ARI NETWORK SERVICES INC /WI
Form 10-Q/A
June 01, 2001

1

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q/A

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

For the quarterly period ended January 31, 2001

OR

( ) TRANSITION REPORT PURSUANT TO 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 registrant as specified in its charter)

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

330 E. Kilbourn Avenue, Milwaukee, Wisconsin 53202
(Address of principal executive office)

Registrant's telephone number, including area code (414) 278-7676

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of The Securities Exchange Act of 1934 during the preceding 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

As of May 25, 2001 there were 6,184,281 shares of the registrant's shares outstanding.

2

ARI NETWORK SERVICES, INC.

NOTE REGARDING AMENDED FORM 10-Q

The Company is making this filing to show, among other things, the effect of the restatement of our financial statements noted below. For current information on ARI Network Services, Inc., please refer to other recent filings with the Securities and Exchange Commission.

The Company sells licenses or license renewals and maintenance service agreements to most of its customers for the software products sold to them. The Company had previously recognized revenues related to the licenses at the time of delivery and license renewals at the time of renewal. Following discussions with the staff of the Securities and Exchange Commission, the Company revised its revenue recognition policy for transactions entered into after August 1, 1999, to recognize revenues resulting from these licenses and renewals over the term of the arrangement, which is generally twelve months.

As a result of this revision, the Company has restated its financial statements as of and for the three and six months ended January 31, 2001 and 2000. As a result of this revision, the Company's revenues and earnings have increased by $226,000 or $0.03 per share and decreased by $437,000 or $0.07 per share for the three and six months ended January 31, 2001, respectively and decreased by $523,000 or $0.09 per share and $853,000 or $0.14 per share for the three and six months ended January 31, 2000, respectively.

To give effect to the above restatement, the Company is amending only the following sections of the Report on Form 10-Q:

Part I, Item 1. Financial Statements

Part I, Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation

ARI NETWORK SERVICES, INC.

FORM 10-Q

FOR THE THREE MONTHS ENDED JANUARY 31, 2001

INDEX

PART I - FINANCIAL INFORMATION

Item 1 Financial statements
Condensed balance sheets - January 31, 2001 and July 31, 2000

Condensed statements of operations for the three and six months ended January 31, 2001 and 2000

Condensed statements of cash flows for the six months ended January 31, 2001 and 2000

Notes to unaudited condensed financial statements

Item 2 Management's discussion and analysis of financial condition and results of operations

Signatures

ARI NETWORK SERVICES, INC.
BALANCE SHEETS
(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)
(RESTATED AND UNAUDITED)

ASSETS	JANUARY 31 2001	JULY 200
Current assets:		
Cash and cash equivalents	$ 810	$
Trade receivables, less allowance for doubtful accounts of $754 at January 31, 2001 and $697 at July 31, 2000	3,045	
Prepaid expenses and other	107	
Total current assets	3,962	
Equipment and leasehold improvements:		
Computer equipment	4,394	
Leasehold improvements	239	
Furniture and equipment	992	
	5,625	
Less accumulated depreciation and amortization	5,193	
Net equipment and leasehold improvements	432	

Goodwill, less accumulated amortization of $1,742 at January 31, 2001 and $1,413 at July 31, 2000	1,547	
Deferred financing costs, less accumulated amortization of $126 at January 31, 2001 and $59 at July 31, 2000	293	
Capitalized software development:		
Network platform	11,467	1
Software products	30,257	2
	41,724	4
Less accumulated amortization	30,841	2
Net capitalized software development	10,883	1
TOTAL ASSETS	$ 17,117	$ 1

ARI NETWORK SERVICES, INC.
BALANCE SHEETS
(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)
(RESTATED AND UNAUDITED)

LIABILITIES AND SHAREHOLDERS' EQUITY	JANUARY 31 2001
Current liabilities:	
Current portion of notes payable to shareholder	$ 361
Current portion of notes payable	422
Accounts payable	651
Unearned income	5,293
Accrued payroll and related liabilities	1,730
Other accrued liabilities	1,331
Current portion of capital lease obligations	151
Total current liabilities	9,939
Long term liabilities:	
Notes payable to shareholder (net of discount)	164
Notes payable (net of discount)	2,360
Capital lease obligations	233
Total long term liabilities	2,757
Shareholders' equity:	
Cumulative preferred stock, par value $.001 per share, 1,000,000 shares authorized; 20,350 shares issued and outstanding at January 31, 2001 and July 31, 2000	--
Common stock, par value $.001 per share, 25,000,000 shares authorized; 6,168,270 shares issued and outstanding at January 31, 2001 and July 31, 2000	6

Common stock warrants and options	2,459
Additional paid-in-capital	91,781
Accumulated deficit	(89,825)
Total shareholders' equity	4,421
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$ 17,117

See notes to unaudited condensed financial statements.

Note: The balance sheet at July 31, 2000 has been derived from the audited balance sheet at that date but does not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

5

6

ARI NETWORK SERVICES, INC.
STATEMENTS OF OPERATIONS
(IN THOUSANDS, EXCEPT PER SHARE DATA)
(RESTATED AND UNAUDITED)

	THREE MONTHS ENDED JANUARY 31	
	2001	2000
Net revenues:		
Subscriptions, support and transaction fees	$ 2,550	$ 2,479
Software licenses and renewals	842	210
Professional services	694	637
	4,086	3,326
Operating expenses:		
Cost of products and services sold:		
Subscriptions, support and transaction fees	317	403
Software licenses and renewals*	907	981
Professional services	402	408
	1,626	1,792
Depreciation and amortization (exclusive of amortization of software products included in cost of sales)	370	412
Customer operations and support	409	541
Selling, general and administrative	2,200	2,115
Software development and support	830	822
Operating expenses before amounts capitalized	5,435	5,682
Less capitalized portion	(508)	(447)

Net operating expenses	4,927	5,235
Operating loss	(841)	(1,909)
Other expense:		
Interest expense	(396)	(180)
Other, net	21	(2)
Total other expense	(375)	(182)
Net loss	$ (1,216)	(2,091)
Average common shares outstanding	6,168	5,974
Basic and diluted net loss per share	$ (0.20)	$ (0.35)

See notes to unaudited condensed financial statements.

* Includes amortization of software products of $793, $820, $1,672 and $1,575 and excludes other depreciation and amortization shown separately

6

7

ARI NETWORK SERVICES, INC.
STATEMENTS OF CASH FLOWS
(IN THOUSANDS)
(RESTATED AND UNAUDITED)

	SIX MONTHS JANUARY 2001
OPERATING ACTIVITIES	
Net loss	$ (2,738)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:	
Amortization of network platform	286
Amortization of software products	1,672
Amortization of goodwill	329
Amortization of deferred financing costs and debt discount	476
Depreciation and other amortization	155
Net change in receivables, prepaid expenses and other	239
Net change in accounts payable, unearned income and accrued liabilities	1,304
Net cash provided by (used in) operating activities	1,723
INVESTING ACTIVITIES	
Purchase of equipment and leasehold improvements	(10)
Software products capitalized	(940)
Net cash provided by (used in) investing activities	(950)

FINANCING ACTIVITIES	
Net borrowings under line of credit	--
Repayments under notes payable	(405)
Deferred financing costs	(39)
Payments of capital lease obligations	(82)
Proceeds from issuance of common stock	--
Net cash provided by (used in) financing activities	(526)
Net increase (decrease) in cash	247
Cash at beginning of period	563
Cash at end of period	$ 810
Cash paid for interest	$ 291
NONCASH INVESTING AND FINANCING ACTIVITIES	
Capital lease obligations incurred for:	
Furniture and equipment	$ 141
Issuance of common stock as payment of line of credit	--
Conversion of line of credit to note payable	--

See notes to unaudited condensed financial statements.

7

8

NOTES TO CONDENSED FINANCIAL STATEMENTS
(RESTATED AND UNAUDITED)
JANUARY 31, 2001

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 generally accepted accounting principles 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 six months ended January 31, 2001 are not necessarily indicative of the results that may be expected for the fiscal year ending July 31, 2001. For further information, refer to the financial statements and footnotes thereto included in the Company's annual report on Form 10-KA for the year ended July 31, 2000.

2. BASIC AND DILUTED NET LOSS PER SHARE

Dilutive earnings per share is not shown as the impact is antidilutive.

3. PREFERRED STOCK

The Series A preferred stock accrues dividends on a quarterly basis,

cumulatively, at a rate per annum equal to the product of the stated value thereof and 2% above the prime rate (minimum dividend rate of 10% and maximum of 14%). All Series A preferred stock must be redeemed at $100 per share plus accrued and unpaid dividends prior to any payment of dividends on, or repurchases by the Company of, the Company's common stock. Prior to August 1, 2002, dividends, if declared by the Board of Directors, can be paid in either cash or additional shares of Series A preferred stock. The total amount of dividends in arrears on the Series A preferred stock is $887,000 at January 31, 2001.

4. NOTES PAYABLE

The convertible debentures, issued on April 27, 2000, and accrued interest thereon are convertible into common stock at a rate of $4 per share, subject to certain conditions and adjustments. Concurrent with the issuance of the debentures, the Company issued the investors 600,000 common stock purchase warrants expiring April 27, 2005 and 800,000 investment options expiring October 27, 2001. Each of the warrants and options are exercisable for one share of common stock at a price of $6 per share. The warrants and options, which were estimated to have a value of $2,354,000 at the time of issuance, less accumulated amortization, reduce the carrying amount of the debt.

5. DERIVATIVES

Effective August 1, 2000, the Company adopted Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended by SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities," which establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. SFAS No. 133, as amended, requires the recognition of all derivative instruments as either assets or liabilities in the statement of financial position measured at fair value. The impact of the adoption of SFAS 133 was immaterial to the Company's financial statements.

6. RESTATEMENT

As a result of discussions with the Securities and Exchange Commission that concluded on May 21, 2001, the Company has restated its financial statements as of and for the three and six months ended January 31, 2001 and 2000 to defer revenue recognition allocable to software licenses in multiple element arrangements under SOP 97-2, Software Revenue Recognition, as amended by SOP 98-4 and SOP 98-9. SOP 98-9, which included more restrictive requirements for establishing vendor specific objective evidence of fair value in multiple element arrangements, was effective for transactions entered into by the Company beginning August 1, 1999. As a result of this revision, the Company's revenues and earnings have increased by $226,000 or $0.03 per share and decreased by $437,000 or $0.07 per share for the three and six months ended January 31, 2001, respectively and decreased by $523,000 or $0.09 per share and $853,000 or $0.14 per share for the three and six months ended January 31, 2000, respectively. The effect on the balance sheet as of January 31, 2001 and July 31, 2000 was an increase in unearned income and an increase in accumulated deficit of $1,693,000 and $1,256,000, respectively.

NOTES TO CONDENSED FINANCIAL STATEMENTS (CONTINUED)

(UNAUDITED)
OCTOBER 31, 2000

7. SUBSEQUENT EVENTS

On March 29, 2001, the Company received a letter from the Nasdaq National Market (Nasdaq) stating that the Company's common stock failed to maintain a minimum market value of public float of $5 million over 30 consecutive trading days. The Company has been provided 90 days to become compliant with this Nasdaq requirement. On May 15, 2001, the Company received a letter from Nasdaq stating that the Company's common stock failed to maintain a minimum bid price of $1.00 over 30 consecutive trading days. The Company has been provided 90 days to become compliant with this Nasdaq requirement. Unless the Company demonstrates compliance with the requirements or appeals the decisions, the Company's common stock will be delisted from Nasdaq and trading in the Company's common stock would thereafter be conducted in the over-the-counter markets such as the OTC Bulletin Board.

The RGC International Investors Debenture (see liquidity) requires the Company to maintain the listing of its common stock on Nasdaq, the Nasdaq Small Cap Market, the New York Stock Exchange or the American Stock Exchange. Failure to cure a violation under the Debenture within 10 days is considered a default which would result in the subordinated debenture becoming due and payable at 130% of the outstanding principal and accrued interest balances, as well as, an increase in the stated interest rate from 7% to 17%.

The Company's loan agreement with a shareholder (see liquidity) requires maintenance of a minimum net worth of $5.3 million at all times. As of January 31, 2001, the Company is in violation of this covenant, resulting in the note payable to shareholder and line of credit payable to shareholder being due and payable. The line of credit expires December 31, 2001. The Company is in discussions with the shareholder to reduce the net worth requirement.

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

RESULTS OF OPERATIONS

Total revenue for the quarter ended January 31, 2001 increased 23% from $3,326,000 in fiscal 2000 to $4,086,000 in fiscal 2001, representing the nineteenth of the past twenty consecutive quarters of year-over-year revenue improvement. Earnings improved by 42%, from a net loss of $2,091,000, or $0.35 per share for the quarter ended January 31, 2000 to a net loss of $1,216,000 or $0.20 per share for the quarter ended January 31, 2001.

REVENUES

The Company is a leading provider of Partner Relationship Management and business-to-business Internet e-Commerce solutions for sales, service and life-cycle product support in the manufactured equipment market. The Company currently serves over 100 manufacturers and 20,000 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. The Company builds and supports a full suite of multi-media electronic catalog publishing and viewing software for the Web or CD. The Company's communications systems provide a global electronic pathway for parts orders, product registrations, warranty claims and other transactions between manufacturers and their networks

of sales and service points.

The Company also has a supplemental business that provides a variety of electronic commerce services to non-Equipment industries such as: transportation, agribusiness and publishing. The non-Equipment industries generate positive cash flows for the Company but have not shown significant growth over the past three years.

Management reviews the Company's recurring vs. non-recurring revenue in the aggregate and within the U.S. and Canadian Equipment, International Equipment and non-Equipment markets.

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

REVENUE BY INDUSTRY SECTOR
(IN THOUSANDS)

INDUSTRY SECTOR	THREE MONTHS ENDED JANUARY 31 2001	THREE MONTHS ENDED JANUARY 31 2000	PERCENT CHANGE	SIX MONTHS ENDED JANUARY 31 2001	SIX MONTHS ENDED JANUARY 31 2000
EQUIPMENT INDUSTRY					
U.S. and Canadian					
Recurring	$ 2,150	$ 1,310	64%	$ 3,781	$ 2,589
Non-recurring	699	623	12%	1,574	1,038
Subtotal	2,849	1,933	47%	5,355	3,627
International					
Recurring	269	108	149%	547	182
Non-recurring	80	114	(30)%	207	140
Subtotal	349	222	57%	754	322
Total Equipment Industry					
Recurring	2,419	1,418	71%	4,328	2,771
Non-recurring	779	737	6%	1,781	1,178
Subtotal	3,198	2,155	48%	6,109	3,949
NON-EQUIPMENT INDUSTRY					
Recurring	888	1,158	(23)%	2,072	2,289
Non-recurring	--	13	(100)%	47	143
Subtotal	888	1,171	(24)%	2,119	2,432
TOTAL REVENUE					
Recurring	3,307	2,576	28%	6,400	5,060
Non-recurring	779	750	4%	1,828	1,321
Grand Total	$ 4,086	$ 3,326	23%	$ 8,228	$ 6,381

========= ========= ========= =========

Recurring revenues are derived from catalog subscription 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 license fees and professional services fees. Recurring revenue, as a percentage of total revenue, increased from 77% to 81% for the three months ended January 31, 2000 and 2001, respectively, due to an increase in annual renewal revenues and lower than expected new software license revenues in the Equipment Industry as a result of heavy turnover in the Company's sales force and a "lag time" to hire new sales people. On a year to date basis, recurring revenue is 78% of total revenue compared to 79% of total revenue for the same period last year. Management believes that the remainder of the year will be more in line with the Company's ideal relationship of approximately two thirds recurring revenue to one third non-recurring revenue. Management believes that this "target" ratio establishes an appropriate level of base revenue while the Company continues to add new sales to drive future increases in recurring revenue. This ratio is expected to fluctuate from quarter to quarter and year to year, depending on the size and timing of new business.

Equipment Industry

The Equipment Industry comprises several vertical markets including outdoor power, recreation vehicles, motorcycles, auto and truck parts after-market, manufactured housing, farm equipment, marine, construction, power sports, 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 and dealer communications software and services business with manufacturers and distributors and their dealers in the existing vertical markets and to expand to other similar markets in the future.

U.S. and Canada

Recurring revenues in the U.S. and Canadian Equipment Industry increased for the three and six month periods ended January 31, 2001, compared to the same periods last year, primarily due to increased catalog license, maintenance and subscription renewals from the Company's growing base of customers and the renegotiation of prior agreements from a fixed price structure to the Company's time and materials based business model. Non-recurring revenues in the U.S. and Canadian Equipment Industry increased for the three and six month periods ended January 31, 2001, compared to the same periods last year, due to the proportional recognition of software licenses sold in fiscal 2000 and to new software licenses and professional services sold to dealers and manufacturers in the first quarter of this fiscal year. Revenues in the U.S. and Canadian Equipment Industry increased, as a percentage of total revenues, from 57% for the six months ended January 31, 2000 to 65% for the six months ended January 31, 2001. Management expects recurring and non-recurring revenues in the U.S. and Canadian Equipment Industry to increase at a higher rate than total revenues for the remainder of fiscal 2001, as management continues to focus attention and resources in this industry.

International (Europe and Australia)

Recurring revenues in the International Equipment Industry increased for the three and six month periods ended January 31, 2001, compared to the same

periods last year, primarily due to catalog license, maintenance and subscription renewals from new business added last year. Non-recurring revenues in the International Equipment Industry decreased for the three month period ended January 31, 2001 compared to the same period last year, due to a lack of new software sales in the first half of fiscal 2001 but increased for the six month period ended January 31, 2001 compared to the same period last year due to the proportional recognition of software licenses sold in fiscal 2000. Revenues in the International Equipment Industry increased, as a percentage of total revenues, from 5% for the six months ended January 31, 2000 to 9% for the six months ended January 31, 2001, although the increase was lower than expected due to the Company's Shift from the Equipment markets to other more lucrative markets and the establishment of new sales leads. Management expects recurring and non-recurring revenues in the International Equipment Industry to increase at a higher rate than total revenues for the remainder of fiscal 2001, as management continues to focus attention and resources in this industry.

Non-Equipment Industry

The Company's business outside of the Equipment Industry includes sales of database management services to the agricultural inputs and railroad industries, electronic communications services to the agricultural inputs industry, and the on-line provision of information for republication to the non-daily newspaper publishing industry. The non-Equipment Industry business is characterized by a base of customers with long-term relationships with the Company. Revenues in the non-Equipment Industry decreased for the three and six month periods ended January 31, 2001, compared to the same periods last year, due to the Company's focus in the Equipment Industry. Management expects revenues in the non-Equipment Industry will decline for the remainder of fiscal 2001. Management expects that consolidation in the agricultural customer base is the reason for the decline in recurring revenues from the agricultural inputs industry and management believes that revenue from this market will continue to decrease in the future as the Company reaches saturation in this market. The Company's five-year contract with the Association of American Railroads expired on December 31, 2000. Per quarter, the Association of American Railroads represented approximately $250,000 of non-Equipment Industry recurring revenues. The Company's five year contract with the Associated Press, on which its business in the non-daily newspaper publishing industry depends, expired in December 2000 and was extended to September 14, 2001. Management is currently negotiating with the Associated Press to renew the contract, and, based on discussions we have had, management believes that if the contract is renegotiated, margins are likely to decline, although there is no assurance that the contract will be renewed.

11

12

COST OF PRODUCTS AND SERVICES SOLD

The following table sets forth, for the periods indicated, certain revenue and cost of products and services sold information 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 JANUARY 31		PERCENT	SIX M JA
	2001	2000	CHANGE	2001
Subscriptions, support and transaction fees				
Revenue	$ 2,550	$ 2,479	3%	$ 5,10
Cost of revenue	317	403	(21)%	69
Cost of revenue as a percent of revenue	12%	16%		1
Software licenses and renewals				
Revenue	842	210	301%	1,60
Cost of revenue	907	981	(8)%	1,87
Cost of revenue as a percent of revenue	108%	467%		11
Professional services				
Revenue	694	637	9%	1,52
Cost of revenue	402	408	(1)%	90
Cost of revenue as a percent of revenue	58%	64%		5
Total				
Revenue	$ 4,086	$ 3,326	23%	$ 8,22
Cost of revenue	1,626	1,792	(9)%	3,46
Cost of revenue as a percent of revenue	40%	54%		4

Cost of subscriptions, support and transaction fees consists primarily of Associated Press royalties, telecommunications and catalog replication and distribution costs. Cost of subscriptions, support and transaction fees as a percentage of revenue decreased for the three month period ended January 31, 2001, compared to the same period last year, primarily due to lower telecommunications costs and remained relatively consistent for the six month period ended January 31, 2001, compared to the same period last year. Management expects gross margins from subscriptions, support and transaction fees to fluctuate somewhat from quarter to quarter based on the mix of products and services sold.

Cost of software licenses and renewals consists primarily of amortization of software products, royalties, and software distribution costs. Cost of software licenses and renewals as a percentage of revenue varies significantly due to the variability of new software license revenues and relatively fixed cost of sales, which comprises primarily amortization of software costs. Cost of software licenses and renewals as a percentage of revenue decreased for the three and six month periods ended January 31, 2001, compared to the same periods last year, due to higher software license revenues in fiscal 2001 primarily as a result of the proportional recognition of software licenses sold in fiscal 2000. Management expects gross margins from software licenses and renewals to fluctuate significantly from quarter to quarter based on the number of licenses sold.

Cost of professional services consists of customization and catalog production

labor. Cost of professional services as a percentage of revenue decreased for the three and six month periods ended January 31, 2001, compared to the same periods last year, primarily because professional services revenue increased from the conversion of old "fixed bid" contracts to time and materials contracts without a corresponding increase in the cost needed to provide those services. 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 estimate given to customers for customization projects.

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 JANUARY 31		PERCENT	SIX MON JANU
	2001	2000	CHANGE	2001
Cost of products and services sold	$ 1,626	$ 1,792	(9)%	$ 3,468
Customer operations and support	409	541	(24)%	813
Selling, general and administrative	2,200	2,115	4%	4,433
Software development and support	830	822	1%	1,675
	5,065	5,270	(4)%	10,389
Depreciation and amortization	370	412	(10)%	771
Less capitalized portion	(508)	(447)	14%	(940)
Net operating expenses	$ 4,927	$ 5,235	(6)%	$ 10,220

Customer operations and support consists primarily of data center operations, software maintenance agreements for the Company's core network, catalog data maintenance and customer support costs. Customer operations and support costs decreased for the three and six month periods ended January 31, 2001, compared to the same periods last year, due to classifying direct labor costs, which were not tracked prior to the integration of the NDI acquisition, to direct cost of sales in the catalog production area of professional services.

The increase in selling, general and administrative expenses ("SG&A") for the three and six month periods ended January 31, 2001, compared to the same periods last year, was primarily due to increased bonuses and commissions associated with the increased sales and to the addition of a senior level financial consultant. SG&A, as a percentage of revenue, decreased from 61% for the six month period ended January 31, 2000 to 54% for the six month period ended January 31, 2001. Management expects costs to continue to increase in SG&A for the remainder of fiscal 2001, as the Company's revenues grow, but the increase is expected to be at a slower rate than revenues.

The Company's technical staff (in-house and contracted) performs both software development and support and software customization services for customer applications. Therefore, management expects fluctuations between software customization services and development expenses quarter to quarter, as the mix of development and customization activities will change based on customer requirements. Software development and support costs increased for the six month period ended January 31, 2001, compared to the same period last year, primarily due to an increase in resources focused on development of Web-based communications and cataloging software. Management expects software development and support costs to continue to increase for the remainder of fiscal 2001, but at a slower rate than revenues.

Depreciation and amortization expense decreased slightly for the three and six month periods ended January 31, 2001, compared to the same periods last year. Management expects depreciation and amortization to remain relatively consistent for the remainder of fiscal 2001, providing there are no additional acquisitions.

Capitalized software development costs represented 56% of software development and support for the six month period ended January 31, 2001, compared to 55% for the same period last year. Management expects capitalized software development to fluctuate from quarter to quarter depending on the deployment of the Company's resources between software development available for capitalization and customer customizations.

OTHER ITEMS

Net loss decreased for the three and six month periods ended January 31, 2001, compared to the same periods last year, due to revenues increasing at a higher rate than costs. As the Company continues its acquisition program, non-cash amortization of goodwill and other intangible assets from the Company's acquisitions may cause net losses to continue even if net cash provided by operations and used in investing activities is positive.

Cash paid for interest increased for the three and six month periods ended January 31, 2001, compared to the same periods last year, primarily due to increased utilization of the RFC Facility. Non-cash interest expense was incurred for the three and six month periods ended January 31, 2001 as the Company accrued interest and amortized debt discount for the Debenture sold to Rose Glen in April 2000. Management expects cash paid for interest to decrease as the Company continues to pay off debt and non-cash interest expense to increase, compared to the prior year, as the Company accrues and amortizes non-cash interest expense associated with the Debenture. See "Liquidity and Capital Resources."

LIQUIDITY AND CAPITAL RESOURCES

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

CASH FLOW INFORMATION

(IN THOUSANDS)

	THREE MONTHS ENDED JANUARY 31		PERCENT	S
	2001	2000	CHANGE	2
Net cash provided by (used in) operating activities before changes in working capital	$ 183	$ (859)	121%	$
Net cash provided by (used in) investing activities	(500)	(480)	(4)%	
Subtotal	(317)	(1,339)	76%	
Effect of net changes in working capital	1,130	(540)	309%	
Net cash provided by (used in) operating and investing activities	$ 813	$ (1,879)	143%	$

Net cash provided by operating activities before changes in working capital increased for the three and six months ended January 31, 2001, compared to the same periods last year, due to revenues increasing at a higher rate than expenses. Net cash used in investing activities increased for the three and six months ended January 31, 2001, compared to the same periods last year, primarily due to increased costs attributable to the development of the Company's Web-based software. 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 by operating activities to be positive for the fiscal year ended July 31, 2001, however, there can be no assurance that these results will be ultimately achieved.

The Company expects to continue to incur operating losses for the fiscal year ending July 31, 2001 due to non-cash expenses. Although there can be no assurance that profitability will be achieved thereafter, management expects to achieve full profitability before the end of fiscal 2003, provided there are no additional acquisitions.

At January 31, 2001, the Company had cash and cash equivalents of approximately $810,000 compared to approximately $563,000 at July 31, 2000.

14

15

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)

	JANUARY 31 2001 (UNAUDITED)	JULY 31 2000 (AUDITED)	NET CHAN
Debt to Shareholder:			
Current portion of notes payable	$ 361	$ 361	$
Long-term portion of notes payable	222	389	
Debt discount (common stock warrants)	(58)	(76)	
Total Debt to Shareholder	525	674	
Subordinated Debenture:			
Long-term notes payable other	4,000	4,000	
Debt discount (common stock warrants and options)	(1,767)	(2,158)	
Total Subordinated Debenture	2,233	1,842	
Other Debt:			
Current portion of notes payable other	422	461	
Long-term notes payable other	127	326	
Total Other Debt	549	787	
Total Debt	$ 3,307	$ 3,303	$

On April 27, 2000, the Company issued and sold pursuant to a Securities Purchase Agreement, dated as of April 25, 2000, by and among the Company and RGC International Investors, LDC (the "Investor"), (i) a convertible subordinated debenture in the amount of Four Million Dollars ($4,000,000) due on April 27, 2003 (the "Debenture"), and convertible into shares of the Company's common stock, $.001 par value per share (the "Common Stock"), (ii) warrants to purchase Six Hundred Thousand (600,000) shares of Common Stock (the "Warrants"), and (iii) an investment option to purchase Eight Hundred Thousand (800,000) shares of Common Stock (the "Investment Option"). The Investment Option expires on October 27, 2001 and the Warrants expire on April 27, 2005. The Debenture is convertible into Common Stock at $4 per share and the Warrants and Investment Option are exercisable at $6 per share. At any time after October 27, 2000, the Company can require the Investor to convert the amount owed under the Debenture into Common Stock at $4.00 per share provided that: (i) the closing bid price of the Common Stock has been greater than $6.60 for twenty (20) consecutive trading days and (ii) the Company's resale registration statement has been effective for at least three (3) months. The resale registration became effective on September 1, 2000. The Company is required to maintain listing of its common stock on the Nasdaq National Market, the Nasdaq Small Cap Market, the New York Stock Exchange or the American Stock Exchange; failure to meet this requirement would result in the Debenture becoming fully due at 130% of outstanding principal and accrued interest and an increase in the stated interest rate from 7% to 17%. At any time after April 27, 2001, the Company can require the Investor to exercise the Investment Option if the closing bid price of the Common Stock is greater than $9.90 for twenty (20) consecutive trading days and the Company's resale registration statement has been effective for at least three (3) months. If exercised, the Investment Option would contribute an additional Four Million Eight Hundred Thousand Dollars ($4,800,000) of working capital to the Company.

The Company is currently not in compliance with the Nasdaq National Market

requirements, including the dollar minimum bid price, the $5 million public float and $4 million net tangible asset test. If the Company is delisted, and if the Company is unable to obtain waivers from the Investor or renegotiate the Debenture, shareholders could be materially and adversely affected.

ARI has a $1.0 million line of credit with WITECH (the "WITECH Line") that has been in place since October 4, 1993. The WITECH Line expires on December 31, 2001. The WITECH Line bears interest at prime plus 2.0%. As of May 25, 2001 there were no amounts outstanding under the WITECH Line and $472,000 outstanding under the WITECH term loan. In conjunction with obtaining the WITECH Line, since 1993, ARI has issued to WITECH 350 shares of its non-voting cumulative preferred stock and total warrants for the purchase of up to 280,000 shares of its common stock, including (i) warrants for the purchase of 250,000 shares at $2.125 per share and (ii) warrants for the purchase of 30,000 shares of its common stock at $4.00 per share. The exercise price under the warrants is reduced if ARI issues stock at less than the then current exercise price. WITECH also purchased 20,000 shares of non-voting cumulative preferred stock on July 15, 1997. Of the 280,000 warrants to purchase shares of Common Stock issued to WITECH; (i) warrants to purchase 175,000 shares of Common Stock at $2.125 expired on October 1, 2000; (ii) warrants to purchase 75,000 shares of Common Stock at $2.125 expire on January 1, 2002; and (iii) warrants to purchase 30,000 shares of Common Stock at $4.000 expire on October 1, 2006.

The only financial covenant in the WITECH Credit Facility is that ARI must maintain a net worth (calculated in accordance with generally accepted accounting principles) of at least $5.3 million. ARI was not in compliance with the financial covenant in the Agreement on January 31, 2001 and intends to seek a waiver. If the Company is unable to obtain a waiver, the Company would lose an essential source of liquidity.

In connection with both the subordinated debenture and the WITECH Line, the Company recognizes amortization of a debt discount, the gross amount of which is the value of the warrants and options issued as partial consideration for the terms of the debt instrument. The amortization of the debt discount appears as non-cash interest expense on the statement of operations and the net value of the debt discount reduces the carrying value of the debt on the balance sheet.

On September 28, 1999, ARI and RFC Capital Corporation ("RFC") executed a Receivables Sales Agreement (the "Sale Agreement") establishing a $3.0 million working capital facility (the "RFC Facility"). The three year Sale Agreement allows RFC to purchase up to $3.0 million (the "Purchase Commitment") of ARI's accounts receivable. The Purchase Commitment may be increased in increments of $1.0 million upon mutual agreement and a payment by ARI of $10,000 for each $1.0 million increase. Under the Sale Agreement, RFC purchases 90% of eligible receivables. ARI is obligated to pay a monthly program fee equal to the greater of (a) $3,000 or (b) the amount of the purchased but uncollected receivables times the prime rate plus 2%. ARI may terminate the Sale Agreement prior to three years by paying: 3.0% of the Purchase Commitment during the first year; 2.0% of the Purchase Commitment during the second year; and 1.0% of the Purchase Commitment during the third year. The balance of the RFC Facility at May 25, 2001 was $664,000.

The RFC Facility states that the Company must be in compliance with the covenants under the WITECH facility, which it currently is not. If the Company is unable to obtain a waiver from RFC, the Company would lose an essential source of liquidity.

Management believes that funds generated from operations, the RFC Facility, the

Debenture and the WITECH Line will be adequate to fund the Company's operations and investments through fiscal 2001 if the necessary waivers are obtained. If management is unable to obtain the necessary waivers, the Company will be in default and owe in excess of $6 million, which would have a material adverse effect on the Company. On a long-term basis, management believes that cash for operations as well as capital expenditures will come principally from cash generated from operations. Management is working diligently to obtain the necessary waivers, but there can be no assurance that these efforts will be successful. Management is also analyzing its anticipated cash flows under a variety of growth scenarios ranging from no growth to modest growth. Management believes that, provided the defaults can be avoided, either (i) sufficient cash can be generated from the business to fund operations and a modest level of investment or (ii) that the cash profile of the business can be restructured to be self-funding.

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

EARNINGS BEFORE INTEREST, TAXES, DEPRECIATION AND AMORTIZATION
(IN THOUSANDS)

	THREE MONTHS ENDED JANUARY 31		PERCENT	SIX MONTHS EN JANUARY 31	
	2001	2000	CHANGE	2001	
Net loss	$ (1,216)	$ (2,091)	42%	$ (2,738)	$
Interest (cash)	230	180	28%	291	
Interest (non-cash)	166	--	100%	476	
Amortization of software products	793	820	(3)%	1,672	
Other depreciation and amortization	370	412	(10)%	770	
Earnings before interest, taxes, depreciation and amortization	$ 343	$ (679)	151%	$ 471	$

Earnings before interest, taxes, depreciation and amortization (EBITDA) increased for the three and six month periods ended January 31, 2001, compared to the same periods last year, due primarily to the Company's improvement in earnings. Management expects EBITDA to continue to remain positive for the remainder of fiscal 2001, although there can be no assurance that these results will be ultimately achieved. As the Company continues its acquisition program, non-cash

16

17

amortization of goodwill and other intangible assets from the Company's acquisitions may cause net losses to continue even if EBITDA is positive.

We have included data with respect to EBITDA because it is commonly used as a measurement of financial performance and by investors to analyze and compare companies on the basis of operating performance. EBITDA is not a measurement of

financial performance under generally accepted accounting principles and should not be considered an alternative to operating income, as determined in accordance with generally accepted accounting principles, as an indictor of our operating performance, or to cash flows from operating activities, as determined in accordance with generally accepted accounting principles, as a measure of our liquidity. EBITDA is not necessarily comparable with similarly titled measures for other companies.

ACQUISITIONS

Since December 1995, the Company has had a formal and aggressive 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, approximately 300 acquisition candidates have been evaluated, resulting in four completed acquisitions.

ACQUISITION DATE	ACQUIRED COMPANY AND LOCATION	DESCRIPTION OF ACQUI
November 4, 1996	cd*.IMG, Inc. ("CDI") New Berlin, WI	CDI developed the Plus(parts catalog, which fe information from over 2 in the outdoor power, m and power sports indust
September 30, 1997	Empart Technologies, Inc. ("EMPART") Foster City, CA	EMPART provided us with EMPARTpublisher and EMP software.
September 15, 1998	POWERCOM-2000 ("POWERCOM"), a subsidiary of Briggs & Stratton Corporation Colorado Springs, CO	POWERCOM provided elect and communication servi number of manufacturers America, Europe, and Au the outdoor power, powe power sports industries
May 13, 1999	Network Dynamics Incorporated ("NDI") Williamsburg, VA	NDI provided us with th electronic catalog, whi over 10,000 dealers to from 50 different manuf sectors of the Equipmen

FORWARD LOOKING STATEMENTS

Certain statements contained in the Management's Discussion and Analysis of Results of Operations and Financial Condition are forward looking statements, including, without limitation, statements with respect to growth plans, projected sales, revenues, earnings, costs, product development schedules and future cash requirements and sources of liquidity. Other forward looking information includes (i) information included or incorporated by reference in our future filings with the Commission including, without limitation, statements

with respect to growth plans, projected sales, revenues, earnings and costs, and product development schedules and plans and (ii) information contained in written material, releases and oral statements issued by us, or on our behalf, including, without limitation, statements with respect to growth plans, projected sales, revenues, earnings and costs, and product development schedules and plans. Generally, the words "anticipates," "believes," "expects," "intends" and similar expressions identify forward looking statements. The Company's actual results may differ materially from those contained in the forward looking statements identified above. Factors which may cause such a difference to occur, include, but are not limited to, those factors set forth in the section entitled "Risk Factors," in the Company's registration statement on Form S-3 filed on May 12, 2000, as amended.

SIGNATURES

Pursuant to the requirements of the Securities and Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

ARI Network Services, Inc.
(Registrant)

Date: June 1, 2001 /s/ Brian E. Dearing

Brian E. Dearing, Chairman of the Board
(and acting CFO)