ARI NETWORK SERVICES INC /WI
Form 10-K
November 13, 2001

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

(XX) ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

for the fiscal year ended July 31, 2001
or

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

From the transition period from .............. to ..............

Commission File No. 0-19608

ARI NETWORK SERVICES, INC.
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Wisconsin | 39-1388360 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| 330 East Kilbourn Ave.<br>Milwaukee, Wisconsin<br>(Address of principal executive offices) | 53202-3149<br>(zip code) |

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

Securities registered pursuant to Section 12(b) of the Act:
NONE
Securities registered pursuant to Section 12(g) of the Act:
COMMON STOCK, $.001 PAR VALUE
(TITLE OF CLASS)

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 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 [X] NO [ ]

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [_____]

As of October 25, 2001, aggregate market value of the Common Stock held by non-affiliates (based on the closing price on the NASDAQ bulletin board) was approximately $1.7 million.

As of October 25, 2001, there were 6,184,281 shares of Common Stock of the registrant outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Definitive Proxy Statement, to be filed with the Securities and Exchange Commission no later than 120 days after July 31, 2001, for the 2001 Annual Meeting of Shareholders are incorporated by reference in Part III hereof.

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ITEM 1. BUSINESS

BUSINESS OVERVIEW

ARI Network Services, Inc. (the "Company" or "ARI") is a provider of technology-enabled business solutions that connect manufacturers in selected industries with their service and distribution networks. We focus our sales and marketing on the U.S., Canadian, European and Australian manufactured equipment industry (the "Equipment Industry"), providing direct sales and service in North America and operating through value-added sales and service agents elsewhere. Sales for these manufacturers are driven by their dealers' needs for parts for repair, warranty, and maintenance services. The Equipment Industry is made up of separate sub-markets in which the manufacturers often share common distributors, retail dealers and/or service points. These sub-markets include: outdoor power, recreation vehicles, motorcycles, manufactured housing, farm equipment, marine, construction, power sports, floor maintenance, auto parts aftermarket and others. By "Equipment" we mean capital goods which are repaired rather than discarded when broken and for which the repairs are generally performed by a distributed network of independent dealers and/or repair shops. The Equipment Industry has been a growing percentage of our revenue over the past three years, representing 76% of fiscal 2001 revenue. We expect this percentage to continue to increase in fiscal 2002 and beyond.

Our products and services enable Equipment Industry manufacturers to automate business communications with their worldwide distributors, dealers, and service points. We supply three types of software and services: robust Web and CD-ROM electronic parts catalogs, transaction services and template-based website services. The electronic cataloging products and services enable partners in a service and distribution network to electronically look up technical reference information such as illustrated parts lists, service bulletins, price files, repair instructions and other technical information regarding the products of multiple manufacturers. The transaction services allow the manufacturers and their distribution and service partners to exchange electronic business documents such as purchase orders, invoices, warranty claims, and status inquiries. The template-based website service makes it easy for a dealer to create a professional web presence and to optionally conduct electronic business with its customers. Our products and

services use the Internet for data transport and a combination of the World-Wide Web and CD-ROM technology for user interfaces and data presentation.

Our sales and marketing activities are focused primarily on Equipment Industry manufacturers that sponsor our products and services to their dealers, distributors and/or service points. These manufacturers have the financial capability and business power to implement an automation strategy throughout their service and distribution networks. We believe that the implementation of our products can increase loyalty and productivity in the service and distribution network as well as end-customer satisfaction. In addition to software licenses and support services, a typical implementation for a given manufacturer will involve professional services for project management, software customization, and roll-out management. Once manufacturer sponsorship is obtained, we also develop a direct business relationship with the distributors, dealers, and service points for software and services.

An important aspect of our business is the relationships we have developed with over 100 dealer business management system providers through our COMPASS Partners(TM) program. A dealer business management system is used to manage inventory, maintain accounting records, bill customers and focus marketing efforts. Our software's ability to interface with these systems provides the end-user with a more robust, informative, and cost-effective solution.

Our customer base currently comprises approximately 100 manufacturers in 12 different sub-markets of the Equipment Industry, as well as over 20,000 dealers, distributors, and repair facilities in more than 50 countries. No single customer accounted for 10% or more of our revenues in fiscal 2001.

As part of our historical business practice, we continue to provide electronic directory and transaction services, to the U.S. and Canadian agribusiness industry, which accounted for 11% of our total revenue in fiscal 2001. During fiscal 2001, we provided electronic directory services to the U.S. and Canadian freight transportation industry and on-line information management services to the non-daily newspaper publishing industry, which accounted for 3% and 10%, respectively, of our total revenue in fiscal 2001. The contract with the freight transportation industry expired in December, 2000 and the contract with the non-daily newspaper publishing industry will expire in November, 2001.



Our executive offices are located at 330 East Kilbourn Avenue, Milwaukee, Wisconsin 53202 and our telephone number at that location is (414) 278-7676. ARI is a Wisconsin corporation, incorporated in 1981. We maintain a website at http://www.arinet.com(TM), which is not part of this report.

MISSION AND STRATEGY

Our mission is to be the leading provider of technology-enabled business solutions for sales, services and product support in selected manufacturing industry segments with shared distribution channels and service networks. Our vision is that whenever a manufacturer in one of our target markets communicates or does business electronically with a distributor, dealer or service location, it will use at least some of our products and services to do so. To achieve this vision, our strategy is to concentrate on a few vertical markets, and to be the leading provider of catalog products and services. After establishing a position in a market, we will then bring other products and services to bear in order to expand our presence and solidify our

competitive position. Our goal is to provide a complete array of high-quality software and services that industry participants will adopt and use effectively.

Our strategy includes driving growth in our targeted markets through three distinct programs: (i) sales; (ii) strategic alliances; and (iii) acquisitions. Our external sales team focuses on large manufacturers and distributors in the targeted industry sectors, while internal telesales representatives sell to dealers and small to medium sized distributors. The alliance strategy includes three parts: (i) manufacturer sales parties; (ii) COMPASS partners; and (iii) non-US sales and service agents. We have a relationship with Click Commerce, under which they sell our web catalog products and services as part of their total product suite. We are actively cultivating relationships with other potential manufacturer sales partners. Through our COMPASS Partners program, we have a strategic alliance relationship with over 100 companies that provide complementary software and services to distributors and dealers in our targeted industries. Outside of North America, we sell to manufacturers directly, but use local agents to provide sales and support to dealers. We also have an active acquisition program that has generated four acquisitions in the last five years. We seek to acquire businesses with market positions in our targeted markets, additional products that we can provide to our customer base, and development talent to supplement our current staff.

Through our sales, alliance and acquisition programs, we expect to expand our business both by growing market share in our current Equipment sectors and by entering new sectors.

PRODUCTS AND SERVICES

We offer three basic kinds of services to our customers in the Equipment Industry: (i) electronic catalogs for publishing and viewing technical reference information about the equipment, (ii) electronic communications for exchanging documents such as purchase orders, invoices, and warranty claims and (iii) website services which allow a dealer to create a website using a series of templates. The following table shows the software products and services that we offer, a brief description of the products and the industries where they are currently in use.

| ELECTRONIC CATALOG PRODUCTS AND SERVICES | | |
|---|---|---|
| PRODUCT OR SERVICE | DESCRIPTION | PRIMARY |
| EMPARTweb(TM) | Web based electronic parts catalog based upon the EMPART database technology | Equipment - ou parts after-ma motorcycle |
| PartSmart(TM) | Electronic parts catalog for equipment dealers | Equipment - al RV and manufac |
| EMPARTviewer(TM) | Electronic parts catalog viewing software | Equipment - RV housing only |
| EMPARTpublisher(TM) | Electronic parts catalog creation software used to produce catalogs for viewing on EMPARTweb, PartSmart, and EMPARTviewer | Equipment - al |
| Electronic publishing | Project management, data conversion, editing, | Equipment - al |

| | | |
|---|---|---|
| services | production, and distribution services for manufacturers who wish to outsource catalog production operations | |



| ELECTRONIC COMMUNICATIONS PRODUCTS AND SERVICES | | |
|---|---|---|
| PRODUCT OR SERVICE | DESCRIPTION | PRIMARY |
| TradeRoute(R)Customized Web forms | Web-based e-Commerce forms to support transactions such as product ordering, warranty claims and other business processes | Equipment - ou |
| TradeRoute(R) | Document handling and communications for product ordering, warranty claims and other business documents | Equipment - al |
| Professional services | Project management, software customization, roll-out management, and help desk support services | All Industries sub-markets |

| WEBSITE SERVICES | | |
|---|---|---|
| PRODUCT OR SERVICE | DESCRIPTION | PRIMARY INDUSTRY/M |
| WebSite Smart(TM) | Template-based software to create customized dealer websites and conduct business electronically | Equipment - outdoor pow sports |

As part of our historical business practice, we continue to provide e-Commerce services to certain non-equipment industries, including the U.S. and Canadian agribusiness industry and the U.S. non-daily newspaper publishing industry. In these non-equipment industries, we provide electronic directory and transaction services as well as on-line information management services. In fiscal 2001, these products and services accounted for 21% of our total revenue and are expected to decline significantly in fiscal 2002.

ACQUISITIONS

Since December 1995, ARI has had a business development program aimed at identifying, evaluating and closing acquisitions which augment and strengthen our market position, product offerings, and personnel resources. Since the program's inception, more than 300 acquisition candidates have been evaluated, resulting in four completed acquisitions. The following table shows selected information regarding these acquisitions:

| Acquisition Date | Acquired Company and Location | Description of Acquired |
|---|---|---|
| November 4, 1996 | cd*.IMG, Inc. ("CDI")<br>New Berlin, WI | CDI developed the Plus1<br>parts catalog which fea<br>information from over 2<br>manufacturers in the ou<br>marine, motorcycle and<br>industries and was repl<br>Partsmart electronic ca |
| September 30, 1997 | Empart Technologies, Inc. ("EMPART")<br>Foster City, CA | EMPART provided us with<br>EMPARTpublisher and EMP<br>software. |
| September 15, 1998 | POWERCOM-2000 ("POWERCOM"), a subsidiary of<br>Briggs & Stratton Corporation outdoor power,<br>power tools, and power Colorado Springs, CO | POWERCOM provided elect<br>and communication servi<br>number of manufacturers<br>America, Europe, and Au<br>sports industries. |
| May 13, 1999 | Network Dynamics Incorporated ("NDI")<br>Williamsburg, VA | NDI provided us with th<br>electronic catalog whic<br>over 10,000 dealers to<br>from 50 different manuf<br>sectors of the Equipmen |

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COMPETITION

Competition for ARI's products and services in the Equipment Industry varies by product and by sub-market. No single competitor today competes with us in each of our targeted vertical Equipment Industry sub-markets. In electronic catalog software and services, our direct competitors include ProQuest, Enigma, and NetVendor Inc. which provide electronic catalog services in the motorcycle, marine, and auto markets, and a variety of small companies focused on specific industries. Many of these smaller companies may also represent acquisition targets for us. There are also other companies that provide catalog services such as Saqqara Systems, Inc. and Requisite Technology, Inc. that may in the future directly compete with us in our target markets. In addition, there are also a number of larger companies which have targeted Web-based catalogs for procurement, such as Ariba, Commerce One, and i2 Technologies, Inc., which could expand their offerings to address the needs of our markets and become competitors in the future. In the communications part of our business, the primary competition comes from in-house information technology groups who may prefer to build their own Web-based proprietary systems, rather than use our industry-common solutions. There are also large, general market e-Commerce companies like SBC Technologies Inc. and Peregrine Systems, Inc., which offer products and services which could address some of our customers' needs. These general e-Commerce companies do not typically compete with us directly, but they could decide to do so in the future. These companies may also represent alliance partner opportunities for us. In addition, as in the catalog side of our business, there are a variety of small companies focused on specific industries which compete with us and which may also represent acquisition targets. Another potential source of competition in

the future is the group of companies attempting to build so-called "net communities," such as Chemdex or VerticalNet, which could expand their offerings to target our served markets. Finally, given the high level of interest in Internet-related investment opportunities and the current pace of technological change, it is possible that as yet unidentified well-capitalized competitors could emerge, that existing competitors could merge and/or obtain additional capital thereby making them more formidable, or that new technologies could come on-stream that could threaten our position.

ARI's primary competitive advantages are (i) our focus on our target markets and the industry knowledge and customer relationships we have developed in those target markets, (ii), our robust electronic parts catalog software products, and (iii) our relationships with over 100 dealer business management system providers. When combined with products and services that are designed for our targeted industries, we believe that our competitive advantages will enable us to compete effectively and sustainably in these markets.

## EMPLOYEES

As of October 25, 2001, we had 101 full-time equivalent employees. Of these, 12 are engaged in maintaining or developing software and providing software customization services, 27 are in sales and marketing, 23 are engaged in catalog creation and maintenance or database management, 30 are involved in customer implementation and support and 9 are involved in administration and finance. None of these employees is represented by a union.

## ITEM 2. PROPERTIES

ARI occupies approximately 23,000 square feet in an office building in Milwaukee, Wisconsin, under a lease expiring July 31, 2002. This facility houses our headquarters and data center. In Colorado Springs, Colorado, we occupy approximately 5,500 square feet of office space under a lease expiring January 31, 2006. In Williamsburg, Virginia we occupy approximately 5,100 square feet of office space under a lease that expires October 1, 2004. In the Netherlands we occupy approximately 450 square feet of office space under a month-to-month lease.

## ITEM 3. LEGAL PROCEEDINGS

ARI is not currently involved in any material legal proceedings.

## ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.



## EXECUTIVE OFFICERS OF THE REGISTRANT

The table below sets forth the names of ARI's executive officers as of October 25, 2001. The officers serve at the discretion of the Board.

| Name | Age | Capacities in Which Serving |
|---|---|---|
| Brian E. Dearing | 46 | Chairman of the Board of Directors, CEO and President |
| Timothy Sherlock | 49 | CFO, Secretary, Treasurer and Vice President of Finance |

| | | |
|---|---|---|
| John C. Bray | 44 | Vice President of Sales |
| Michael E. McGurk | 53 | Vice President of Technology Operations |
| Frederic G. Tillman | 39 | Vice President of Technology Development |

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BRIAN E. DEARING. Mr. Dearing, Chief Executive Officer and a director since 1995 and Chairman of the Board of Directors since 1997, is CEO and President. Prior to joining ARI, Mr. Dearing held a series of electronic commerce executive positions at Sterling Software, Inc. in the U.S. and in Europe. Prior to joining Sterling in 1990, Mr. Dearing held a number of marketing management positions in the EDI business of General Electric Information Services from 1986. Mr. Dearing holds a Masters Degree in Industrial Administration from Krannert School of Management at Purdue University and a BA in Political Science from Union College.

TIMOTHY SHERLOCK. Mr. Sherlock was appointed Chief Financial Officer, Secretary, Treasurer and Vice President of Finance in April, 2001. Prior to joining ARI, Mr. Sherlock was CFO and vice president of finance and administration for Catalyst International, Inc., a warehouse management software specialist. Before joining Catalyst in 1999, he held a series of progressively more responsible finance positions at Advantage Learning Systems, Inc. (ALS), a leading educational software firm based in Wisconsin Rapids, Wis. culminating in his appointment as vice president, secretary and CFO. His early career included a variety of financial management positions at Cray Research, Inc., Eagan, Minn., from 1983 to 1995. Mr. Sherlock, a Certified Public Accountant, received a BA in business administration from the College of St. Thomas, St. Paul, Minn.

JOHN C. BRAY. Mr. Bray was appointed Vice President of Sales in September 1996. Prior to joining ARI, Mr. Bray was Manager of Global Internet Sales and Consulting at GE Information Services (GEIS) in Rockville, Maryland. Before joining GEIS, Mr. Bray had a six year sales career at AT&T, culminating in his appointment as Regional Vice President of Sales for AT&T's EasyLink Services, marketing electronic commerce services. He holds a BA in marketing from the University of Iowa.

MICHAEL E. MCGURK. Mr. McGurk was appointed Vice President of Technology in January 1997 and became Vice President of Technology Operations in August 1999. Prior to joining ARI, Mr. McGurk developed and operated a large format printing services business for customers involved in business process re-engineering projects. Before opening the printing service, Mr. McGurk had a twelve year career in information technology management at various divisions of General Electric, including GE Medical Systems, GE Corporate and GE Aircraft Engines. Mr. McGurk's early career included sales and technology positions at Cullinet and CinCom Systems. Mr. McGurk holds an MBA and BS from Miami University in Ohio.

FREDERIC G. TILLMAN. Mr. Tillman was appointed Vice President of Technology Development in August 1999. He joined ARI in September 1998 as part of the acquisition of Powercom where he had been Vice President of Software Development. Prior to joining Powercom in May 1998, Mr. Tillman was Director of New Product Development for ADAC Healthcare Information Systems in Houston, Texas, a producer of information systems for hospital laboratories and radiology departments. Before joining ADAC in 1990, Mr. Tillman spent six years at General Dynamics as a software engineer. Mr. Tillman holds an MBA from Texas Christian University and a BS in Computer Science from Oklahoma State University.

PART II

ITEM 5. MARKET FOR COMPANY'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

ARI's common stock is currently quoted on the NASDAQ Over the Counter Bulletin Board ("OTCBB") under the symbol ARIS. Prior to July 7, 2001, ARI's common stock was quoted on the NASDAQ National Market System. The following table sets forth the high and low closing sales price for the periods indicated. OTCBB quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not necessarily reflect actual transactions.

| Fiscal Quarter Ended | High | Low |
|---|---|---|
| October 31, 1999.................... | $6.281 | $3.500 |
| January 31, 2000.................... | $18.750 | $3.250 |
| April 30, 2000...................... | $12.813 | $3.500 |
| July 31, 2000....................... | $6.063 | $2.000 |
| October 31, 2000.................... | $2.594 | $1.750 |
| January 31, 2001.................... | $2.250 | $0.938 |
| April 30, 2001...................... | $1.625 | $0.688 |
| July 31, 2001....................... | $1.050 | $0.220 |

As of October 25, 2001, there were approximately 228 holders of record of the Company's common stock. The Company has not paid cash dividends to date and has no present intention to pay cash dividends.



ITEM 6. SELECTED FINANCIAL DATA

The following table sets forth certain financial information with respect to the Company as of and for each of the five years in the period ended July 31, 2001, which was derived from audited Financial Statements and Notes thereto of ARI Network Services, Inc. Audited Financial Statements and Notes as of July 31, 2001 and 2000 and for each of the three years in the period ended July 31, 2001, and the report of Ernst & Young LLP thereon are included elsewhere in this Report. The selected financial data should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the Financial Statements and Notes thereto included elsewhere herein.

STATEMENT OF OPERATIONS DATA:
(IN THOUSANDS, EXCEPT PER SHARE DATA)

| | YEAR ENDED JULY 31 | | | |
|---|---|---|---|---|
| | 2001 | 2000 | 1999 | |
| Subscriptions, support and other services revenues | $ 9,985 | $ 9,743 | $ 8,616 | $ |
| Software license and renewal revenues | 3,266 | 1,289 | 2,822 | |
| Professional services revenues | 2,526 | 2,272 | 1,450 | |
| Total revenues | 15,777 | 13,304 | 12,888 | |
| Operating expenses: | | | | |
| Cost of subscriptions, support and other services sold | 1,740 | 1,415 | 1,431 | |
| Cost of software licenses and renewals sold (1) | 3,137 | 3,614 | 2,543 | |
| Cost of professional services sold | 1,359 | 1,965 | 1,234 | |
| Depreciation and amortization (exclusive of amortization of software products included in cost of sales | 1,517 | 1,778 | 1,773 | |
| Customer operations and support | 1,597 | 2,048 | 1,017 | |
| Selling, general and administrative | 8,790 | 8,214 | 6,995 | |
| Software development and technical support | 3,317 | 2,779 | 2,786 | |
| Restructuring and other charges (2) | 7,766 | - | - | |
| Operating expenses before amounts capitalized | 29,223 | 21,813 | 17,779 | |
| Less capitalized portion | (1,972) | (1,729) | (1,802) | ( |
| Net operating expenses | 27,251 | 20,084 | 15,977 | |
| Operating loss | (11,474) | (6,780) | (3,089) | ( |
| Other income (expense) | (1,551) | (822) | (326) | |
| Net loss | $(13,025) | $ (7,602) | $ (3,415) | $ ( |
| Weighted average common shares outstanding | 6,175 | 6,002 | 5,061 | |
| Basic and diluted net loss per share | $ (2.11) | $ (1.27) | $ (0.67) | $ |

SELECTED BALANCE SHEET DATA:
(IN THOUSANDS)

| | | | | |
|---|---|---|---|---|
| Working capital (deficit) | $ (9,819) | $ (4,680) | $ (3,476) | $ |
| Capitalized software development (net) (3) | 3,961 | 11,901 | 14,052 | |
| Total assets | 7,060 | 18,488 | 20,438 | |
| Current portion of long-term debt and capital lease obligations | 3,608 | 933 | 713 | |
| Total long-term debt and capital lease obligations | 251 | 2,695 | 3,511 | |
| Total shareholders' equity (deficit) | (5,850) | 7,159 | 9,756 | |

(1) Includes amortization of software products of $3,178, $3,224, $2,057, $1,121 and $772.

(2) See note 4 to the financial statements.

(3) Fiscal 1999 includes a reclassification of $5,208 from goodwill as a result of the finalization of the purchase price allocation for the NDI acquisition.



ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

SUMMARY

Total revenue grew 19% during fiscal 2001 compared to fiscal 2000, while revenues in the Equipment Industry grew 42%. Total revenue growth was slightly less than the Company's target growth rate of between 20% and 30% due to the faster than expected decline in non-Equipment Industry revenue. Net loss increased in fiscal 2001, compared to fiscal 2000, due to the restructuring and other charges the Company incurred for employee termination costs, termination of operating lease agreements and to write off certain impaired assets related to its network platform and communications products. Operating loss before restructuring and other charges decreased in fiscal 2001, compared to fiscal 2000, primarily due to increased margins and decreased operating expense. As a result of cost reductions related to the Company's restructuring, management expects results to improve in fiscal 2002.

REVENUES

Management reviews the Company's recurring vs. non-recurring revenue in the aggregate and within the Equipment Industry and all other industries. The Equipment Industry has been a growing percentage of our revenue over the past four years, representing approximately 76% of the Company's revenue in fiscal 2001.

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

REVENUE BY INDUSTRY
(IN THOUSANDS)

| | YEAR ENDED JULY 31 | | | | | |
|---|---|---|---|---|---|---|
| INDUSTRY: | 2001 | 2000 | PERCENT CHANGE | 2000 | 1999 | PERCEN CHANG |
| Equipment Industry | | | | | | |
| Recurring | $ 8,696 | $ 5,621 | 55% | $ 5,621 | $ 3,243 | 73 |
| Non-recurring | 3,364 | 2,864 | 17% | 2,864 | 4,157 | (31% |
| Subtotal | 12,060 | 8,485 | 42% | 8,485 | 7,400 | 15 |
| Other Revenues | | | | | | |
| Recurring | 3,686 | 4,483 | (18%) | 4,483 | 4,841 | (7% |
| Non-recurring | 31 | 336 | (91%) | 336 | 647 | (48% |
| Subtotal | 3,717 | 4,819 | (23%) | 4,819 | 5,488 | (12% |

| | | | | | | |
|---|---|---|---|---|---|---|
| Total Revenue | | | | | | |
| Recurring | 12,382 | 10,104 | 23% | 10,104 | 8,084 | 25 |
| Non-recurring | 3,395 | 3,200 | 6% | 3,200 | 4,804 | (33% |
| Grand Total | $ 15,777 | $ 13,304 | 19% | $ 13,304 | $ 12,888 | 3 |

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. Recurring revenues increased in fiscal 2001 and fiscal 2000, compared to the prior year, primarily due to increases in the Equipment Industry revenues. Recurring revenue, as a percentage of total revenue, increased from 63% in fiscal 1999 and 76% in fiscal 2000 to 78% in fiscal 2001 primarily due to increases in the customer base in the Equipment Industry. Management believes a ratio of approximately two thirds recurring revenue to one third non-recurring revenue is desirable in order to establish an appropriate level of base revenue while continuing to add new sales to drive future increases in recurring revenue. This revenue mix may fluctuate from quarter to quarter or year to year.

Non-recurring revenues are derived from initial software licenses and professional service fees. Non-recurring revenues increased in fiscal 2001, compared to fiscal 2000, due to increased catalog license revenue in the Equipment Industry. Non-recurring revenues decreased in fiscal 2000, compared to fiscal 1999, as the Company experienced delays in the development of customized communications software and changed its recognition of software license and renewal revenue from up front upon sale to ratably over the twelve month period of the arrangement, beginning in fiscal 2000. Management believes that non-recurring revenues will increase during fiscal 2002.



Equipment Industry

The Equipment Industry comprises several vertical markets including outdoor power, recreation vehicles, motorcycles, manufactured housing, farm equipment, marine, construction, power sports, floor maintenance, auto parts aftermarket and others. 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 additional products and services in these markets and then expand to other similar markets in the future. Revenues from all of the Company's acquisitions are included in the Equipment Industry revenues. Recurring revenues in the Equipment Industry increased in fiscal 2001 and fiscal 2000, compared to the prior year, primarily due to an increase in the base of catalog customers. Non-recurring revenues in the Equipment Industry increased in fiscal 2001, compared to the prior year, due to increased software and professional services sold to new and existing manufacturer customers. Non-recurring revenues in the Equipment Industry decreased in fiscal 2000, compared to the prior year, primarily due to changing the recognition of software license and renewal revenue to be over a twelve month period and to delays in the delivery of the Company's customized communications software. Management expects recurring and non-recurring revenues in the Equipment Industry to increase at a higher percentage of total revenues in fiscal 2002, as management continues to focus attention and resources in this industry.

Non-Equipment Industry Business

The Company's business outside of the Equipment Industry includes sales of database management services to the agricultural inputs industry and, for fiscal 2000 and part of fiscal 2001, the railroad industry, electronic communications services to the agricultural inputs industry, and the on-line provision of information for republication to the non-daily newspaper publishing industry. Both recurring and non-recurring revenues in this business have decreased from the prior year in fiscal 2001 and in fiscal 2000. Our five-year contract with the Association of American Railroads expired in December, 2000 and our five-year contract with the Associated Press, on which our business in the non-daily newspaper publishing industries depends, expires in November, 2001. Revenues from these contracts was approximately $2 million in fiscal 2001.

## OPERATING EXPENSES

The following table sets forth, for the periods indicated, certain operating expense information derived from the Company's financial statements:

OPERATING EXPENSES
(IN THOUSANDS)

| | YEAR ENDED JULY 31 | | | |
|---|---|---|---|---|
| | 2001 | 2000 | PERCENT CHANGE | 2000 |
| Cost of products and services sold | $ 6,236 | $ 6,994 | (11%) | $ 6,994 |
| Customer operations and support | 1,597 | 2,048 | (22%) | 2,048 |
| Selling, general & administrative | 8,790 | 8,214 | 7% | 8,214 |
| Software development and technical support | 3,317 | 2,779 | 19% | 2,779 |
| Depreciation and amortization (exclusive of amortization of software products included in cost of products and services sold) | 1,517 | 1,778 | (15%) | 1,778 |
| Restructuring and other charges | 7,766 | - | n/a | - |
| Less capitalized portion | (1,972) | (1,729) | 14% | (1,729) |
| Net operating expenses | $ 27,251 | $ 20,084 | 36% | $ 20,084 |

Net operating expenses increased in fiscal 2001, compared to the prior year, primarily due to restructuring and other charges and increased in fiscal 2000, compared to the prior year, primarily as a result of the NDI acquisition completed on May 13, 1999.

Cost of products and services sold consists primarily of amortization of software products, royalties, telecommunications, distribution costs, customization and catalog production labor and temporary help fees. Cost of products and services sold decreased in fiscal 2001, compared to the prior



year, primarily due to a change in the mix of products and services sold. Cost of products and services sold increased in fiscal 2000, compared to the prior

year, primarily as a result of increased revenues and a change in the mix of products and services sold. Cost of products and services sold as a percentage of total revenue decreased to 40% in fiscal 2001, from 53% in fiscal 2000, primarily due to decreased customization revenue and higher license and subscription revenues, which have higher margins. Cost of products and services sold as a percentage of total revenue increased to 53% in fiscal 2000, from 40% in fiscal 1999, primarily due to development cost overruns and increased amortization of software products. Cost of professional services as a percentage of professional services revenue was 54% in fiscal 2001, compared to 86% in fiscal 2000 and 85% in fiscal 1999. The decrease in fiscal 2001, compared to the prior two years, was primarily due to i) the completion of several major customization projects in the Equipment Industry which had costs in excess of the customer's expected cost to complete and were not invoiced to the customer and ii) an increase in data conversion revenue as the Company converted several NDI contracts from a fixed price to a time and materials price. Subscription, support and other services cost of sales as a percentage of subscription, support and other services revenue has remained relatively the same over the past three years: 17% in fiscal 2001, 15% in fiscal 2000 and 17% in fiscal 1999. Software license and renewal cost of sales as a percentage of software license and renewal revenue was 96% in fiscal 2001, compared to 280% in fiscal 2000 and 90% in fiscal 1999. The cost of software licenses and renewals as a percentage of software license and renewal revenue increased significantly in fiscal 2000, compared to fiscal 2001 and fiscal 1999, due to lower software license revenues with higher software product amortization costs, which are fixed, regardless of the level of sales. Management expects gross margins for total revenues to be approximately between 55% and 65% in fiscal 2002 and to fluctuate slightly from quarter to quarter based on the mix of products and services sold.

Customer operations and support costs consist primarily of data center operations, software maintenance agreements for the Company's core network, catalog data maintenance and customer support. Customer operations and support costs decreased in fiscal 2001, compared to the prior year, primarily due to cost reductions in catalog data maintenance and directory services. Customer operations and support costs increased significantly in fiscal 2000, compared to fiscal 1999, due to increased staffing in the catalog data maintenance area from the May 13, 1999 acquisition of NDI. Management expects these costs to decline as a percentage of revenue in the future.

Selling, general and administrative expenses ("SG&A") increased in fiscal 2001, compared to the prior year, primarily due to the hiring of additional upper level finance, sales and marketing personnel. SG&A increased in fiscal 2000, compared to fiscal 1999, due to additional costs absorbed in the NDI acquisition. SG&A, as a percentage of revenue, was 56% in fiscal 2001, 62% in fiscal 2000 and 54% in fiscal 1999. The increase in fiscal 2000 was primarily due to the lower than expected increase in revenue in fiscal 2000 as a result of the recognition of software licenses and renewals over a twelve month period and additional costs absorbed from the acquisition of NDI without a corresponding increase in revenue. Management expects SG&A to decline as a percentage of revenues in the future.

The Company's technical staff (in-house and contracted) is allocated between software development and technical support and software customization services for customer applications. Therefore, management expects fluctuations between software customization services and development expenses from quarter to quarter, as the mix of development and customization activities will change based on customer requirements. During fiscal 2001, our technical resources were focused primarily on a new release of TradeRoute(R), a major customization project of our Web-based catalog for a customer in the auto parts aftermarket industry and on-going catalog data updates. During fiscal 2000, our technical resources were focused primarily on customization projects for our TradeRoute(R) customers and development of Web-based communications

and cataloging software. During fiscal 1999, our technical resources were focused primarily on the development of TradeRoute(R) and PLUS1(R). We expect our technical resources to continue to focus on software customization, catalog data updates and development of Web-based software in fiscal 2002, although the mix may fluctuate quarter to quarter based on customer requirements. We expect software customization and development expenses to decrease during fiscal 2002 due to the Company's restructuring to focus on our catalog products, which require less customization and development than our communication products.

Depreciation and amortization expenses decreased in fiscal 2001, compared to fiscal 2000 and fiscal 1999, primarily due to fully depreciated data processing equipment. As a percentage of total revenue, depreciation and amortization was 10% in fiscal 2001, 13% in fiscal 2000 and 14% in fiscal 1999. Management expects depreciation and amortization expenses to decrease in fiscal 2002 due to the write-off of impaired assets due to the restructuring of operations.

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In the fourth quarter of fiscal 2001, management commenced a restructuring designed to refocus resources from the Company's communication products to the Company's core catalog products, which contribute greater cash margins, in order to reach sustainable cash generation and earnings. During the quarter ended July 31, 2001, the Company incurred non-cash impairment charges of $7,333,000 for the write-off of long-lived assets related to our network platform and communication software and $433,000 in accrued restructuring expense related to severance and future minimum lease payments. As of October 25, 2001, the Company had reduced its number of full-time equivalent employees to 101 from 137 prior to the restructuring and eliminated all but a few contract staff. The Company does not believe the reductions will have a material adverse effect on the Company's future competitiveness or operations and that the restructuring will position the Company to show a quarterly profit before the end of fiscal 2002, although there can be no assurance that this will occur.

Capitalized development costs represented 59% of software development and support expense in fiscal 2001, compared to 62% in fiscal 2000 and 65% in fiscal 1999. Capitalized expenses decreased in fiscal 2001, compared to fiscal 2000 and fiscal 1999, as a percentage of software development and technical support, due to the fact that the Company's development resources were focused on software customization projects and catalog data updates, both of which are expensed.

OTHER ITEMS

Interest expense increased $794,000 in fiscal 2001 and $481,000 in fiscal 2000, compared to the prior year, due to the Debenture sold to Rose Glen (described below) and additional financing by the Company under its RFC facility (also described below). The Company expects interest expense to decrease slightly in fiscal 2002, as the Company pays down principal balances. See "Liquidity and Capital Resources".

Net loss increased $5,423,000 in fiscal 2001, compared to the prior year, primarily due to the write-off of impaired assets and the accrual of related expenses in the Company's restructuring. Net loss increased $4,187,000 in fiscal 2000, compared to the prior year, primarily due to lower than expected new sales, the change in revenue recognition to recognize software licenses

and renewals over a twelve month period rather than up front, increased costs from delays in development and the increase in non-cash amortization expense resulting from the Company's acquisition of NDI.

LIQUIDITY AND CAPITAL RESOURCES

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

CASH FLOW INFORMATION
(IN THOUSANDS)

| | YEAR ENDED JULY 31 | | | |
|---|---|---|---|---|
| | 2001 | 2000 | PERCENT CHANGE | 2000 |
| Net cash provided by (used in) operating activities before changes in working capital | $ 401 | $ (2,316) | 117% | $ (2,316) |
| Net cash used in investing activities | (1,977) | (1,792) | (10%) | (1,792) |
| Subtotal | (1,576) | (4,108) | 62% | (4,108) |
| Effect of net changes in working capital | 2,084 | 1,153 | 81% | 1,153 |
| Net cash provided by (used) in operating and investing activities | $ 508 | $ (2,955) | 117% | $ (2,955) |

Net cash provided by (used in) operating activities before changes in working capital increased in fiscal 2001, compared to the prior year, due to increased revenues and tight cost controls. Net cash provided by (used in) operating activities before changes in working capital decreased in fiscal 2000, compared to the prior year, primarily



due to lower than expected revenues, $1,256,000 of which was due to the adoption of SOP 98-9, and increased costs as a result of delays in development.

Net cash used in investing activities increased in fiscal 2001, compared to fiscal 2000 and fiscal 1999, due to increased costs attributable to the development of the Company's Web-based communications and catalog software and a new release of the Company's TradeRoute(R) software.

The effect of net changes in working capital is dependent on the timing of payroll and other cash disbursements and may vary significantly from year to year. In fiscal 2001, cash provided by working capital was higher, compared to the prior year, primarily due to intensive collection efforts on past due accounts receivables and an increase in deferred revenue as sales increased. In fiscal 2000, cash provided by working capital was higher, compared to the prior year, primarily due to higher deferred revenue balances caused by the

Company's change in revenue recognition policy. The Company expects that positive cash flow from operations will continue in the first quarter of fiscal 2002. The Company expects to fund research and development costs in fiscal 2002 with excess cash from operations and the proceeds of its current financing instruments described below.

At July 31, 2001, the Company had cash and cash equivalents of approximately $313,000 compared to approximately $563,000 at July 31, 2000.

The following table sets forth, for the periods indicated, certain information related to the Company's debt derived from the Company's audited financial statements.

DEBT SCHEDULE
(IN THOUSANDS)

| | JULY 31 2001 | JULY 31 2000 | NET CHANGE |
|---|---|---|---|
| Debt to Shareholder: | | | |
| Current portion of line of credit | $ 200 | $ - | $ 200 |
| Current portion of notes payable | 333 | 361 | (28) |
| Long-term portion of notes payable | 56 | 389 | (333) |
| Debt discount (common stock warrants) | (41) | (76) | 35 |
| Total Debt to Shareholder | 548 | 674 | (126) |
| Subordinated Debenture: | | | |
| Notes payable, in default at July 31, 2001 | 4,000 | 4,000 | - |
| Debt discount (common stock warrants and options) | (1,373) | (2,158) | 785 |
| Total Subordinated Debenture | 2,627 | 1,842 | 785 |
| Other Debt: | | | |
| Current portion of notes payable other | 275 | 461 | (186) |
| Long-term notes payable other (net of discount) | 78 | 326 | (248) |
| Total Other Debt | 353 | 787 | (434) |
| Total Debt | $ 3,528 | $ 3,303 | $ 225 |

On April 27, 2000, the Company issued and sold pursuant to a Securities Purchase Agreement, dated as of April 25, 2000, by and among the Company and RGC International Investors, LDC (the "Investor"), (i) a convertible subordinated debenture in the amount of $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. The Company is required to maintain listing of its common stock on the Nasdaq National Market, the Nasdaq Small Cap Market, the New York Stock Exchange or the American Stock Exchange; failure to meet this requirement results in the Debenture becoming fully due at 130% of principal and accrued interest, as well as an increase in the interest rate from 7% to 17%. At any time after October 27, 2000, the Company can require the Investor to convert the amount owed under the Debenture into Common Stock at $4.00 per share provided that: (i) the closing bid price of the Common Stock has been greater than $6.60 for twenty (20) consecutive trading days and (ii) the Company's resale

registration statement has been effective for at least three (3) months. 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.

The Company is currently not in compliance with the Nasdaq National Market requirements including the dollar minimum bid price, the $5 million public float and $4 million net tangible asset test. The Company was delisted on July 7, 2001 from NASDAQ National Market System but is currently listed on the NASDAQ Bulletin Board Market. The delisting resulted in a default condition on the RGC debenture, which gives RGC the right to accelerate the Debenture, although they have not actually done so. The Company is currently negotiating a new debenture with RGC and has a signed term sheet. However, if the Company is unable to complete the negotiation of a new debenture or obtain waivers from the Investor, shareholders could be materially and adversely affected.

ARI has a line of credit with WITECH that has been in place since October 4, 1993 (the "WITECH Credit Facility"). On September 30, 1999, ARI and WITECH restructured the $3.0 million outstanding under the WITECH Credit Facility to provide for (i) a $1.0 million revolving line of credit (the "WITECH Line") which expires on December 31, 2001; (ii) a $1.0 million term loan (the "WITECH Term Loan") payable in equal monthly principal installments over three years, commencing November 1, 1999; and (iii) WITECH's purchase of $1.0 million of ARI's common stock at $5.125 per share. The WITECH Line bears interest at prime plus 3.25% and the WITECH Term Loan bears interest at prime plus 4.0%. The WITECH Line terminates on December 31, 2001. As of October 25, 2001 there was $132,000 outstanding under the WITECH Line and $333,000 was outstanding under the WITECH term loan.

The only financial covenant stipulated in the WITECH Credit Facility was that ARI maintained a net worth (calculated in accordance with generally accepted accounting principles) of at least $1 million. This net worth covenant was waived as of July 31, 2001 and for the fiscal year ended July 31, 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 "RFC Facility"). The three-year Sale Agreement allows RFC to purchase up to $3.0 million (the "Purchase Commitment") of ARI's accounts receivable. The Purchase Commitment may be increased in increments of $1.0 million upon mutual agreement and a payment by ARI of $10,000 for each

$1.0 million increase. Under the Sale Agreement, RFC purchases 90% of eligible receivables. 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%. ARI may terminate the Sale Agreement prior to three-year term by paying 2.0% of the Purchase Commitment during the second year, and 1.0% of the Purchase Commitment during the third year. As of October 25, 2001, the balance of the RFC Facility was $710,000.

Management believes that funds generated from operations and the RFC Facility will be adequate to fund the Company's operations, investments and debt payments through fiscal 2002 if the Debenture is successfully renegotiated or the necessary waiver is obtained from RGC. If management is unable to renegotiate the Debenture or obtain the necessary waiver, the Company will remain in default and owe in excess of $5 million, which would have a material adverse effect on the Company. Management is working diligently to renegotiate the Debenture, but there can be no assurance that these efforts will be successful. Management has restructured the Company to reduce cash overhead by over $1.5 million in fiscal 2002. Management is also continually analyzing its anticipated cash flows under a variety of growth scenarios ranging from slight contraction to modest growth. Management believes that, provided the defaults can be amended, either (i) sufficient cash can be generated from the business to fund operations and a modest level of investment or (ii) that the cash profile of the business can be further restructured to be self-funding, although there can be no assurance that these efforts will be successful.



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 negative $1,807,000 in fiscal 2000 to negative $6,743,000 in fiscal 2001 primarily due to restructuring and other charges, partially offset by increased revenues and cost controls over cash expenditures. EBITDA decreased from positive $727,000 in fiscal 1999 to negative $1,807,000 in fiscal 2000 primarily due to money spent to address the software development issues without corresponding revenue and to the change in revenue recognition. Management believes that EBITDA will be positive in fiscal 2002, 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 generally accepted accounting principles and should not be considered an alternative to operating income, as determined in accordance with generally accepted accounting principles, as an indicator of our operating performance, or to cash flows from operating activities, as determined in accordance with generally accepted accounting principles, as a measure of our liquidity. EBITDA is not necessarily comparable with similarly titled measures for other companies.

## FORWARD LOOKING STATEMENTS

Certain statements contained in this Form 10-K 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-K for the year ended July 31, 2001, which is incorporated herein by reference.

QUARTERLY FINANCIAL DATA

The following table sets forth the unaudited operations data for each of the eight quarterly periods ended July 31, 2001, prepared on a basis consistent with the audited financial statements, reflecting all normal recurring adjustments that are considered necessary. The quarterly information is as follows ( in thousands):

| | 1st | | 2nd | | 3rd | | |
|---|---|---|---|---|---|---|---|
| | 2001 | 2000 | 2001 | 2000 | 2001 | 2000 | |
| Net revenues | $4,142 | $3,055 | $4,086 | $3,326 | $3,876 | $3,155 | $ |
| Gross profit | 2,300 | 1,461 | 2,460 | 1,534 | 2,499 | 1,423 | |
| Net loss | (1,522) | (1,658) | (1,216) | (2,091) | (1,502) | (1,843) | (8 |
| Basic and diluted net loss per share | ($0.25) | ($0.29) | ($0.20) | ($0.35) | ($0.24) | ($0.30) | ($ |

ITEM 7A. 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 Line and the WITECH Term Loan and (ii) monthly program fees owed with respect to the RFC Facility. See "Liquidity and Capital Resources". The WITECH Line and Term Loan bear interest tied to prevailing market rates. The monthly program fees under the RFC Facility 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 loss by approximately plus or minus $13,000, annualized, based on the outstanding balances under the WITECH and RFC Facilities at October 25, 2001. As a result, ARI believes that the market risk relating to interest rate movements is minimal.



ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

ARI's Financial Statements and related notes for the fiscal years ended July 31, 2001, 2000 and 1999 together with the report thereon of ARI's independent auditors, Ernst & Young LLP, are attached hereto as Exhibit A-1.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURES

None

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF ARI

Information regarding the directors of ARI and compliance with Section 16(a) of the Exchange Act is included in ARI's definitive 2001 Annual Meeting Proxy Statement, and is incorporated herein by reference. See "Election of Directors" and "Section 16(a) Beneficial Ownership Reporting Compliance". Information with respect to ARI's executive officers is shown at the end of Part I of this Form 10-K.

ITEM 11. EXECUTIVE COMPENSATION

Information regarding Executive Compensation, Employment Agreements, Compensation of Directors, Employee Stock Options and other compensation plans is included in ARI's definitive 2001 Annual Meeting Proxy Statement, and is incorporated herein by reference. See "Executive Compensation" and "Election of Directors".

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

Information regarding beneficial ownership of ARI's common stock is included in ARI's definitive 2001 Annual Meeting Proxy Statement and is incorporated herein by reference. See "Security Ownership of Certain Beneficial Owners".

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Information related to Certain Relationships and Related Transactions is included in ARI's definitive 2001 Annual Meeting Proxy Statement, and is incorporated herein by reference. See "Certain Transactions".

PART IV

ITEM 14. FINANCIAL STATEMENTS, FINANCIAL STATEMENT SCHEDULES, EXHIBITS AND REPORTS ON FORM 8-K

(a)1.
FINANCIAL STATEMENTS

Report of independent auditors on Financial Statements and Financial Statement Schedule.

Balance sheets - July 31, 2001 and 2000.

Statements of operations for each of the three years in the period ended July 31, 2001.

Statements of shareholders' equity(deficit) for each of the three years in the period ended July 31, 2001.

Statements of cash flows for each of the three years in the period ended July 31, 2001.

Notes to financial statements - July 31, 2001.

The Financial Statements are located immediately following the signature pages.

(a)2.
FINANCIAL STATEMENT SCHEDULES

Schedule II
Valuation and qualifying accounts for the years ended July 31, 2001, 2000, and 1999.

The Financial Statement Schedule is located immediately following the Financial Statements. All other schedules to which provision is made in the applicable accounting regulation of the Securities and Exchange Commission are not required under the related instructions or are inapplicable, and therefore have been omitted.

(a)3.
EXHIBITS:

See (c) below.

(b) REPORTS ON FORM 8-K:

On May 25, 2001 ARI filed a Form 8-K (dated July 31, 2000) with respect to Item 7 of Form 8-K.

(c)
EXHIBITS:

| EXHIBIT NUMBER | DESCRIPTION |
|---|---|
| 3.1 | Articles of Incorporation of the Company, as amended, incorporated herein by reference to Exhibit 3.1 of the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended April 30, 1999. |
| 3.2 | By-laws of the Company incorporated herein by reference to Exhibit 3.1 of the Company's Registration Statement on Form S-1 (Reg. No. 33-43148). |
| 4.1 | The Company agrees to furnish to the Commission upon request copies of any agreements with respect to long term debt not exceeding 10% of the Company's consolidated assets. |
| 10.1* | 1991 Stock Option Plan, as amended, incorporated by reference to Exhibit 10.2 of the Company's Form 10-Q for the quarter ended January 31, 1999. |
| 10.2* | 1993 Director Stock Option Plan, as amended, incorporated herein by reference to Exhibit 10.3 of the Company's Form 10-Q for the quarter ended January 31, 1999. |
| 10.3* | 2000 Stock Option Plan, incorporated herein by reference to Exhibit 10.3 of the Company's Annual Report on Form 10-K for the fiscal year ended July 31, 2000. |
| 10.4* | Loan Agreement by and between the Company and WITECH Corporation dated October 4, 1993, incorporated herein by reference to Exhibit 10.10 of the Company's Form 10-K for the fiscal year ended July 31, 1993. |

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|---|---|
| 10.5 | Amendment to Loan Agreement dated May 19, 1994 between the Company and WITECH Corporation, incorporated herein by reference to Exhibit 10.22 of the Company's Registration Statement on Form S-3 (Reg. No. 33-75760). |
| 10.6 | Amendment No. 2 to Loan Agreement dated July 28, 1994 between the Company and WITECH Corporation, incorporated herein by reference to Exhibit 10.22 of the Company's Registration Statement on Form S-1 (Reg. No. 33-80914). |
| 10.7 | Consent and Amendment No. 3 to Loan Agreement dated December 2, 1994 between the Company and WITECH Corporation, incorporated herein by reference to Exhibit 10.1 of the Company's Form 10-Q for the quarter ended October 31, 1994. |
| 10.8 | Amendment No. 4 to Loan Agreement dated October 18, 1995 between the Company and WITECH Corporation, incorporated herein by reference to Exhibit 10.14 of the Company's Form 10-K for the fiscal year ended July 31, 1995. |
| 10.9 | Amendment No. 5 to Loan Agreement dated December 20, 1995 between the Company and WITECH Corporation, incorporated herein by reference to Exhibit 10.31 of the Company's Form 10-K for the fiscal year ended July 31, 1996. |



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|---|---|
| 10.10 | Amendment No. 6 to Loan Agreement dated January 23, 1996, between the Company and W incorporated herein by reference to Exhibit 10.32 of the Company's Form 10-K for th ended July 31, 1996. |
| 10.11 | Amendment No. 7 to Loan Agreement dated April 20, 1996 between the Company and WITE incorporated herein by reference to Exhibit 10.1 of the Company's Form 10-Q for th April 30, 1996. |
| 10.12 | Amendment No. 8 to Loan Agreement dated May 31, 1996 between the Company and WITECH incorporated herein by reference to Exhibit 10.2 of the Company's Form 10-Q for the April 30, 1996. |
| 10.13 | Amendment No. 9 to Loan Agreement dated November 5, 1996, between the Company and W including Forms of Amended and Restated Commitment Warrant and Usage Warrant, incor reference to Exhibit 10.1 of the Company's Form 10-Q for the quarter ended October |
| 10.14 | Amendment No. 10 to Loan Agreement dated May 30, 1997, between the Company and WITE incorporated herein by reference to Exhibit 10.1 of the Company's Form 10-Q for th April 30, 1997. |
| 10.15 | Amendment No. 11 to Loan Agreement dated January 21, 1998 between the Company and W Corporation, incorporated herein by reference to Exhibit 10.1 of the Company's Form quarter ended April 30, 1998. |
| 10.16 | Amendment No. 12 to Loan Agreement dated May 27, 1998 between the Company and WITEC incorporated herein by reference to Exhibit 10.1 of the Company's Form 10-Q for th ended April 30, 1998. |
| 10.17 | Amendment No. 13 to Loan Agreement dated September 14, 1998 between the Company and |

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|---|---|
| | incorporated herein by reference to Exhibit 10.16 of the Company's Form 10-K for th July 31, 1998. |
| 10.18 | Consent of WITECH Corporation, dated September 15, 1998, incorporated herein by ref 10.1 of the Company's Form 10-Q for the fiscal quarter ended October 31, 1998. |
| 10.19 | Amendment No. 14 to Loan Agreement dated January 29, 1999, between the Company and incorporated herein by reference to Exhibit 10.1 of the Company's 10-Q for the fisc January 31, 1999. |
| 10.20 | Consent of WITECH Corporation, dated April 19, 1999, incorporated herein by referen of the Company's Form 10-Q for the fiscal quarter ended April 30, 1999. |
| 10.21 | Amendment No. 15 to Loan Agreement dated September 23, 1999, between the Company an Corporation, incorporated herein by reference to Exhibit 10.20 of the Company's For fiscal year ended July 31, 1999. |
| 10.22 | Amendment No. 16 to Loan Agreement dated December 21, 1999 between the Company and incorporated herein by reference to Exhibit 10.1 of the Company's Form 10-Q for the ended January 31, 2000. |
| 10.23 | Amendment No. 17 to Loan Agreement dated July 9, 2001 between the Company and WITEC |
| 10.24 | Amendment No. 18 to Loan Agreement dated October 22, 2001 between the Company and W |
| 10.25 | Receivables Sales Agreement, dated September 28, 1999, between the Company and RFC incorporated herein by reference to Exhibit 10.21 of the Company's Form 10-K for th July 31, 1999. |
| 10.26* | Form of Change of Control Agreement between the Company and each of Brian E. Dearin Michael E. McGurk, Frederic G. Tillman and Timothy Sherlock, incorporated herein by Exhibit 10.25 of the Company's Form 10-K for the fiscal year ended July 31, 1999. |
| 10.27* | Deferred Compensation Plan, incorporated herein by reference to Exhibit 10.26 of th 10-K for the fiscal year ended July 31, 1999. |
| 10.28* | Deferred Bonus Plan, incorporated herein by reference to Exhibit 10.27 of the Compa the fiscal year ended July 31, 1999. |
| 10.29 | Preferred Stock Purchase Agreement dated July 15, 1997, between the Company and WIT incorporated herein by reference to Exhibit 10.1 of the Company's Registration Stat (Reg. No. 333-31295) filed on July 15, 1997. |
| 10.30* | Website Development Agreement dated December 9, 1999 between the Company and Gordon incorporated herein by reference to Exhibit 10.2 of the Company's Form 10-Q for the ended January 31, 2000. |

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|---|---|
| 10.31 | Securities Purchase Agreement, dated as of April 25, 2000, by and among the Company and RGC International Investors, LDC, incorporated herein by reference to Exhibit 99.1 of the Company's Report on Form 8-K filed May 2, 2000. |
| 10.32 | Convertible Subordinated Debenture dated as of April 27, 2000, incorporated herein by reference to Exhibit 99.2 of the Company's Report on Form 8-K filed May 2, 2000. |

| | |
|---|---|
| 10.33 | Stock Purchase Warrant dated as of April 27, 2000, incorporated herein by reference to Exhibit 99.3 of the Company's Report on Form 8-K filed May 2, 2000. |
| 10.34 | Investment Option dated as of April 27, 2000, incorporated herein by reference to Exhibit 99.4 of the Company's Report on Form 8-K filed May 2, 2000. |
| 10.35 | Registration Rights Agreement, dated as of April 27, 2000, by and among the Company and RGC International Investors, LDC, incorporated herein by reference to Exhibit 99.5 of the Company's Report on Form 8-K filed May 2, 2000. |
| 23.1 | Consent of Ernst & Young LLP. |
| 24.1 | Powers of Attorney appear on the signature page hereof. |
| 99.1 | Forward-Looking Statements Disclosure. |

* Management Contract or Compensatory Plan.



SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Milwaukee, State of Wisconsin on this 13th day of November, 2001.

ARI NETWORK SERVICES, INC.

By: /s/ Brian E. Dearing

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Brian E. Dearing,
Chairman, President & CEO

KNOW ALL MEN BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Brian E. Dearing, his true and lawful attorney-in-fact and agent with full power of substitution and resubstitution, for him and his name, place and stead, in any and all capacities, to sign any and all amendments to this report and to file the same with all exhibits thereto, and other documents in connection therewith, with the Commission, granting unto said attorney-in-fact and agent full power and authority to do and perform each act and thing requisite and necessary to be done, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that said attorney-in-fact and agent, or his substitute or substitutes, may lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons in the capacities and on the dates indicated.

| SIGNATURE | TITLE | DATE |
| --- | --- | --- |
| /s/ Brian E. Dearing<br>Brian E. Dearing | Chairman, President, CEO & Director (Principal Executive Officer) | November 13, 2001 |
| /s/ Timothy Sherlock<br>Timothy Sherlock | Chief Financial Officer, Secretary, Treasurer & VP of Finance | November 13, 2001 |
| /s/ Gordon J. Bridge<br>Gordon J. Bridge | Director | November 13, 2001 |
| /s/ Ted C. Feierstein<br>Ted C. Feierstein | Director | November 13, 2001 |
| /s/ D. Bruce Merrifield, Jr.<br>D. Bruce Merrifield, Jr. | Director | November 13, 2001 |
| /s/ Richard W. Weening<br>Richard W. Weening | Director | November 13, 2001 |



FINANCIAL STATEMENTS

ARI Network Services, Inc.
Years ended July 31, 2001, 2000 and 1999

ARI Network Services, Inc.

Financial Statements

Years ended July 31, 2001, 2000 and 1999

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Report of Ernst & Young LLP, Independent Auditors

To the Board of Directors and Shareholders
ARI Network Services, Inc.

We have audited the accompanying balance sheets of ARI Network Services, Inc. (the Company) as of July 31, 2001 and 2000, and the related statements of operations, shareholders' equity (deficit) and cash flows for each of the three years in the period ended July 31, 2001. Our audits also included the financial statement schedule listed in the Index at Item 14(a). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company at July 31, 2001 and 2000, and the results of its operations and its cash flows for each of the three years in the period ended July 31, 2001, in conformity with accounting principles generally accepted in the United States. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.



The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As more fully described in Note 3, the Company has incurred recurring operating losses, has a working capital deficiency and has a shareholders' deficit. In addition, the Company has not complied with certain covenants of its loan agreement and does not have long-term credit availability. These conditions raise substantial doubt about the Company's ability to continue as a going concern. Management's plans in

regard to these matters are also described in Note 3. The financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classification of liabilities that may result from the outcome of this uncertainty.

Milwaukee, Wisconsin
September 28, 2001, except for
Note 5, as to which the date is
October 22, 2001

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ARI Network Services, Inc.

Balance Sheets
(Dollars in Thousands, Except Per Share Data)

| | JULY 31 | |
|---|---|---|
| | 2001 | |
| ASSETS | | |
| Current assets: | | |
| Cash | $ 313 | $ |
| Trade receivables, less allowance for doubtful accounts of $757 in 2001 and $697 in 2000 | 2,084 | |
| Prepaid expenses and other | 140 | |
| Total current assets | 2,537 | |
| Equipment and leasehold improvements: | | |
| Computer equipment | 4,394 | |
| Leasehold improvements | 239 | |
| Furniture and equipment | 1,000 | |
| | 5,633 | |
| Less accumulated depreciation and amortization | 5,293 | |
| Net equipment and leasehold improvements | 340 | |
| Goodwill, less accumulated amortization of $54 in 2001 and $1,413 in 2000 | 15 | |
| Deferred financing costs, less accumulated amortization of $203 in 2001 and $59 in 2000 | 207 | |
| Capitalized software development: | | |
| Network platform | - | |
| Software products | 23,533 | |
| | 23,533 | |

| | |
|---|---|
| Less accumulated amortization | 19,572 |
| | 3,961 |
| | $ 7,060 |



| | JULY 31 2001 | |
|---|---|---|
| LIABILITIES AND SHAREHOLDERS' EQUITY (DEFICIT) | | |
| Current liabilities: | | |
| Line of credit payable to shareholder | $ 200 | $ |
| Current portion of note payable to shareholder | 333 | |
| Current portion of notes payable, including $2,627 of long-term debt in default at July 31, 2001 | 2,902 | |
| Accounts payable | 951 | |
| Deferred revenue | 4,811 | |
| Accrued payroll and related liabilities | 1,487 | |
| Other accrued liabilities | 1,499 | |
| Current portion of capital lease obligations | 173 | |
| Total current liabilities | 12,356 | |
| Note payable to shareholder | 15 | |
| Notes payable | 78 | |
| Accrued restructuring costs | 303 | |
| Capital lease obligations | 158 | |
| Total noncurrent liabilities | 554 | |
| Commitments and contingencies (Notes 7 and 12) | | |
| Shareholders' equity (deficit): | | |
| Cumulative preferred stock, par value $.001 per share, 1,000,000 shares authorized; 20,350 shares issued and outstanding | - | |
| Common stock, par value $.001 per share, 25,000,000 shares authorized; 6,184,281 and 6,168,270 shares issued and outstanding in 2001 and 2000, respectively | 6 | |
| Common stock warrants and options | 2,459 | |
| Additional paid-in capital | 91,797 | |
| Accumulated deficit | (100,112) | |
| Total shareholders' equity (deficit) | (5,850) | |
| | $ 7,060 | $ |

See accompanying notes.

ARI Network Services, Inc.

Statements of Operations
(Dollars in Thousands, Except Per Share Data)

| | YEAR ENDED JULY 31 2001 | 2000 | |
|---|---|---|---|
| Net revenues: | | | |
| Subscriptions, support and other services fees | $ 9,985 | $ 9,743 | $ |
| Software licenses and renewals | 3,266 | 1,289 | |
| Professional services | 2,526 | 2,272 | |
| | 15,777 | 13,304 | |
| Operating expenses: | | | |
| Cost of products and services sold: | | | |
| Subscriptions, support and other services fees | 1,740 | 1,415 | |
| Software licenses and renewals | 3,137 | 3,614 | |
| Professional services | 1,359 | 1,965 | |
| | 6,236 | 6,994 | |
| Depreciation and amortization (exclusive of amortization of software products included in cost of products and services sold) | 1,517 | 1,778 | |
| Customer operations and support | 1,597 | 2,048 | |
| Selling, general and administrative | 8,790 | 8,214 | |
| Software development and technical support | 3,317 | 2,779 | |
| Restructuring and other charges | 7,766 | - | |
| Operating expenses before amounts capitalized | 29,223 | 21,813 | |
| Less capitalized portion | (1,972) | (1,729) | |
| Net operating expenses | 27,251 | 20,084 | |
| Operating loss | (11,474) | (6,780) | |
| Other income (expense): | | | |
| Interest expense | (1,587) | (793) | |
| Other, net | 36 | (29) | |
| | (1,551) | (822) | |
| Net loss | $ (13,025) | $ (7,602) | $ |
| Basic and diluted net loss per share | $ (2.11) | $ (1.27) | $ |

See accompanying notes.

ARI Network Services, Inc.

Statements of Shareholders' Equity (Deficit)
(Dollars in Thousands)

| | Number of Shares Iss Outstanding | |
|---|---|---|
| | Preferred Stock | C |
| Balance July 31, 1998 | 20,000 | 4 |
| Issuance of preferred stock | 350 | |
| Issuance of common stock in connection with acquisitions | - | |
| Issuance of common stock under stock purchase plan and from exercise of stock options | - | |
| Net loss | - | |
| Balance July 31, 1999 | 20,350 | 5 |
| Issuance of common stock in connection with acquisitions | - | |
| Issuance of common stock as payment on line of credit | - | |
| Issuance of common stock for professional services received | - | |
| Issuance of common stock under stock purchase plan and from exercise of stock options | - | |
| Issuance of common stock warrants and options in connection with notes payable | - | |
| Net loss | - | |
| Balance July 31, 2000 | 20,350 | 6 |
| Issuance of common stock under stock purchase plan | - | |
| Stock compensation expense | - | |
| Net loss | - | |
| Balance July 31, 2001 | 20,350 | 6 |

6

| Common Stock to be Issued | | Par Value | | Common Stock Warrants and Options | Additional Paid-in Capital | Acc D |
|---|---|---|---|---|---|---|
| Number of Shares | Amount | Preferred Stock | Common Stock | | | |
| - | $ - | $ - | $4 | $ - | $85,028 | $( |

| | | | | | | |
|---|---|---|---|---|---|---|
| - | - | - | - | - | - | |
| 550,019 | 2,406 | - | 1 | - | 1,784 | |
| - | - | - | - | | 18 | |
| - | - | - | - | - | - | |
| 550,019 | 2,406 | - | 5 | - | 86,830 | ( |
| (550,019) | (2,406) | - | 1 | - | 2,405 | |
| - | - | - | - | - | 1,000 | |
| - | - | - | - | - | 211 | |
| - | - | - | - | - | 1,335 | |
| - | - | - | - | 2,459 | - | |
| - | - | - | - | - | - | |
| - | - | - | 6 | 2,459 | 91,781 | ( |
| - | - | - | - | - | 14 | |
| - | - | - | - | - | 2 | |
| - | - | - | - | - | - | ( |
| - | $ - | $ - | $6 | $2,459 | $91,797 | $(1 |

See accompanying notes.

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ARI Network Services, Inc.

Statements of Cash Flows
(In Thousands)

| | YEAR ENDED JULY | |
|---|---|---|
| | 2001 | 2000 |
| OPERATING ACTIVITIES | | |
| Net loss | $(13,025) | $(7,602 |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities: | | |
| Amortization of network platform | 604 | 656 |
| Amortization of software products | 3,178 | 3,224 |
| Amortization of goodwill | 658 | 658 |
| Amortization of debt discount and deferred financing fees | 963 | 284 |
| Depreciation and other amortization | 255 | 464 |
| Restructuring and other charges | 7,766 | - |
| Stock compensation expense | 2 | - |
| Net change in receivables, prepaid expenses and other current assets | 1,167 | (90 |
| Net change in accounts payable, deferred revenue and accrued liabilities | 917 | 1,243 |

| | | |
|---|---|---|
| Net cash provided by (used in) operating activities | 2,485 | (1,163 |
| INVESTING ACTIVITIES | | |
| Purchase of equipment and leasehold improvements | (5) | (63 |
| Cash received in acquisitions | - | - |
| Software product costs capitalized | (1,972) | (1,729 |
| Net cash used in investing activities | (1,977) | (1,792 |
| FINANCING ACTIVITIES | | |
| Borrowings (repayments) under line of credit | 200 | (1,000 |
| Borrowings under notes payable | - | 4,000 |
| Payments of capital lease obligations and notes payable | (942) | (690 |
| Debt issuance costs incurred | (30) | (254 |
| Proceeds from issuance of common stock | 14 | 1,335 |
| Net cash provided by (used in) financing activities | (758) | 3,391 |
| Net increase (decrease) in cash | (250) | 436 |
| Cash at beginning of year | 563 | 127 |
| Cash at end of year | $ 313 | $ 563 |
| Cash paid for interest | $ 532 | $ 437 |

See accompanying notes.



ARI Network Services, Inc.

Statements of Cash Flows (continued)
(In Thousands)

| | YEAR ENDED JULY | |
|---|---|---|
| | 2001 | 2000 |
| NONCASH INVESTING AND FINANCING ACTIVITIES | | |
| Capital lease obligations incurred for - | | |
| Computer equipment | $ 154 | $ 328 |
| Issuance of common stock for acquisitions | - | - |
| Issuance of common stock as payment on line of credit | - | 1,000 |
| Conversion of line of credit to notes payable to shareholder | - | 1,000 |
| Issuance of common stock warrants and options | - | 2,459 |
| Issuance of common stock for professional services: | | |
| Computer equipment | - | 85 |
| Deferred financing costs | - | 126 |

See accompanying notes.

ARI Network Services, Inc.

Notes to Financial Statements

July 31, 2001

1. DESCRIPTION OF BUSINESS AND SIGNIFICANT ACCOUNTING POLICIES

DESCRIPTION OF BUSINESS

ARI Network Services, Inc. (the Company) operates in one business segment and provides technology-enabled business solutions that connect manufacturers in selected industries with their service and distribution networks. Disaggregated operating expense information is not provided to the chief operating decision maker of the Company. The Company focuses on the U.S., Canadian, European and Australian manufactured equipment industry. The Company provides both electronic catalog and transaction services, enabling partners in a service and distribution network to electronically look up parts, service bulletins and other technical reference information, and to exchange electronic business documents such as purchase orders, invoices, warranty claims and status inquiries. The Company's customers are located primarily in the United States, Europe and Canada. Transaction gains and losses that arise from exchange rate fluctuations on transactions denominated in a currency other than the U.S. dollar are included in the results of operations as incurred. Transaction gains and losses were insignificant in each of the periods reported.

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 is recognized ratably over the period the maintenance is provided. Revenue from catalog subscriptions is recognized over the subscription term.

Prior to the adoption of Statement of Position (SOP) 98-9 on August 1, 1999, the Company recognized revenue allocable to software licenses in multiple element arrangements upon delivery of the software product to the end user. Upon adoption of SOP 98-9 on August 1, 1999, revenue from software licenses in multiple element arrangements is recognized ratably over the contractual term of the arrangement. The Company considers all arrangements with payment terms extending beyond 12 months and other arrangements with payment terms longer than normal not to be fixed or



ARI Network Services, Inc.

Notes to Financial Statements (continued)

1. DESCRIPTION OF BUSINESS AND SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

determinable. If the fee is not fixed or determinable, revenue is recognized as payments become due from the customer. 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. Types of services that are considered essential include customizing complex features and functionality in the products' base software code or developing complex interfaces within a customer's environment. 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 uncertainty on the ability and intent of the reseller to sell such software independent of their payment to the Company.

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 that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

EQUIPMENT AND LEASEHOLD IMPROVEMENTS

Equipment and leasehold improvements are stated at cost. Depreciation and amortization are computed under the straight-line method for financial reporting purposes and under accelerated methods for income tax purposes. Depreciation and amortization have been provided over the estimated useful lives of the assets as follows:

| | Years |
|---|---|
| Computer equipment | 2 - 7 |
| Leasehold improvements | 10 |
| Furniture and equipment | 2 - 5 |





1. DESCRIPTION OF BUSINESS AND SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

CAPITALIZED SOFTWARE DEVELOPMENT

The Company developed a basic network and telecommunications platform which has been the foundation of its network. The platform can be used on different hardware and has not been subject to the frequency of technological changes that sometimes occur with hardware or software products.

The Company also develops and purchases software products for personal computers and mainframes which, when utilized with the platform, give rise to the Company's products and services tailored to its targeted industries.

Certain software development costs and network construction and expansion costs are capitalized when incurred. Capitalization of these costs begins upon the establishment of technological feasibility. The establishment of technological feasibility and the ongoing assessment of recoverability of software and network system costs requires considerable judgment by management with respect to certain external factors, including, but not limited to, technological feasibility, anticipated future gross revenues, estimated economic life and changes in software and hardware technologies. Note 4 further describes certain capitalized software development costs written down to net realizable value based upon the Company's future plans.

The annual amortization of the platform and the software products is the greater of the amount computed using: (a) the ratio that current gross revenues for the network or a software product bear to the total of current and anticipated future gross revenues for the network or a software product, or (b) the straight-line method over the estimated economic life of the product (20 years - platform, 3 years - software products). Amortization starts when the product is available for general release to customers.

All other software development and support expenditures are charged to expense in the period incurred.

GOODWILL

Goodwill, representing the excess of cost over net assets of businesses acquired, is stated at cost and is amortized on a straight-line basis over five years. Note 4 further describes certain goodwill costs written down to net realizable value based upon the Company's future plans.





1. DESCRIPTION OF BUSINESS AND SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

IMPAIRMENT OF LONG-LIVED ASSETS

Equipment and leasehold improvements, capitalized software development costs and goodwill 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.

Such analyses necessarily involve judgment. The Company evaluated the ongoing value of its long-lived assets as of July 31, 2001 and 2000, and the impact on the Company's results of operations for the year ended July 31, 2001, is described in Note 4.

DEFERRED FINANCING COSTS

Costs incurred to obtain long-term financing are amortized using the interest method over the term of the related debt.

CAPITALIZED INTEREST COSTS

In 2001, 2000 and 1999, interest costs of $180,000, $76,000 and $56,000, respectively, were capitalized and included in the capitalized software development costs.

OTHER ACCRUED LIABILITIES

Other accrued liabilities include accrued royalties of $574,000 and $486,000 at July 31, 2001 and 2000, respectively.

COMPREHENSIVE INCOME

Net loss for 2001, 2000 and 1999 is the same as comprehensive income defined pursuant to Statement of Financial Accounting Standards (SFAS) No. 130, "Reporting Comprehensive Income."





1. DESCRIPTION OF BUSINESS AND SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

NET LOSS PER SHARE

The basic and diluted weighted-average shares used in the net loss per share calculation are 6,175,000, 6,002,000 and 5,061,000, respectively, in 2001, 2000 and 1999. Basic and diluted net loss per share is the same for all periods as the impact of all dilutive securities is antidilutive.

ACCOUNTING PRONOUNCEMENTS

In June 1998, the Financial Accounting Standards Board issued SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended by SFAS No. 138, which establishes accounting and reporting standards for derivative instruments and hedging activities. SFAS No. 133, which was effective for the Company beginning August 1, 2000, requires that an entity recognize all derivatives as either assets or liabilities in the balance sheet and measure those instruments at fair value. The adoption of SFAS No. 133 did not have any impact on the Company's financial statements.

The Financial Accounting Standards Board issued SFAS No. 142, "Goodwill and Other Intangible Assets," in July 2001. SFAS No. 142 addresses the initial recognition and measurement of intangible assets acquired outside of a business combination, whether individually acquired or with a group of other assets, and the accounting and reporting for goodwill and other intangible assets subsequent to their acquisition. Goodwill will no longer be amortized but instead will be subject to impairment tests at least annually. The Company is required to adopt and SFAS No. 142 on a prospective basis as of August 1, 2002. As of July 31, 2001, the Company had $15,000 of goodwill; accordingly, the adoption of SFAS No. 142 is not expected to have a significant impact on

its financial statements.

SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," has been applied prospectively for transfers of financial assets occurring after April 1, 2001. SFAS No. 140 replaces SFAS No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities." As a result of this statement, the Company has changed the recognition of transactions discussed in Note 6 from a sale to a secured borrowing to comply with SFAS No. 140.





2. ACQUISITIONS

The Company has accounted for its acquisitions using the purchase method of accounting, and accordingly, the purchase price was allocated to assets acquired and liabilities assumed based upon their respective fair values at the date of acquisition. The financial statements include the operating results of the acquisitions from their respective dates of acquisition.

On May 13, 1999, the Company acquired the assets of Network Dynamics, Inc. (NDI). On this date, NDI was merged with and into the Company and the separate corporate existence of NDI ceased. Common stock to be paid as consideration to the former shareholders of NDI was held in escrow until the Total NDI Value, as defined, was determined in August 1999 upon completion of an audit of the balance sheet as of May 13, 1999. Aggregate consideration for the acquisition consisted of 550,019 shares of the Company's common stock, which were issued in September 1999, and the assumption of certain liabilities totaling $3,623,000. The purchase price in excess of net tangible assets acquired was recorded as goodwill until a final valuation by an independent appraisal firm to allocate the purchase price was completed in December 1999. The Company then allocated the purchase price in excess of net tangible assets acquired to software products.

3. LIQUIDITY AND MANAGEMENT'S PLAN

As further discussed in Note 6, the Company is not in compliance with certain covenants of its subordinated debenture agreement. Management is currently negotiating with the subordinated debenture holder to reset the covenants and payment terms or obtain a waiver. In addition, under the Company's credit agreement with a shareholder (see Note 5), the Company does not have long-term credit availability.

The Company has implemented a series of reductions in its work force and plans to implement other strategies to reduce its cash expenditures, as further described in Notes 4 and 13.

Management believes the cash flows from the Company's operations in fiscal 2002 will fund its operations and that other strategic or financing options will provide the Company with the ability to meet its cash flow obligations. Accordingly, the financial statements have been prepared on the basis of a going concern, which contemplates realization of assets and satisfaction of liabilities in the normal course of business.

ARI Network Services, Inc.

Notes to Financial Statements (continued)

4. RESTRUCTURING AND OTHER CHARGES

In July 2001, the Board of Directors authorized management to restructure the Company and discontinue certain noncatalog software products and related services. Revenue generated from noncatalog product lines was approximately $5.3 million in 2001. The Company plans to sell or transition these product lines to other service providers during fiscal 2002. The Company's actions resulted in a work force reduction of approximately 15%, mainly consisting of software development and support personnel. The Company communicated all severance benefits to the 18 affected employees before July 31, 2001.

Additionally, an impairment charge of $7,333,000 was recorded in July 2001 related to long-lived assets for the noncatalog product lines. The Company estimated undiscounted cash flows expected over the remaining amortization period of the long-lived assets. Immediately before recording the impairment charge, the carrying value of goodwill and capitalized software development costs related to discontinued product lines was $1,203,000 and $6,130,000, respectively. The discontinued product lines are expected to generate minimal or negative cash flows (including any estimated sales proceeds) through their expected date of discontinuance, and accordingly, the Company has recorded an impairment charge to write off the carrying value of the assets.

The restructuring and impairment charges were determined based upon formal plans approved by the Company's Board of Directors in July 2001. An additional restructuring charge will be recognized in fiscal 2002 as described in Note 13. It is possible that further restructuring charges will be recognized in fiscal 2002 as more information becomes available. Actual proceeds from the sale of any discontinued product line could differ significantly from amounts estimated in the Company's impairment analysis.

Restructuring and other charges recorded in the statement of operations during the fourth quarter of fiscal 2001 are as follows (in thousands):

| | |
|---|---|
| Employee termination costs | $ 130 |
| Noncancellable operating agreements | 303 |
| Asset impairment charges | 7,333 |
| | $ 7,766 |

At July 31, 2001, no payments had been made for any of the restructuring costs. Other accrued liabilities and noncurrent liabilities include restructuring accruals of $130,000 and $303,000, respectively, at July 31, 2001.



ARI Network Services, Inc.

Notes to Financial Statements (continued)

5. LINE OF CREDIT AND NOTE PAYABLE TO SHAREHOLDER

At July 31, 1999, the Company had a $3,000,000 revolving line-of-credit agreement with a shareholder that was to expire on December 31, 2001. On September 30, 1999, the Company and the shareholder restructured and amended the line-of-credit agreement in order to reduce the line of credit from $3,000,000 to $1,000,000, establish a $1,000,000 term loan payable and convert $1,000,000 of the line of credit into 195,122 shares of common stock.

On October 22, 2001, the Company and the shareholder amended the agreement to waive the restrictive covenant requiring maintenance of a minimum level of net worth at July 31, 2001 and through July 31, 2002, and to increase the interest rates on borrowings.

The term loan is payable in equal monthly installments over three years commencing November 1, 1999, and bears interest at prime (6.75% at July 31, 2001) plus 3.25% (amended to prime plus 4% effective October 22, 2001). The line of credit expires December 31, 2001. The Company is required to pay a fee of .025% per month on the unused portion of the line of credit. Borrowings under the line of credit bear interest at prime plus 2.25% (amended to prime plus 3.25% effective October 22, 2001). Under the line of credit, $200,000 is outstanding at July 31, 2001.

In connection with the amendment in September 1999, the Company issued a warrant to purchase 30,000 shares of the Company's common stock at $4 per share. These warrants are exercisable at any time through September 2006 and were initially valued at $105,000 for financial statement purposes. The value allocated to the warrants, which reduced the carrying value of the debt, was measured at the date of grant because the number of shares was fixed and determinable. The value was determined based upon a Black-Scholes option pricing model with the following assumptions: risk-free interest rate of 6%, dividend yield of 0%, expected common stock market price volatility factor of .72 and an expected life of the warrants of six years. The debt discount is being amortized straight-line over the three-year term of the debt. The unamortized balance of the debt discount at July 31, 2001, was $41,000. The entire agreement is secured by substantially all assets of the Company other than accounts receivable securitized under the receivable sale agreement described in Note 6.





5. LINE OF CREDIT AND NOTE PAYABLE TO SHAREHOLDER (CONTINUED)

In connection with the origination of the line-of-credit agreement and various extensions of the agreement, in addition to the warrants discussed above, the Company has issued the shareholder warrants for the purchase of up to 75,000 shares of its common stock at $2.125 per share. These warrants expire on December 31, 2001. The agreement contains various restrictive covenants including maintenance of a minimum level of net worth and restrictions on additional indebtedness.

6. NOTES PAYABLE

Notes payable consist of the following at July 31 (in thousands):

| | 2001 |
|---|---|
| Term loan | $ 172 |
| Note payable to bank | 167 |
| Convertible subordinated debenture, in default at July 31, 2001 | 4,000 |
| Less debt discount for convertible subordinated debenture | (1,373) |
| Other | 14 |
| | 2,980 |
| Less current maturities | 2,902 |
| | $ 78 |

On April 27, 2000, the Company issued RGC International Investors, LDC (RGC): (i) a convertible subordinated debenture (the Debenture) for $4,000,000, (ii) warrants to purchase 600,000 shares of common stock at $6 per share (the Warrants), and (iii) an investment option to purchase 800,000 shares of common stock at $6 per share (the Investment Option). The Investment Option expires on October 27, 2001, and the Warrants expire on April 27, 2005. The value allocated to the Warrants and Investment Option, which reduced the carrying value of the debt, were measured at the date of grant because the number of shares was fixed and determinable. The value was determined based upon a Black-Scholes option pricing model with the following assumptions: risk-free interest rate of 6%, dividend yield of 0%, expected common stock market price volatility factor of .80, an expected life of the Investment Option of eighteen months and an expected life of the Warrants of five years. A debt discount was recorded for the fair





6. NOTES PAYABLE (CONTINUED)

value of the Warrants and Investment Option of $2,354,000. The Debenture bears interest at 7% and is convertible into common stock at $4 per share. The Company can require RGC to convert the amount owed under the Debenture into common stock at $4 per share provided that the closing bid price of the Company's common stock has been greater than $6.60 for 20 consecutive trading days.

Under the terms of the Debenture and the related Investment Option and Warrants, the Debenture is convertible and the Investment Option and Warrants are exercisable by RGC only to the extent that the number of shares of common stock issuable, together with the number of shares of common stock owned by RGC and its affiliates, generally would not exceed 4.9% of the Company's outstanding common stock at the time of conversion or exercise. In certain circumstances where the Company has the right to force conversion of the Debenture and exercise of the Investment Option, RGC's percentage ownership may exceed 4.9% but cannot exceed 9.9%.

As part of the consulting fee paid in conjunction with obtaining the RGC financing, the Company issued warrants for the purchase of 8,000 shares of its common stock at $7.03 per share. These warrants expire on April 27, 2005.

The terms of the Debenture require the Company to maintain the listing of its common stock on Nasdaq, the Nasdaq Small Cap Market, the New York Stock Exchange or the American Stock Exchange. The Company is in violation of this covenant and has not obtained a waiver for the covenant violation. The covenant violation allows RGC to accelerate principal repayment and accordingly, the outstanding amount is due and payable and has been classified as current in the accompanying balance sheet. In addition, due to the default, RGC can demand 130% of the outstanding principal and accrued interest balances as well as an increase in the stated interest rate from 7% to 17%. The Company received forbearance from RGC through August 10, 2001, related to the events of default.

The term loan requires monthly principal and interest payments of approximately $8,000 through May 2003. The note payable to bank bears interest at 9.75%, which is payable monthly through December 2001.





6. NOTES PAYABLE (CONTINUED)

On September 28, 1999, the Company commenced funding under a Receivable Sale Agreement (the RFC Agreement) with RFC Capital Corporation (RFC) pursuant to which RFC has agreed to loan amounts to the Company based on a security interest in certain receivables generated by the Company in the ordinary course of the Company's business. The RFC Agreement allows for RFC to loan up to $3,000,000 of the Company's eligible receivables. Under the Agreement, RFC loans 90% of the eligible receivables from the Company from time to time upon presentation thereof for a value equal to approximately the net value of such receivables. Net value is designed to yield RFC an effective rate of 11.5% plus allow RFC to retain a holdback of 5% in the face amount of the receivables, net of collections, against future collection risk. To comply with SFAS No. 140, the Company has changed the recognition of these transactions from a sale to secured borrowing.

At July 31, 2001, a secured borrowing of $469,000 is included in accounts payable. For the years ended July 31, 2001 and 2000, the Company incurred $98,000 and $71,000, respectively, of financing expense relating to this agreement.

Under the RFC Agreement, the Company performs certain servicing, administrative and collection functions with respect to the secured receivables. Also, pursuant to the terms of the RFC Agreement, the Company has granted to RFC a security interest in and to the Company's U.S. receivables not sold to RFC and the Company's customer base, excluding non-U.S. customers, relating to the generation of such accounts receivable.

7. CAPITAL AND OPERATING LEASES

The Company leases office space under operating lease arrangements expiring in 2002 through 2007. The Company is generally liable for its share of increases in the landlord's direct operating expenses and real estate taxes up to 5% of the previous year's rent. Total rental expense for the operating leases was

$787,000 in 2001, $616,000 in 2000 and $400,000 in 1999.





7. CAPITAL AND OPERATING LEASES (CONTINUED)

Minimum lease payments under remaining capital and operating leases are as follows (in thousands):

| Fiscal year ending | Capital Leases | Operating |
|---|---|---|
| 2002 | $184 | $ |
| 2003 | 153 | |
| 2004 | 11 | |
| 2005 | 2 | |
| 2006 | - | |
| Thereafter | - | |
| Total minimum lease payments | 350 | $ |
| Amounts representing interest and taxes | 19 | |
| Present value of minimum capital lease payments | 331 | |
| Less amounts payable in one year | 173 | |
| | $158 | |

8. SHAREHOLDERS' EQUITY

Preferred Stock

At July 31, 2001, the Company has 20,350 shares of Series A Preferred Stock outstanding. The shares are entitled to cumulative annual dividends equal to the product of $100 and prime plus 2% payable quarterly, as and when declared by the Board of Directors. Prior to August 1, 2002, dividends payable may be paid, at the Company's option, in lieu of cash, in additional shares of Series A Preferred Stock. The Company may redeem outstanding shares at any time at the redemption price of $100 per share plus accrued and unpaid dividends.

In the event of liquidation or dissolution of the Company, the holders of shares of Series A Preferred Stock shall be entitled to receive $100 per share plus accrued and unpaid dividends before any distribution is made to the holders of common stock. Accumulated dividends in arrears at July 31, 2001, are $1,030,000.

Notes to Financial Statements (continued)

9. STOCK PLANS

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 through July 31, 2001.

The Company's 2000 Employee Stock Purchase Plan has 75,000 shares of common stock reserved for issuance, and none of the shares have been issued as of July 31, 2001. 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.

1991 Stock Option Plan

The Company's 1991 Stock Option Plan (1991 Plan) had 850,000 shares of common stock authorized for issuance through August 14, 2001. 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 is granted under the 1991 Plan may 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 may be granted at the exercise price established by the Stock Option Committee, which may be less than, equal to or greater than the fair market value of the stock on the date of grant.

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 Stock Option 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 Stock Option 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.





9. STOCK PLANS (CONTINUED)

Changes in option shares under the 1991 Plan are as follows:

| | 2001 | | 2000 | | 19 | |
|---|---|---|---|---|---|---|
| | Options | Weighted-Average Exercise Price | Options | Weighted-Average Exercise Price | Options | W |
| Outstanding at the beginning of the year | 513,220 | $7.20 | 675,849 | $5.58 | 528,715 | |
| Granted | 106,000 | 2.33 | 181,950 | 8.36 | 213,175 | |
| Exercised | - | - | (223,136) | 1.89 | (784) | |
| Forfeited | (74,789) | 4.33 | (121,443) | 9.63 | (65,257) | |
| Outstanding at the end of the year | 544,431 | $6.67 | 513,220 | $7.20 | 675,849 | |
| Exercisable | 368,849 | $5.63 | 308,774 | $7.55 | 429,763 | |
| Available for grant | 40,999 | | 72,210 | | 132,717 | |

The weighted-average contractual life of options outstanding at July 31, 2001, was 7.5 years. The range of exercise prices for options outstanding at July 31, 2001, was $2 to $32.

2000 Stock Option Plan

The Company's 2000 Stock Option Plan (2000 Plan) has 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 Stock Option Committee.

Each 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).





9. STOCK PLANS (CONTINUED)

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 Stock Option 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 year ended July 31,

2001, are as follows:

| | Options | Weighted-Average Exercise Price |
|---|---|---|
| Granted | 320,400 | $ 1.24 |
| Forfeited | (19,275) | (1.34) |
| Outstanding at the end of the year | 301,125 | $ 1.23 |
| Exercisable | 63,781 | $ 1.35 |
| Available for grant | 148,875 | |

The weighted-average contractual life of options outstanding at July 31, 2001, was 9.6 years. The range of exercise prices for options outstanding at July 31, 2001, was $.33 to $1.75.

1993 Director Stock Option Plan

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 are granted at the fair market value of the stock on the grant date.



ARI Network Services, Inc.

Notes to Financial Statements (continued)

9. STOCK PLANS (CONTINUED)

Each option granted under the Director Plan is exercisable one year after the date of grant and cannot expire later than ten years from the date of grant. Changes in option shares under the Director Plan are as follows:

| | 2001 | | 2000 | | 19 | |
|---|---|---|---|---|---|---|
| | Options | Weighted-Average Exercise Price | Options | Weighted-Average Exercise Price | Options | We A E |
| Outstanding at the beginning of the year | 62,086 | $6.76 | 54,879 | $ 6.12 | 40,433 | |
| Granted | 13,379 | 2.01 | 27,261 | 8.09 | 14,446 | |
| Exercised | - | - | (11,509) | 3.23 | - | |
| Forfeited | (19,325) | 6.04 | (8,545) | 11.62 | - | |

| | | | | | |
|---|---|---|---|---|---|
| Outstanding at the end of the year | 56,140 | $5.88 | 62,086 | $ 6.76 | 54,879 |
| Exercisable | 43,701 | $6.98 | 38,390 | $ 5.56 | 40,433 |
| Available for grant | 82,351 | | 76,405 | | 95,121 |

The weighted-average contractual life of options outstanding at July 31, 2001, was 7.5 years. The range of exercise prices for options outstanding at July 31, 2001, was $1.78 to $17.00.

Certain nonemployee directors have been granted stock options outside of the Director Plan aggregating 50,000 shares of common stock at $2.50 to $9 per share.

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ARI Network Services, Inc.

Notes to Financial Statements (continued)

9. STOCK PLANS (CONTINUED)

As permitted by SFAS No. 123, "Accounting for Stock-Based Compensation," the Company follows Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," in accounting for its stock option plans. Had the Company accounted for its stock option plans based upon the fair value at the grant date for options granted under the plan, based on the provisions of SFAS No. 123, the Company's pro forma net loss and pro forma net loss per share would have been as follows (for purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the options' vesting period):

| | YEAR ENDED JULY 31 | | |
|---|---|---|---|
| | 2001 | 2000 | 19 |
| Pro forma net loss (in thousands) | $ (13,950) | $(8,647) | $( |
| Pro forma net loss per share | $ (2.26) | $ (1.44) | $ |

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ARI Network Services, Inc.

Notes to Financial Statements (continued)

9. STOCK PLANS (CONTINUED)

The weighted-average fair value of the options granted in 2001 and 2000 was $1.49 and $7.76, respectively.

Pro forma information regarding net loss and net loss per share is required by SFAS No. 123, and has been determined as if the Company had accounted for its employee stock options using a Black-Scholes option pricing model with the following assumptions: risk-free interest rates ranging from 5% to 6%, dividend yield of 0%; expected common stock market price volatility factors ranging from .6 to 1.1 and an expected life of the options of ten years.

During 2001, 6,000 of the stock options granted were to a nonemployee in exchange for services. No performance commitment existed at the date of grant for the nonemployee options granted. At each reporting period, the Company records compensation expense for the fair value of the options as calculated using the Black-Scholes method. Compensation expense is being recorded over the period of the service agreement.

10. INCOME TAXES

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and income tax purposes. Significant components of the Company's deferred tax liabilities and assets as of July 31 are as follows (in thousands):

| | 2001 | 20 |
|---|---|---|
| Deferred tax assets: | | |
| Net operating loss carryforwards | $ 30,650 | $ 3 |
| Deferred revenue | 1,880 | |
| Goodwill | 1,010 | |
| Other | 720 | |
| Total deferred tax assets | 34,260 | 3 |
| Valuation allowance for deferred tax assets | (33,700) | (3 |
| Net deferred tax asset | 560 | |
| Deferred tax liabilities : | | |
| Network system | (250) | ( |
| Other | (310) | |
| Net deferred taxes | $ - | $ |

As of July 31, 2001, the Company has unused net operating loss carryforwards for federal income tax purposes of $36,757,000 expiring in 2007 through 2021.





10. INCOME TAXES (CONTINUED)

In addition, the Company has unused net operating loss carryforwards for federal income tax purposes of $6,132,000 expiring in 2002, of which not more than $444,000 annually can be utilized to offset taxable income. Also, the Company has unused net operating loss carryforwards for federal income tax

purposes of $33,656,000 expiring between 2003 and 2007, of which not more than $3,655,000 annually can be utilized to offset taxable income. Also, the Company has unused net operating loss carryforwards for federal income tax purposes of $2,038,000 expiring between 2012 and 2014, of which not more than $116,000 annually can be utilized to offset taxable income. Use of the net operating loss carryforwards is restricted under Section 382 of the Code because of changes in ownership in 1987 and 1992.

A reconciliation between income tax expense and income taxes computed by applying the statutory federal income tax rate to net loss is as follows (in thousands):

| | 2001 | 2000 |
|---|---|---|
| Computed income taxes at 34% | $(4,429) | $(2,585) |
| Permanent items | 451 | 435 |
| Net operating loss carryforward | 3,978 | 2,150 |
| Income tax expense | $ - | $ - |

11. EMPLOYEE BENEFIT PLAN

The Company has a qualified retirement savings plan (the 401(k) Plan) covering its employees. Each employee may elect to reduce his or her current compensation by up to 15%, up to a maximum of $10,500 in calendar 2001 (subject to adjustment in future years to reflect cost of living increases) and have the amount of the reduction contributed to the 401(k) Plan. Company contributions to the 401(k) Plan are at the discretion of the Board of Directors. The Company has not made any contribution to the 401(k) Plan since its inception.

12. CONTINGENCIES

The Company is involved in various claims brought about by certain parties that are incidental to its operations. In the opinion of management, the outcome of these matters will not have a material adverse impact on the Company's financial position or results of operations.





13. SUBSEQUENT EVENTS

In September 2001, the Company eliminated ten software development positions, resulting in an additional restructuring charge of approximately $43,000.