

ARI NETWORK SERVICES INC /WI

Form 10QSB

December 15, 2003

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-QSB

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

For the quarterly period ended October 31, 2003

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 (ü) NO ()

Transitional Small Business Disclosure Format (check one).

YES () NO (ü)

As of December 10, 2002 there were 5,768,444 shares of the registrant's shares outstanding.

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

ASSETS	<u>October 31 2003</u>	<u>July 31 2003</u>
Current assets:		
Cash	\$ 1,774	\$ 2,120
Trade receivables, less allowance for doubtful accounts of \$84 at October 31, 2003 and \$98 at July 31, 2003	964	1,088
Prepaid expenses and other	95	115
	<u> </u>	<u> </u>
Total current assets	2,833	3,323
Equipment and leasehold improvements:		
Computer equipment	4,475	4,475
Leasehold improvements	73	73
Furniture and equipment	1,389	1,372
	<u> </u>	<u> </u>
	5,937	5,920
Less accumulated depreciation and amortization	5,509	5,474
	<u> </u>	<u> </u>
Net equipment and leasehold improvements	428	446
Other assets	20	0
Capitalized software product costs	9,808	9,602
Less accumulated amortization	8,164	7,721
	<u> </u>	<u> </u>
Net capitalized software product costs	1,644	1,881
	<u> </u>	<u> </u>
Total Assets	\$ 4,925	\$ 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)

LIABILITIES AND SHAREHOLDERS EQUITY (DEFICIT)	October 31 2003	July 31 2003
Current liabilities:		
Current portion of notes payable	\$ 800	\$ 400
RFC financed receivables facility	94	346
Accounts payable	336	401
Deferred revenue	4,842	5,280
Accrued payroll and related liabilities	1,108	1,088
Other accrued liabilities	689	601
Current portion of capital lease obligations	17	20
	<u>7,886</u>	<u>8,136</u>
Total current liabilities	7,886	8,136
Long term liabilities:		
Notes payable (net of discount)	4,154	3,769
Other long term liabilities	555	559
Capital lease obligations	12	16
	<u>4,721</u>	<u>4,344</u>
Total long term liabilities	4,721	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 October 31, 2003 and July 31, 2003, respectively		
Common stock, par value \$.001 per share, 25,000,000 shares authorized; 5,768,444 and 6,645,191 shares issued and outstanding at October 31, 2003 and July 31, 2002, respectively	5	6
Common stock warrants and options	36	141
Additional paid-in-capital	93,477	94,295
Accumulated deficit	(101,200)	(101,272)
	<u>(7,682)</u>	<u>(6,830)</u>
Total shareholders' equity (deficit)	(7,682)	(6,830)
Total Liabilities and Shareholders' Equity (Deficit)	\$ 4,925	\$ 5,650

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.

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

	Three months ended October 31	
	2003	2002
Net revenues:		
Subscriptions, support and other services fees	\$2,289	\$1,991
Software licenses and renewals	589	557
Professional services	407	507
	<u>3,285</u>	<u>3,055</u>
Operating expenses:		
Cost of products and services sold:		
Subscriptions, support and other services fees	155	189
Software licenses and renewals *	462	425
Professional services	191	150
	<u>808</u>	<u>764</u>
Depreciation and amortization (exclusive of amortization of software products included in cost of products and services sold)	35	59
Customer operations and support	283	310
Selling, general and administrative	1,758	1,514
Software development and technical support	341	475
	<u>3,225</u>	<u>3,122</u>
Operating expenses before amounts capitalized	3,225	3,122
Less capitalized portion	(64)	(160)
	<u>3,161</u>	<u>2,962</u>
Net operating expenses	3,161	2,962
Operating income	124	93
Other expense:		
Interest expense	(81)	(335)
Other, net	29	(3)
	<u>(52)</u>	<u>(338)</u>
Total other expense	(52)	(338)
Net income (loss)	\$ 72	\$ (245)
Average common shares outstanding:		
Basic	5,796	6,329
Diluted	5,921	6,329
Net income (loss) per share:		
Basic	\$ 0.01	\$ (0.04)
Diluted	\$ 0.01	\$ (0.04)

See notes to unaudited condensed financial statements.

* Includes amortization of software products of \$443 and \$419 and excludes other depreciation and amortization shown separately
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ARI Network Services, Inc.
Statements of Cash Flows
(In thousands)
(Unaudited)

	Three months ended October 31	
	2003	2002
Operating activities		
Net income (loss)	\$ 72	\$(245)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Amortization of software products	443	419
Amortization of deferred financing costs, debt discount and excess carrying value over face amount of notes payable	(15)	237
Depreciation and other amortization	35	59
Stock issued as contribution to 401(k) plan	37	
Net change in receivables, prepaid expenses and other current assets	149	133
Net change in accounts payable, deferred revenue, accrued liabilities and other long term liabilities	(653)	(370)
	68	233
Investing activities		
Purchase of equipment and leasehold improvements	(17)	(3)
Purchase of assets related to acquisitions	(108)	
Software product costs capitalized	(64)	(160)
	(189)	(163)
Financing activities		
Payments under notes payable	(200)	(80)
Payments of capital lease obligations	(7)	(47)
Debt issuance costs incurred	(20)	
Proceeds from issuance of common stock	2	
	(225)	(127)
Net decrease in cash	(346)	(57)
Cash at beginning of period	2,120	879
	\$ 1,774	\$ 822
Cash paid for interest	\$ 22	\$ 29
Noncash investing and financing activities		
Issuance of common stock in connection with acquisitions	\$ 37	\$
Exchange of equity to debt	1,000	

See notes to unaudited condensed financial statements.

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Notes to Condensed Financial Statements
(Unaudited)
October 31, 2003

1. BASIS OF PRESENTATION

The accompanying unaudited financial statements have been prepared and reviewed 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 October 31, 2003 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 that are in the money were exercised (calculated using the treasury stock method). The effect of dilutive stock options on net loss per common share is antidilutive and therefore 0. 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(loss) per common share for (in thousands) the periods indicated.

	Three months ended October 31	
	2003	2002
Weighted average common shares outstanding	5,796	6,329
Dilutive effect of stock options	125	
Diluted weighted average common shares outstanding	5,921	6,329

3. STOCK-BASED COMPENSATION

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

	Three months ended October 31	
	2003	2002
Net income (loss), as reported	\$ 72	\$ (245)
Stock-based compensation using the fair value method	(20)	(19)
Pro forma net income (loss)	\$ 52	\$ (264)
Net income (loss) per share		
Basic - as reported	\$0.01	\$(0.04)
Basic - pro forma	\$0.01	\$(0.04)
Diluted - as reported	\$0.01	\$(0.04)
Diluted - pro forma	\$0.01	\$(0.04)

4. NOTES PAYABLE

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

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 are 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.

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 October 31, 2003 increased \$231,000 or 8% 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 \$245,000, or \$0.04 per share for the quarter ended October 31, 2002 to net income of \$72,000 or \$0.01 per share for the quarter ended October 31, 2003. 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 "Liquidity and Capital Resources" and "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

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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 74 catalogs of manufactured equipment for 57 manufacturers to approximately 23,000 dealers in more than 100 countries in 12 segments of the worldwide manufactured equipment market including outdoor power, recreation vehicles, auto and truck parts aftermarket, marine, construction, power sports, floor maintenance and others. Collectively, dealers and distributors have approximately 84,000 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 subscription is 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 October 31, 2003)

	Catalogs	Distinct Manufacturers	Subscriptions	Distinct Distributors (Estimated)	Distinct Dealers (Estimated)
North American	67	49	67,544	117	17,930
Non-North American	68	8	16,100	17	5,232
Included in both Regions	(61)				
Total	74	57	83,644	134	23,162

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