ARI NETWORK SERVICES INC /WI
Form 10QSB
June 14, 2006

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

(Mark One)

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

For the quarterly period ended April 30, 2006

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

For the transition period from ____________________ to ____________________

Commission file number 000-19608

ARI Network Services, Inc.

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

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

11425 W. Lake Park Drive, Milwaukee, Wisconsin 53224
(Address of principal executive 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 þ NO o

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

YES o NO þ

As of June 7, 2006 there were 6,202529 shares of the registrant s common stock outstanding.

Transitional Small Business Disclosure Format (check one).

YES o NO þ

ARI Network Services, Inc.
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ITEM 1. FINANCIAL STATEMENTS

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

	April 30 2006	July 31 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 3,652	$ 3,651
Trade receivables, less allowance for doubtful accounts of $133 and $71 at April 30, 2006 and July 31, 2005, respectively	1,308	1,023
Prepaid expenses and other	253	203
Deferred income taxes	747	160
Total current assets	5,960	5,037
Equipment and leasehold improvements:		
Computer equipment	4,961	4,813
Leasehold improvements	111	73
Furniture and equipment	2,010	1,702
	7,082	6,588
Less accumulated depreciation and amortization	6,171	5,893
Net equipment and leasehold improvements	911	695
Deferred income taxes	1,156	705
Other assets	7	10
Capitalized software product costs	11,395	10,927
Less accumulated amortization	9,899	9,441
Net capitalized software product costs	1,496	1,486
Total Assets	$ 9,530	$ 7,933

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

	April 30 2006	July 31 2005
LIABILITIES AND SHAREHOLDERS EQUITY (DEFICIT)		
Current liabilities:		
Current portion of notes payable	$ 1,400	$ 1,200
Accounts payable	322	323
Deferred revenue	5,585	5,441
Accrued payroll and related liabilities	793	1,134
Accrued sales, use and income taxes	52	74
Accrued vendor specific liabilities	607	530
Other accrued liabilities	351	242
Current portion of capital lease obligations		4
Total current liabilities	9,110	8,948
Long term liabilities:		
Notes payable (net of discount)	940	2,037
Long term payroll related	480	461
Other long term liabilities	41	96
Total long term liabilities	1,461	2,594
Shareholders equity (deficit):		
Cumulative preferred stock, par value $.001 per share, 1,000,000 shares authorized; 0 shares issued and outstanding at April 30, 2006 and July 31, 2005, respectively		
Common stock, par value $.001 per share, 25,000,000 shares authorized; 6,197,529 and 6,064,534 shares issued and outstanding at April 30, 2006 and July 31, 2005, respectively	6	6
Common stock warrants and options	36	36
Additional paid-in-capital	93,832	93,751
Accumulated deficit	(94,915)	(97,402)
Total shareholders equity (deficit)	(1,041)	(3,609)
Total Liabilities and Shareholders Equity (Deficit)	$ 9,530	$ 7,933

See notes to unaudited condensed consolidated financial statements.

Note: The balance sheet at July 31, 2005 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)

	Three months ended April 30		Nine months ended April 30	
	2006	**2005**	**2006**	**2005**
Net revenues:				
Subscriptions, support and other services fees	$ 2,621	$ 2,534	$ 7,733	$ 7,358
Software licenses and renewals	498	552	1,531	1,686
Professional services	434	373	1,302	994
	3,553	3,459	10,566	10,038
Cost of products and services sold:				
Subscriptions, support and other services fees	265	186	653	612
Software licenses and renewals *	168	153	490	452
Professional services	81	134	276	264
	514	473	1,419	1,328
Gross margin	3,039	2,986	9,147	8,710
Operating expenses:				
Depreciation and amortization (exclusive of amortization of software products included in cost of products and services sold)	104	67	278	190
Customer operations and support	273	265	855	784
Selling, general and administrative	1,862	1,805	5,561	5,259
Software development and technical support	344	295	924	855
Net operating expenses	2,583	2,432	7,618	7,088
Operating income	456	554	1,529	1,622
Other income (expense):				
Interest expense	(45)	(49)	(144)	(140)
Other, net	46	3	94	25
Total other income (expense)	1	(46)	(50)	(115)
Income before provision for income taxes	457	508	1,479	1,507
Income tax benefit (provision)	1,008	(13)	1,008	(63)
Net income	$ 1,465	$ 495	$ 2,487	$ 1,444

Average common shares outstanding:

Basic	6,175	6,008	6,152	5,974
Diluted	6,621	6,598	6,598	6,564
Basic and diluted net income per share:				
Basic	$ 0.24	$ 0.08	$ 0.40	$ 0.24
Diluted	$ 0.22	$ 0.08	$ 0.38	$ 0.22

See notes to unaudited condensed consolidated financial statements.

* Includes amortization of software products of $161, $143, $458 and $417 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)

	Nine months ended April 30	
	2006	**2005**
Operating activities		
Net income	$ 2,487	$ 1,444
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of software products	458	417
Amortization of deferred financing costs, debt discount and excess carrying value over face amount of notes payable	(44)	(58)
Depreciation and other amortization	278	190
Deferred income taxes	(1,038)	
Stock issued as contribution to 401(k) plan	21	37
Net change in receivables, prepaid expenses and other current assets	(335)	376
Net change in accounts payable, deferred revenue, accrued liabilities and other long term liabilities	(70)	(272)
Net cash provided by operating activities	1,757	2,134
Investing activities		
Purchase of equipment and leasehold improvements	(494)	(232)
Software product costs capitalized	(468)	(939)
Net cash used in investing activities	(962)	(1,171)
Financing activities		
Payments under notes payable	(850)	(750)
Payments of capital lease obligations	(4)	(7)
Proceeds from issuance of common stock	60	69
Net cash used in financing activities	(794)	(688)
Net increase in cash	1	275
Cash at beginning of period	3,651	3,357
Cash at end of period	$ 3,652	$ 3,632
Cash paid for interest	$ 190	$ 197
Cash paid for income taxes	$	$ 55

Noncash investing and financing activities

Redemption of common stock in connection with exercise of stock options	$	54	$

See notes to unaudited condensed consolidated financial statements.

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Notes to Condensed Consolidated Financial Statements
(Unaudited)
April 30, 2006

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, 2006 are not necessarily indicative of the results that may be expected for the fiscal year ending July 31, 2006. 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, 2005.

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 from the functional currency into United States dollars 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 April 30		Nine months ended April 30	
	2006	2005	2006	2005
Weighted average common shares outstanding	6,175	6,008	6,152	5,974
Dilutive effect of stock options and warrants	446	590	446	590
Diluted weighted average common shares outstanding	6,621	6,598	6,598	6,564

3. STOCK-BASED COMPENSATION

The Company has stock-based compensation plans. SFAS No. 123 Accounting for Stock-Based Compensation encourages, but does not require companies to record compensation cost for stock-based employee compensation plans at fair value. The Company has chosen to continue using the intrinsic value method in accounting for its stock option plans. SFAS No. 123 requires companies with stock-based compensation plans to disclose the pro forma effect of stock-based compensation on earnings and earnings per share. The following table sets forth the effect on earnings and earnings per share (in thousands, except per share data) of stock-based compensation had the cost been determined based upon the fair value at the grant date for awards under the plan using the Black-Scholes valuation method.

	Three months ended April 30	Nine months ended April 30

	2006	2005	2006	2005
Net income, as reported	$ 1,465	$ 495	$ 2,487	$ 1,444
Stock-based compensation using the fair value method	(85)	(93)	(247)	(229)
Pro forma net income	$ 1,380	$ 402	$ 2,240	$ 1,215
Net income per share				
Basic as reported	$ 0.24	$ 0.08	$ 0.40	$ 0.24
Basic pro forma	$ 0.22	$ 0.07	$ 0.36	$ 0.20
Diluted as reported	$ 0.22	$ 0.08	$ 0.38	$ 0.22
Diluted pro forma	$ 0.21	$ 0.06	$ 0.34	$ 0.19

4. 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 9.75% as of April 30, 2006). 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 9.75% as of April 30, 2006). The note does not contain any financial covenants.

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 the Company s common stock (or if an existing holder of 10% or more of the common stock were to increase its position by more than 1%), the Rights would become exercisable for every shareholder except the acquirer that triggered the exercise. The Rights, if triggered, would give the other shareholders the ability to purchase additional stock of the Company at a substantial discount. The Rights will expire on August 18, 2013, and can be redeemed by the Company for $0.01 per Right at any time prior to a person or group becoming a 10% shareholder.

6. INCOME TAXES

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

	Three months ended April 30		Nine months ended April 30	
	2006	2005	2006	2005
Current:				
Federal	$ 145	$ 11	$ 493	$ 54
State	46	2	108	9
Deferred	(1,000)		(1,000)	
Utilization of net operating loss carryforwards	(199)		(609)	
Income tax (benefit) provision	$ (1,008)	$ 13	$ (1,008)	$ 63

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 had a change in its estimated valuation allowance of approximately $1 million due to a historical trend of eight quarters of profitability and projections of profitability in the near future.

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7. **CLAIM FOR INDEMNIFICATION**
On November 5, 2004, the Company received a letter on behalf of one of its customers asserting a warranty claim and/or a claim for indemnity with respect to a complaint filed against the customer for patent infringement in the United States District Court for the Eastern District of Texas. In connection with the case, the customer identified three other suppliers as potential indemnitors as well. The customer is one of several primarily large, multinational corporate defendants alleged to have violated patents purporting to cover an Electronic Proposal Preparation System (U.S. Patent No. 5,615,342) and/or Computer-Assisted Parts Sales Method (U.S. Patent No. 5,367,627). The customer settled the patent infringement claim in February 2006 and since then, has not reasserted an indemnification claim against the Company.

MANAGEMENT S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

Results of Operations

Total revenue increased $94,000 or 3% for the three month period ended April 30, 2006 and $528,000 or 5% for the nine month period ended April 30, 2006, compared to the same periods last year, primarily due to an increase in revenues from the Company s North American catalog subscriptions, professional services and dealer marketing services. Operating income decreased $98,000 or 18% for the three month period ended April 30, 2006 and $93,000 or 6% for the nine month period ended April 30, 2006, compared to the same periods last year, primarily due to an increase in selling, general and administrative expense. Earnings increased from $495,000 or $0.08 per basic share for the three months ended April 30, 2005 to $1,465,000 or $0.24 per basic share for the three months ended April 30, 2006 and increased from $1,444,000 or $0.24 per basic share for the nine months ended April 30, 2005 to $2,487,000 or $0.40 per basic share for the nine months ended April 30, 2006 primarily due to a change in the valuation allowance related to the Company s deferred tax assets. Management expects revenues and operating expenses to continue to increase over the prior year for the remainder of fiscal 2006.

During fiscal year 2006, the Company is focused on four growth initiatives: (1) maintaining and enhancing the current catalog business; (2) growing the dealer marketing services business; (3) instituting a dealer-direct business model in Europe; and (4) making selected synergistic acquisitions. We anticipate that the expenses and investments associated with these growth initiatives (primarily 2 and 3) will be at a level that will result in little or no growth in operating income for fiscal 2006, but that the revenues generated by these initiatives will result in increased net income for fiscal 2007 and beyond.

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. 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.

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Bad Debts

The Company maintains an allowance for doubtful accounts for estimated losses resulting from the inability or unwillingness 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 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.

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 include 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 commercial paper and money market mutual funds with terms not exceeding ninety days.

Debt Instruments

The Company valued debt discounts for common stock warrants issued in exchange 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 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 a valuation allowance 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

The Company accounts for its employee stock option plans under the recognition and measurement principles whereby no stock-based compensation is reflected in net income, 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.

The FASB amended Statement No. 123(R), Share-Based Payment, which generally requires share-based payments to employees and non-employee directors, including grants of employee stock options and purchases under employee stock purchase plans, to be recognized in the statement of operations based on their fair values. This standard is effective for public companies that are small business issuers for fiscal years beginning after December 15, 2005. The

Company expects to adopt this new standard at the beginning of its fiscal year ending July 31, 2007 using the modified prospective method, which does not restate prior period financial statements but shows comparative financial statements as if they had expensed the stock-based compensation under FASB Statement No. 123.

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Revenues

The Company is a leading provider of electronic parts catalogs and related technology and services to increase sales and profits for dealers in the manufactured equipment market. The Company currently provides 91 catalogs of manufactured equipment from 72 manufacturers to approximately 29,000 dealers in approximately 96 countries in 12 segments of the worldwide manufactured equipment market including outdoor power, power sports, motorcycles, recreation vehicles, marine, construction, floor maintenance, 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 81,000 catalog subscriptions. The Company supplies three types of software and services: (1) robust Web and CD-ROM interactive electronic parts catalogs; (2) dealer marketing services including website creation, hosting and maintenance services, technology-enabled direct mail services,and e-mail marketing services and (3) communication or transaction services. The Company s primary product line at present is electronic parts catalogs; 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 subscription is distributed.

Catalog, Customer and Subscription Information by Region
(As of April 30, 2006)

	Catalogs	Distinct Manufacturers	Subscriptions	Distinct Distributors (Estimated)	Distinct Dealers (Estimated)
North America	83	63	71,818	107	22,923
Rest of World	57	9	9,436	50	6,034
Included in both Regions	(49)				
Total	91	72	81,254	157	28,957

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	=	