ARI NETWORK SERVICES INC /WI
Form 10-Q
March 17, 2015

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended January 31, 2015

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

For the transition period from to

Commission file number 000-19608

ARI Network Services, Inc.

(Exact name of registrant as specified in its charter)

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

10850 West Park Place, Suite 1200, Milwaukee, Wisconsin 53224

(Address of principal executive offices)

(414) 973-4300

(Registrant's telephone number, including area code)

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 NO

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (S232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

YES NO

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer”, “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer	Accelerated filer
Non-accelerated filer (Do not check if a smaller reporting company)	Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

YES NO

As of March 10, 2015, there were 14,348,815 shares of the registrant’s common stock outstanding.

ARI Network Services, Inc.

FORM 10-Q

FOR THE THREE MONTHS ENDED JANUARY 31, 2015

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

ARI Network Services, Inc.
Consolidated Balance Sheets
(Dollars in Thousands, Except per Share Data)

	(Unaudited) Jan 31 2015	(Audited) July 31 2014
ASSETS		
Cash and cash equivalents	$ 1,688	$ 1,808
Trade receivables, less allowance for doubtful accounts of $446 and $359 at January 31, 2015 and July 31,2014, respectively	2,557	1,212
Work in process	149	294
Prepaid expenses and other	987	1,030
Deferred income taxes	2,481	2,655
Total current assets	7,862	6,999
Equipment and leasehold improvements:		
Computer equipment and software for internal use	2,585	2,382
Leasehold improvements	626	626
Furniture and equipment	2,500	2,327
	5,711	5,335
Less accumulated depreciation and amortization	(3,862)	(3,564)
Net equipment and leasehold improvements	1,849	1,771
Capitalized software product costs:		
Amounts capitalized for software product costs	24,184	22,676
Less accumulated amortization	(19,758)	(18,656)
Net capitalized software product costs	4,426	4,020
Deferred income taxes	3,422	3,507
Other long-term assets	115	72
Other intangible assets	7,233	3,612
Goodwill	17,201	12,367
Total non-current assets	34,246	25,349
Total assets	$ 42,108	$ 32,348

See accompanying notes

ARI Network Services, Inc.
Consolidated Balance Sheets
(Dollars in Thousands, Except per Share Data)

	(Unaudited) Jan 31 2015	(Audited) July 31 2014
LIABILITIES		
Current borrowings on line of credit	$ 750	$ —
Current portion of long-term debt	855	675
Current portion of contingent liabilities	668	295
Accounts payable	999	656
Deferred revenue	7,519	7,415
Accrued payroll and related liabilities	1,648	1,336
Accrued sales, use and income taxes	130	123
Other accrued liabilities	543	472
Current portion of capital lease obligations	263	195
Total current liabilities	13,375	11,167
Long-term debt	7,977	3,375
Long-term portion of contingent liabilities	227	153
Capital lease obligations	159	233
Other long-term liabilities	202	214
Total non-current liabilities	8,565	3,975
Total liabilities	21,940	15,142
SHAREHOLDERS' EQUITY		
Cumulative preferred stock, par value $.001 per share, 1,000,000 shares authorized; 0 shares issued and outstanding at January 31, 2015 and July 31, 2014, respectively	—	—
Junior preferred stock, par value $.001 per share, 100,000 shares authorized; 0 shares issued and outstanding at January 31, 2015 and July 31, 2014, respectively	—	—
Common stock, par value $.001 per share, 25,000,000 shares authorized; 14,348,815 and 13,506,316 shares issued and outstanding at January 31, 2015 and July 31, 2014, respectively	14	14
Additional paid-in capital	108,638	106,077
Accumulated deficit	(88,500)	(88,864)
Other accumulated comprehensive income (loss)	16	(21)
Total shareholders' equity	20,168	17,206
Total liabilities and shareholders' equity	$ 42,108	$ 32,348

See accompanying notes

ARI Network Services, Inc.
Consolidated Statements of Operations
(Dollars in Thousands, Except per Share Data)
(Unaudited)

	Three months ended January 31		Six months ended January 31	
	2015	2014	2015	2014
Net revenue	$ 10,139	$ 8,135	$ 19,251	$ 16,295
Cost of revenue	1,862	1,686	3,611	3,246
Gross profit	8,277	6,449	15,640	13,049
Operating expenses:				
Sales and marketing	2,668	2,442	5,210	4,899
Customer operations and support	1,871	1,780	3,561	3,391
Software development and technical support (net of capitalized software product costs)	1,072	781	1,944	1,337
General and administrative	1,588	1,713	3,192	3,201
Depreciation and amortization (exclusive of amortization of software product costs included in cost of revenue)	408	339	780	660
Net operating expenses	7,607	7,055	14,687	13,488
Operating income (loss)	670	(606)	953	(439)
Other income (expense):				
Interest expense	(140)	(78)	(229)	(148)
Loss on change in fair value of stock warrants	—	(10)	—	(32)
Gain on change in fair value of estimated contingent liabilities	—	—	—	26
Other, net	4	7	3	15
Total other income (expense)	(136)	(81)	(226)	(139)
Income (loss) before provision for income tax	534	(687)	727	(578)
Income tax benefit (expense)	(274)	226	(363)	142
Net income (loss)	$ 260	$ (461)	$ 364	$ (436)
Net income (loss) per common share:				
Basic	$ 0.02	$ (0.03)	$ 0.03	$ (0.03)
Diluted	$ 0.02	$ (0.03)	$ 0.03	$ (0.03)

See accompanying notes

Consolidated Statements of Comprehensive Income
(Dollars in Thousands)
(Unaudited)

	Three months ended January 31		Six months ended January 31	
	2015	2014	2015	2014
Net income (loss)	$ 260	$ (461)	$ 364	$ (436)
Other comprehensive income (loss), net of tax:				
Foreign currency translation adjustments	28	(2)	37	(7)
Total other comprehensive income (loss)	28	(2)	37	(7)
Comprehensive income (loss)	$ 288	$ (463)	$ 401	$ (443)

See accompanying notes

ARI Network Services, Inc.

Consolidated Statements of Cash Flows

(Dollars in Thousands)

(Unaudited)

	Six months ended January 31 2015	2014
Operating activities:		
Net income	$ 364	$ (436)
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of software products	1,102	962
Amortization of discount related to present value of earn-out	(7)	(8)
Amortization of bank loan fees	18	24
Interest expense related to earn-out payable	28	41
Depreciation and other amortization	778	656
Loss on change in fair value of stock warrants	-	32
Gain on change in fair value of earn-out payable	-	(26)
Provision for bad debt allowance	79	92
Deferred income taxes	314	(144)
Stock based compensation	141	89
Stock based director fees	69	72
Net change in assets and liabilities:		
Trade receivables	(842)	(835)
Work in process	145	(26)
Prepaid expenses and other	162	218
Other long-term assets	(112)	(5)
Accounts payable	303	156
Deferred revenue	(144)	(1,048)
Accrued payroll and related liabilities	283	(62)
Accrued sales, use and income taxes	(2)	(13)
Other accrued liabilities	55	288
Net cash provided by operating activities	$ 2,734	$ 27
Investing activities:		
Purchase of equipment, software and leasehold improvements	(279)	(523)
Cash received on earn-out from disposition of a component of the business	58	37
Cash paid for contingent liabilities related to acquisitions	(250)	(250)
Cash paid for net assets related to acquisitions	(4,200)	(200)
Software developed for internal use	-	(29)
Software development costs capitalized	(718)	(984)
Net cash used in investing activities	$ (5,389)	$ (1,949)
Financing activities:		
Borrowings under line of credit, net	$ 750	$ 400

Payments on long-term debt	(319)	(224)
Borrowings under long-term debt	2,168	-
Payments of capital lease obligations , net	(115)	(5)
Proceeds from issuance of common stock	72	141
Net cash provided by financing activities	$ 2,556	$ 312
Effect of foreign currency exchange rate changes on cash	(21)	(4)
Net change in cash and cash equivalents	(120)	(1,614)
Cash and cash equivalents at beginning of period	1,808	2,195
Cash and cash equivalents at end of period	$ 1,688	$ 581
Cash paid for interest	$ 176	$ 150
Cash paid for income taxes	$ 55	$ 70
Non-cash investing and financing activities		
Issuance of common stock in connection with acquisitions	$ 1,980	$ 131
Debt issued in connection with acquisitions	2,933	-
Capital leases acquired in connection with acquisitions	109	-
Issuance of common stock related to payment of contingent liabilities	42	33
Tax benefit of stock options exercised	55	-
Issuance of common stock related to payment of director compensation	69	234
Issuance of common stock related to payment of employee compensation	38	91
Contingent liabilities incurred in connection with acquisition	711	-

See accompanying notes

ARI Network Services, Inc.

Notes to Consolidated Financial Statements

1. Description of the Business and Significant Accounting Policies

Description of the Business

ARI Network Services, Inc. (“ARI” or “the Company”) creates software-as-a-service (“SaaS”), data-as-a-service (“DaaS”) and other solutions that help equipment manufacturers, distributors and dealers in selected vertical markets to Sell More Stuff!™ – online and in-store. We remove the complexity of selling and servicing new and used inventory, parts, garments, and accessories (”PG&A”) for customers in the outdoor power equipment (“OPE”), powersports, automotive tire and wheel (“ATW”), home medical equipment (“HME”), marine, recreational vehicle (“RV”) and appliances industries. Our innovative products are powered by a proprietary library of enriched original equipment and aftermarket content that spans more than 750,000 equipment models from over 1,500 manufacturers. More than 23,500 equipment dealers, 195 distributors and 3,360 brands worldwide leverage our web and eCatalog platforms to Sell More Stuff!

We were incorporated in Wisconsin in 1981. Our principal executive office and headquarters is located in Milwaukee, Wisconsin. The office address is 10850 West Park Place, Suite 1200, Milwaukee, WI 53224, and our telephone number at that location is (414) 973-4300. Our principal website address is www.arinet.com. ARI also maintains operations in Duluth, Minnesota; Cypress, California; Floyds Knobs, Indiana; Cookeville, Tennessee; Salt Lake City, Utah and Leiden, The Netherlands.

Basis of Presentation

These consolidated financial statements include the consolidated financial statements of ARI and its wholly-owned subsidiary, ARI Europe B.V. and have been prepared in accordance with accounting principles generally accepted in the United States (“GAAP”). We eliminated all significant intercompany balances and transactions in consolidation. All adjustments that, in the opinion of management, are necessary for a fair presentation for the periods presented have been reflected as required by Regulation S-X, Rule 10-01.

Fiscal Year

Our fiscal year ends on July 31. References to fiscal 2015, for example, refer to the fiscal year ended July 31, 2015, and references to fiscal 2014 refer to the fiscal year ended July 31, 2014.

Revenue Recognition

Revenues from subscription fees for use of our software, access to our catalog content, and software maintenance and support fees are all recognized ratably over the contractual term of the arrangement. ARI considers all arrangements with payment terms extending beyond 12 months not to be fixed or determinable and evaluates other arrangements with payment terms longer than normal to determine whether the arrangement is fixed or 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 standard terms are not recognized until acceptance has occurred. If collectability is not considered probable, revenue is recognized when the fee is collected.

For software license arrangements that do not require significant modification or customization of the underlying software, the Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, and collectability is probable.

Revenues for professional services to customize complex features and functionality in a product's base software code or develop complex interfaces within a customer's environment are recognized as the services are performed if they are determined to have standalone value to the customer or if all of following conditions are met i) the customer has a contractual right to take possession of the software; ii) the customer will not incur significant penalty if it exercises this right; and iii) it is feasible for the customer to either run the software on its own hardware or contract with another unrelated party to host the software . When the current estimates of total contract revenue for professional services and the total related costs indicate a loss, a provision for the entire loss on the contract is made in the period the amount is determined. Professional service revenues for set-up and integration of hosted websites, or other services considered essential to the functionality of other elements of the arrangement, are amortized over the term of the contract.

Revenue for variable transaction fees, primarily for use of the shopping cart feature of our websites, is recognized as it is earned.

Amounts received for shipping and handling fees are reflected in revenue. Costs incurred for shipping and handling are reported in cost of revenue.

Amounts invoiced to customers prior to recognition as revenue, as discussed above, are reflected in the accompanying balance sheets as deferred revenue.

No single customer accounted for 5% or more of ARI's revenue during the three and six months ended January 31, 2015 and 2014.

Trade Receivables, Credit Policy and Allowance for Doubtful Accounts

Trade receivables are uncollateralized customer obligations due on normal trade terms, most of which require payment within thirty (30) days from the invoice date. Payments of trade receivables are allocated to the specific invoices identified on the customer's remittance advice or, if unspecified, are applied to the earliest unpaid invoices.

The carrying amount of trade receivables is reduced by an allowance that reflects management's best estimate of the amounts that will not be collected. Management individually reviews receivable balances that exceed ninety (90) days from the invoice date and, based on an assessment of current creditworthiness, estimates the portion of the balance that will not be collected. The allowance for potential doubtful accounts is reflected as an offset to trade receivables in the accompanying balance sheets.

Capitalized and Purchased Software Product Costs

Certain software development and acquisition costs are capitalized when incurred. Capitalization of these costs begins upon the establishment of technological feasibility. The establishment of technological feasibility and the on-going assessment of recoverability of software costs require considerable judgment by management with respect to certain external factors, including, but not limited to, the determination of technological feasibility, anticipated future gross revenue, estimated economic life and changes in software and hardware technologies.

The amortization of software products is computed using the straight-line method over the estimated economic life of the product which currently runs from two to nine years. Amortization starts when the product is available for general release to customers. The Company capitalizes software enhancements on an on-going basis and all other software development and support expenditures are charged to expense in the period incurred.

Deferred Loan Fees and Debt Discounts

Fees associated with securing debt are capitalized and included in prepaid expense and other and other long term assets on the consolidated balance sheet. Common stock issued in connection with securing debt is recorded to debt discount, reducing the carrying amount of the debt on the consolidated balance sheet. Deferred loan fees and debt discounts are amortized to interest expense over the life of the debt using the effective interest method.

Deferred Income Taxes

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

Legal Provisions

ARI is periodically involved in legal proceedings arising from contracts, patents or other matters in the normal course of business. We reserve for any material estimated losses if the outcome is probable and reasonably estimable, in accordance with GAAP.   We had no provisions for legal proceedings during the three and six months ended January 31, 2015 and 2014.

2. Basic and Diluted Net Income per Common Share

Basic net income per common share is computed by dividing net income by the basic weighted average number of common shares outstanding during the period. Diluted net income per common share is computed by dividing net income by the weighted average number of common shares outstanding during the period and reflects the potential dilution that could occur if all of ARI's outstanding stock options and warrants that are in the money were exercised (calculated using the treasury stock method).

The following table is a reconciliation of basic and diluted net income per common share (in thousands, except per share data):

	Three months ended January 31		Six months ended January 31	
	2015	2014	2015	2014
Net income (loss)	$ 260	$ (461)	$ 364	$ (436)
Weighted-average common shares outstanding	14,393	13,184	14,043	13,154
Effect of dilutive stock options and warrants	468	-	432	-
Diluted weighted-average common shares outstanding	14,861	13,184	14,475	13,154

Net income (loss) per share				
Basic	$ 0.02	$ (0.03)	$ 0.03	$ (0.03)
Diluted	$ 0.02	$ (0.03)	$ 0.03	$ (0.03)
Options and warrants that could potentially dilute net income per share in the future that are not included in the computation of diluted net income per share, as their impact is anti-dilutive	-	1,462	5	1,462

3. Debt

Silicon Valley Bank

On April 26, 2013, the Company entered into a Loan and Security Agreement (the "Agreement") with Silicon Valley Bank ("SVB"), pursuant to which SVB extended to the Company credit facilities consisting of a $3,000,000 revolving credit facility with a maturity date of April 26, 2015 and a $4,500,000 term loan with a maturity date of April 26, 2018. The Agreement replaced the Company's Loan and Security Agreement with Fifth Third Bank.

On September 30, 2014, in connection with the Company's acquisition of Tire Company Solutions, LLC ("TCS"), the Company entered into the First Loan Modification Agreement (the "Modification Agreement") with SVB, which contained substantial amendments to the terms of the Agreement.

The Modification Agreement includes credit facilities consisting of a $3,000,000 revolving credit facility with a maturity date of September 30, 2016 and a $6,050,000 term loan with a maturity date of September 30, 2019. This term loan is an amendment to the existing $4,500,000 term loan with an original maturity date of April 26, 2018.

The term loan and any loans made under the SVB revolving credit facility accrue interest at a per annum rate equal to the Prime rate plus the Applicable Margin for Prime Rate Loans set forth in the chart below determined based on the Total Leverage Ratio, as defined in the Modification Agreement. The Company had $750,000 outstanding on the revolving credit facility and the effective interest rate was 3.75% at January 31, 2015.

Total Leverage Ratio	Applicable Margin for Libor Loans	Applicable Margin for Prime Rate Loans
>= 2.50 to 1.0:	3.25 %	1.50 %
> 1.75 to 1.00 but <2.50 to 1.00:	3.00 %	1.00 %
<= 1.75 to 1.00:	2.75 %	0.50 %

Principal in respect of any loans made under the revolving facility is required to be paid in its entirety on or before September 30, 2016. Principal in respect of the term loan is required to be paid in quarterly installments on the first day of each fiscal quarter of the Company as follows: $151,250 commenced on November 1, 2014 through August 1, 2016; $226,875 commencing on November 1, 2016 through August 1, 2017; and $302,500 commencing on November 1, 2017 through August 1, 2019. All remaining principal in respect of the term loan is due and payable on September 30, 2019. The Company is permitted to prepay all of, but not less than all of, the outstanding principal amount of the term loan upon notice to SVB and, in certain circumstances, the payment of a prepayment penalty of up to $121,000. Following July 31, 2015, the Modification Agreement requires the Company to make additional payments in the amount of 25% of excess cash flow until the Company's Total Leverage Ratio is less than 2.00 to 1.00.

The Modification Agreement contains covenants that restrict, among other things and subject to certain conditions, the ability of the Company to permit a change of control, incur debt, create liens on its assets, make certain investments, enter into merger or acquisition transactions and make distributions to its shareholders. Financial covenants include the maintenance of a minimum Total Leverage Ratio equal to or less than 3.00 to 1.00 and the maintenance of a Fixed Charge Coverage Ratio (as defined in the Modification Agreement) equal to or greater than 1.25 to 1.00. The Modification Agreement also contains customary events of default that, if triggered, could result in an acceleration of the Company's obligations under the Modification Agreement. The loans are secured by a first priority security interest in substantially all assets of the Company.

TCS Promissory Notes

In connection with the acquisition of TCS, on September 30, 2014, the Company issued two promissory notes (the "Notes") in the aggregate principal amount of $3,000,000 to the former owners of TCS. In February 2015, the principal amount of the Notes was reduced by $66,575 as a result of post-closing adjustments to the valuation of the net assets acquired, pursuant to the terms of the asset purchase agreement. The Notes initially will accrue interest on the outstanding unpaid principal balance at a rate per annum equal to 5.0%; however, if any amount payable under a Note is not paid when due, such overdue amount will bear interest at the default rate of 7.5% from the date of such non-payment until such amount is paid in full. Accrued interest on the Notes will be due and payable quarterly commencing on December 29, 2014 and continuing on each 90th calendar day thereafter, until September 30, 2018, at which time all accrued interest and outstanding principal balance will be due and payable in full. The first four payments due and payable under the Notes will be interest only payments, and payments of principal and interest shall not commence until the payment due on December 29, 2015. The payments are subject to acceleration upon certain Events of Default, as defined in the Notes.

The following table sets forth certain information related to the Company’s long-term debt as of January 31, 2015 and July 31, 2014 (in thousands):

	January 31 2015	July 31 2014
Notes payable principal	$ 8,832	$ 4,050
Less current maturities	(855)	(675)
Notes payable - non-current	$ 7,977	$ 3,375

Minimum principal payments due on the SVB Term Note and the TCS Notes are as follows for the fiscal years ending (in thousands):

	SVB Term Note	TCS Notes	Total Notes Payable
2015	$ 303	$ —	$ 303
2016	605	733	1,338
2017	832	978	1,810
2018	1,134	978	2,112
2019	1,210	244	1,454
2020	1,815	—	1,815
	$ 5,899	$ 2,933	$ 8,832

4. Business Combinations

On September 30, 2014, the Company acquired substantially all of the assets of TCS, a leading provider of software, websites and digital marketing services designed exclusively for dealers, wholesalers, retreaders and manufacturers within the automotive tire and wheel industries. Consideration for the acquisition included (1) a cash payment equal to $4,200,000; (2) 618,744 shares of the Company's common stock; (3) the issuance of two promissory notes in aggregate principal amount of $2,933,000 (as adjusted) to the former owners of TCS; and (4) a contingent earn-out purchase price contingent upon the attainment of specific revenue goals over the first three years following the acquisition.

The acquisition eliminated a direct competitor and increased the Company’s portfolio of automotive tire and wheel dealer websites by more than 30%. The acquisition is expected to accelerate ARI’s opportunity to drive organic growth through the cross selling of new products. It also provides solutions for the entire automotive tire and wheel supply chain, including wholesalers, retreaders and manufacturers. TCS offers a business management solution for tire and wheel dealers as well as for auto repair shops. The combined customer benefits and operational efficiencies are expected to result in a stronger organization that can create more value for our customers, shareholders and employees.

The acquisition was funded from cash on hand, an increase in our SVB Term Loan, funds available on our revolving credit facility and seller financing. The following tables show the preliminary allocation of the purchase price (in thousands):

	Purchase Price
Cash	$ 4,200
Financed by note payable	2,933
Issuance of common stock	1,980
Contingent earn-out	711
Purchase price	$ 9,824

	Preliminary Purchase Allocation
Trade receivables, less allowance for doubtful accounts of $260	$ 594
Prepaid expense and other	34
Assumed liabilities	(628)
Furniture and equipment	120
Software product costs	790
Intangible assets	4,080
Goodwill	4,834
Purchase price allocation	$ 9,824

Estimated intangible assets include the fair value of tradenames, customer relationships, and non-competition agreements. Estimated goodwill represents the additional benefits provided to the Company by the acquisition of TCS through operational synergies. The Company cannot determine revenue and expenses specifically related to the TCS operation since the date of acquisition, as we have begun integration of the businesses. The Company acquired approximately $5,200,000 of tax deductible goodwill related to the TCS acquisition.

The final purchase price, as well as the purchase price allocation, is subject to the completion of the final valuation of the net assets acquired and contingent earn-out. The final valuation is expected to be completed as soon as is practicable but no later than September 30, 2015 and could have a material impact on the preliminary purchase price allocation disclosed above.

The following preliminary unaudited pro forma combined financial information presents the Company's results as if the Company had acquired TCS on August 1, 2013. The unaudited pro forma information has been prepared with the following considerations:

i. The unaudited pro forma condensed consolidated financial information has been prepared using the acquisition method of accounting under existing GAAP. The Company is the acquirer for accounting purposes.
ii. The pro forma combined financial information does not reflect any operating cost synergy savings that the combined company may achieve as a result of the acquisition, the costs necessary to achieve these operating synergy savings or additional charges necessary as a result of the acquisition.

The unaudited pro forma financial information presented is for information purposes only and does not purport to represent what the Company's and TCS’s financial position or results of operations would have been had the acquisition in fact occurred on such date or at the beginning of the period indicated, nor does it project the Company's and TCS’s financial position or results of operation for any future date or period.

	Three months ended January 31		Six months ended January 31	
	2015	2014	2015	2014
Revenue	$ 10,139	$ 9,329	$ 20,167	$ 18,536
Net income	$ 260	$ (456)	$ 503	$ (438)
Net income per common share:				
Basic	$ 0.02	$ (0.03)	$ 0.04	$ (0.03)
Diluted	$ 0.02	$ (0.03)	$ 0.03	$ (0.03)

Pro forma adjustments to net income include amortization costs related to the acquired intangible assets, acquisition-related professional fees, interest expense on the debt incurred to acquire the assets of TCS, and the tax effect of the historical TCS results of operations and the pro forma adjustments at an estimated tax rate of 40% as follows:

	Three months ended January 31		Six months ended January 31	
	2015	2014	2015	2014
Amortization of intangible assets	-	81	54	162
Acquisition-related professional fees	-	-	(210)	-
Interest expense	-	67	45	135
Income tax benefit (expense)	-	3	92	(1)

On November 1, 2013, the Company acquired substantially all of the assets of DUO Web Solutions (“DUO”) pursuant to an Asset Purchase Agreement dated November 1, 2013. DUO was a leading provider of social media and online marketing services for the powersports industry, which is in line with the Company’s strategy to grow the digital marketing services side of the business. The Company determined that the DUO assets acquired did not constitute a business that is “significant” as defined in the applicable SEC regulations, nor did it have a material impact on the Company’s financial statements.

On August 17, 2012, the Company acquired substantially all of the assets of Ready2Ride, Incorporated (“Ready2Ride”) pursuant to the terms of an Asset Purchase Agreement dated August 17, 2012. Ready2Ride markets aftermarket fitment data to the powersports industry, which furthers ARI’s differentiated content strategy and expands ARI’s product offerings into aftermarket PG&A.

Consideration for the Ready2Ride acquisition included $500,000 in cash, 100,000 shares of the Company’s common stock and assumed liabilities totaling approximately $419,000, a contingent hold-back purchase price of up to $250,000 and a contingent earn-out purchase price ranging from, in aggregate, $0 to $1,500,000.

On October 22, 2013, the Company amended the Ready2Ride Asset Purchase Agreement in relation to the earn-out payments as follows: (i) the first earn-out payment was composed of $125,000 paid in October 2013 and 10,000 shares of common stock issued in November 2013; (ii) the second earn-out payment of $125,000, was paid in September 2014 and 15,000 shares of common stock were issued in September 2014; and (iii) the third earn-out payment is composed of $125,000 and 15,000 shares of common stock payable in September 2015.

The contingent holdback and earn-out payable was initially measured at fair value on a recurring basis calculated using the present value of future estimated revenue over the next three years, which was originally estimated at $750,000. Prior to the amendment, because the contingent earn-out payable had no comparable market data or significant observable inputs to determine fair value, it was classified as a Level 3 measurement. Because the amended Asset Purchase Agreement defines the future payments based on cash and Company stock actively traded, and the payments are no longer contingent on future events, the earn-out is now classified as a Level 1 fair value measurement. Unrealized gains and losses for changes in fair value are recognized in earnings.

The Company recorded a gain on change in fair value of the estimated contingent earn-out payable of approximately $26,000 or $0.00 per basic and diluted share as a result of the amendment in the first quarter of fiscal 2014.

The remaining estimated contingent payments due as of January 31, 2015 related to the Ready2Ride and TCS acquisitions are as follows (in thousands):

2016	$	679
2017		190
2018		88
Total estimated payments		957
Less imputed interest		(62)
Present value of contingent liabilities	$	895

The following table shows changes in the estimated holdback and earn-out payable related to the Ready2Ride and TCS acquisitions for the six months ended January 31 (in thousands):

	Six months ended January 31

	2015	2014
Beginning balance	$448	$721
Additions (TCS)	711	-
Payments	(292)	(283)
Imputed interest recognized	28	43
Gain on change in fair value of earn-out	-	(26)
Ending balance	$895	$455
Less current portion	$(668)	$(286)
Ending balance, long-term	$227	$169

5. Disposition of a Component of an Entity

On March 1, 2011, the Company entered into an Asset Purchase Agreement (the “Agreement”) with Globalrange Corporation (“Globalrange”). Under the terms of the Agreement, the Company sold to Globalrange certain rights and assets relating to our electronic data interchange business for the agricultural chemicals industry (the “AgChem EDI Business”). Because the AgChem EDI Business was not a separate entity or reportable segment, the transaction was recorded as a disposition of a component of an entity.

As part of the purchase price for the AgChem EDI Business, Globalrange agreed to assume certain liabilities of ARI relating to the AgChem EDI Business, primarily consisting of unearned revenue (as defined in the Agreement). Globalrange is making earn-out payments to ARI annually over a four-year period following the closing date, with an initial pre-payment of $80,000. The amounts of such earn-out payments are determined based on collections received by Globalrange relating to the AgChem EDI Business during such period, and are subject to a floor and cap, in accordance with the terms of the Agreement.

The contingent earn-out receivable is measured at fair value on a recurring basis calculated using the present value of future estimated revenue. Unrealized gains and losses for changes in fair value are recognized in earnings. Because the contingent earn-out receivable has no comparable market data or significant observable inputs to determine fair value, it is classified as Level 3 measurement. The primary factors used to determine the fair value include: (i) the estimated future revenue related to the business recognized by the buyer; and (ii) the estimated risk free interest rate of a market participant. Increases in the estimated future revenue related to the business sold, which has the most impact on the fair value of the contingent earn-out receivable, would cause the fair value of the earn-out to increase.

The amount of the earn-out receivable was originally estimated at $580,000 less an imputed discount of $97,000, based on the present value of the estimated earn-out payments (the "earn-out receivable"), discounted at 14%, which was the prevailing rate of interest charged on the Company's debt at the time of the sale. The discount is amortized to interest income, which is included in other income on the consolidated statements of income, over the life of the earn-out.

An assessment of the expected future cash flows of the Earn-out Receivable is performed annually in the third fiscal quarter based on historical receipts over the previous twelve month period. Changes in estimate and cash received in excess of expected cash receipts are recorded as a gain or loss in other expense (income).

The remaining earn-out receivable totals $22,000 in prepaid expenses and other on the consolidated balance sheet at January 31, 2015, with estimated receivables as follows (in thousands):

Total estimated current payments receivable	$ 24
Less imputed interest	(2)
Present value of earn-out receivable	$ 22

The following table shows changes in the earn-out receivable during the six months ended January 31, 2015 (in thousands):

	Six months ended January 31	
	2015	2014
Beginning balance	$73	$160
Net receipts	(58)	(37)
Imputed interest recognized	7	8
Ending balance	$22	$131

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6. Other Intangible Assets

Amortizable intangible assets include customer relationships and other intangibles including trade names and non-compete agreements. We estimate that we acquired $4,080,000 of intangible assets from the TCS acquisition in the first quarter of fiscal 2015. Amortizable intangible assets are composed of the following at January 31, 2015 and 2014 (in thousands):

	Six months ended January 31, 2014			Wtd. Avg.
Customer relationships	Cost Basis	Accumulated Amortization	Net Value	remaining life
Beginning balance	$ 7,064	$ (3,090)	$ 3,974	
Activity	110	(250)	(140)	
Ending balance	$ 7,174	$ (3,340)	$ 3,834	11.29
Other intangibles				
Beginning balance	$ 383	$ (258)	$ 125	
Activity	-	(58)	(58)	
Ending balance	$ 383	$ (316)	$ 67	0.72
Total intangibles				
Beginning balance	$ 7,447	$ (3,348)	$ 4,099	
Activity	110	(308)	(198)	
Ending balance	$ 7,557	$ (3,656)	$ 3,901	11.11

	Six months ended January 31, 2015			Wtd. Avg.
Customer relationships	Cost Basis	Accumulated Amortization	Net Value	remaining life
Beginning balance	$ 7,174	$ (3,584)	$ 3,590	
Activity	2,680	(360)	2,320	
Ending balance	$ 9,854	$ (3,944)	$ 5,910	12.49
Other intangibles				
Beginning balance	$ 383	$ (361)	$ 22	
Activity	1,400	(99)	1,301	
Ending balance	$ 1,783	$ (460)	$ 1,323	2.05
Total intangibles				
Beginning balance	$ 7,557	$ (3,945)	$ 3,612	
Activity	4,080	(459)	3,621	
Ending balance	$ 11,637	$ (4,404)	$ 7,233	11.88

7. Stock-based Compensation Plans

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

Stock options granted to employees under the Company's stock option plans typically vest 25% on the first anniversary of the grant and 25% on the one year anniversary of each of the three following years. Stock options granted to non-employee directors under the Company's stock option plans typically vest 50% on the first anniversary of the grant and 50% on the next one year anniversary. The Company recognizes stock option expense over the vesting period for each vesting tranche.

As recognizing stock-based compensation expense is based on awards ultimately expected to vest, the amount of recognized expense has been reduced for estimated forfeitures based on the Company's historical experience. Total stock option compensation expense recognized by the Company was approximately $40,000 and $12,000 during the three month periods ended January 31, 2015 and 2014, respectively, and approximately $69,000 and $48,000 during the six month periods ended January 31, 2015 and 2014, respectively. There was approximately $234,000 and $326,000 of total unrecognized compensation costs related to non-vested options granted under the Company's stock option plans as of January 31, 2015 and 2014, respectively. Total unrecognized compensation cost will be adjusted for any future changes in estimated and actual forfeitures. There were no capitalized stock-based compensation costs during the periods presented.

The following table shows the weighted average assumptions used to estimate the fair value of options granted:

	Three months ended January 31		Six months ended January 31	
	2015	2014	2015	2014
Expected life (years)	5 years	10 years	5 years	10 years
Risk-free interest rate	1.7 %	2.8 %	1.7 %	2.8 %
Expected volatility	65.7 %	73.4 %	65.3 %	73.4 %
Expected forfeiture rate	7.0 %	28.7 %	7.0 %	16.8 %
Expected dividend yield	-	-	-	-
Weighted-average estimated fair value of options granted during the year	$ 1.97	$ 2.56	$ 1.80	$ 2.56
Cash received from the exercise of stock options	$ 56,000	$ 125,000	$ 80,000	$ 141,000

2000 Stock Option Plan

The Company's 2000 Stock Option Plan (the "2000 Plan") had 1,950,000 shares of common stock authorized for issuance. Each incentive stock option that was 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 a 10% shareholder of the Company, unless the stock options are nonqualified), or such shorter period as determined by the Compensation Committee, and shall lapse upon the expiration of said period, or earlier upon termination of the participant's employment with the Company. The 2000 Plan expired on December 13, 2010, at which time it was terminated except for outstanding options. While options previously granted under the 2000 Plan will continue to be effective through the remainder of their terms, no new options may be granted under the 2000 Plan.

Changes in option shares under the 2000 Plan during the three and six months ended January 31, 2015 and fiscal 2014 were as follows:

	Number of Options	Wtd. Avg. Exercise Price	Wtd. Avg. Remaining Contractual Period (Years)	Aggregate Intrinsic Value
Outstanding at 10/31/13	963,661	$ 1.43	3.93	$ 1,773,485
Granted	-	n/a	n/a	n/a
Exercised	(127,500)	0.74	n/a	n/a
Forfeited	(14,087)	0.70	n/a	n/a
Outstanding at 1/31/14	822,074	$ 1.55	3.21	$ 1,514,709
Exercisable at 1/31/14	820,700	$ 1.55	3.20	$ 1,510,836
Outstanding at 10/31/14	508,125	$ 1.57	3.31	$ 960,733
Granted	-	n/a	n/a	n/a
Exercised	(34,375)	2.23	n/a	n/a
Forfeited	(750)	1.24	n/a	n/a
Outstanding at 1/31/15	473,000	$ 1.52	3.22	$ 912,198
Exercisable at 1/31/15	473,000	$ 1.52	3.22	$ 912,198

	Number of Options	Wtd. Avg. Exercise Price	Wtd. Avg. Remaining Contractual Period (Years)	Aggregate Intrinsic Value
Outstanding at 7/31/13	986,786	$ 1.41	4.22	$ 1,564,296
Granted	-	n/a	n/a	n/a
Exercised	(147,500)	0.74	n/a	n/a
Forfeited	(17,212)	0.75	n/a	n/a
Outstanding at 1/31/14	822,074	$ 1.55	3.21	$ 1,514,709
Exercisable at 1/31/14	820,700	$ 1.55	3.20	$ 1,510,836
Outstanding at 7/31/14	611,300	$ 1.60	3.18	$ 834,752
Granted	-	n/a	n/a	n/a
Exercised	(137,350)	1.89	n/a	n/a
Forfeited	(950)	1.26	n/a	n/a
Outstanding at 1/31/15	473,000	$ 1.52	3.22	$ 912,198
Exercisable at 1/31/15	473,000	$ 1.52	3.22	$ 912,198

The range of exercise prices for options outstanding under the 2000 Plan was $0.49 to $2.74 at January 31, 2015 and 2014.

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Changes in the 2000 Plan's non-vested option shares included in the outstanding shares above during the three and six months ended January 31, 2015 and 2014 were as follows:

	Number of Options	Wtd. Avg. Exercise Price
Non-vested at 10/31/13	14,961	$ 0.62
Granted	-	n/a
Vested	-	n/a
Forfeited	(13,587)	0.63
Non-vested at 1/31/14	1,374	$ 0.57
Non-vested at 10/31/14	-	$ -
Granted	-	n/a
Vested	-	n/a
Forfeited	-	n/a
Non-vested at 1/31/15	-	$ -

	Number of Options	Wtd. Avg. Exercise Price
Non-vested at 7/31/13	27,461	$ 0.64
Granted	-	n/a
Vested	(12,500)	0.67
Forfeited	(13,587)	0.63
Non-vested at 1/31/14	1,374	$ 0.57
Non-vested at 7/31/14	-	$ -
Granted	-	n/a
Vested	-	n/a
Forfeited	-	n/a
Non-vested at 1/31/15	-	$ -

The weighted average remaining vesting period was 0 and .5 years at January 31, 2015 and 2014, respectively.

2010 Equity Incentive Plan

The Board of Directors adopted the ARI Network Services, Inc. 2010 Equity Incentive Plan (as amended, the "2010 Plan") on November 9, 2010. The plan was approved by the Company's shareholders in December 2010, and amendments to the 2010 Plan were approved by the Company's shareholders in January 2014. The 2010 Plan is the successor to the Company's 2000 Plan. There are 1,850,000 shares of Company common stock authorized for issuance under the 2010 Plan. Potential awards under the 2010 Plan include incentive stock options ("ISOs'') and non-statutory stock options ("NSOs"), shares of restricted stock or restricted stock units, stock appreciation rights ("SARs), and shares of common stock. Up to 1,525,000 of the shares authorized for issuance under the 2010 Plan may be used for common stock, restricted stock or restricted stock unit awards.

The exercise price for options and stock appreciation rights under the 2010 Plan cannot be less than 100% of the fair market value of the Company's common stock on the date of grant, and the exercise prices for options and stock appreciation rights cannot be repriced without shareholder approval, except to reflect changes to the capital structure of the Company as described in the 2010 Plan. The maximum term of options and stock appreciation rights under the 2010 Plan is 10 years. The 2010 Plan does not have liberal share counting provisions (such as provisions that would permit shares withheld for payment of taxes or the exercise price of stock options to be re-granted under the plan).

Changes in option shares under the 2010 Plan during the three and six months ended January 31, 2015 and 2014 were as follows:

	Number of Options	Wtd. Avg. Exercise Price	Wtd. Avg. Remaining Contractual Period (Years)	Aggregate Intrinsic Value
Outstanding at 10/31/13	385,585	$ 1.24	8.45	$ 781,652
Granted	100,000	3.25	n/a	n/a
Exercised	(45,000)	0.88	n/a	n/a
Forfeited	(14,500)	0.89	n/a	n/a
Outstanding at 1/31/14	426,085	$ 1.76	8.67	$ 693,641
Exercisable at 1/31/14	178,440	$ 1.29	8.07	$ 374,908
Outstanding at 10/31/14	485,876	$ 2.24	8.16	$ 593,984
Granted	5,000	3.54	n/a	n/a
Exercised	(22,375)	1.83	n/a	n/a
Forfeited	(14,000)	2.15	n/a	n/a
Outstanding at 1/31/15	454,501	$ 2.27	8.15	$ 534,732
Exercisable at 1/31/15	203,752	$ 1.72	7.40	$ 351,925

	Number of Options	Wtd. Avg. Exercise Price	Wtd. Avg. Remaining Contractual Period (Years)	Aggregate Intrinsic Value
Outstanding at 7/31/13	394,460	$ 1.25	8.70	$ 691,485
Granted	100,000	3.25	n/a	n/a
Exercised	(45,000)	0.88	n/a	n/a
Forfeited	(23,375)	1.10	n/a	n/a
Outstanding at 1/31/14	426,085	$ 1.76	8.67	$ 693,641
Exercisable at 1/31/14	178,440	$ 1.29	8.07	$ 374,908
Outstanding at 7/31/14	482,542	$ 2.16	8.56	$ 453,057
Granted	50,000	3.24	n/a	n/a
Exercised	(38,375)	1.52	n/a	n/a
Forfeited	(39,666)	2.84	n/a	n/a
Outstanding at 1/31/15	454,501	$ 2.27	8.15	$ 534,732
Exercisable at 1/31/15	203,752	$ 1.72	7.40	$ 351,925

The range of exercise prices for options outstanding under the 2010 Plan was $0.58 to $3.54 and $0.58 to $3.25 at January 31, 2015 and 2014, respectively.

Changes in the 2010 Plan's non-vested option shares included in the outstanding shares above during the three and six months ended January 31, 2015 and 2014 were as follows:

	Number of Options	Wtd. Avg. Exercise Price
Non-vested at 10/31/13	161,145	$ 1.29
Granted	100,000	3.25
Vested	-	1.00
Forfeited	(13,500)	0.90
Non-vested at 1/31/14	247,645	$ 2.10
Non-vested at 10/31/14	253,499	$ 2.66
Granted	5,000	3.54
Vested	-	-
Forfeited	(7,750)	1.26
Non-vested at 1/31/15	250,749	$ 2.72

	Number of Options	Wtd. Avg. Exercise Price
Non-vested at 7/31/13	177,145	$ 1.25