ARI NETWORK SERVICES INC /WI
Form 10-Q
December 16, 2002

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended October 31, 2002

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.)

11425 W. Lake Park Drive, Milwaukee, Wisconsin 53224

(Address of principal executive office)

Registrant's telephone number, including area code (414) 973-4300

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

YES NO X

As of December 10, 2002 there were 6,438,625 shares of the registrant's shares outstanding.

ARI NETWORK SERVICES, INC.

FORM 10-Q

FOR THE THREE MONTHS ENDED OCTOBER 31, 2002

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

ASSETS	OCTOBER 31 2002	JULY 31 2002
Current assets:		
Cash	$ 701	$ 879
Trade receivables, less allowance for doubtful accounts of $146 at October 31, 2002 and $140 at July 31, 2002	1,563	1,743
Prepaid expenses and other	131	84
Total current assets	2,395	2,706
Equipment and leasehold improvements:		
Computer equipment	4,394	4,394
Leasehold improvements	73	73
Furniture and equipment	1,295	1,292
	5,762	5,759
Less accumulated depreciation and amortization	5,321	5,262
Net equipment and leasehold improvements	441	497
Other assets	73	105
Capitalized software product costs	23,745	23,585
Less accumulated amortization	20,938	20,519
Net capitalized software product costs	2,807	3,066
TOTAL ASSETS	$ 5,716	$ 6,374

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

LIABILITIES AND SHAREHOLDERS' EQUITY (DEFICIT)	OCTOBER 31 2002	JULY 31 2002
Current liabilities:		
Current portion of notes payable to shareholder	$ --	$ 50
Current portion of notes payable	3,665	3,490
RFC financed receivables facility	580	360
Accounts payable	567	293
Deferred revenue	4,346	4,619
Accrued payroll and related liabilities	1,094	1,140
Other accrued liabilities	928	1,042
Current portion of capital lease obligations	151	116

Total current liabilities	11,419	11,022
Long term liabilities:		
Capital lease obligations	14	26
Other long term liabilities	535	531
Total long term liabilities	545	561
Shareholders' equity (deficit):		
Cumulative preferred stock, par value $.001 per share, 1,000,000 shares authorized; 20,350 shares issued and outstanding at October 31, 2002 and July 31, 2002	--	--
Common stock, par value $.001 per share, 25,000,000 shares authorized; 6,329,301 shares issued and outstanding at October 31, 2002 and July 31, 2002	6	6
Common stock warrants and options	2,459	2,459
Additional paid-in-capital	91,853	91,853
Accumulated deficit	(100,169)	(99,924)
Total shareholders' equity (deficit)	(5,851)	(5,606)
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY (DEFICIT)	$ 5,716	$ 6,374

See notes to unaudited condensed financial statements.

Note: The balance sheet at July 31, 2002 has been derived from the audited balance sheet at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements.

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

	THREE MONTHS ENDED OCTOBER 31	
	2002	2001
Net revenues:		
Subscriptions, support and other services fees	$ 1,991	$ 2,455
Software licenses and renewals	557	820
Professional services	507	545
	3,055	3,820
Operating expenses:		
Cost of products and services sold:		
Subscriptions, support and other services fees	189	209
Software licenses and renewals *	425	396
Professional services	150	208

	764	813
Depreciation and amortization (exclusive of amortization of software products included in cost of products and services sold)	59	54
Customer operations and support	310	303
Selling, general and administrative	1,514	1,857
Software development and technical support	475	646
Operating expenses before amounts capitalized	3,122	3,673
Less capitalized portion	(160)	(258)
Net operating expenses	2,962	3,415
Operating income	93	405
Other expense:		
Interest expense	(335)	(329)
Other, net	(3)	(13)
Total other expense	(338)	(342)
Net income (loss)	$ (245)	$ 63
Average common shares outstanding	6,329	6,184
Basic and diluted net income (loss) per share	$ (0.04)	$ 0.01

See notes to unaudited condensed financial statements.

* Includes amortization of software products of $419 and $390 and excludes other depreciation and amortization shown separately

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

	THREE MONTHS ENDED OCTOBER 31 2002	2001
OPERATING ACTIVITIES		
Net income (loss)	$ (245)	$ 63
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Amortization of software products	419	390
Amortization of goodwill	--	3
Amortization of deferred financing costs and debt discount	237	237
Depreciation and other amortization	59	51

Net change in receivables, prepaid expenses and other current assets	133	500
Net change in accounts payable, deferred revenue, accrued liabilities and long term liabilities	(491)	(634)
Net cash provided by operating activities	112	610
INVESTING ACTIVITIES		
Purchase of equipment and leasehold improvements	(3)	--
Software product costs capitalized	(160)	(258)
Net cash used in investing activities	(163)	(258)
FINANCING ACTIVITIES		
Repayments under line of credit	--	(102)
Payments under notes payable	(80)	(221)
Payments of capital lease obligations	(47)	(45)
Net cash used in financing activities	(127)	(368)
Net decrease in cash	(178)	(16)
Cash at beginning of period	879	313
Cash at end of period	$ 701	$ 297
Cash paid for interest	$ 29	$ 118

See notes to unaudited condensed financial statements.

NOTES TO CONDENSED FINANCIAL STATEMENTS
(UNAUDITED)
OCTOBER 31, 2002

1. BASIS OF PRESENTATION

The accompanying unaudited financial statements have been prepared and reviewed in accordance with accounting principles generally accepted in the United States for interim financial information. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for fiscal year end financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three months ended October 31, 2002 are not necessarily indicative of the results that may be expected for the fiscal year ending July 31, 2003. For further information, refer to the financial statements and footnotes thereto included in the Company's annual report on Form 10-K for the year ended July 31, 2002.

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

The weighted average number of shares outstanding used to calculate basic and diluted earnings per share result in the same earnings per share amount.

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 $1,303,000 at October 31, 2002.

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 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 which expired October 27, 2001. Each of the warrants are exercisable for one share of common stock at a price of $6 per share. The warrants and options, which were originally estimated to have a value of $2,354,000, less accumulated amortization, reduce the carrying amount of the debt.

5. SUBSEQUENT EVENTS

On August 28, 2002, RGC, International Investors, LDC (RGC) orally offered to enter into an eight month "stand-still" agreement with the Company under which RGC would not exercise any claimed acceleration rights under the Company's convertible subordinated Debenture due in 2003 (Debenture) in return for an immediate payment of $500,000 by the Company and an option to buy back the Debenture and all other securities sold to RGC for $1 million at any time during the eight-month stand-still period. On September 13, 2002, the Company accepted RGC's offer.

On November 1, 2002, the Company received a letter from RGC's legal counsel stating that no such stand-still agreement exists and that RGC had sold its interest in the Debenture and assigned its rights and obligations on or around September 27, 2002.

The Company filed a lawsuit on November 8, 2002 against RGC and three alleged transferees of the Debenture to enforce the terms of the stand-still and buy-back agreement. RGC denies that any such agreement exists. An agent for the alleged transferees of the Debenture has contacted the Company with demands that are inconsistent with the terms of the stand-still and buy-back agreement and has submitted a purported demand to accelerate the maturity of the Debenture. The Company intends to vigorously contest the validity of this demand. The pending litigation and the purported demand may have a significant impact on the Company's results of operations in fiscal 2003.

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

RESULTS OF OPERATIONS

Total revenue for the quarter ended October 31, 2002 decreased $765,000 or 20% compared to the same period last year, primarily due to the expected decline in non-Equipment Industry revenue and a decrease in new sales in the Equipment Industry. Earnings decreased from net income of $63,000, or $0.01 per share for the quarter ended October 31, 2001 to a net loss of $245,000 or $0.04 per share for the quarter ended October 31, 2002. Management believes that, due to cost containment efforts, the Company will continue to generate enough cash from operations to fund operations, investments and debt payments in fiscal 2003, provided the Debenture is satisfactorily resolved and/or restructured. The Company may incur net losses for the remainder of fiscal 2003 and the results of the lawsuit regarding the debenture may have a significant impact on earnings. See "Liquidity and Capital Resources" and "Forward Looking Statements."

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

General

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

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

Revenue Recognition

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

Bad Debts

The Company maintains an allowance for doubtful accounts for estimated losses resulting from the inability of its customers to make required payments. The Company currently reserves for most amounts due over 90 days, unless there is reasonable assurance of collectability. 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, including royalties and other contingent expenses that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Debt Instruments

The Company valued a debt discount for Common Stock Warrants and Options granted in consideration for the Debenture and the WITECH Facility 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.

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.

REVENUES

The Company is a leading provider of electronic catalog-enabled business solutions for sales, service and life cycle product support in the manufactured equipment market. The Company currently serves approximately 100 lines of manufactured equipment and 25,000 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 supplies three types of software and services: robust Web and CD-ROM electronic parts catalogs, template-based website services and communication or transaction services. The Company's primary product line is electronic cataloging the other products are supplementary offerings that leverage its position in the catalog market.

As part of its historical business practice, the Company continues to provide electronic directory and transaction services to U.S. and Canadian agribusiness 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 during fiscal 2003.

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

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

REVENUE BY INDUSTRY SECTOR
(IN THOUSANDS)

INDUSTRY SECTOR:	THREE MONTHS ENDED OCTOBER 31 2002	2001	PERCENT CHANGE
EQUIPMENT INDUSTRY			
North American			
Recurring	$1,938	$1,964	(1%)
Non-recurring	448	737	(39%)
Subtotal	2,386	2,701	(12%)
Non-North American			
Recurring	273	218	25%
Non-recurring	47	98	(52%)
Subtotal	320	316	1%
Total Equipment Industry			
Recurring	2,211	2,182	1%
Non-recurring	495	835	(41%)
Subtotal	2,706	3,017	(10%)
NON-EQUIPMENT INDUSTRY			
Recurring	349	803	(57%)
Non-recurring	--	--	--
Subtotal	349	803	(57%)
TOTAL REVENUE			
Recurring	2,560	2,985	(14%)
Non-recurring	495	835	(41%)
Grand Total	$3,055	$3,820	(20%)

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REVENUE BY PRODUCT IN THE EQUIPMENT INDUSTRY
(IN THOUSANDS)

PRODUCT:	THREE MONTHS ENDED OCTOBER 31 2002	2001	PERCENT CHANGE

EQUIPMENT INDUSTRY			
Catalog and related			
Recurring	$2,114	$1,945	9%
Non-recurring	485	777	(38%)
Subtotal	2,599	2,722	(5%)
Communications			
Recurring	97	237	(59%)
Non-recurring	10	58	(83%)
Subtotal	107	295	(64%)
Total Equipment Industry	$2,706	$3,017	(10%)

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 licenses and professional services fees. Recurring revenue, as a percentage of total revenue, was 84% for the three months ended October 31, 2002 compared to 78% for the same period last year. Management believes that the relationship of approximately three quarters recurring revenue to one quarter non-recurring revenue establishes an appropriate level of base revenue while the Company continues to add new sales to drive future increases in recurring revenue. If the manufacturing sector of the economy improves in the future, the percentage of recurring revenue may be slightly lower, indicating a higher amount of new business. This ratio is expected to fluctuate from quarter to quarter and year to year, depending on the size and timing of new business. Management expects the Equipment Industry revenues to increase and non-Equipment Industry revenues to decrease resulting in decreased total revenues for the remainder of fiscal 2003 compared to the prior year.

Equipment Industry

The Equipment Industry has been a growing percentage of the Company's revenue over the past five years and is composed of several vertical markets including outdoor power, recreation vehicles, motorcycles, auto and truck parts after-market, 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 software and services business with manufacturers and distributors and their dealers in the existing vertical markets, add supplemental products for existing customers, and then expand to other similar markets in the future. Revenues in the Equipment Industry increased, as a percentage of total revenues, from 79% for the three months ended October 31, 2001 to 89% for the three months ended October 31, 2002.

North American

Recurring revenues in the North American Equipment Industry decreased marginally for the three month period ended October 31, 2002, compared to the same period last year, primarily due to a decrease in the base revenue from the Company's communication products. Non-recurring revenues in the North American Equipment Industry decreased for the three month period ended October 31, 2002, compared to the same period last year, primarily due to fewer new customer contracts and customization projects because of the decline in the manufacturing sector of the economy.

Non-North American

Recurring revenues in the non-North American Equipment Industry increased for the three month period ended October 31, 2002, compared to the same period last year, primarily due to an increase in the base revenue of catalog customers. Non-recurring revenues in the non-North American Equipment Industry decreased for the three month period ended October 31, 2002, compared to the same period last year, primarily due to less revenue from new customer contracts.

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Catalog and Related Products

Recurring revenues from the Company's catalog and related products in the Equipment Industry increased for the three month period ended October 31, 2002, compared to the same period last year, primarily due to an increase in the Company's base revenue of catalog customers and an increase in the volume of catalogs purchased by dealers. Management expects recurring catalog and related revenues to continue at the same level or higher in both the North American and non-North American Equipment Industry for the remainder of fiscal 2003, as the Company continues to focus attention and resources on its catalog products, but that non-recurring catalog and related revenue growth may be delayed until the economy improves.

Communications Products

Revenues from the Company's communications products decreased for the three months ended October 31, 2002, compared to the same period last year, primarily due to a decline in the base revenue of communications customers. The Company has focused the business primarily on its catalog products. Management expects revenues from communications products will be a declining percentage of total revenue for the remainder of fiscal 2003.

Non-Equipment Industry Business

The Company's business outside of the Equipment Industry includes sales of database management and electronic communication services to the agricultural inputs industry and, for part of fiscal 2002, the on-line provision of information for republication to the non-daily newspaper publishing industry. Revenues in this business have decreased for the three months ended October 31, 2002, compared to the same period last year. The Company's five-year contract with the Associated Press expired in February 2002. Revenue from this contract was approximately $384,000 for the three months ended October 31, 2001. Management expects revenue from its database management services to the agricultural inputs industry, which is approximately $500,000 on an annual basis, to decline significantly in the second half of fiscal 2003 due to competitive pressure.

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 OCTOBER 31 2002	2001	PERCENT CHANGE
Subscriptions, support and other services fees			
Revenue	$1,991	$2,455	(19%)
Cost of revenue	189	209	(9%)
Cost of revenue as a percent of revenue	10%	9%	
Software licenses and renewals			
Revenue	557	820	(32%)
Cost of revenue	425	396	7%
Cost of revenue as a percent of revenue	76%	48%	
Professional services			
Revenue	507	545	(7%)
Cost of revenue	150	208	(28%)
Cost of revenue as a percent of revenue	30%	38%	
Total			
Revenue	$3,055	$3,820	(20%)
Cost of revenue	764	813	(6%)
Cost of revenue as a percent of revenue	25%	21%	

Cost of subscriptions, support and other services fees consists primarily of telecommunications and catalog replication and distribution costs and, during fiscal 2001, royalties on revenues in the publishing industry. Cost of subscriptions, support and other services fees as a percentage of revenue increased 1% for the three month period ended October 31, 2002, compared to the same period last year. Management expects gross margins, as a percent of revenue from subscriptions, support and other services fees, to be relatively consistent from quarter to quarter.

Cost of software licenses and renewals consists primarily of amortization of software products, royalties and software distribution costs. Cost of software license and renewals as a percentage of revenue increased for the three month period ended October 31, 2002, compared to the same period last year, primarily due to lower software license revenues. Gross margins from software licenses and renewals will fluctuate from quarter to quarter based on the level of revenue, while costs remain relatively the same as amortization of software is not related to the level of revenue generated from software license and renewals.

Cost of professional services consists of customization and catalog production labor. Cost of professional services as a percentage of revenue decreased for the three month period ended October 31, 2002, compared to the same period last year, primarily due to a decrease in software customization, which has a lower margin, and an increase in data conversion revenue, which has a higher margin. Management expects cost of professional services to fluctuate from quarter to quarter depending on the mix of services sold and on the Company's performance towards the contracted amount for customization projects.

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 2002	2001	PERCENT CHANGE
Cost of products and services sold	$ 764	$ 813	(6%)
Customer operations and support	310	303	2%
Selling, general and administrative	1,514	1,857	(18%)
Software development and technical support	475	646	(26%)
Less capitalized portion	(160)	(258)	(38%)
Depreciation and amortization	59	54	9%
Net operating expenses	$2,962	$3,415	(13%)

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 remained relatively the same for the three month period ended October 31, 2002, compared to the same period last year. Management expects customer operations and support costs to continue at relatively the same level for the remainder of fiscal 2003.

Selling, general and administrative expenses ("SG&A") decreased for the three month period ended October 31, 2002, compared to the same period last year, primarily due to cost reductions. SG&A, as a percentage of revenue, increased slightly from 49% for the three month period ended October 31, 2001 to 50% for the three month period ended October 31, 2002. Management expects costs in SG&A to continue to be lower than last year for the remainder of fiscal 2003 due to the cost containment efforts instituted by the Company.

The Company's technical staff (in-house and contracted) performs both software development and technical support and software customization and data conversion services for customer applications. Therefore, management expects fluctuations between software customization and data conversion services and development and technical support expenses quarter to quarter, as the mix of development and customization activities will change based on customer requirements. Software development and technical support costs decreased for the three month period ended October 31, 2002, compared to the same period last year, primarily due to the reduction of resources. Management expects software development and technical support costs to continue to be lower than the previous year for the first six months and remain constant for the balance of fiscal 2003.

Capitalized software product costs represented 34% of software development and technical support for the three month period ended October 31, 2002, compared to 40% for the same period last year. Management expects capitalized software product costs to fluctuate from quarter to quarter depending on the deployment of the Company's resources between early stage research, software development available for capitalization, data conversion, customer customizations and maintenance and technical support.

Depreciation and amortization expense increased slightly for the three month period ended October 31, 2002, compared to the same period last year. Management expects depreciation and amortization to continue at relatively the same level for the remainder of fiscal 2003.

OTHER ITEMS

Earnings decreased from net income of $63,000 for the three month period ended October 31, 2001, to a net loss of $245,000 for the three month period ended October 31, 2002. The decrease in earnings is primarily due to the reduction in revenue, which was only partially offset by cost reductions. Management expects operating income and cash to be positive, but earnings to remain negative for the remainder of fiscal 2003.

Interest paid or accrued for payment increased from $124,000 for the three month period ended October 31, 2001, to $130,000 for the three month period ended October 31, 2002. Non-cash interest expense of approximately $205,000 was incurred for each of the three month periods ended October 31, 2001 and 2002 due to amortization of debt discount related to the Debenture.

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, four acquisitions have been completed, all of which were fully integrated into the Company's operations prior to fiscal year 2000. The business development program is still an important component of the Company's growth strategy.

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 2002	2001	PERCENT CHANGE
Net cash provided by operating activities before changes in working capital	$ 470	$ 744	(37%)
Net cash used in investing activities	(163)	(258)	37%
Subtotal	307	486	(37%)
Effect of net changes in working capital			

	(358)	(134)	(167%)
Net cash provided by (used in) operating and investing activities	$ (51)	$ 352	(114%)

Net cash provided by operating activities before changes in working capital decreased for the three month period ended October 31, 2002, compared to the same period last year, due to the reduction in revenue. Net cash used in investing activities decreased for the three month period ended October 31, 2002, compared to the same period last year, due to decreased capitalized software costs. 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 the summation of cash provided by operating activities before changes in working capital and used in investing activities to continue to be positive for the remainder of the fiscal year ended July 31, 2003, although there can be no assurance that this result will be ultimately achieved.

At October 31, 2002, the Company had cash of approximately $701,000 compared to approximately $879,000 at July 31, 2002.

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 2002 (UNAUDITED)	JULY 31 2002 (AUDITED)	NET CHANG
Debt to Shareholder:			
Current portion of notes payable	--	56	
Debt discount (common stock warrants)	--	(6)	
Total Debt to Shareholder	--	50	
Subordinated Debenture:			
Notes payable *	4,000	4,000	
Debt discount (common stock warrants and options)	(389)	(588)	
Total Subordinated Debenture	3,611	199	3
Other Debt:			
Current portion of notes payable other	54	78	
Total Other Debt	54	78	
Total Debt	$ 3,665	$ 3,540	$

* The Debenture requires the Company 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 and that failure to meet this requirement allows the original holder to accelerate the Debenture at 130% of principal and accrued interest, and to increase the interest rate from 7% to 17%. The Company's common stock is not so listed.

On April 27, 2000, the Company issued and sold pursuant to a Securities Purchase Agreement, dated as of April 25, 2000, (i) a convertible subordinated debenture in the amount of $4,000,000 due on April 27, 2003 (the "Debenture"), and convertible into shares of the Company's common stock, (ii) warrants to purchase 600,000 shares of common stock (the "Warrants"), and (iii) an investment option to purchase 800,000 shares of common stock (the "Investment Option"). The Investment Option expired 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 are exercisable at $6 per share. As long as $500,000 or more principal amount of the Debenture is outstanding, the Company agreed not to: (i) pay any dividends or make any other distribution on our common stock, other than stock dividends and stock splits; (ii) repurchase or redeem any shares of our capital stock, except in exchange for common stock or preferred stock; (iii) incur or assume any liability for borrowed money, except our existing debt, debt from a bona fide financial lending institution, indebtedness to trade creditors, borrowings used to repay the debenture, indebtedness assumed or incurred in connection with the acquisition of a business, product, license or other asset, refinancing of any of the above, and indebtedness that is subordinate to the Debenture; (iv) sell or otherwise dispose of assets outside the normal course of business, except the sale of a business, product, license or other asset that our board of directors determines is in the best interests of us and our shareholders, and sales of assets with a value not exceeding $500,000 in any 12-month period following the issuance of the debenture; (v) lend money or make advances to any person not in the ordinary course of business, except loans to subsidiaries or joint ventures approved by a majority of our independent directors, guarantee another person's liabilities, except, among other things, guarantees made in connection with the acquisition of a business, product, license or other asset.

As set forth in "Part II, Item 1 - Legal Proceeding," the Company has filed a lawsuit in Milwaukee County Circuit Court against the original holder of the Debenture and three alleged transferees to enforce the terms of a stand-still and buy-back agreement between the Company and the original holder of the Debenture. The original holder of the Debenture denies that any such agreement exists. An agent for the alleged transferees of the Debenture has contacted the Company with demands that are wholly inconsistent with the terms of the stand-still and buy-back agreement and has submitted a purported demand to accelerate the maturity of the Debenture. The Company intends to vigorously contest the validity of this demand. In the event that the Company is not successful in its lawsuit, management expects that the Company would be able to pay the Debenture in full over several years but it cannot pay it in full at this time. The pending litigation and the purported demand may have a significant impact on the Company's results of operations in fiscal 2003.

During fiscal 2002, the Company had a term loan and a revolving line of credit with WITECH Corporation. The term loan was initially for $1.0 million, payable in equal monthly installments over three years, and the revolving line of credit was for a maximum of $1.0 million. The interest rate on the term loan was at prime plus 4.0% and on the revolving line of credit was prime plus 3.25%. The revolving line of credit terminated on December 31, 2001 and the term loan was repaid in full on October 1, 2002.

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 three-year Sale Agreement allows RFC to purchase up to

$3.0 million of ARI's accounts receivable. Under the Sale Agreement, RFC purchases 90% of eligible receivables. In connection with the Sale Agreement ARI was required to pay a commitment fee of $45,000 on September 28, 1999, $30,000 on September 28, 2000, and $15,000 on September 28, 2001. In addition, 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%. The Sale Agreement has been extended through January 28, 2003. If the Sale Agreement is not renewed beyond the current expiration date, ARI's primary source of additional liquidity will no longer be available to it. In addition, the most recent extension provides that any attempt by the holder of the Debenture to accelerate the obligation shall be deemed an event of default under the Sale Agreement. As noted above, the Company has received a purported demand for immediate payment of the Debenture, but intends to vigorously contest the validity of this demand. If the Company loses the source of liquidity under the Sale Agreement and is unable to replace it, ARI's financial condition and capital resources would be significantly and adversely affected. As of December 10, 2002, the balance of the RFC Facility was $549,000.

Management believes that funds generated from operations and the Sales Agreement will be adequate to fund the Company's operations, investments and debt payments through fiscal 2003, provided the Debenture is satisfactorily resolved and/or restructured and the Sale Agreement renewed.

The Company believes that earnings before interest, taxes, depreciation and amortization ("EBITDA") is generally accepted as providing useful information regarding a company's ability to service and/or incur debt. EBITDA decreased from $836,000 for the three month period ended October 31, 2001 to $568,000 for the three month period ended October 31, 2002, primarily due to the decrease in revenue. Management believes that EBITDA will continue to be positive in fiscal 2003 and beyond, although there can be no assurance that this will occur.

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

FORWARD LOOKING STATEMENTS

Certain statements contained in this Form 10-Q are forward looking statements including projected revenue growth, future cash flows and cash generation and sources of liquidity. Expressions such as "believes," "anticipates," "expects," and similar expressions are intended to identify such forward looking statements. Several important factors can cause actual results to materially differ from those stated or implied in the forward looking statements. Such factors include, but are not limited to the factors listed on exhibit 99.1 of the Company's annual report on Form 10-K for the year ended July 31, 2002, which is incorporated herein by reference.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

ARI is subject to market risks pertaining to interest rate movements and collectibility of accounts receivable. ARI's only expenses subject to interest rate risk are (i) interest expense on the WITECH Term Loan and (ii) monthly program fees owed with respect to the Sale Agreement. See "Liquidity and Capital Resources". The WITECH Term Loan, which bore interest tied to prevailing market rates, was paid in full as of October 15, 2002. The monthly program fees under the Sale Agreement are also tied to prevailing market interest rates. An increase or decrease of one percent in the prime interest rate would affect ARI's net income by approximately plus or minus $5,000, annualized, based on the outstanding balances under the Sale Agreement at December 10, 2002. As a result, ARI believes that the market risk relating to interest rate movements is minimal.

ITEM 4. CONTROLS AND PROCEDURES

An evaluation was performed under the supervision and with the participation of management, including the Chief Executive Officer (CEO) and Chief Financial Officer (CFO), of the effectiveness of the design and operation of the Company's disclosure controls and procedures within 90 days before the filing date of this quarterly report. Based on that evaluation, management, including the CEO and CFO, concluded that the disclosure controls and procedures of the Company are adequate and effective. There have been no significant changes in the Company's internal controls or in other factors that could significantly affect these controls subsequent to the evaluation, including any corrective actions with regard to significant deficiencies or material weaknesses.

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

On November 8, 2002, the Company filed a complaint (the "Complaint") in the Milwaukee County Circuit Court, Milwaukee, WI, against RGC International Investors, LDC ("Rose Glen"), ARI Network Services Partners (which is not in any way affiliated with the Company), Dolphin Offshore Partners, LP and SDS Merchant Fund, LP. Rose Glen is the original purchaser of the Company's outstanding convertible subordinated Debenture due 2003 (the "Debenture") and the other defendants are alleged transferees of the Debenture. Taglich Brothers, Inc. is the agent for the three alleged transferees.

The Complaint alleges that on August 28, 2002, Rose Glen orally offered to enter into an eight month "stand-still" agreement with the Company under which Rose Glen would not exercise any claimed acceleration rights under the Debenture. On August 28, 2002, Rose Glen orally offered to enter into this eight month "stand-still" in return for an immediate payment of $500,000 by the Company. Rose Glen also offered to give the Company an option to buy back the Debenture and all other securities sold to Rose Glen in return for a payment of $1 million at any time during the eight month stand-still period. Rose Glen subsequently confirmed the offer in writing. The Company accepted Rose Glen's offer on September 13, 2002.

The Complaint further alleges that Rose Glen was apparently shopping the Debenture behind the Company's back. Although Rose Glen verbally confirmed the agreement with the Company, Rose Glen later changed its position and informed the Company it would not live up to the terms of the agreement. Rose Glen then told the Company that it had sold the Debenture. The Company has now been contacted by Taglich Brothers, Inc., on behalf of three alleged transferees, which is making demands that are wholly inconsistent with the agreement and which has submitted a purported demand to accelerate the maturity of the Debenture. The Company intends to vigorously contest the validity of this demand.

The Complaint alleges, among other things, claims for a declaratory judgment, breach of contract, specific performance and breach of the covenant of good faith and fair dealing. The Complaint requests, among other things, damages and specific performance of the agreement.

The Complaint was only recently filed and, as of December 13, 2002, none of the defendants had filed an answer.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

See Item 1 - Legal proceedings with respect to information concerning a purported demand to accelerate the maturity of the Company's Debenture.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

10.1 2000 Stock Option Plan, as amended
99.1 Section 906 certification of Chief Executive Officer
99.2 Section 906 certification of Chief Financial Officer

(b) Reports on Form 8-K

There were no reports on Form 8-K filed for the quarter ended October 31, 2002.

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: December 16, 2002

/s/ Brian E. Dearing

Brian E. Dearing, Chairman of the Board

/s/ Timothy Sherlock

Timothy Sherlock, Chief Financial Officer

CERTIFICATIONS

I, Brian E. Dearing, certify that:

1. I have reviewed this quarterly report on Form 10-Q of ARI Network Services, Inc.;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report; and

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report.

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

   a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared.

   b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

   c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

   a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors and material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: December 16, 2002

/s/ Brian E. Dearing

By: Brian E. Dearing
Title: Chairman, President and CEO

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I, Timothy Sherlock, certify that:

1. I have reviewed this quarterly report on Form 10-Q of ARI Network Services, Inc.;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report; and

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report.

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared.

b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

   a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors and material weaknesses in internal controls; and

   b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: December 16, 2002

/s/ Timothy Sherlock

By: Timothy Sherlock
Title: Chief Financial Officer, Secretary, Treasurer, and VP of Finance

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EXHIBIT INDEX

EXHIBIT NO.	DESCRIPTION
10.1	2000 Stock Option Plan, as amended
99.1	Section 906 certification of Chief Executive Officer
99.2	Section 906 certification of Chief Financial Officer