ARI NETWORK SERVICES INC /WI
Form 10QSB
December 15, 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 October 31, 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 December 8, 2006 there were 6,227,335 shares of the registrant s shares outstanding.

Transitional Small Business Disclosure Format (check one).

YES o NO þ

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**ARI Network Services, Inc.**
FORM 10-QSB
FOR THE THREE MONTHS ENDED OCTOBER 31, 2006
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**ARI Network Services, Inc.**
**Consolidated Balance Sheets**
***(In thousands, except share and per share data)***
*(Unaudited)*

| | October 31 2006 | July 31 2006 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 3,191 | $ 3,584 |
| Trade receivables, less allowance for doubtful accounts of $89 and $103 at October 31, 2006 and July 31, 2006, respectively | 609 | 885 |
| Work in Progress | 143 | 163 |
| Prepaid expenses and other | 245 | 254 |
| Deferred income taxes | 675 | 675 |
| Total current assets | 4,863 | 5,561 |
| Equipment and leasehold improvements: | | |
| Computer equipment | 5,130 | 5,084 |
| Leasehold improvements | 123 | 116 |
| Furniture and equipment | 2,139 | 2,057 |
| | 7,392 | 7,257 |
| Less accumulated depreciation and amortization | 6,382 | 6,275 |
| Net equipment and leasehold improvements | 1,010 | 982 |
| Deferred income taxes | 1,419 | 1,419 |
| Other assets | 4 | 6 |
| Capitalized software product costs | 11,635 | 11,557 |
| Less accumulated amortization | 10,276 | 10,089 |
| Net capitalized software product costs | 1,359 | 1,468 |
| **Total Assets** | $ 8,655 | $ 9,436 |

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

| | October 31 2006 | July 31 2006 |
|---|---|---|
| **LIABILITIES AND SHAREHOLDERS EQUITY (DEFICIT)** | | |
| Current liabilities: | | |
| Current portion of notes payable | $ 1,400 | $ 1,400 |
| Accounts payable | 384 | 500 |
| Deferred revenue | 4,990 | 5,616 |
| Accrued payroll and related liabilities | 1,124 | 1,006 |
| Accrued sales, use and income taxes | 8 | 38 |
| Accrued vendor specific liabilities | | 104 |
| Other accrued liabilities | 301 | 254 |
| Total current liabilities | 8,207 | 8,918 |
| Long term liabilities: | | |
| Notes payable (net of discount) | 219 | 580 |
| Long term payroll related | 202 | 202 |
| Other long term liabilities | 43 | 48 |
| Total long term liabilities | 464 | 830 |
| Shareholders equity (deficit): | | |
| Cumulative preferred stock, par value $.001 per share, 1,000,000 shares authorized; 0 shares issued and outstanding at October 31, 2006 and July 31, 2006, respectively | | |
| Common stock, par value $.001 per share, 25,000,000 shares authorized; 6,227,335 and 6,202,529 shares issued and outstanding at October 31, 2006 and July 31, 2006, respectively | 6 | 6 |
| Common stock warrants and options | 62 | 36 |
| Additional paid-in-capital | 93,883 | 93,838 |
| Accumulated deficit | (93,967) | (94,192) |
| Total shareholders equity (deficit) | (16) | (312) |
| **Total Liabilities and Shareholders Equity (Deficit)** | $ 8,655 | $ 9,436 |

*See notes to unaudited condensed consolidated financial statements.*

Note: The balance sheet at July 31, 2006 has been derived from the audited balance sheet at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements.

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

| | Three months ended October 31 | |
|---|---|---|
| | **2006** | **2005** |
| Net revenues: | | |
| Subscriptions, support and other services fees | $ 2,663 | $ 2,564 |
| Software licenses and renewals | 543 | 518 |
| Professional services | 297 | 409 |
| | 3,503 | 3,491 |
| Cost of products and services sold: | | |
| Subscriptions, support and other services fees | 272 | 181 |
| Software licenses and renewals * | 196 | 158 |
| Professional services | 78 | 111 |
| | 546 | 450 |
| Gross margin | 2,957 | 3,041 |
| Operating expenses: | | |
| Depreciation and amortization (exclusive of amortization of software products included in cost of products and services sold) | 106 | 80 |
| Customer operations and support | 268 | 303 |
| Selling, general and administrative | 1,985 | 1,859 |
| Software development and technical support | 369 | 275 |
| Net operating expenses | 2,728 | 2,517 |
| Operating income | 229 | 524 |
| Other income (expense): | | |
| Interest expense | (38) | (49) |
| Other, net | 34 | 23 |
| Total other income (expense) | (4) | (26) |
| Income before provision for income taxes | 225 | 498 |
| Income tax benefit (provision) | | |
| Net income | $ 225 | $ 498 |
| Average common shares outstanding: | | |
| Basic | 6,210 | 6,126 |

| | | |
|---|---|---|
| Diluted | 6,587 | 6,729 |
| Basic and diluted net income per share: | | |
| Basic | $ 0.04 | $ 0.08 |
| Diluted | $ 0.03 | $ 0.07 |

*See notes to unaudited condensed consolidated financial statements.*

* Includes amortization of software products of $187 and $145 and excludes other depreciation and amortization shown separately

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

| | Three months ended October 31 | |
|---|---|---|
| | **2006** | **2005** |
| **Operating activities** | | |
| Net income | $ 225 | $ 498 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Amortization of software products | 187 | 145 |
| Amortization of deferred financing costs, debt discount and excess carrying value over face amount of notes payable | (11) | (16) |
| Depreciation and other amortization | 106 | 81 |
| Stock based compensation related to stock options | 26 | |
| Stock issued as contribution to 401(k) plan | 42 | 21 |
| Net change in receivables, prepaid expenses and other current assets | 307 | 119 |
| Net change in accounts payable, deferred revenue, accrued liabilities and other long term liabilities | (716) | (472) |
| Net cash provided by operating activities | 166 | 376 |
| **Investing activities** | | |
| Purchase of equipment and leasehold improvements | (134) | (77) |
| Software product costs capitalized | (78) | (178) |
| Net cash used in investing activities | (212) | (255) |
| **Financing activities** | | |
| Payments under notes payable | (350) | (250) |
| Proceeds from issuance of common stock | 3 | 33 |
| Net cash used in financing activities | (347) | (217) |
| Net decrease in cash | (393) | (96) |
| Cash at beginning of period | 3,584 | 3,651 |
| Cash at end of period | $ 3,191 | $ 3,555 |
| Cash paid for interest | $ 51 | $ 65 |
| Cash paid for income taxes | $ 14 | $ |

*See notes to unaudited condensed consolidated financial statements.*

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**Notes to Condensed Consolidated Financial Statements**
**(Unaudited)**
**October 31, 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 months ended October 31, 2006 are not necessarily indicative of the results that may be expected for the fiscal year ending July 31, 2007. For further information, refer to the financial statements and footnotes thereto included in the Company s annual report on Form 10-KSB for the year ended July 31, 2006.

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

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

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

Basic net income per common share is computed by dividing net income by the 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 October 31 | |
|---|---|---|
| | 2006 | 2005 |
| Weighted average common shares outstanding | 6,210 | 6,126 |
| Dilutive effect of stock options and warrants | 377 | 603 |
| Diluted weighted average common shares outstanding | 6,587 | 6,729 |

**3. STOCK-BASED COMPENSATION**

Effective August 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standard No. 123R, Share-Based Payment an Amendment of FASB Statement Nos. 123 and 95 , ( SFAS 123R ) for its stock option and stock purchase plans. The Company previously accounted for these plans under the recognition and measurement principles of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, ( APB 25 ) and related interpretations and disclosure requirements established by Statement of Financial Accounting Standard No. 123, Accounting for Stock-Based Compensation, ( SFAS 123R ), as amended by Statement of Financial Accounting Standard No. 148, Accounting for Stock-Based Compensation Transition and Disclosure.

The Company adopted SFAS 123R using the modified prospective method. Under this transition method, compensation cost recognized in fiscal 2007 includes: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of August 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123 and (b) compensation cost for all share-based payments granted subsequent to August 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R. Results

for prior periods have not been restated. Compensation cost for options will be recognized in earnings, net of estimated forfeitures, on a straight-line basis over the requisite service period. There were no capitalized stock-based compensation costs at October 31, 2006. Total stock compensation expense recognized by the Company during the three months ended October 31, 2006 was $26,907. As of October 31, 2006, there was $202,360 of total unrecognized compensation cost related to nonvested options granted under the plans.

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

As stock-based compensation expense recognized in our results for the three months ended October 31, 2006 is based on awards ultimately expected to vest, the amount has been reduced for estimated forfeitures. SFAS 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based on our historical experience. Prior to fiscal year 2007, we accounted for forfeitures as they occurred for the purposes of our pro forma information under SFAS 123.
The fair value of each option grant is estimated using the assumptions in the following table:

| | Three months ended October 31, | |
|---|---|---|
| | 2006 | 2005 |
| Expected life (years) | 10 years | 10 years |
| Risk-free interest rate | 4.88% | 4.00% |
| Expected volatility | 124% | 124% |
| Expected dividend yield | 0% | 0% |

The following table illustrates the effect on net income and earnings per share as if the Company had accounted for stock-based compensation in accordance with SFAS 123R for the three months ended October 31, 2005:

| | | Three months ended October 31 2005 |
|---|---|---|
| Net income as reported | $ | 498 |
| Stock-based compensation expense determined under fair value based method for options | | (82) |
| Pro forma net income | $ | 416 |
| Pro forma net income per share basic | $ | .07 |
| Pro forma net income per share diluted | $ | .06 |

*Employee Stock Purchase Plans*

The Company s 1992 Employee Stock Purchase Plan had 62,500 shares of common stock reserved for issuance, and all 62,500 shares have been issued. The Company s 2000 Employee Stock Purchase Plan has 175,000 shares of common stock reserved for issuance, and 135,387 of the shares have been issued as of October 31, 2006. All employees of the Company, other than executive officers, with six months of service are eligible to participate. Shares may be purchased at the end of a specified period at the lower of 85% of the market value at the beginning or end of the specified period through accumulation of payroll deductions, not to exceed 5,000 shares per employee per year.

*Stock Option Plans*

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

*1991 Stock Option Plan*

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

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

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

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

Changes in option shares under the 1991 Plan during the three months ended October 31, 2006 were as follows:

| | Options | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Period | Aggregate Intrinsic Value |
|---|---|---|---|---|
| Outstanding at August 1, 2006 | 146,686 | $ 2.28 | 2.85 | $ 13,125 |
| Granted | | | | |
| Exercised | | | | |
| Forfeited | | | | |
| Outstanding at October 31, 2006 | 146,686 | $ 2.28 | 2.60 | |
| Exercisable at October 31, 2006 | 146,686 | $ 2.28 | 2.60 | |

The range of exercise prices for options outstanding at October 31, 2006, was $2.00 to $9.0625.

*2000 Stock Option Plan*

The Company s 2000 Stock Option Plan (2000 Plan) has 1,450,000 shares of common stock authorized for issuance. Options granted under the 2000 Plan may be either: (a) options intended to qualify as incentive stock options under Section 422 of the Code, or (b) nonqualifed stock options.

Any incentive stock option that is granted under the 2000 Plan may not be granted at a price less than the fair market value of the stock on the date of the grant (or less than 110% of the fair market value in the case of a participant who is a 10% shareholder of the Company within the meaning of Section 422 of the Code). Nonqualified stock options may be granted at the exercise price established by the Compensation Committee.

Each incentive stock option granted under the 2000 Plan is exercisable for a period of not more than ten years from the date of grant (five years in the case of a participant who is 10% shareholder of the Company). Nonqualified stock options do not have this restriction.

Eligible participants include current and prospective employees, nonemployee directors, consultants or other persons who provide services to the Company and whose performance, in the judgment of the Compensation Committee or management of the Company, can have a significant effect on the success of the Company.

Changes in option shares under the 2000 Plan during the three months ended October 31, 2006 were as follows:

| | Options | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Period | Aggregate Intrinsic Value |
|---|---|---|---|---|
| Outstanding at August 1, 2006 | 1,054,350 | $ 1.35 | 7.27 | $ 814,975 |
| Granted | 50,000 | $ 2.10 | | |
| Exercised | (6,250) | $ .28 | | |
| Forfeited | (53.500) | $ 1.38 | | |
| Outstanding at October 31, 2006 | 1,044,600 | $ 1.39 | 7.18 | $ 710,480 |
| Exercisable at October 31, 2006 | 818,051 | $ 1.30 | 6.79 | $ 624,157 |

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Changes in non-vested option shares under the 2000 Plan during the three months ended October 31, 2006 were as follows:

| | Options | Weighted-Average Grant Date Fair Value |
|---|---|---|
| Non-vested at August 1, 2006 | 188,799 | $ 1.59 |
| Granted | 50,000 | $ 2.10 |
| Vested | | |
| Forfeited | (12,250) | $ 1.35 |
| Non-vested at October 31, 2006 | 226,549 | $ 1.72 |

The range of exercise prices for options outstanding at October 31, 2006, was $0.15 to $2.735.

*1993 Director Stock Option Plan*

The Company s 1993 Director Stock Option Plan has expired and is terminated except for outstanding options. The Company s 1993 Director Stock Option Plan (Director Plan) has 150,000 shares of common stock reserved for issuance to nonemployee directors. Options under the Director Plan were granted at the fair market value of the stock on the grant date.

Each option granted under the Director Plan is exercisable one year after the date of grant and cannot be exercised later than ten years from the date of grant.

Changes in option shares under the Director Plan during the three months ended October 31, 2006 were as follows:

| | Options | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Period | Aggregate Intrinsic Value |
|---|---|---|---|---|
| Outstanding at August 1, 2006 | 1,313 | $ 2.65 | 3.97 | $ 152 |
| Granted | | | | |
| Exercised | | | | |
| Forfeited | | | | |
| Outstanding at October 31, 2006 | 1,313 | $ 2.65 | 3.72 | |
| Exercisable at October 31, 2006 | 1,313 | $ 2.65 | 3.72 | |

The range of exercise prices for options outstanding at October 31, 2006, was $2.00 to $3.56.

**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 10.25% as of October 31, 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 quarterly through September 30, 2007 at the prime interest rate plus 2%, adjusted quarterly (effective rate of 10.25% as of October 31, 2006). The note does not contain any financial covenants.

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**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 other 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.

**6. INCOME TAXES**

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

| | Three months ended October 31 | |
|---|---|---|
| | 2006 | 2005 |
| Current: | | |
| Federal | $ 80 | $ 169 |
| State | 20 | 30 |
| Deferred | | |
| Utilization of net operating loss carryforwards | (100) | (199) |
| Income tax benefit (provision) | $ | $ |

Provision for income taxes is based on taxes payable under currently enacted tax laws and an analysis of temporary differences between the book and tax bases of our assets and liabilities, including various accruals, allowances, depreciation and amortization. The tax effect of these temporary differences and the estimated tax benefit from tax net operating losses are reported as deferred tax assets and liabilities in the balance sheet. An assessment of the likelihood that net deferred tax assets will be realized from future taxable income is performed on a quarterly basis. To the extent that management believes it is more likely than not that some portion, or all, of the deferred tax asset will not be realized, a valuation allowance is established. Because the ultimate realizability of deferred tax assets is highly subject to the outcome of future events, the amount established as a valuation allowance is a significant estimate that is subject to change in the near future. The change in the valuation allowance during a period is reflected with a corresponding increase or decrease in the tax provision in the statement of operations. Because of the uncertainty of long-term future economic conditions, the estimated future utilization of deferred net tax assets is based on twelve quarters of projections. The Company made no change in its estimated valuation allowance this quarter.

**MANAGEMENT S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION**

**Results of Operations**

Total revenue for the quarter ended October 31, 2006 increased $12,000 or less than 1%, compared to the same period last year, primarily due to an increase in revenues from the Company s dealer marketing services. Operating income decreased $295,000 or 56% for the quarter ended October 31, 2006, compared to the same period last year, primarily due to the increased investment in developing and marketing new products and the lower gross margins generated by some of those products. Net Income of $225,000 or $0.04 per basic share for the quarter ended October 31, 2006, decreased compared to net income of $498,000 or $0.08 per basic share for the quarter ended October 31, 2005. Management expects revenues and operating expenses to continue to increase over the prior year for the remainder of fiscal 2007.

During fiscal year 2007, the Company plans to continue to focus on the same four growth initiatives as last year: (1) maintaining and enhancing the current catalog business; (2) growing the dealer marketing services business;

(3) changing to 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 a slight decrease in operating income for fiscal 2007, but that the revenues generated by these initiatives will result in increased net income for fiscal 2008 and beyond.

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## 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.

*Bad Debts*

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

*Use of Estimates*

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

*Legal Provisions*

The Company is periodically involved in legal proceedings arising from contracts, patents or other matters in the normal course of business. The Company reserves for any material estimated losses if the outcome is reasonably certain, in accordance with the provisions of SFAS No. 5 Accounting for Contingencies .

*Impairment of Long-Lived Assets*

Equipment and leasehold improvements 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 included direct obligations of the U.S. Treasury, obligations issued or guaranteed by the U.S. government, certain time deposits,

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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 funds with terms not exceeding ninety days.

*Debt Instruments*

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

*Deferred Tax Asset*

The tax effect of the temporary differences between the book and tax bases of assets and liabilities and the estimated tax benefit from tax net operating losses are reported as deferred tax assets and liabilities in the balance sheet. An assessment of the likelihood that net deferred tax assets will be realized from future taxable income is performed. Because the ultimate realizability of deferred tax assets is highly subject to the outcome of future events, the amount established as valuation allowances is considered to be a significant estimate that is subject to change in the near term. To the extent a valuation allowance is established or there is a change in the allowance during a period, the change is reflected with a corresponding increase or decrease in the tax provision in the statement of operations.

*Stock-Based Compensation*

Effective August 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standard No. 123R, Share-Based Payment an Amendment of FASB Statement Nos. 123 and 95 , ( SFAS 123R ) for its stock option and stock purchase plans. The Company previously accounted for these plans under the recognition and measurement principles of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, ( APB 25 ) and related interpretations and disclosure requirements established by Statement of Financial Accounting Standard No. 123, Accounting for Stock-Based Compensation, ( SFAS 123 ), as amended by Statement of Financial Accounting Standard No. 148, Accounting for Stock-Based Compensation Transition and Disclosure.

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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, distributors and manufacturers in the manufactured equipment market. The Company currently provides 99 catalogs of manufactured equipment from 77 manufacturers to approximately 25,000 dealers in approximately 89 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 approximately 76,000 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 template-based website services and technology-enabled direct mail services and e-mail marketing services and (3) communication or transaction services. The Company s primary product line is currently electronic cataloging; the marketing services are an anticipated growth area and 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 October 31, 2006)**

| | Catalogs | Distinct Manufacturers | Subscriptions | Distinct Distributors (Estimated) | Distinct Dealers (Estimated) |
|---|---|---|---|---|---|
| North America | 87 | 67 | 66,983 | 92 | 20,336 |
| Rest of World | 57 | 10 | 8,994 | 58 | 5,465 |
| Included in both Regions | (45) | | | | |
| Total | 99 | 77 | 75,977 | 150 | 25,801 |

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

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

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

As part of its historical business practice, the Company continues to provide electronic directory and transaction services to the U.S. and Canadian agribusiness industry. These revenue are included as part of Dealer and distributor communications, which also includes some transaction services to the Equipment industry. As the Company focuses on its core businesses in the Equipment industry, revenues in the non-equipment industry are expected to continue to decline. The Company does not anticipate its Equipment industry transaction services revenues to increase; therefore dealer and distributor communications revenues in total are expected to continue to decline during fiscal 2007.

The Equipment industry has been a growing percentage of the Company s revenue over the past six years and is composed of several vertical markets 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.

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

**Revenue by Geography and Service**
**(In Thousands)**

| | Three months ended October 31 | | Percent |
|---|---|---|---|
| | **2006** | **2005** | **Change** |
| **North America** | | | |
| Catalog subscriptions | $ 2,583 | $ 2,578 | 0% |
| Catalog professional services | 282 | 355 | -21% |
| Dealer marketing services | 217 | 68 | 219% |
| Dealer & distributor communications | 198 | 227 | -13% |
| Subtotal | 3,280 | 3,228 | 2% |
| **Rest of the World** | | | |
| Catalog subscriptions | 203 | 214 | -5% |
| Catalog professional services | 20 | 49 | -59% |
| Subtotal | 223 | 263 | -15% |
| **Total Revenue** | | | |
| Catalog subscriptions | 2,786 | 2,792 | 0% |
| Catalog professional services | 302 | 404 | -25% |
| Dealer marketing services | 217 | 68 | 219% |
| Dealer & distributor communications | 198 | 227 | -13% |
| Total | $ 3,503 | $ 3,491 | 0% |

***North America***

*Catalog Subscripitons*

North American catalog subscription revenues are derived from software license fees, license renewal fees, software maintenance and support fees, catalog subscription fees, and other miscellaneous subscription fees charged to dealers, distributors and manufacturers for the use of the Company s catalog products in the United States and Canada. Catalog subscription revenues increased slightly for the three months ended October 31, 2006, compared to the same period last year, primarily due to increased subscriptions from the Company s web-based catalog products. Catalog subscription renewals from the Company s North American customers were approximately 87% for the three months ended October 31, 2006. Management expects revenues from catalog subscriptions in North America to increase for the remainder of fiscal 2007 compared to the prior year.

*Catalog Professional Services*

Revenues from the Company s North American catalog professional services are derived from software customization labor, data conversion labor, data conversion replication fees, travel and shipping fees primarily charged to manufacturers in the United States and Canada. Revenues from catalog professional services in North America decreased for the three months ended October 31, 2006, compared to the same period last year, primarily due to the timing of new implementations and updates for manufacturer databases and to renegotiation of certain manufacturer contracts. Management expects revenues from catalog professional services in North America to increase for the remainder of fiscal 2007 compared to the prior year.

*Dealer Marketing Services*

Revenues from the Company s North American dealer marketing services are derived primarily from start-up and access fees charged to dealers for Website Smart and set-up and postage fees for ARI MailSmart in the United States and Canada. Revenues from dealer marketing services in North America increased for the three months ended October 31, 2006, compared to the same period last year, primarily due to new sales of Website Smart and MailSmart . Management expects revenues



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from dealer marketing services in North America to increase significantly for the remainder of fiscal 2007 compared to the prior year.

*Dealer and Distributor Communications*

Revenues from dealer and distributor communications are derived from license renewal fees, software maintenance, customization labor and other communication fees charged for dealers and distributors to communicate with manufacturers in the manufactured equipment industry and the agricultural inputs industry. Dealer and distributor communication revenues decreased for the three months ended October 31, 2006, compared to the same period last year, primarily due to a decline in the base of customers as the Company focused the business primarily on its catalog products in the equipment industry. Management expects revenues from dealer and distributor communication products will be a declining percentage of total revenue for the remainder of fiscal 2007 compared to the prior year.

***Rest of the World***

*Catalog Subscriptions*

Catalog subscription revenues from the rest of the world are derived from software license fees, license renewal fees, software maintenance and support fees, catalog subscription fees, and other miscellaneous subscription fees charged to dealers, distributors and manufacturers for the use of the Company s catalog products. Catalog subscription revenues for the rest of the world decreased for the three months ended October 31, 2006, compared to the same period last year, primarily due to a decline in subscriptions purchased by manufacturers for distribution and/or resale to their dealers offset by an increase in dealer subscriptions as the Company changed its operations to a dealer-direct model. Management expects revenues from catalog subscriptions in the rest of the world to increase slightly for the remainder of fiscal 2007.

*Catalog Professional Services*

Revenues from the Company s rest of the world catalog professional services are derived from software customization labor, data conversion labor, data conversion replication fees, travel and shipping fees primarily charged to manufacturers that do not reside in North America. Revenues from catalog professional services in the rest of the world decreased for the three months ended October 31, 2006, compared to the same period last year, primarily due to the timing of updates for manufacturer databases. Management expects revenues from catalog subscriptions in the rest of the world to fluctuate from quarter to quarter depending on the nature, size and timing of manufacturer contracts.

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**Cost of Products and Services Sold**

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

**Cost of Products and Services Sold as a Percent of Revenue by Revenue Type**

***(In thousands)***

| | Three months ended October 31 | | Percent |
|---|---|---|---|
| | **2006** | **2005** | **Change** |
| Catalog subscriptions | | | |
| Revenue | $2,786 | $2,792 | 0% |
| Cost of revenue | 296 | 278 | 6% |
| Cost of revenue as a percent of revenue | 11% | 10% | |
| Catalog professional services | | | |
| Revenue | 302 | 404 | (25%) |
| Cost of revenue | 125 | 100 | 25% |
| Cost of revenue as a percent of revenue | 41% | 25% | |
| Dealer marketing services | | | |
| Revenue | 217 | 68 | 219% |
| Cost of revenue | 94 | 31 | 202% |
| Cost of revenue as a percent of revenue | 43% | 46% | |
| Dealer and distributor communications | | | |
| Revenue | 198 | 227 | (13%) |
| Cost of revenue | 32 | 41 | (22%) |
| Cost of revenue as a percent of revenue | 16% | 18% | |
| Total | | | |
| Revenue | $3,503 | $3,491 | 0% |
| Cost of revenue | 546 | 450 | 21% |
| Cost of revenue as a percent of revenue | 16% | 13% | |

Cost of catalog subscriptions consists primarily of reseller fees, software amortization costs, catalog replication and distribution costs. Cost of catalog subscriptions as a percentage of revenue remained relatively the same for the three month period ended October 31, 2006, compared to the same period last year. Management expects gross margins, as a percent of revenue from catalog subscriptions, to vary slightly from quarter to quarter due to the timing of data shipments.

Cost of catalog professional services consists of customization and catalog production labor. Cost of professional services as a percentage of revenue increased for the three month period ended October 31, 2006, compared to the same period last year, primarily due to an increase in non-billable professional services. Management expects cost of catalog professional services to fluctuate from quarter to quarter depending on the mix of services sold, the nature of manufacturer data conversion contracts, and the Company s performance towards the contracted amount for customization projects.

Cost of dealer marketing services consists primarily of website setup labor, software amortization costs, postcards and distribution costs. Cost of dealer marketing services as a percentage of revenue decreased for the three month period ended October 31, 2006, compared to the same period last year, primarily due to a decrease in MailSmart costs. Management expects gross margins, as a percent of revenue from dealer marketing services, to fluctuate from quarter to quarter depending on the mix of products and services sold.

Cost of dealer and distributor communications revenue consists primarily of telecommunication costs, royalties and software customization labor. Cost of dealer and distributor communications as a percentage of revenue decreased for the three month period ended October 31, 2006, compared to the same period last year, primarily due to a decrease in telecommunication costs and software customization labor. Management expects gross margins, as a percent of revenue from dealer and distributor communications, to be relatively consistent from quarter to quarter.

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**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 October 31 | | Percent |
|---|---|---|---|
| | 2006 | 2005 | Change |
| Customer operations and support | $ 268 | $ 303 | (12%) |
| Selling, general and administrative | 1,985 | 1,859 | 7% |
| Software development and technical support | 369 | 275 | 34% |
| Depreciation and amortization | 106 | 80 | 33% |
| Net operating expenses | $ 2,728 | $ 2,517 | 8% |

Customer operations and support consists primarily of server room operations, software maintenance agreements for the Company s core network and customer support costs. Customer operations and support costs decreased for the three month period ended October 31, 2006, compared to the same period last year, primarily due to the reduction of temporary help used at the Virginia office. Management expects customer operations and support costs to continue at relatively the same level for the remainder of fiscal 2007.

Selling, general and administrative expenses ( SG&A ) increased for the three month period ended October 31, 2006, compared to the same period last year, as the Company invested in continued sales and marketing initiatives in both the North American and European markets and because of the new costs related to the FAS123R expensing of stock options. SG&A, as a percentage of revenue, increased from 53% for the three month period ended October 31, 2005 to 57% for the three month period ended October 31, 2006. Management expects SG&A costs to increase compared to the previous year for the remainder of fiscal 2007 as the Company continues its sales and marketing initiatives and to recognize the costs of stock options under FAS123R.

The Company s technical staff (in-house and contracted) performs software development, technical support, software customization and data conversion services for customer applications. Management expects fluctuations from quarter to quarter, as the mix of development and customization activities will change based on customer requirements even if the total technical staff cost remains relatively constant. Software development and technical support costs increased for the three month period ended October 31, 2006, compared to the same period last year, primarily due to additional expenses related to the deployment of the new catalog software in the first quarter of fiscal 2007. Management expects software development and technical support costs to continue to be higher than the previous year for the remainder of fiscal 2007 as the Company invests in its new catalog products.

Depreciation and amortization expense increased for the three month period ended October 31, 2006, compared to the same period last year. Management expects depreciation and other amortization to increase slightly for the remainder of fiscal 2007, as the Company continues to invest in the business.

**Other Items**

Earnings decreased from net income of $498,000 for the three month period ended October 31, 2005, to net income of $225,000 for the three month period ended October 31, 2006. This decrease was primarily due to increased investments in developing, marketing and deploying the Company s dealer marketing services. Management expects to continue to generate positive earnings and cash flows for the remainder of fiscal 2007.

Interest expense includes both cash and non-cash interest. Interest paid or accrued for payment was approximately $51,000 and $65,000 for the three month periods ended October 31, 2006 and 2005, respectively. In addition, approximately $11,000 and $16,000 of excess debt principal was amortized to offset interest expense for the three month period ended October 31, 2006 and 2005, respectively.

**Acquisitions**

Since December 1995, the Company has had a formal business development program aimed at identifying, evaluating and closing acquisitions that augment and strengthen the Company s market position, product offerings, and personnel resources. Since the program s inception, five business acquisitions and one software asset acquisition have been completed, all of which have been fully integrated into the Company s operations..

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

**Liquidity and Capital Resources**

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

**Cash Flow Information**
***(In thousands)***

| | Three months ended October 31 | | Percent |
|---|---|---|---|
| | 2006 | 2005 | Change |
| Net income | $ 225 | $ 498 | (55%) |
| Amortization of software products | 187 | 145 | 29% |
| Amortization of deferred finance costs and debt discount | (11) | (16) | 31% |
| Depreciation and other amortization | 106 | 81 | 31% |
| Stock based compensation related to options | 26 | | 100% |
| Stock issued as contribution to 401(k) plan | 42 | 21 | 100% |
| Net change in working capital | (409) | (353) | (16%) |
| Net cash provided by operating activities | 166 | 376 | (56%) |
| Net cash used in investing activities | (212) | (255) | 17% |
| Net cash used in financing activities | (347) | (217) | (60%) |
| Net change in cash | ($ 393) | ($ 96) | (309%) |

Net cash provided by operating activities decreased for the three month period ended October 31, 2006, compared to the same period last year, primarily due to the decrease in net income. The effect of net changes in working capital is dependent on the timing of payroll and other cash disbursements, accruals and the timing of invoices and may vary significantly from quarter to quarter. Net cash used in investing activities decreased for the three month period ended October 31, 2006, compared to the same period last year, primarily due to the decrease in capitalized software costs. Management expects the net of cash provided by operating activities and used in investing activities to be positive for the remainder of fiscal 2007.

At October 31, 2006, the Company had cash and cash equivalents of approximately $3,191,000 compared to approximately $3,584,000 at July 31, 2006.

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)***

| | October 31 2006 (Unaudited) | July 31 2006 (Audited) | Net Change |
|---|---|---|---|
| Note payable to WITECH: | | | |
| Current portion of note payable | 200 | 200 | |
| Long term portion of note payable | | 50 | (50) |
| Total note payable to WITECH | 200 | 250 | (50) |
| Notes payable to New Holders: | | | |
| Current portion of notes payable | 1,200 | 1,200 | |

| | | | | | | |
|---|---|---|---|---|---|---|
| Long term portion of notes payable | | 200 | | 500 | | (300) |
| Total face value of notes payable to New Holders | | 1,400 | | 1,700 | | (300) |
| Carrying value in excess of face amount of notes payable | | 28 | | 42 | | (14) |
| Debt discount (common stock warrants and options) | | (9) | | (12) | | 3 |
| Total carrying value of notes payable to New Holders | | 1,419 | | 1,730 | | (311) |
| Total debt | $ | 1,619 | $ | 1,980 | $ | (361) |

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On April 24, 2003, the Company restructured its debt. In exchange for previously outstanding debt and securities, the Company issued to a group of investors (the New Holders ), in aggregate, $500,000 in cash, new unsecured notes in the amount of $3.9 million (the New Notes ) and new warrants for 250,000 common shares, exercisable at $1.00 per share (the New Warrants ). The interest rate on the New Notes is prime plus 2%, adjusted quarterly (effective rate of 10.25% as of October 31, 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.

On August 8, 2003, the Company repurchased from WITECH Corporation 1,025,308 shares of Common Stock, a warrant to purchase 30,000 shares of Common Stock at $.24 per share, and 20,350 shares of Series A Preferred Stock with an approximate face value plus accrued and undeclared dividends of $3.5 million. The Company paid $200,000 in cash and issued a four-year note for $800,000, payable quarterly and bearing interest at prime plus 2%, adjusted quarterly (effective rate of 10.25% as of October 31, 2006). The note does not contain any financial covenants.

On July 9, 2004, the Company entered into a line of credit with Bank One, N.A. which permits the Company to borrow an amount equal to 80% of the book value of all eligible accounts receivable plus 45% of the value of all eligible open renewal orders (provided the renewal rate is at least 85%) minus $75,000, up to $1,000,000, and bears interest at prime rate. Eligible accounts include certain non-foreign accounts receivable which are less than 90 days from the invoice date. The line of credit terminates July 9, 2007, and is secured by substantially all of the Company s assets. The line of credit limits repurchases of common stock, the payment of dividends, liens on assets and new indebtedness, and requires the Company to meet minimum net worth and debt service coverage financial covenants.

Management believes that funds generated from operations will be adequate to fund the Company s operations, investments and debt payments for the foreseeable future, although additional financing may be necessary if the Company were to complete a material acquisition or to make a large investment in its business.

**Off-Balance Sheet Arrangements**

The Company has no off-balance sheet arrangements as of December 8, 2006.

**Forward Looking Statements**

Certain statements contained in this Form 10-QSB are forward looking statements including revenue growth, future cash flows and cash generation and sources of liquidity. Expressions such as believes, anticipates, expects, and similar expressions are intended to identify such forward looking statements. Several important factors can cause actual results to materially differ from those stated or implied in the forward looking statements. Such factors include, but are not limited to the factors listed on Exhibit 99.1 of the Company s annual report on Form 10-KSB for the year ended July 31, 2006, which is incorporated herein by reference. The forward-looking statements are made only as of the date hereof, and the Company undertakes no obligation to publicly release the result of any revisions to these forward-looking statements.

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**ITEM 3. CONTROLS AND PROCEDURES**

The Company maintains a set of disclosure controls and procedures that are designed to ensure that information required to be disclosed by it in the reports filed by it under the Securities Exchange Act of 1934, as amended ( Exchange Act ) is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms. The Company carried out an evaluation, under the supervision and with the participation of its management, including its Chief Executive Officer and its Chief Financial Officer, of the effectiveness of the design and operation of its disclosure controls and procedures pursuant to Rule 13a-15 of the Exchange Act. Based on that evaluation, the Company s Chief Executive Officer and its Chief Financial Officer concluded that the Company s disclosure controls and procedures are effective as of October 31, 2006.

There have been no changes in the Company s internal control over financial reporting identified in connection with the evaluation discussed above that occurred during the quarter ended October 31, 2006 that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

**PART II OTHER INFORMATION**

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

During the quarter ended October 31, 2006, the Company did not sell any equity securities which were not registered under the Securities Act or repurchase any of its equity securities.

**ITEM 6. EXHIBITS**

10.1 Summary of Non-employee Director Compensation Arrangements

31.1 Section 302 Certification of Chief Executive Officer.

31.2 Section 302 Certification of Chief Financial Officer.

32.1 Section 906 Certification of Chief Executive Officer.

32.2 Section 906 Certification of Chief Financial Officer.

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**SIGNATURES**

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

ARI Network Services, Inc.
(Registrant)

Date: December 15, 2006 /s/ Brian E. Dearing

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

/s/ Timothy Sherlock

Timothy Sherlock, Chief Financial Officer

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