (331) | (369) | (10%) |
| Depreciation and amortization | 38 | 52 | (27%) | 110 | 164 | (33%) |
| Net operating expenses | \$3,112 | \$3,625 | (14%) | \$9,334 | \$9,672 | 3% |

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 decreased for the three and nine month periods ended April 30, 2004, compared to the same periods last year primarily due to reduced server room and software maintenance costs. Management expects customer operations and support costs to continue at relatively the same level for the remainder of fiscal 2004.

Selling, general and administrative expenses (SG&A) decreased significantly for the three month period ended April 30, 2004, compared to the same period last year, primarily due to decreased legal fees. SG&A decreased slightly for the nine month period ended April 30, 2004, compared to the same period last year, primarily due to increased legal fees in the second and third quarter of fiscal 2003 related to the Company's lawsuit to enforce the buy-back agreement and the first quarter of fiscal 2004 related to the option exchange program and the WITECH equity buy-back agreement. SG&A, as a percentage of revenue, decreased slightly from 57% for the nine month period ended April 30, 2003 to 52% for the nine month period ended April 30, 2004. Management expects SG&A costs as a percentage of revenue to decline for the remainder of fiscal 2004 due to a reduction in legal fees.

The Company's technical staff (in-house and contracted) performs both software development and technical support and software customization and data conversion services for customer applications. Therefore, management expects fluctuations between software customization and data conversion services and development and technical support expenses quarter to quarter, as the mix of development and customization activities will change based on customer requirements. Software development and technical support costs increased for the three month period ended April 30, 2004, compared to the same period last year, primarily due to increased consulting labor related to software development of the Company's catalog products. Software development and technical support costs decreased for the nine month period ended April 30, 2004, compared to the same period last year, primarily due to temporarily open positions. Management expects software development and technical support costs to increase slightly for the

remainder of fiscal 2004.

Capitalized software product costs represented 30% of software development and technical support for the nine month periods ended April 30, 2004 and 2003. Capitalized software product costs fluctuate from quarter to quarter depending on the deployment of the Company's resources between early stage research, software development available for capitalization, data conversion, customer customizations and maintenance and technical support. Management expects that capitalized software product costs will increase for the remainder of fiscal 2004, because of planned allocation of resources towards product development investments.

Depreciation and amortization expense decreased for the three and nine month periods ended April 30, 2004, compared to the same periods last year as some computer equipment became fully depreciated. Management expects depreciation and amortization to continue at relatively the same level for the remainder of fiscal 2004.

Other Items

Earnings increased from a net loss of \$1,274,000 for the nine month period ended April 30, 2003, to net income of \$427,000 for the nine month period ended April 30, 2004. The increase in earnings is primarily due to the increase in revenues and the decrease in interest expense. Management expects to continue to generate positive earnings and cash flows for the remainder of fiscal 2004, although there can be no assurance that this will occur.

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Interest expense includes both cash and non-cash interest. Interest paid or accrued for payment was approximately \$242,000 and \$269,000 for the nine month periods ended April 30, 2004 and 2003, respectively. In addition, approximately \$42,000 of excess debt principal was amortized to offset interest expense for the nine month period ended April 30, 2004 and approximately \$701,000 of non-cash interest expense was incurred for the nine month period ended April 30, 2003 due to amortization of debt discount related to the Debenture and shareholder note.

On November 19, 2003, pursuant to its option exchange program, the Company accepted for cancellation 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 in exchange for the old options cancelled in the offer.

Acquisitions

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

On October 27, 2003, the Company acquired the technology and customer base of VertX Commerce Corporation (VertX). ARI had previously been reselling the VertX software under the brand name WebsiteSmart. The acquisition did not have a material impact on the Company's financial statements for the nine months ended April 30, 2004. The Company expects to realize modest synergies in both revenues and costs during the remainder of fiscal 2004.

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

Liquidity and Capital Resources

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

Earn/Burn Rate
(In thousands)

| | Three months ended | | Percent Change | Nine months ended | | Percent Change |
|---|---------------------------|-------------|-----------------------|--------------------------|--------------|-----------------------|
| | April 30 2004 | 2003 | | April 30 2004 | 2003 | |
| Net cash provided by operating activities | \$ 443 | \$1,037 | (57%) | \$1,700 | \$1,765 | (4%) |
| Net increase (decrease) in receivables, prepaid expenses and other current assets | 272 | (326) | 183% | (215) | (403) | 47% |
| Net (increase) decrease in accounts payable, deferred revenue and accrued liabilities | (75) | (409) | 82% | 370 | (194) | 291% |
| | <u>640</u> | <u>302</u> | <u>112%</u> | <u>1,855</u> | <u>1,168</u> | <u>59%</u> |

| | | | | | | |
|---|-------------------|-------------------|-------|-------------------|-------------------|-------|
| Net cash provided by operating activities before changes in working capital | | | | | | |
| Net cash used in investing activities | (173) | (125) | (38%) | (545) | (411) | (33%) |
| | <u> </u> | <u> </u> | | <u> </u> | <u> </u> | |
| Earn/burn rate | \$ 467 | \$ 177 | 164% | \$1,310 | \$ 757 | 73% |
| | <u> </u> | <u> </u> | | <u> </u> | <u> </u> | |

Net cash provided by operating activities decreased for the nine month period ended April 30, 2004, compared to the same period last year, primarily due to components of working capital. Net cash used in investing activities increased for the nine month period ended April 30, 2004, compared to the same period last year, primarily due to the software purchased in the Company's acquisition. 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. Management expects cash provided from operations and investments before changes in working capital (earn/burn rate) to be positive for the remainder of fiscal 2004, although there can be no assurance that this result will be ultimately achieved.

At April 30, 2004, the Company had cash of approximately \$2,747,000 compared to approximately \$2,120,000 at July 31, 2003.

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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)

| | April 30 2004 (Unaudited) | July 31 2003 (Audited) | Net Change |
|--|--|---------------------------------------|-----------------------|
| Note payable to WITECH: | | | |
| Current portion of note payable | 200 | | 200 |
| Long term portion of note payable | 500 | | 500 |
| | <hr/> | <hr/> | <hr/> |
| Total note payable to WITECH | 700 | | 700 |
| Notes payable to New Holders: | | | |
| Current portion of notes payable | 800 | 400 | 400 |
| Long term portion of notes payable | 2,900 | 3,500 | (600) |
| | <hr/> | <hr/> | <hr/> |
| Total face value of notes payable to New Holders | 3,700 | 3,900 | (200) |
| Carrying value in excess of face amount of notes payable | 250 | 302 | (52) |
| Debt discount (common stock warrants and options) | (27) | (33) | 6 |
| | <hr/> | <hr/> | <hr/> |
| Total carrying value of notes payable to New Holders | 3,923 | 4,169 | (246) |
| Receivables financing | | 346 | (346) |
| | <hr/> | <hr/> | <hr/> |
| Total debt and receivables financing | \$ 4,623 | \$ 4,515 | \$ 108 |
| | <hr/> | <hr/> | <hr/> |

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 in quarterly installments of \$50,000 and bearing interest at prime plus 2%. The note does not contain any financial covenants.

On April 24, 2003, the Company restructured previously outstanding securities which were then held by New Holders. The interest rate on the new notes is prime plus 2%. Collectively, 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.

On September 28, 1999, ARI and RFC Capital Corporation (RFC) executed a Receivables Sales Agreement (the Sale Agreement). The initial three-year Sale Agreement allowed RFC to purchase up to \$3.0 million of ARI s accounts receivable. Under the Sale Agreement, RFC purchased 90% of eligible receivables. The Sale Agreement expired on November 28, 2003 and was not renewed. Management does not believe this will materially impact its ability to fund operations in fiscal 2004.

Management believes that funds generated from operations will be adequate to fund the Company s operations, investments and debt payments through fiscal 2004.

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

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

| | Three months ended | | Percent Change | Nine months ended | | Percent Change |
|---|-----------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| | April 30 | | | April 30 | | |
| | 2004 | 2003 | | 2004 | 2003 | |
| Net income (loss) | \$ 180 | \$ (654) | 128% | \$ 427 | \$(1,274) | 134% |
| Plus: Interest | 55 | 291 | (81%) | 200 | 970 | (79%) |
| Amortization of software products | 435 | 440 | (1%) | 1,323 | 1,304 | 1% |
| Other depreciation and amortization | 38 | 52 | (27%) | 110 | 164 | (33%) |
| | <u> </u> | <u> </u> | | <u> </u> | <u> </u> | |
| Earnings before interest, taxes, depreciation and amortization | \$ 708 | \$ 129 | 449% | \$2,060 | \$ 1,164 | 77% |
| | <u> </u> | <u> </u> | | <u> </u> | <u> </u> | |

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Earnings before interest, taxes, depreciation and amortization (EBITDA) increased for the three and nine month periods ended April 30, 2004, compared to the same periods last year, primarily due to the increase in revenue and a decrease in overhead expenses, primarily third quarter legal expense. Management believes that EBITDA will continue to increase over last year for the remainder of fiscal 2004, although there can be no assurance that this will occur.

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

Forward Looking Statements

Certain statements contained in this Form 10-QSB are forward looking statements including revenue growth, future cash flows and cash generation and sources of liquidity. Expressions such as believes, anticipates, expects, and similar expressions are intended to identify such forward looking statements. Several important factors can cause actual results to materially differ from those stated or implied in the forward looking statements. Such factors include, but are not limited to the factors listed on exhibit 99.1 of the Company's annual report on Form 10-K for the year ended July 31, 2003, 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

ARI maintains a set of disclosure controls and procedures that are designed to ensure that information required to be disclosed by it in the reports filed by it under the Securities Exchange Act of 1934, as amended (Exchange Act) is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. ARI carried out an evaluation, under the supervision and with the participation of its management, including its Chief Executive Officer and its Chief Financial Officer, of the effectiveness of the design and operation of its disclosure controls and procedures pursuant to Rule 13a-15 of the Exchange Act. Based on that evaluation, ARI's Chief Executive Officer and its Chief Financial Officer concluded that ARI's disclosure controls and procedures are effective as of April 30, 2004.

There have been no changes in ARI's internal control over financial reporting identified in connection with the evaluation discussed above that occurred during the fiscal quarter ended April 30, 2004 that have materially affected,

or are reasonably likely to materially affect, ARI's internal control over financial reporting.

PART II OTHER INFORMATION

ITEM 2. CHANGES IN SECURITIES AND SMALL BUSINESS ISSUER PURCHASES OF EQUITY SECURITIES

During the quarter ended April 30, 2004, except as noted below, the Company did not sell any equity securities which were not registered under the Securities Act or repurchase any of its equity securities.

On April 2, 2004, the Company settled \$260,961 of deferred compensation owed to three executive officers. The settlement was paid one-half in cash and one-half in stock. The stock was priced at \$1.60 per share, the average of the closing bid and asked prices of the Company's common stock on the date of settlement. A total of 81,550 shares of stock were issued.

The transaction was exempt from registration under the Securities Act pursuant to Section 4(2) thereof. Each of the executive officers provided investment representations, and the stock certificates bear a restrictive legend.

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ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

10.1 Payment of Deferred Compensation agreement dated April 2, 2004 , between the Company and Mr. Brian Dearing.

10.2 Payment of Deferred Compensation agreement dated April 2, 2004 , between the Company and Mr. John Bray.

10.3 Payment of Deferred Compensation agreement dated April 2, 2004 , between the Company and Mr. Michael McGurk.

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.

(b) Reports on Form 8-K

On February 26, 2004, ARI furnished a Form 8-K (dated February 26, 2004) with respect to Item 12.

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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 14, 2004

/s/ Brian E. Dearing

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

/s/ Timothy Sherlock

Timothy Sherlock, Chief Financial Officer