ARI NETWORK SERVICES, INC.
MD&A FOR THE THREE MONTHS ENDED OCTOBER 31, 2014

Item 2. *Management's Discussion and Analysis of Financial Condition and Results of Operations*

The following discussion of our results of operations and financial condition should be read together with our unaudited consolidated financial statements for the three months ended October 31, 2014 and 2013, including the notes thereto, which appear elsewhere in this quarterly report on Form 10-Q. All amounts are in thousands, except per share data. This discussion, including, without limitation, the section entitled "Summary of Operating Results", contains forward-looking statements regarding future events and our future results that are subject to the safe harbors created under the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act"). All statements other than statements of historical facts are statements that could be deemed to be forward-looking statements. These statements are based on current expectations, estimates, forecasts, and projections about the markets in which we operate and the beliefs and assumptions of our management. Words such as "expects," "anticipates," "targets," "goals," "projects," "intends," "plans," "believes," "seeks," "estimates," "endeavors," "strives," "may," variations of such words, and similar expressions are intended to identify such forward-looking statements. In addition, any statements that refer to projections of our future financial performance, our anticipated growth and trends in our businesses, and other characterizations of future events or circumstances are forward-looking statements. Readers are cautioned that these forward-looking statements are only predictions and are subject to risks, uncertainties, and assumptions that are difficult to predict, estimate, or verify, including those identified in Part I, Item 1A of our annual report on Form 10-K for the year ended July 31, 2014, and elsewhere herein. Therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. We undertake no obligation to revise or update any forward-looking statements for any reason.

Overview

ARI Network Services, Inc. offers an award-winning suite of data-driven software tools and marketing services to help dealers, equipment manufacturers and distributors in selected vertical markets Sell More Stuff!™ – online and in-store. Our innovative products are powered by a proprietary data repository of enriched original equipment and aftermarket electronic content spanning more than 17 million active part and accessory SKUs and 750,000 equipment models. Business is complicated, but we believe our customers' technology tools don't have to be. We remove the complexity of selling and servicing new and used vehicle inventory, parts, garments and accessories ("PG&A") for customers in the automotive tire and wheel aftermarket ("ATW"), powersports, outdoor power equipment ("OPE"), marine, home medical equipment ("HME"), recreational vehicles ("RV") and appliance industries. More than 23,500 equipment dealers, 195 distributors and 3,360 brands worldwide leverage our web and eCatalog platforms to Sell More Stuff!™

Our Solutions

Our SaaS and DaaS solutions include: (i) eCommerce-enabled websites, which provide a web presence for dealers and serve as a platform for driving leads and eCommerce sales; (ii) eCatalog content, which drives sales of inventory and PG&A both online and within the dealership; and (iii) lead management software designed to increase sales for dealers through more efficient management and improved closure of leads. Our solutions also improve our customers' overall customer satisfaction through a highly efficient and accurate data lookup experience at the parts counter and a quicker response time to online inquiries, both of which serve to significantly improve a customer's overall experience with the dealer. Through the recent acquisition of Tire Company Solutions, LLC ("TCS") we also added fully integrated business management software for the ATW market to our product portfolio.

Our SaaS and DaaS solutions are sold through our internal sales force and are composed primarily of recurring license and eCatalog subscriptions. Customers typically sign annual, auto-renewing contracts. Today, approximately 90% of our revenues are recurring.

In addition to our award-winning SaaS and DaaS solutions, ARI offers a suite of complementary products and services designed to supplement our four primary offerings in order to help our customers Sell More Stuff!™

Web Platform Solutions

Our eCommerce-enabled website solutions provide consumers with information about a dealership and its product lines through our extensive library of electronic catalog content and allow consumers to obtain information on whole goods and purchase PG&A via the dealers' website 24 hours a day, 7 days a week. Our website solutions are tailored to each of the vertical markets we serve and tightly integrated with our electronic library of inventory and PG&A content. We also offer a mobile solution that allows dealers' websites to be fully functional on smart mobile phones.

Websites are sold through our inside sales teams, which are aligned by vertical market. The sales process will typically include a live demo of the site and may even include a free trial period (we refer to these as "test drives"). We may charge a nominal, one-time set-up fee to develop a new dealer website. Additional fees will include monthly recurring subscription fees and, under certain circumstances, variable transaction fees. Our website solutions are typically sold under one year, renewable contracts with monthly payment terms. We currently host and maintain more than 7,000 websites for dealers in all of our vertical markets.

eCatalog Platform Solutions

Our eCatalog solutions, which encompass our PartSmart®, PartSmart Web™ and PartStream™ products, leverage our industry-leading library of electronic whole goods and PG&A content to allow distributors and dealers to view and interact with this information to efficiently support the sales and service of equipment. We believe that our eCatalog solution is the fastest and most efficient in the market, as it allows multi-line dealers to quickly access data for any of the brands serviced from within the same software, allowing the dealer's parts and service operations to more quickly identify, locate and sell products and services to their customers. Our eCatalog solutions include:

> *PartSmart®,* our CD-based electronic parts catalog, is used by dealers worldwide in the OPE, powersports, marine, appliance and agricultural equipment industries to increase productivity by significantly reducing parts lookup time. Our PartSmart® software is designed to allow multi-line dealers to look up parts and service information for all manufacturer product lines that the dealer carries, and integrates with more than 90 of the leading dealer business management systems.
>
> *PartSmart Web™,* a SaaS solution, is used by distributors and manufacturers to provide their dealers with access to parts and pricing information via the Internet.
>
> *PartStream™,* a SaaS solution, is a modular, consumer-focused illustrated parts lookup application that integrates with existing dealer and distributor websites and shopping carts and allows consumers to quickly identify the desired part, add the part to their electronic shopping cart and check out. It leverages ARI's parts content, delivering it to PartStream™ users on demand from ARI servers.
>
> *AccessorySmart™,* a SaaS solution, is the only aftermarket PG&A lookup product of its kind, providing access to more than 500,000 SKUs from more than 1,400 powersports aftermarket manufacturers. AccessorySmart provides parts and service counter personnel a one-stop resource to look up products, cost and availability for all of the leading aftermarket PG&A distributors. AccessorySmart significantly decreases the time it takes to look up PG&A information and availability, allowing dealers to service and sell more stuff to customers on a given day. This product is powered by the fitment data we acquired with the assets of Ready2Ride, Inc. in August 2012.

Our eCatalog products are sold through our dedicated internal sales team, and fees charged include a recurring license fee, subscription fees for subscribed catalogs, and in some cases, page view fees.

Lead Management Solution

Our award-winning SaaS solution, Footsteps™, is designed to efficiently manage and nurture generated leads, increasing conversion rates and ultimately revenues for our customers. Footsteps™ connects equipment manufacturers with their dealer channel through lead consolidation and distribution, and allows the dealers to handle leads more efficiently and professionally through marketing automation and business management system integration. The product is used as a complete database of customers and prospects, and manages the dealer-to-customer relationship, from generating email campaigns and automated responses, to providing sales teams with a daily follow-up calendar and reminder notices.

Digital Marketing Solution

Our digital marketing solutions provide lead generation tools through search engine optimization, social media marketing and website enhancements, which serve to drive on-line sales and increase traffic at dealerships. Digital marketing services is a relatively new service offering by ARI and in the third quarter of fiscal 2014, we went to market with a more robust offering in the space as a result of our continued integration of the DUO acquisition.

Other Solutions

We also offer a suite of complementary solutions, which include software and website customization services and hosting services. Through the September 2014 acquisition of TCS, we acquired a fully integrated suite of business management software solutions for the ATW market. These solutions, TirePower for tire retailers, ePower for tire wholesalers and TreadTracks for tire retreaders, are designed to streamline every aspect of a dealer's operations to allow them to provide improved customer service. These products are sold through our dedicated internal sales team, and fees charged include a perpetual one-time license or installation fee, maintenance and other fees.

Our Growth Strategy

ARI's goal is to become the leading provider of SaaS and DaaS solutions that help our customers, in selected vertical markets, efficiently and effectively sell and service more whole goods and PG&A – in other words, to Sell More Stuff!™ Our goal is to grow revenues at a double-digit rate and to grow earnings through scalability. We will provide our solutions to dealers, distributors, manufacturers, service providers, and consumers in vertical markets where the finished goods are complex equipment requiring service and are primarily sold and serviced through an independent dealer channel. We believe this strategy will drive increased value to our shareholders, employees, and customers.

We also believe the execution of the following strategic pillars will enable us to achieve the growth and profitability needed to drive long-term sustainable value for our shareholders. These strategic foundations are primarily centered on enhancing the value proposition to our customers, which will lead to additional revenues through pricing actions, product and feature upsells, and reduced customer churn rates, and expansion by leveraging our core competencies in new markets where appropriate. Each of these strategic pillars is a long-term foundation for growth; within each one we have established near-term goals, as discussed below.

Drive organic growth through innovative new solutions, differentiated content, entering new markets and expanding geographically

As a subscription-based, recurring revenue ("RR") business, the most important drivers of future growth are increasing the level of our RR and reducing the rate of our customer churn. We define RR as revenue from products and services which are subscription-based and renewable, including software access fees, data content fees, maintenance and support fees and hosting fees, and we define churn as the percentage of RR that does not renew. During the three months ended October 31, 2014, our RR increased 5.5% over the same period last year while the percentage of our total revenues that were RR decreased to 89.5% for the three months ended October 31, 2014 from 94.7% for the same period in fiscal 2014, primarily due to TCS having a lower percentage of RR than our historical RR.

- *Develop and deploy innovative new solutions*. We have resources assigned to each of our core products that continue to research and develop new value-added features and functionality for our existing products. The introduction of new solutions, upgrades to existing products, and new feature sets are all designed to grow our average revenue per dealer ("ARPD"), an important measure for a subscription-based business, and the increase in our customer base serves to quickly compound the benefits of an increased ARPD. In fiscal 2014, we released a number of new features, upgrades and products including the following:

  Web Platform

  - We developed an all new vehicle shopping experience, delivering the most advanced unit inventory browsing experience in the market, which includes convenient search and filtering capabilities that rival the leading independent shopping portals.
  - We released the first smartphone and tablet application for iOS and Android in the market that enables dealers to manage all of their unit inventory directly from the app, including adding units, taking photos, managing promotions, and pushing inventory to 3rd party channels such as CycleTrader and Craigslist.
  - We also redesigned our entire tire shopping experience to significantly reduce the number of steps required to submit a quote, which resulted in a 48% increase in leads to our dealers.
  - We released a new auto-quote response feature for tire and wheel products, as well as major units that automatically emails interested consumers with current pricing information upon submitting a quote request.
  - We partnered with a third party vendor to release ARI Inventory, an add-on feature to our website that enables dealers to automatically push inventory listings from their website to third party channels such as Craigslist and eBay Motors, as well as to their social media channels.
  - We developed and released an all new tire shopping experience to pre-release customers, which presents consumers with targeted tire recommendations for their unique vehicle based on various key decision criteria, such as expert recommendations, best warranty, best promotion, lowest price, and more.

  eCatalog

  - We developed a major update to our PartSmart Web platform, delivering a series of market-driven enhancements and innovations, including a streamlined user experience, dynamic diagram thumbnail previews, and fast moving parts tracking and display by unit.
  - We released an expanded DataSmart product offering that provides key product data extract access, in addition to on-demand API access, to offer additional flexibility for implementation with various e-commerce software and SEO customization capabilities.
  - We developed a new Search Engine Optimization plugin for our AccessoryStream product, helping to bolster the search engine ranking of parts, garments, and apparel products on website running on the PHP framework. This release compliments a previous release of the same tool for the .NET framework.
  - We completed a partnership and integration of our Data as a Service offering with Channel Advisor, the leader in multi-channel e-commerce, to help dealers utilize our data to automatically place product sales listings on Amazon and eBay.

  These product enhancements were designed to automate and enhance the marketing, sales and servicing activities for our customers, in order to help them sell and service more parts, garments, accessories and whole goods.

- *Differentiate our content.* We believe we have the largest library of replacement part, major unit, and PG&A content in the vertical markets we serve. During the first quarter of fiscal 2015, we authored 5 new OEM parts catalogs and we added 7 new product catalogs to our library, encompassing more than 40,000 new items. However, simply offering the largest content library in the markets we serve is not sufficient to drive the long-term revenue growth we desire. We strive to deliver more value to our customers through enrichment of our content. Content enrichment can take several forms, including the incorporation of user reviews and feedback into our existing content, further enhancing content provided to us by our OEM customers, and creating new forms of content that further our customers' ability to efficiently service and sell more whole goods and PG&A. During the first quarter of fiscal 2015, our enrichment activities included the addition of over 230,000 new part-to-unit fitments and 115,000 new product attributes. Additionally, we substantially expanded the level of enrichment of our tire product information with the addition of 11 new performance and quality classifications to better aid the shopping experience, such as dry handling, wet handling, snow traction, and braking. We have also continued integrating analytic tools into several of our products, offering value-added feedback to our customers and channel partners to help them "Sell More Stuff!"

- *Enter new markets.* ARI currently maintains a significant share of the OPE and appliances markets. Accordingly, we anticipate low single-digit growth in these markets.

  - As we continue to increase our share in our current markets, leveraging our technology in new and underserved markets will be important to maintaining substantial organic growth rates. Including the acquisition of TCS, ARI currently has more than 3,000 dealer websites in the ATW market. We estimate that the total market approximates 18,000 dealers and further, the broader automotive aftermarket comprises nearly 80,000 dealers, more than all of our other markets combined. We intend to continue to invest heavily in this market, including seeking opportunities to leverage our products and services in the broader automotive aftermarket. We are one of the first website providers to service the HME market. We estimate that this market comprises nearly 25,000 service providers, and believe the market to be in its infancy with respect to eCommerce. We recently invested in dedicated resources designed to expedite our growth in this market.

  - Our acquisition of TCS not only cemented our position as the largest supplier of e-commerce solutions in the ATW market, it also eliminated a direct competitor and included a new business management software product for retailers, wholesalers and retreaders in the ATW market.

- *Expand geographically*. Although we maintain relationships with dealers throughout the world, we have very low penetration into international markets. Growing our international business will require us to secure and publish electronic content from OEMs outside the U.S. and make changes to our existing products that will allow us to rapidly deploy these products in a scalable and efficient manner and without the need to have "boots on the ground" in those countries.

  To this end we have a business development resource solely dedicated to obtaining new international content and to date, we have added 10 new catalog content offerings in the international OPE market and begun to establish relationships with OEMs in China and Europe. Also, we have upgraded our product roadmaps to allow us to rapidly deploy our products in these markets as discussed above.

Nurture and retain existing customers through world-class customer service and value-added product feature updates

In order to achieve sustained double-digit organic growth, we not only need to execute the new growth strategies described above, we must also retain our existing customers. In a SaaS business, the cost to retain an existing customer is much less than the cost to acquire a new customer. Accordingly, customer churn is one of the most important metrics we track and manage. We experienced marked improvements in our churn rates the past several years as a result of strategic actions taken by the Company, all of which are designed to enhance the "stickiness" of our product within our customers' operations. We will continue to leverage our relationships with existing customers and closely monitor and manage the level of customer churn. On a trailing 12 month basis, customer churn was 12.9% for the period ending October 31, 2014. We will continue to leverage our relationships with existing customers and closely monitor and manage the level of customer churn.

Lead the market with open integration to related platforms

One of our strategic advantages is our focus on integrating our solutions with dealer business management systems ("DMS") in order to pass key information, including customer and transactional data, between our solutions and the DMS, saving our customers valuable time and eliminating redundant data entry. We currently have integration capabilities with over 90 DMSs (we refer to these relationships as "Compass Partners") and we continue to seek other strategic alliances that can be integrated with our product and service offerings.

Successfully execute acquisitions that align with our core strategy

Since 1995 we have had a formal corporate development program aimed at identifying, evaluating and closing acquisitions that align with our strategy. Since the program's inception, we have closed twelve acquisitions. A summary of some of our most recent acquisitions is as follows:

Acquisition	Date	Strategy
Tire Company Solutions, LLC	September 2014	▪ Eliminate competition, consolidate position and add new business management software in the ATW market
DUO Web Solutions	November 2013	▪ A leading provider of social media and online marketing services in the powersports industry
50 Below Sales & Marketing, Inc. (Retail Division)	November 2012	▪ A market leader in the powersports industry ▪ Entrance into ATW and DME industries ▪ New award-winning website platform
Ready2Ride, Inc.	August 2012	▪ First of its kind aftermarket fitment data for the powersports industry
Channel Blade Technologies	April 2009	▪ Market-leading entrance into marine and RV markets ▪ New lead management product, Footsteps™
Info Access	July 2008	▪ Market-leading entrance into appliance market
OC-Net, Inc.	January 2007	▪ New website platform

All of these acquisitions, with the exception of TCS and 50 Below, have been fully integrated into our operations.

Summary of Operating Results

Total revenue increased 11.7% or $952,000 in the first quarter of fiscal 2015 over the same period last year. Recurring revenue constituted 89.5% of our total revenue for the three months ended October 31, 2014, compared to 94.7% for the same period last year. Recurring revenue increased 5.5% or $422,000 during the three months ended October 31, 2014, compared to the same period last year. The growth in year over year total revenue was attributable to incremental revenue from the TCS business acquired in September 2014, as well as 5.9% organic growth in revenue from ARI's historical products.

Operating income increased 69.5% or $116,000, from $167,000 for the three months ended October 31, 2013 to $283,000 for the same period this year. Net operating expenses increased 10.1% or $647,000 during the three month period ended October 31, 2014, compared to the same period last year, primarily due to the additional costs of the TCS operation and transaction fees related to the TCS acquisition.

Net income was $104,000 or $0.01 per share for the quarter ended October 31, 2014, compared to $25,000 or $0.00 per share for the same period last year.

Cash provided by operations was $1,634,000 during the three months ended October 31, 2014 compared to cash usage of $26,000 during the same period last year. We experienced an improvement in operating cash flows during the first quarter of fiscal 2015, compared to the same period last year, as a result of revenue growth, operational efficiencies and the workforce reduction made in January 2014.

Revenue

The following table summarizes our RR and non-recurring revenue by product for the three months ended October 31 (in thousands). Revenue categories are presented differently than what was previously reported in our financial statements.

		2014	% of Total		2013	% of Total	% Change
Website	$	4,457	48.9 %	$	4,218	51.7 %	5.7 %
eCatalog		3,476	38.1 %		3,548	43.5 %	(2.0)%
Lead management		285	3.1 %		227	2.8 %	25.6 %
Digital marketing		231	2.5 %		64	0.8 %	260.9 %
Other		663	7.3 %		103	1.3 %	543.7 %
Total Revenue	$	9,112	100.0 %	$	8,160	100.0 %	11.7 %
Recurring revenue		8,151	89.5		7,729	94.7	5.5 %
Non-recurring revenue		961	10.5		431	5.3	123.0 %
Total Revenue	$	9,112	100.0 %	$	8,160	100.0 %	11.7 %

Total revenue increased 11.7% or $952,000 for the three months ended October 31, 2014, compared to the same period last year. Recurring revenue increased 5.5% or $422,000 for the three months ended October 31, 2014, compared to the same period last year. The decline in RR, as a percentage of total revenue for the quarter ended October 31, 2014, was contributed to by the mix in revenue related to the TCS business, which, due to some of its perpetually licensed software, has a lower percentage of RR than our historical business, as well as the mix in revenue related to non-recurring professional services in the quarter.

Website Revenue

Our Website solutions generate revenue from one-time set-up and customization fees to develop new dealer websites, which is recognized ratably over the term of the contract, monthly recurring subscription fees and variable transaction fees. Our website solutions are typically sold as one year, renewable contracts with monthly payment terms. Websites have become ARI's largest source of revenue and accounted for 48.9% of total revenue during the first quarter of fiscal 2015. Website revenue increased 5.7% to $4,457,000 for the three months ended October 31, 2014, compared to $4,218,000 during the same period last year. The growth in Website revenue was largely the result of our acquisition of TCS in September 2014. We anticipate that our web platforms will continue to be the Company's largest source of growth, much of this growth coming in the ATW market which is the primary market serviced by the TCS operation.

eCatalog Revenue

Our eCatalog solutions generate revenue from renewable subscription fees for our software, data content, software maintenance and support fees and software customization fees. eCatalog is our second largest source of RR, representing 38.1% of total revenue during the first quarter of fiscal 2015. eCatalog revenue decreased 2.0% or $72,000 during the three months ended October 31, 2014, compared to the same period last year, due to a decrease in non-recurring professional services revenue. eCatalog revenues have historically had the Company's lowest revenue growth rates, primarily attributable to ARI's already strong market position.

Lead Management Revenue

Lead management revenue is primarily generated from renewable subscription fees and variable transaction fees for the use of our Footsteps™ products. Lead management revenue increased 25.6% to $285,000 during the three months ended October 31, 2014 from $227,000 during the same period last year, as a result of growth in both recurring subscriptions and non-recurring set-up fees. Management is currently reviewing various options with respect to the Footsteps™ product, including the possibility of including the core functionality of the product within our web platforms and expects this product to continue to be instrumental in our goal of helping our customers Sell More Stuff!™

Digital Marketing Revenue

Revenues from our digital marketing solutions are generated from set-up fees and subscription fees for our lead generation tools through search engine optimization, social media marketing and website enhancements. Digital marketing services is a relatively new service offering by ARI and in the third quarter of fiscal 2014 we went to market with a more robust offering in the space. This new offering includes RR offerings derived from of our integration of the DUO business we acquired in November 2013. In addition to this, the recently acquired TCS business provides recurring digital marketing services to its customers. Total digital marketing revenue increased 260.9% to $231,000 during the three months ended October 31, 2014 from $64,000 during the same period last year. We expect digital marketing revenue to continue to increase over the prior year as we continue to grow this business.

Other Revenue

We also offer a suite of complementary solutions, which include software and website customization services and hosting services. Other revenue increased 543.7% to $663,000 during the three months ended October 31, 2014 from $103,000 during the same period last year. The increase in other revenue is primarily due to an increase in our professional services revenue, related to a professional service contract with one of our major manufacturers. In addition to this, other revenue increased due to the sale of business management software and services by the TCS operation.

Recurring Revenue

RR is one of the most important growth drivers of our business. Increasing the percentage of our revenues that are recurring, while at the same time reducing the rate of product churn, enhances our ability to generate profitable growth. Our subscription-based SaaS and DaaS products generate higher margins than our non-recurring products and services, and the incremental cost of selling these products to new dealers (we refer to these as new "logos") is relatively low. Reducing the rate of our product churn, which is the percentage of RR that does not renew, helps drive organic growth as it allows for a greater percentage of our new logos to be incremental to the top line (versus making up for lost logos) and also increases the base upon which we can apply price increases and sell additional products and features.

We generate RR from each of our primary product categories from monthly license, subscription, maintenance and support fees. RR increased 5.5% to $8,151,000 during the first quarter of fiscal 2015 from $7,729,000 during the first quarter of fiscal 2014. The growth in RR was primarily attributable to our Website products. We expect Website RR to continue to be our largest contributor to RR growth in fiscal 2015.

Non-recurring Revenue

Non-recurring revenue is generated from certain offerings within the Company's digital marketing services, including its lead generation tool SearchEngineSmart™, professional services related to software customization and data conversion, usage fees charged on our RR products, perpetual license revenue and other complementary products and services. Total non-recurring revenues were $961,000 for the three months ended October 31, 2014, versus $431,000 for the same period in fiscal 2014, an increase of 123.0%, primarily due to an increase in professional service revenue. As a percentage of total revenues, non-recurring revenues were 10.5% for the first quarter of fiscal 2015, versus 5.3% for the same period in fiscal 2014.

Our goal is to maintain non-recurring revenues of less than 10% of total revenues, as the margins on these revenues tend to be lower than our RR products. Furthermore, these revenues must be resold each year. Revenue from the TCS operation has a lower percentage of RR than our other revenue due to a portion of its revenue being derived from perpetual licenses, however, these offerings carry similar margins to our RR and often are sold with a recurring revenue maintenance fee component.

Cost of Revenue and Gross Margin

We classify as cost of revenue those costs directly attributable to the provision of services. These costs include (i) software amortization, which represents the periodic amortization of costs for internally developed or purchased software sold to customers; (ii) direct labor for the provision of catalog production, product implementations and professional services revenue; and (iii) other direct costs, which represent amounts paid to third party vendors for data royalties, as well as data conversion and replication fees directly attributable to the services we provide our customers.

The table below breaks out cost of revenue into each of these three categories for the three months ended October 31 (in thousands):

	2014	% of Revenue	2013	% of Revenue	% Change
Net revenues	$ 9,112		$ 8,160		11.7 %
Cost of revenues:					
Amortization of capitalized software costs	549	6.0 %	443	5.4 %	23.9 %
Direct labor	476	5.2 %	644	7.9 %	(26.1) %
Other direct costs	724	7.9 %	473	5.8 %	53.1 %
Total cost of revenues	1,749	19.2 %	1,560	19.1 %	12.1 %
Gross profit	$ 7,363	80.8 %	$ 6,600	80.9 %	11.6 %

Gross profit was $7,363,000 or 80.8% of revenue for the three months ended October 31, 2014, compared to $6,600,000 or 80.9% of revenue for the same period last year. Amortization of capitalized software costs have increased as a percentage of revenue for the three months ended October 31, 2014, compared to the same period last year primarily due to the enhancements made to our website software during fiscal 2014. Direct labor costs as a percentage of revenue decreased 26.1% for the three months ended October 31, 2014, compared to the same period last year due to operational efficiencies in our catalog production operation which resulted in a workforce reduction in January 2014. Other direct costs increased as a percentage of revenue during the first quarter of fiscal 2015, compared to the same period last year, due to an increase in royalty expense as we expanded our website catalog offerings, as well as subcontracted labor that was used for a portion of our professional services work in the period. The Company expects fluctuations in gross margin from quarter to quarter and year over year based on the mix of products sold.

Operating Expenses

We categorize net operating expenses as follows:

- Sales and marketing expenses consist primarily of personnel and related costs, including commissions for our sales and marketing employees, and the cost of marketing programs and trade show attendance;
- Customer operations and support expenses are composed of our computer hosting operations, software maintenance agreements for our core network, and personnel and related costs for operations and support employees;
- Software development and technical support expenses are composed primarily of personnel and related costs; we capitalize certain of these costs in accordance with GAAP, which is discussed below, while the remaining costs are primarily related to technical support and research and development;
- General and administrative expenses primarily consist of personnel and related costs for executive, finance, human resources and administrative personnel, legal and other professional fees and other corporate expenses and overhead;
- Depreciation and amortization expenses consist of depreciation on fixed assets, which are composed of leasehold improvements and information technology assets, and the amortization of acquisition-related intangible assets. Costs associated with the amortization of software products are a component of cost of revenue; and
- We allocate certain shared costs among the various net operating expense classifications. Allocated costs include facilities, insurance, and telecommunications. These costs are generally allocated based on headcount, unless circumstances dictate otherwise. All public company costs, including legal and accounting fees, investor relations costs, board fees and directors and officers liability insurance, remain in general and administrative.

The following table summarizes our unaudited operating expenses by expense category for the three months ended October 31 (in thousands):

	2014	% of Revenue	2013	% of Revenue	% Change
Sales and marketing	$ 2,542	27.9 %	$ 2,457	30.1 %	3.5%
Customer operations and support	1,690	18.5 %	1,611	19.7 %	4.9%
Software development and technical support	872	9.6 %	556	6.8 %	56.8%
General and administrative	1,604	17.6 %	1,488	18.2 %	7.8%
Depreciation and amortization (1)	372	4.1 %	321	3.9 %	15.9%
Net operating expenses	$ 7,080	77.7 %	$ 6,433	78.8 %	10.1%

(1) Exclusive of amortization of software products of $549 and $443 for the three months ended October 31, 2014 and 2013, respectively, which are included in cost of revenue.

Net operating expenses increased 10.1% or $647,000 during the three months ended October 31, 2014, compared to the same period last year. The Company acquired the net assets of TCS in September 2014. The increase in net operating expenses was largely due to transaction fees for the TCS acquisition and the TCS operating costs for October 2014. Management expects net operating expenses to decline as a percentage of total revenue, as we integrate the TCS operation and, to the extent the Company can leverage growth in its core RR products, as incremental costs related to these products decrease for every dollar of new revenue.

Sales and Marketing

Sales and marketing expense increased 3.5% or $85,000 during the three months ended October 31, 2014, compared to the same period last year. The increase was primarily a result of the expense associated with the TCS operations for October 2014. Sales and marketing expense as a percentage of revenue decreased from 30.1% of revenue in the first quarter of fiscal 2014 to 27.9% for the same period in fiscal 2015. Management expects sales and marketing expense as a percentage of revenue to fluctuate, based upon the timing of the Company's marketing events and trade show schedule and its decision to add additional sales and marketing resources to drive organic revenue growth.

Customer Operations and Support

Customer operations and support expense increased 4.9% or $79,000 during the three months ended October 31, 2014, compared to the same period last year. The increase was primarily a result of the expense associated with the TCS operations for October 2014. Customer operations and support expense as a percentage of revenue decreased from 19.7% of revenue during the first quarter of fiscal 2014 to 18.5% during the first quarter of fiscal 2015. Management expects customer operations and support expenses to continue to decline as a percentage of total revenues over time, as we realize anticipated cost savings related to the efficiencies implemented in the catalog conversion and customer implementation and support areas, while RR continues to grow.

Software Development and Technical Support

Our software development and technical support staff have three essential responsibilities for which the accounting treatment varies depending upon the work performed: (i) costs associated with internal software development efforts (after technological feasibility is established) are capitalized as software product costs and amortized over the estimated useful lives of the product; (ii) costs for professional services performed for customers related to software customization projects are classified as cost of revenue; and (iii) all other activities, including research and development, are considered operating expenses and included within the software development and technical support operating expense category.

The table below summarizes our internal software development and technical support for the three months ended October 31 (in thousands):

	2014	2013	% Change
Total software development and technical support costs	$ 1,608	$ 1,704	(5.6) %
Less: amount capitalized as software development	(260)	(504)	(48.4) %
Less: direct labor classified as cost of revenues	(476)	(644)	(26.1) %
Net software development and technical support costs classified as operating expenses	$ 872	$ 556	56.8 %

**Does not include outside vendor costs or capitalized interest costs*

Total software development and technical support costs decreased 5.6% or $96,000 during the three months ended October 31, 2014 versus the same period last year. The decrease was primarily a result of the workforce reduction in January 2014, offset in part, by the addition of TCS software development and technical support costs.

During the three months ended October 31, 2014, we capitalized $260,000 of software development labor and overhead, versus $504,000 during the same period last year. In addition to internal capitalized software costs, we had outsourced development costs of $77,000 during the three months ended October 31, 2014 and $63,000 during the same period last year. During the three months ended October 31, 2014, we devoted resources to several enhancements to our website products and a major new upgrade to our web eCatalog product, but have largely completed our work on AccessorySmart and PartStream, products which contributed to the higher capitalization rate in the same period last year.

Direct labor classified as cost of sales declined 26.1% or $168,000 during the three months ended October 31, 2014, versus the same period last year, due to workforce reduction, which was a result of efficiencies implemented in the catalog conversion and customer implementation and support areas.

We expect fluctuations in the percentage of software development and technical support costs classified as operating expenses from period to period, based on the mix of research and prototype work versus capitalized software development and professional services activities.

General and Administrative

General and administrative expense increased 7.8% or $116,000 during the three months ended October 31, 2014, compared to the same period last year. The increase was primarily a result of the TCS operations for October 2014. The Company had legal fees of approximately $200,000 during the first quarter of fiscal 2015 related to the TCS acquisition and during the first quarter of fiscal 2014 related to the DUO acquisition and the Company’s lawsuit against a competitor. General and administrative expense as a percentage of revenue decreased from 18.2% of revenue in the first quarter of fiscal 2014 to 17.6% for the same period in fiscal 2015. Management expects general and administrative expense as a percentage of revenue to decrease over time as we continue to scale the business.

Other Income and Expense

The table below summarizes the components of other income and expenses for the three months ended October 31 (in thousands):

	2014	2013	% Change
Interest expense	$ (89)	$ (70)	27.1%
Loss on change in fair value of stock warrants	—	(22)	(100.0)%
Gain on change in fair value of contingent liabilities	—	26	(100.0)%
Other, net	(1)	8	(112.5)%
Total other income (expense)	$ (90)	$ (58)	55.2%

Interest expense is composed of both interest paid on the Company’s debt financing arrangements and amortization of non-cash interest charges related to deferred finance costs. Interest expense increased 27.1% or $19,000 during the three months ended October 31, 2014, compared to the same period last year. The increase in interest expense is a result of additional debt to partially fund the TCS acquisition.

Acquisitions

On September 30, 2014, we completed the acquisition of TCS, a leading provider of software, websites and marketing services designed exclusively for the automotive tire and wheel vertical. 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 $3,000,000 to the former owners of TCS; and (4) a contingent earn-out purchase price payable in three potential payments and contingent upon the attainment of specific revenue goals. The earn-out does not have an upper range, however, the payout at 100% per the asset purchase agreement is $933,000 and the estimated fair value is $761,000. The purchase price will be adjusted 90 days after the acquisition based on the net asset value on the closing balance sheet being above or below the targeted amount of $350,000.

On November 5, 2013, the Company acquired the assets of DUO Web Solutions, a leading provider of social media and online marketing services for the powersports industry. The transaction was not material to the Company’s financial statements.

On November 28, 2012, the Company, through a wholly-owned subsidiary, completed the acquisition of the assets of the Retail Services Division of Fifty Below Sales & Marketing, Inc., a leading provider of eCommerce websites in the powersports, ATW and HME industries for a purchase price of $5,000,000 and the assumption of contracts having deferred revenue originally valued in the amount of $4,601,000. The Company funded $1,500,000 of the purchase price through a combination of the Company's operating cash flows and availability under its existing credit facilities. The balance of the purchase price was funded through a term note with a significant shareholder.

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 marketed 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 acquisition included $500,000 in cash, 100,000 shares of the Company's common stock and assumed liabilities totaling approximately $419,000 and contingent liabilities with an estimated fair market value of approximately $600,000.

Income Taxes

The Company has net deferred tax assets of $6,093,000 as of October 31, 2014, primarily consisting of net operating loss carryforwards ("NOLs") and book to tax temporary differences. Income tax expense is provided for at the applicable statutory tax rate applied to current U.S. income before taxes, plus or minus any adjustments to the deferred tax assets and to the estimated valuation allowance against deferred tax assets. Income tax expense, if any, does not represent a significant current cash obligation, as we continue to have NOLs to offset substantially all of the taxable income.

We had income tax expense of $89,000 during the three months ended October 31, 2014, compared to $84,000 during the same period last year. We paid income taxes of $20,000 and $66,000 during the three months ended October 31, 2014 and 2013, respectively, primarily related to statutory alternative minimum taxes. Income tax expense may vary from period to period as we continue to evaluate the valuation allowance against net deferred tax assets.

We also have NOLs related to tax losses incurred by our Netherlands operation. We have determined that, consistent with prior periods, it is not likely that the net operating losses will be utilized and therefore, a full valuation allowance is recorded, resulting in $0 net deferred tax assets related to the Netherlands operation at October 31, 2014 and 2013.

Liquidity and Capital Resources

The following table sets forth certain cash flow information derived from our unaudited financial statements for the three months ended October 31 (in thousands):

	2014	2013	Change
Net cash provided by operating activities	$ 1,634	$ (26)	$ 1,660
Net cash used in investing activities	(4,811)	(952)	(3,859)
Net cash provided by (used in) financing activities	2,961	(96)	3,057
Effect of foreign currency exchange rate changes on cash	5	—	5
Net change in cash	$ (211)	$ (1,074)	$ 863
Cash at end of period	$ 1,597	$ 1,121	$ 476

We utilized $211,000 of net cash during the three months ended October 31, 2014, compared to $1,074,000 during the same period last year. We generated net cash provided by operating activities of $1,634,000 during the three months ended October 31, 2014 compared to usage of $26,000 during the same period last year. This increase in cash generation was primarily due to cost reductions related to the integration of the 50 Below operation and the timing of payments of short-term liabilities.

Cash used in investing activities increased $3,859,000 for the three months ended October 31, 2014, compared to the same period last year. We paid cash of $4,200,000 as consideration for the TCS acquisition, paid $249,000 related to the Ready2Ride cash earn-out and holdback, capitalized $341,000 of software development costs, and acquired technology equipment of $21,000, during the three months ended October 31, 2014. We paid net cash of $252,000 related to the Ready2Ride cash earn-out and holdback, capitalized $548,000 of software development costs, acquired technology equipment of $189,000, and received $37,000 from an earn-out receivable during the same period last year. We will continue to invest cash in the business to further our growth strategies previously discussed.

Net cash provided from financing activities was $2,961,000 during the three months ended October 31, 2014, as the Company increased its senior debt, as described below, by $3,000,000 to partially fund the TCS acquisition in September 2014. Net cash used in financing activities was $96,000 in fiscal 2013.

Management believes that current cash balances and its ability to generate cash from operations are sufficient to fund our needs over the next twelve months, although additional financing may be necessary if the Company were to complete a material acquisition or to make a large investment in its business.

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 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 $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 based on the Total Leverage Ratio. The Company had $1,000,000 outstanding on the revolving credit facility and an effective interest rate was 4.25% at October 31, 2014.

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 3.25 to 1.00 through the period ending October 31, 2014 and 3.00 to 1:00 thereafter, and the maintenance of a Fixed Charge Coverage Ratio (as defined in the Agreement) equal to or greater than 1.25 to 1.00. The Agreement also contains customary events of default that, if triggered, could result in an acceleration of the Company’s obligations under the Agreement. The loans are secured by a first priority security interest in substantially all assets of the Company. The Company was in compliance with its debt covenants as of October 31, 2014.

TCS Promissory Notes

In connection with the acquisition of TCS, on September 30, 2014, the Company issued two promissory notes with an aggregate value of $3,000,000 to the former owners of TCS. The notes initially will accrue interest on the outstanding unpaid principal balance at a rate per annum equal to 5%; 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.

Off-Balance Sheet Arrangements

The Company has no off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on its financial condition, revenue or expenses, results of operations, liquidity, capital expenditures or capital resources.