ARI NETWORK SERVICES INC /WI
Form 10-K
October 29, 2010

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

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

For the fiscal year ended July 31, 2010

o TRANSITION REPORT UNDER 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.

(Name of small business issuer 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 office)

Issuer's telephone number (414) 973-4300

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act:
Common Stock, par value $0.001 per share
(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act
Yes o No þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act.
Yes o No þ

Indicate by check mark whether the registrant (1) 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 þ No o

Indicate by checkmark 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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes o No o

Indicate by check if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (S229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.o

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes o No þ

As of January 31, 2010, the aggregate market value of the Common Stock held by non-affiliates (based on the closing price on the NASDAQ OTC bulletin board) was approximately $4.8 million.

As of October 15, 2010, there were 7,785,585 shares of the registrant's shares outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Definitive Proxy Statement, to be filed with the Securities and Exchange Commission no later than 120 days after July 31, 2010, for the 2010 Annual Meeting of Shareholders are incorporated by reference in Part III hereof.

ARI Network Services, Inc.

FORM 10-K
FOR THE FISCAL YEAR ENDED JULY 31, 2010
INDEX

Index

This Annual Report on Form 10-K, including "Management's Discussion and Analysis of Financial Condition and Results of Operations," 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," "endeavor 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 below, under "Item 1A. Risk Factors," 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.

PART I

Item 1. Description of the Business

Overview

ARI Network Services, Inc. ("ARI") provides technology-enabled services that help dealers, distributors and manufacturers worldwide enhance revenue and reduce costs. We deliver our services to companies of all sizes across a dozen vertical markets, with a core emphasis on the outdoor power, power sports, marine, RV, and appliance sectors. Approximately 18,000 equipment dealers, 125 manufacturers, and 150 distributors worldwide leverage our technology to drive revenue, gain efficiencies and increase customer satisfaction. We also develop and offer electronic catalog content for approximately 125 leading equipment manufacturers.

We were incorporated in Wisconsin in 1981, founded on the concept of delivering electronic catalog services to the agriculture industry. In 1996, we evolved our business to focus on delivering electronic parts and service catalogs to a broader range of vertical markets. Since then, we have expanded our service offerings to achieve our mission of being recognized as the leader in creating, marketing and supporting the best solutions that enhance revenue or reduce costs for our customers. Since 2005, we have steadily developed and acquired new technologies to build a core competency around delivering technology-enabled marketing and web-based solutions. Today, we offer a full suite of products, including lead generation and lead management services, website services, and electronic catalogs.

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.

Our business segments are internally organized by geographic location of the operating facilities. We have segregated the Netherlands operation and the United States operations into separate reportable segments. Segment revenue for the Netherlands operation includes only revenue generated out of the Netherlands subsidiary and does not include rest of world revenue sold by the United States operation. We evaluate the performance of and allocate resources to each of the segments based on their operating results.

Our Solution

Our technology-enabled services allow customers in a service or distribution network to: (i) increase revenues by selling products online; (ii) efficiently market to their customers and prospects; (iii) manage and nurture customers and prospects; and (iv) conveniently reference parts, service bulletins and other technical information.

Our combined portfolio of services helps the full equipment distribution and service channel – manufacturers, distributors, and dealers – to realize increased revenue, improved efficiency and greater customer satisfaction. Manufacturers and distributors implement our technology-enabled services and leverage our approximately 18,000 dealer relationships to better communicate with and service their dealer networks. Dealers rely on our technology-enabled services and our extensive network of manufacturer and distributor connections to access parts, service and warranty data, as well as important marketing materials. Dealers also rely on our website, lead management and other technology-enabled services to connect with their current and prospective customers, thereby fostering sales.

Today, we realize revenue from three primary categories of technology-enabled services: (i) electronic catalogs for publishing, viewing and interacting with technical reference information about equipment; (ii) lead management services, designed to help dealers grow their businesses and increase profitability through efficient marketing of their products; and (iii) websites with eCommerce capabilities designed to generate sales through the sites and provide information to consumers in the dealers' local areas.

Index

Electronic Catalogs

Our electronic catalog services enable manufacturers to quickly and easily publish and update parts and technical reference information pertaining to their products. Distributors and dealers can in turn view and interact with this information to support the sales and service of equipment. As of July 31, 2010 our electronic catalog services portfolio encompassed three core services: PartSmart®, PartSmart Web™ and PartStream™. We derived 58.0% of our revenues from subscriptions to, and support for, our electronic catalog services in fiscal 2010.

PartSmart®, our CD-based electronic parts catalog, is used by approximately 18,000 dealers worldwide in the outdoor power, power sports, marine and agriculture industries to increase productivity by reducing parts lookup time by more than 50%. PartSmart® integrates with more than 85 of the leading dealer business management systems. We also provide a version of our PartSmart® product to the appliance industry, known as PartSmart® IPL.

PartSmart Web™ is used by distributors and manufacturers to provide their dealers with access to parts and pricing information via the Internet.

PartStream™ is a modular, consumer-focused illustrated parts lookup application that integrates with existing website platforms 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.

Lead Management Services

Our award-winning lead management services are provided through Footsteps™. Footsteps™ helps dealers follow-up on incoming leads more quickly and professionally. 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. Footsteps™ accounted for approximately 4.5% of our revenues in fiscal 2010.

Website Solutions

Our website solutions include WebSiteSmart Pro®, eXceleratePro™ and eXceleratePro™ 2, and LeadStorm™, which are used by more than 1000 dealers in the outdoor power, power sports, marine and RV industries to connect with customers and increase revenues 24 hours a day, 7 days a week. eXceleratePro™ and eXceleratePro™ 2 provide dealers and manufacturers in the marine and RV industries with a compelling, informative website that is easy to maintain to engage prospects and generate leads and, ultimately, increase dealership traffic, sales and profits. eXceleratePro™ Mobile allows customers' websites to be fully functional on smart mobile phones. LeadStorm™ is used by marine and RV dealers to showcase their inventory 24 hours a day, 7 days a week with customizable website designs. Website services accounted for 24.7% of revenues in fiscal 2010.

Other Services

In addition to electronic catalog, lead management and website services, we also offer a suite of complementary technology-enabled services. These services include: SearchEngineSmart™, which provides dealer and distributor customers the opportunity for paid advertising on all major search engines so that potential consumers will be directed to the dealers' websites; professional services for the customization of software and website solutions; website hosting; and document transfer and communication services to customers in the manufactured equipment and agricultural inputs industries. On a combined basis, these other services accounted for 12.8% of fiscal 2010 revenues.

Our Strategy

Our mission is to be recognized in each market we serve as the leader in creating, marketing and supporting solutions that enhance revenue and reduce costs for our customers. To do this, our technology-enabled services create connections between manufacturers, distributors, dealers and their end-customers. Key elements of our strategy include:

Deepening relationships with our existing customer base to foster organic growth

We believe there is a significant opportunity to leverage our relationships with existing customers. We believe that our catalog services are highly penetrated in the outdoor power, power sports (including motorcycles), marine, and appliances vertical markets, both in terms of dealers and catalog titles. As dealers continue to realize the benefits of our services, and the ease of doing business with us, we believe we can leverage our presence and these relationships to sell additional services, including websites and lead management services, to these customers. We will also continually seek opportunities to develop and deploy new technology-enabled services that enable our customer to be more successful.

Index

Continually enhancing our core services to foster new sales and subscription renewals

To maintain and enhance the current base of business and to continue to cross-sell and renew service subscriptions for our newer lead management, website, and other technology-enabled services, we target a renewal rate of approximately 90% on existing dealer electronic catalog subscriptions. To facilitate this renewal rate, we designed our services to easily accommodate new features and functions. While we historically have maintained high renewal rates, this fiscal year we saw increased turnover in our client base (commonly referred to as “churn”). We believe that this “churn” reflects poor overall economic conditions and specifically: i) attrition in the dealer body (dealers going out of business); and ii) customers electing to delay renewing or deciding to not renew their subscriptions in an effort to minimize their cost structure. While we cannot control the number of customers going out of business, we are focusing on giving customers even greater value for their money by including an even more robust set of functions and features in our products. As an example, this fiscal year we made a decision to subscribe to the methodologies prescribed by agile software development, and have realigned our internal teams accordingly to enable us to follow an iterative, quick (one to four week), product development process. With more frequent, market-driven, service upgrades, we believe that customers will continue to purchase additional subscriptions, renew their existing subscriptions and upgrades to new releases.

Refining our organization and processes to drive innovation and efficiency

It is critical that we achieve economies of scale and continue to refine our organization and processes to support not only efficiency, but innovation. Specific to this area, and in addition to the implementation of agile software development processes, we made significant upgrades to our publishing and implementation capabilities. Entering into fiscal 2011 we implemented a revised corporate incentive compensation structure, which aligns the compensation paid throughout the entire organization to the Company’s strategic and financial objectives.

Sales, Marketing and Customer Support

We organize our sales and marketing programs by product and by geographic regions, including North America and Europe.

Direct Sales

We sell subscriptions to our services primarily through our direct sales force, which is composed of inside sales, consisting of personnel who sell to dealers primarily by phone, and field sales personnel, who focus their efforts on manufacturers and distributors. Our sales teams are supported by marketing personnel who help to identify leads and execute the organization’s marketing strategy.

Marketing

Our marketing strategy is to continue to elevate and communicate our brand and service offerings, and generate demand. We use a variety of marketing programs to target and build relationships with our prospective and current customers and partners. Our primary marketing activities include:

- participation in dealer meetings, trade shows and industry events to create awareness, build our lead database and develop relationships;
- search engine marketing and online and print direct marketing to generate awareness and action;
- ongoing website development to educate prospects and provide product information, testimonials, live demonstrations and marketing collateral;
- email and phone campaigns used to capture leads;

- use of customer testimonials; and
- sales tool kits and field marketing training to enable our sales organization to more effectively develop leads and close transactions.

Customer Service and Support

Customer support is essential to retaining and growing our customer base. We maintain customer support operations in each of the Company's four locations. Our support representatives are available via telephone or email, and respond to general customer inquiries.

International Sales

We sell direct into international markets through our Netherlands-based European operation. We also generate international sales indirectly through sales of our services to North American customers with international operations. We expect international markets to provide increased opportunities for our services in the future. Our strategy is to adapt our success in the U.S. electronic catalog services market to our European-based customers through a combination of direct and indirect business relationships with dealers and manufacturers. We believe this will position us for growth, by leveraging what we do well while being responsive to the local operating requirements within the various European countries.

Index

Competition

The markets for our electronic catalog, lead management and website services are competitive, rapidly evolving, and subject to changing technology, shifting customer needs and frequent introduction of new products and services. While the competitive environment is formidable, we benefit from our focus on core vertical markets and our relationships within and expert knowledge of those markets.

Our principal competitive advantages include:

- our direct relationships with approximately 18,000 dealers, 125 manufacturers and 150 distributors;
- our company stability, offering more than 25 years of servicing the equipment industry;
- our core, established electronic catalog service line, which enables multi-line dealers to easily access catalogs from one single software platform;
- the breadth and depth of our published data;
- the eCommerce capabilities of our technology-enabled services; and
- our relationships with more than 85 dealer business management system providers.

We believe that our competitive advantages will enable us to compete effectively and sustainably in our core markets.

Competition for our products and services varies by product and by vertical market. No single competitor today competes with us on every product and service in each of our industry verticals. In electronic catalogs, we compete primarily with Snap-on Business Solutions (“Snap-on”). Snap-on designs and delivers electronic parts catalogs, accessory sales tools, and manufacturer network development services, primarily to the automotive, power sports, outdoor power, construction, agriculture and mining markets. In addition, there are a variety of smaller companies focused on one or two specific industries.

In lead management, websites and eCommerce, our two most direct competitors are PowerSports Network, owned by Dominion Enterprises, and 50 Below. Competition for our website development services also comes from in-house information technology groups that may prefer to build their own web-based proprietary systems, rather than use our common industry solutions. There are also large, general market eCommerce companies, such as IBM, which offer products and services that could address some of our customers’ needs. These general eCommerce companies do not typically compete with us directly, but they could decide to do so in the future.

Given the current pace of technological change, it is possible that unidentified competitors could emerge, existing competitors could merge and/or obtain additional capital, thereby making them more formidable, or new technologies could come on-stream and potentially threaten our position.

Intellectual Property

We rely on various intellectual property laws in the United States and other jurisdictions as well as confidentiality procedures and contractual provisions to protect our proprietary technology and our brand. We also enter into confidentiality and proprietary rights agreements with our employees, consultants and other third parties and control access to software, documentation and other proprietary information. We have two registered trademarks in the U.S. and elsewhere: PartSmart and WebsiteSmart Pro. We also use numerous unregistered trademarks.

Employees

As of July 31, 2010, we had approximately 147 employees. Of these, 54 are involved in customer operations and support, 41 are in sales and marketing, 28 are engaged in maintaining or developing software and providing software customization services and 24 are involved in general and administration functions. None of these employees is represented by a union.

Fiscal Year

ARI's fiscal year ends on July 31st. Any references throughout this document to fiscal 2010 or fiscal 2009 refer to the fiscal years ended July 31, 2010 and 2009, respectively. Also note that the reference to the word "fiscal" has been removed from all tables throughout this document.

Index

Executive Officers of the Registrant

The table below sets forth the names of ARI's executive officers as of October 15, 2010. The officers serve at the discretion of the Board of Directors.

Name	Age	Capacity Served
Roy W. Olivier	51	President, Chief Executive Officer and Director
Brian E. Dearing	55	Chairman of the Board, Chief Corporate Development and Strategy Officer, Interim Chief Financial Officer, Treasurer and Secretary
Michael T. Tenpas	42	Vice President of Global Sales and Marketing

Roy W. Olivier

Mr. Olivier was appointed President and Chief Executive Officer of the Company in May 2008, after having served in the capacity of Vice President of Global Sales and Marketing of the Company since September 2006. Prior to joining ARI in 2006, Mr. Olivier was a consultant to start-up, small and medium-sized businesses. Until December 2001, he was Vice President, Sales & Marketing for ProQuest Media Solutions, a business he founded in 1993 and sold to ProQuest in 2000. Prior to that, Mr. Olivier held various sales and marketing executive and managerial positions with companies in the telecommunications and computer industries, including Multicom Publishing, Inc., BusinessLand and PacTel.

Brian E. Dearing

Mr. Dearing is the Chairman of the Board, Chief Corporate Development and Strategy Officer, Interim Chief Financial Officer, Treasurer and Corporate Secretary of the Company. He has been a director of ARI since 1995 and was elected Chairman of the Board of Directors in 1997. Mr. Dearing served as the Company's President and Chief Executive Officer from 1995 until May 2008. Prior to joining ARI in 1995, Mr. Dearing held a series of executive positions within the U.S. and Europe in the eCommerce business of Sterling Software, Inc. Prior to joining Sterling in 1990, Mr. Dearing held a number of marketing management positions in the EDI business of General Electric Information Services. Mr. Dearing holds a Masters Degree in Industrial Administration from Krannert School of Management at Purdue University and a Bachelor of Arts degree in Political Science from Union College.

Michael T. Tenpas

Mr. Tenpas joined ARI as Vice President of Global Sales and Marketing in July 2008. For the twelve years prior to joining ARI, Mr. Tenpas worked for Norlight Telecommunications, Inc. in Brookfield, Wisconsin, starting as a senior account executive in 1996, and then serving in a number of other sales roles, culminating in his promotion to Executive Vice President and General Manager of Norlight Data Centers, Inc. Mr. Tenpas earned a Bachelor of

Science degree in Business Management from the University of Phoenix.

Available Information

You can obtain copies of our 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and other filings with the SEC, and all amendments to these filings, free of charge from our website at www.arinet.com as soon as reasonably practical following our filing of any of these reports with the SEC. You can also obtain copies free of charge by contacting us at our office address listed above.

Index

Item 1A. Risk Factors

The risks and uncertainties described below are not the only ones facing us. Other events that we do not currently anticipate or that we currently deem immaterial also may affect our results of operations and financial condition.

Continued unfavorable economic conditions or reduced investments in technology-enabled services spending may harm our business.

Our business depends on the overall demand for technology services spending, and on the economic health and general willingness of our current and prospective customers to make capital commitments. If the conditions in the U.S. and global economic environment remain uncertain or continue to be volatile, or if they deteriorate further, our business, operating results and financial condition may be adversely affected. Our customers sell capital goods, which is highly dependent on the disposable income of end consumers. Continued weak or volatile economic conditions, or a reduction in consumer spending may weaken our customers' demand for electronic catalogs, websites, lead management or other technology-enabled services, or general information technology spending, which would likely harm our business and operating results in a number of ways, including longer sales cycles, potential lower prices for our services, reduced sales, and reduced subscription renewal rates.

We may become liable to our customers and lose customers if we have defects or disruptions in our service or if we provide poor service.

Because we deliver some of our technology as a service, errors or defects in the software applications underlying our service, or a failure of our hosting infrastructure, may make our services, in particular our eCommerce services, unavailable to our customers. Since our customers use our eCommerce services to facilitate their sales, any errors, defects, disruptions in service or other performance problems with our services, whether in connection with the day-to-day operation of our services, upgrades or otherwise, could damage our customers' businesses.

Despite the implementation of security measures, the core of our network infrastructure is vulnerable to unauthorized access, computer viruses, equipment failure and other disruptive problems, including the following:

- we and our users may experience interruptions in service as a result of the accidental or intentional actions of Internet users, current and former employees or others;
- unauthorized access may jeopardize the security of confidential information stored in our computer systems and our customers' computer systems, which may result in liability to our customers and also may deter potential customers;
- we may face liability for transmitting viruses to third parties that damage or impair their access to computer networks, programs, data or information;
- there may be a systemic failure of Internet communications, leading to claims associated with the general unavailability of some of our products; or
- eliminating computer viruses and alleviating other security or technical problems may require interruptions, delays or cessation of service to our customers.

If we have any errors, defects, disruptions in service or other performance problems with our services, customers could elect not to renew, or delay or withhold payment to us, we could lose future sales or customers may make claims against us, which could result in an increase in our provision for doubtful accounts, an increase in collection cycles for accounts receivable or litigation costs.

Our core markets and verticals are competitive, and if we do not compete effectively, our operating results may be harmed.

The markets for electronic catalog, websites, lead management and other technology-enabled services targeted at the equipment industry are competitive, and the eCommerce area, specifically, is rapidly changing with relatively low barriers to entry. With the introduction of new technologies and market entrants, we expect competition to remain intense. In addition, increased competition generally could result in reduced sales, reduced margin or the failure of our services to achieve or maintain more widespread market acceptance. Competition in our market is based principally upon service breadth and functionality; service performance, security and reliability; ability to tailor and customize services for a specific company, vertical market or industry; ease of use of the service; speed and ease of deployment, integration and configuration; total cost of ownership, including price and implementation and support costs; professional services implementation; strength of customer relationships; and financial resources of the vendor. To compete effectively, we also must be able to more frequently update our services to meet market demand.

Our principal competitors include Snap-on Business Solutions, 50 Below and Powersports Network. Some of our actual and potential competitors enjoy competitive advantages over us, such as greater name recognition within our target vertical markets, larger marketing budgets, as well as substantially greater financial, technical and other resources. If we are not able to compete effectively, our operating results will be harmed.

Index

Our operating results may fluctuate from quarter to quarter.

Because we recognize subscription revenue over the term of the applicable agreement, the lack of subscription renewals or new service agreements may not be reflected immediately in our operating results. The majority of our revenue in any given period is attributable to service agreements entered into during previous periods. A decline in new or renewed service agreements in any one period will not be fully reflected in our revenue in that period but will harm our revenue in future periods. As a result, the effect of significant downturns in sales and market acceptance of our services in a particular period may not be fully reflected in our operating results until future periods. Our subscription model also makes it difficult for us to rapidly increase our revenue through additional sales in any period, because revenue from new customers must be recognized over the applicable subscription term.

We expect that a portion of our revenue in the future will be derived from non-recurring fee income, which consists primarily of revenues from professional services such as software customization and training, software sales and one-time network installation fees. The timing of receipt of this revenue is dependent upon several factors that we cannot predict. These factors include:

- the time required to close large license fee and development agreements (these agreements can be delayed due to customer requirements and decision-making processes);
- the seasonality of certain sectors of the equipment industry in which we operate;
- delays in the introduction of new products or services and their acceptance by customers; and
- delays in delivering customized software to our customers.

Our costs are not entirely predictable and may vary from quarter-to-quarter due to acquisitions or non-recurring expenditures. Cash flows may also vary from quarter to quarter, depending on the timing of disbursements and customer payments, which exhibit considerable seasonality. We believe that period-to-period comparisons of our results of operations will not necessarily be meaningful and should not be relied upon as indicative of our future performance.

Changes in financial accounting standards or practices may cause adverse, unexpected financial reporting fluctuations and harm our operating results.

A change in accounting standards or practices could harm our operating results and may even affect our reporting of transactions completed before the change is effective. New accounting pronouncements and varying interpretations of accounting pronouncements have occurred and may occur in the future. Changes to existing rules or the questioning of current practices may harm our operating results or the way we conduct our business and may increase our compliance costs.

Our business could suffer if we are unable to protect our intellectual property rights or are liable for infringing the intellectual property rights of others.

We regard our trademarks, proprietary technology and similar intellectual property as critical to our success, and we rely upon trademark law, trade secret protection, and confidentiality and license agreements with our employees, strategic partners, and others to protect our proprietary rights, which can have only limited effectiveness. The development of the Internet has also increased the ease with which third parties can distribute our intellectual property without our authorization.

We intend to pursue the registration of our material trademarks as necessary. We may not be entitled to the benefits of any such registration for an extended period due to the cost and delay in effecting such registration. In addition, effective protection may not be available in every country in which our products are available. Further, we may be subject to claims in the ordinary course of our business, including claims of alleged infringement of the trademarks, copyrights and other intellectual property rights of third parties by us and our licensees.

Other parties may assert claims of infringement of intellectual property or other proprietary rights against us. These claims, even if without merit, could require us to expend significant financial and managerial resources. Furthermore, if claims like this were successful, we might be required to change our trademarks, alter our content or pay financial damages, any of which could substantially increase our operating expenses. We also may be required to obtain licenses from others to refine, develop, market and deliver new services. We may be unable to obtain any needed license on commercially reasonable terms or at all, and rights granted under any licenses may not be valid and enforceable. In the future we could be subject to legal proceedings and claims from time to time in the ordinary course of our business, including claims of alleged infringement of trademarks and other intellectual property rights of third parties by us and our licensees. Any such claims could have a material adverse effect on our business, financial condition and operating results.

Index

We are dependent on our management and employees.

We are dependent on the services of our executive officers and other key employees. There can be no assurance, however, that we can obtain executives of comparable expertise and commitment in the event of death or voluntary departure of one of our executive offers or other key employees, or that our business would not suffer material adverse effects as the result of the death or voluntary departure. Further, the loss of the services of any one or more of these employees could have an adverse effect on our business. In addition, we will also need to attract and retain other highly skilled technical and managerial personnel for whom competition is intense. If we are unable to do so, our business, results of operations and financial condition could be materially adversely affected.

Our common stock has a very limited trading market.

Our common stock is traded on the over-the-counter Bulletin Board LLC electronic quotation service, an inter-dealer quotation system that provides significantly less liquidity than the NASDAQ stock market or any other national securities exchange. In addition, trading in our common stock has historically been extremely limited. Because of the thinness of the market for our stock, the price of our common stock may be subject to manipulation. This limited trading may adversely affect the liquidity of our common stock, not only in terms of the number of shares that can be bought and sold at a given price, but also through delays in the timing of transactions and reduction in security analysts' and the media's coverage of us. As a result, there could be a larger spread between the bid and the ask prices of our common stock and you may not be able to sell shares of our common stock when or at prices you desire.

Our shareholder rights plan may permit our board to block a takeover attempt and adversely affect the value of our common stock.

Our board of directors adopted a shareholder rights plan and declared a dividend of an associated right, which together are expected to have the effect of deterring any takeover of the Company that is not preceded by board approval of the proposed transaction. The existence of such shareholder rights plan may deter potential tender offers for our common stock or other acquisition offers and may have the effect of delaying or preventing a change of control.

We may not be able to identify, acquire and successfully integrate acquisitions.

A key component of our growth strategy has been and will continue to be acquisitions and other business development opportunities that solidify or accelerate our market position in our core offerings and vertical markets. The successful implementation of this strategy depends upon our ability to identify suitable acquisition candidates, acquire such businesses on acceptable terms, finance the acquisition and integrate their operations successfully into ARI. There can be no assurance that such candidates will be available or, if such candidates are available, that the price will be attractive or that we will be able to identify, acquire, finance or integrate such businesses successfully. In addition, in pursuing such acquisition opportunities, we may compete with other entities with similar growth strategies; these competitors may be larger and have greater financial and other resources than ARI. Competition for these acquisition targets could also result in increased prices of acquisition targets and/or a diminished pool of companies available for acquisition.

The successful integration of these acquisitions also may involve a number of additional risks, including: (i) the inability to retain the clients of the acquired business; (ii) the lingering effects of poor client relations or service performance by the acquired business, which also may taint our existing business; (iii) the inability to retain the desirable management, key personnel and other employees of the acquired business; (iv) the inability to fully realize the desired efficiencies and economies of scale; (v) the inability to establish, implement or police ARI's existing standards, controls, procedures and policies on the acquired business; (vi) diversion of management attention; and (vii) exposure to client, employee and other legal claims for activities of the acquired business prior to acquisition. In addition, any acquired business could perform significantly worse than expected.

The inability to identify, acquire, finance and successfully integrate acquisitions could have a material adverse effect on ARI or its estimated or desired business, income, growth or other condition and results.

Future acquisitions may result in dilution to existing shareholders.

The timing, size and success of acquisition efforts and any associated capital commitments cannot be readily predicted. Future acquisitions may be financed by issuing shares of common stock, cash, or a combination thereof. To the extent our common stock is used for all or a portion of the consideration to be paid for future acquisitions, dilution may be experienced by existing stockholders.

Index

We face risks with our international strategy.

Our business strategy includes increasing our presence in the non-U.S. equipment markets. This strategy presents a number of special risks, including:

- managing more geographically diverse operations;
- dealing with currency fluctuations;
- the increased costs of operation;
- only having a small number of employees in these markets;
- our dependence on value-added resellers and contractors to sell and service our products;
- a much smaller and more concentrated current customer base; and
- the assumption that U.S. international policy will remain favorable towards the countries in which we sell our products and services.

Our historical losses have resulted in our weak balance sheet.

While we have been profitable in recent years, we have experienced net losses in numerous fiscal years since our organization in 1981, resulting in an accumulated deficit of $92.0 million at July 31, 2010. We may not be able to maintain profitability or increase profitability in the future. As a result of our historical losses, our financial position has been weakened, and our ability to finance our growth is constrained.

We will require a significant amount of cash to service our indebtedness. Our ability to generate cash depends on certain factors beyond our control.

Our ability to make principal and interest payments on our indebtedness and to fund planned capital expenditures and product development efforts will depend on our ability to generate cash in the future. Our future operating performance and financial results will be subject, in part, to factors beyond our control, including dealer bankruptcies in the vertical markets we serve, and general economic, financial and business conditions. We cannot assure that our business will generate sufficient cash flow from operations or that future financing facilities will be available to us in an amount sufficient to enable us to pay our indebtedness or to fund our other liquidity needs.

If we are unable to generate sufficient cash flow to service our debt, we may be required to:

- refinance all or a portion of our debt or obtain additional financing, neither of which can be assured;
- sell some of our assets or operations;
- reduce or delay capital expenditures, research and development efforts and acquisitions; or
- revise or delay our strategic plans.

If we are required to take any of these actions, it could have a material adverse effect on our business, financial condition and results of operations. In addition, we cannot assure that we would be able to take any of these actions, that these actions would enable us to continue to satisfy our capital requirements or that these actions would be permitted under the terms of the our various debt instruments.

Index

Item 2. Description of Properties

The table below summarizes ARI's current facilities. Management believes that the Company's current facilities are suitable and sufficient to support present operations.

Description of Use	Location	Square Footage	Lease Expiration	Operating Segment
Corporate headquarters	Milwaukee, WI	16,300	July 2021	North America
Product development and professional services team	Cypress, CA	6,000	August 2011	North America
Marine and RV sales and support	Virginia Beach, VA	9,800	April 2011	North America
Vacant space (1)	Colorado Springs, CO	5,200	March 2011	North America
European sales and support	Leiden, The Netherlands	200 m2	April 2015	Netherlands

(1) All future rents have been fully accrued as of July 31, 2010.

Item 3. Legal Proceedings

None.

Item 4. [Removed and Reserved for Future Use]

Index

PART II

Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

ARI’s common stock is currently quoted on the NASDAQ over the counter bulletin board (“OTCBB”) under the symbol ARIS. The following table sets forth the high and low sales price for the periods indicated. OTCBB quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not necessarily reflect actual transactions.

Fiscal Quarter Ended:	High	Low
10/31/2008	$ 1.42	$ 0.60
1/31/2009	$ 1.18	$ 0.60
4/30/2009	$ 1.01	$ 0.60
7/31/2009	$ 1.16	$ 0.62
10/31/2009	$ 1.07	$ 0.55
1/31/2010	$ 1.10	$ 0.63
4/30/2010	$ 1.00	$ 0.70
7/31/2010	$ 0.84	$ 0.61

As of October 15, 2010, there were approximately 897 holders of record of ARI common stock. We have not paid cash dividends to date and have no current intention to pay cash dividends.

During fiscal 2010, the Company did not repurchase any of its equity securities.

On April 27, 2009, the Company acquired substantially all of the assets of Channel Blade Technologies (“Channel Blade”). Pursuant to the terms of the Asset Purchase Agreement, the Company issued 615,385 shares of common stock as a portion of the consideration paid.

The Company believes that this transaction was exempt from registration requirements pursuant to Section 4(2) of the Securities Act, as amended. The recipient of the shares of our common stock in this transaction represented its intention to acquire the shares for investment purposes only and not with a view towards distribution, and appropriate legends were affixed to the share certificates.

Index

Item 6. Selected Financial Data

The following tables set forth certain financial information with respect to the Company for each of the previous five fiscal years, which includes information derived from ARI's audited financial statements and notes thereto for fiscal 2010 and fiscal 2009. The reports, thereon, of Wipfli LLP are included elsewhere in this report. The selected financial data should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operation" and the aforementioned Financial Statements and Notes. All amounts are in thousands, except per share data.

Statement of Income Data

	2010	2009	2008	2007	2006
Net revenue	$ 21,484	$ 17,560	$ 16,917	$ 15,435	$ 14,002
Gross profit	17,131	14,160	14,046	12,716	12,001
Gross margin	79.7 %	80.6 %	83.0 %	82.4 %	85.7 %
Net operating expenses	16,626	13,051	13,225	12,551	9,932
Operating income	505	1,109	821	165	2,069
Other expense	(630)	(221)	(28)	(60)	(59)
Income (loss) from continuing operations before provision for income taxes	(125)	888	793	105	2,010
Income tax benefit (expense)	1,294	(123)	590	(4)	1,200
Income from continuing operations	1,169	765	1,383	101	3,210
Discontinued operations	(392)	(341)	-	-	-
Net income	$ 777	$ 424	$ 1,383	$ 101	$ 3,210
Earnings per share:					
Income from continuing operations:					
Basic	$ 0.15	$ 0.11	$ 0.21	$ 0.02	$ 0.52
Diluted	$ 0.15	$ 0.11	$ 0.20	$ 0.02	$ 0.49
Net income:					
Basic	$ 0.10	$ 0.06	$ 0.21	$ 0.02	$ 0.52
Diluted	$ 0.10	$ 0.06	$ 0.20	$ 0.02	$ 0.49

Other Financial Data

	2010	2009	2008	2007	2006
Amortization of capitalized software products	$ 1,054	$ 876	$ 764	$ 800	$ 648
Depreciation and amortization	1,640	1,054	727	631	382
Capital expenditures	541	636	119	639	669
Software development costs	1,340	759	524	358	630

Index

Balance Sheet Data

	As of July 31st: 2010	2009	2008	2007	2006
Cash and cash equivalents	$ 938	$ 650	$ 1,086	$ 1,050	$ 3,584
Working capital deficit	(3,692)	(4,246)	(5,475)	(5,221)	(3,357)
Net capitalized software product costs	2,395	2,397	1,596	1,606	1,468
Total assets	19,777	18,607	12,193	9,927	9,436
Current portion of debt and lease obligations	192	226	771	1,031	1,400
Long term debt and lease obligations	5,338	5,115	349	484	580
Total shareholders' equity (deficit)	5,219	4,187	2,896	718	(312)

Cash Flow Data

	2010	2009	2008	2007	2006
Net cash provided by (used for):					
Operating activities	$1,624	$2,745	$2,027	$1,144	$2,375
Investing activities	(1,891)	(2,219)	(1,651)	(2,174)	(1,299)
Financing activities	550	(968)	(353)	(1,491)	(1,143)

Pro Forma Operating Results

The following table compares fiscal 2010's summary results of operations to the fiscal 2009 unaudited pro forma results of operations, which assumes the Channel Blade acquisition occurred at the beginning of fiscal 2009. Refer to Note 5 of the consolidated financial statements for further discussion.

	2010	(Unaudited) Pro Forma 2009
Net revenues	$ 21,484	$ 20,998
Operating income	505	76
Loss from continuing operations before provision for income taxes	(125)	(670)

Index

Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operation

The following discussion of our results of operations and financial condition should be read together with our audited consolidated financial statements for fiscal 2010 and fiscal 2009, including the notes thereto, which appear elsewhere in this Annual Report on Form 10-K. This discussion contains forward-looking statements, which as previously identified are subject to the safe harbors created under the Securities Act and Exchange Act.

Overview

ARI was presented with many challenges during the past year. Through addressing these challenges, management continued to develop a much deeper understanding of the key drivers within our markets as well as our customers’ perceptions of value. Despite these challenges, we continued to grow revenues and remain profitable, and we believe we have implemented the right strategy for continued growth and improved profitability into the future. Throughout this analysis, we will discuss these challenges and their impact on fiscal 2010’s results of operations, what we learned from these challenges, our plans to address each of them, and our future expectations resulting from our strategy.

One of the challenges over the past year was the integration of our April 2009 acquisition of Channel Blade. As we anticipated, a lot of time, energy, and management attention were given to the integration throughout the year, which reduced the amount of time available for other priorities. Although much of the integration efforts are behind us, our efforts related to the integration of the combined technology infrastructure, which includes the move to one common software platform, will continue into fiscal 2011 and will drive additional cost savings going forward.

During the latter half of fiscal 2010 we began to experience an increase in the rate of customer attrition (known throughout the industry as “churn”), which management attributes to several critical factors, both within and outside of our control. During the year we undertook a study to better understand the reasons for the churn and discovered that a significant portion of the churn was driven by dealer and manufacturer closures and bankruptcies, which are the combined result of the current state of the economy and the nature of the vertical markets we serve. Unfortunately, these factors are outside our span of control. We also discovered reasons ancillary to the current economic conditions that have caused our customers to delay or not renew their subscriptions. Management believes that we can control the amount of churn related to these factors by reinforcing our value proposition to our customers and by further increasing that value proposition through the release of product upgrades and new services. Management has made increasing this value proposition a high priority for fiscal 2011. In an effort to better help ARI focus on these issues, we undertook a workforce reduction and business improvement initiative in our fiscal fourth quarter, which will be discussed in further detail below.

ARI produced net income of $777,000 in fiscal 2010, compared to $424,000 in fiscal 2009. The increase in earnings was the result of income tax benefits recognized due to a change in estimate of our deferred tax asset valuation allowance. These tax benefits were offset by losses from ARI F&I Services LLC (“AFIS”), which was sold in July 2010 and has been classified as a discontinued operation, an increase in interest expense, as well as certain restructuring charges incurred in the fiscal fourth quarter. Each of these items will be discussed separately later in this section. We incurred a loss from continuing operations before tax of $125,000 in fiscal 2010, compared to fiscal 2009 income before tax of $888,000. This decline was driven by an increase in interest expense, an increase in depreciation and amortization, as well as the restructuring charges incurred in the fourth quarter.

When compared to fiscal 2009’s pro forma results of operations, which assumes that the acquisition of Channel Blade occurred August 1, 2008, the Company’s operating income increased from $76,000 in fiscal 2009 to $505,000 in fiscal 2010, and income from continuing operations before provision for income taxes improved from a loss of $670,000 in fiscal 2009 to a loss of $125,000 in fiscal 2010. Management attributes this improvement to the progress made integrating the acquisition. Further integration still remains, particularly with respect to the combined technology infrastructure, and management expects further synergies to result from these efforts.

Net operating expenses increased to $16,626,000 in fiscal 2010 from $13,051,000 in fiscal 2009. This increase is due to the addition of Channel Blade's operations, including the amortization of intangible assets recorded as part of the accounting for the purchase, as well as restructuring costs of $437,000 incurred in the fiscal fourth quarter. When compared to fiscal 2009's pro forma results of operations, operating expenses declined by $212,000; excluding restructuring charges incurred in the fourth quarter, this decline would have been more significant. Cost control has been an area of increased focus for management over the past fiscal year in light of the challenges we have faced, including the increased in customer churn.

In July 2010 the Company undertook a workforce reduction and business improvement initiative, which included the divestiture of AFIS, the write off of certain assets related to non-core operations, and a headcount reduction. The Company incurred restructuring charges of $437,000 related to this initiative. The results of operations of AFIS were reclassified as a discontinued operation in the Company's consolidated financial statements. Also in July 2010, we recognized a significant tax benefit resulting from an increase in our estimate of the future realizability of net operating loss carryforwards. Refer to Note 11 of the consolidated financial statement for further discussion.

Index

At July 31, 2010, we had cash balances of $938,000, versus $650,000 at July 31, 2009. This increase in cash was primarily the result of additional borrowing on the Company's line of credit in order to help fund our investments in software development and publishing. Due to the nature of our business, the Company typically maintains a working capital deficit. A large percentage of our subscription based revenues is paid in advance, resulting in the recognition of a deferred revenue liability. The Company anticipates continued sufficient cash flow from operations to execute our plans.

Net Revenues and Gross Margins

The table below summarizes the Company's net revenues, gross profit and gross margin by major product category for fiscal 2010 and fiscal 2009.

	2010	2009	Percent Change
Catalog			
Revenue	$ 12,474	$ 11,953	4.4 %
Cost of revenue	1,621	1,746	-7.2 %
Gross profit	10,853	10,207	6.3 %
Gross margin percentage	87.0 %	85.4 %	
Website			
Revenue	5,305	3,156	68.1 %
Cost of revenue	1,012	704	43.8 %
Gross profit	4,293	2,452	75.1 %
Gross margin percentage	80.9 %	77.7 %	
Lead management			
Revenue	961	64	n/m
Cost of revenue	120	1	n/m
Gross profit	841	63	n/m
Gross margin percentage	87.5 %	98.4 %	
Other			
Revenue	2,744	2,387	15.0 %
Cost of revenue	1,600	949	68.6 %
Gross profit	1,144	1,438	-20.4 %
Gross margin percentage	41.7 %	60.2 %	
Total			
Revenue	21,484	17,560	22.3 %
Cost of revenue	4,353	3,400	28.0 %
Gross profit	$ 17,131	$ 14,160	21.0 %
Gross margin percentage	79.7 %	80.6 %	

Summary

We continued our trend of increasing revenues in fiscal 2010. Revenues for the year were $21,484,000, an increase of 22.3% over fiscal 2009 revenues of $17,560,000. Since 2006, the Company's revenues have grown at a compounded annual growth rate of 11.3%. The increase in fiscal 2010 revenues primarily resulted from two factors: (i) the realization of a full year of revenues from the April 2009 acquisition of Channel Blade; and (ii) revenues from our SearchEngineSmartTM ("SES") product, which was introduced in fiscal 2009.

When compared to fiscal 2009's pro forma results of operations, which for comparability purposes assumes the Channel Blade acquisition occurred at the beginning of fiscal 2009, revenues in fiscal 2010 grew approximately

$486,000, or 2.3%. Of this increase, $338,000 resulted from an increase in revenues recognized from the amortization of a deferred revenue liability recorded at the time of the acquisition. We recognized revenues of approximately $800,000 in fiscal 2010 from the amortization of the liability, versus $462,000 in fiscal 2009. As of July 31, 2010, substantially all of the deferred revenue liability has been amortized. With the exception of the amortization of the deferred revenue liability, pro forma revenues remained essentially flat year over year. It is important to note, however, that year over year organic growth for non-acquired products was 7.8%.

Despite the current economic conditions, we continued to experience strong new sales growth in fiscal 2010. Unfortunately, much of this growth was offset by the aforementioned customer churn. Management anticipates continued strong sales in fiscal 2011 and anticipates these sales will begin to generate recurring revenue growth as we address the issues impacting our customer churn.

Index

Catalog

Catalog revenues are generated from software license fees, license renewal fees, software maintenance and support fees, catalog subscription fees, and professional services related to data conversion. Catalog revenues increased 4.4% in fiscal 2010, resulting from increased sales of our web-based catalog products, a change in our dealer catalog pricing model, and internal efforts to realize and collect subscription revenues on out of compliance software licenses.

Although catalog subscription renewals remain strong, the Company has experienced several significant trends related to our catalog business. First, the availability of free content has been a source of customer attrition, especially in these tough economic times. Although the free content comes with degradation in content quality and lack of value-added features, many of our dealer customers have been forced to cut significant costs out of their operations to combat the reduction in sales the past several years. Another trend is the movement of our OEM customers from bulk content purchases to a “dealer direct” model. Under the dealer direct model, the OEM provides us with its catalog content for publishing. However, rather than paying ARI a lump sum subscription for all of its dealers, the OEM allows ARI to sell the content directly to its dealers. The full impact of this trend has not been ascertained; however, the dealer direct model can also lead to increased revenues, depending upon the number of dealers to which we are able to sell our catalog products.

Management expects catalog subscriptions to remain the most significant source of revenues to the Company and anticipates modest growth in this category in the foreseeable future.

Websites

Website revenues are generated from start-up and recurring subscription fees on our website products, as well as commissions from our customers’ online sales generated via the websites. Website revenues increased 68% in fiscal 2010. This increase was the combined result of the acquisition of Channel Blade in April 2009 as well as organic growth. We recognized twelve months of revenues on former Channel Blade products, or approximately $2,676,000, in fiscal 2010 versus three months, or $1,039,000, last year. Revenues from ARI’s website products increased nearly 25% in fiscal 2010, which was driven by continued strong sales.

Despite the strong sales and year over year revenue growth, we experienced increased customer churn on our website products in fiscal 2010. The reasons for this churn were previously discussed. Management has begun several key initiatives, including the development and launch of major website product upgrades, to counteract the customer attrition experienced over the recent past. Additionally, our sales and marketing group recently launched an internal customer retention initiative. This internal team will work with existing customers to help the customer better understand and take advantage of the value proposition of our products. Management expects website revenues to remain relatively flat in fiscal 2011, due to the loss of revenues associated with the amortization of the deferred revenue liability, which generated approximately $800,000 of revenues in fiscal 2010. However, we do expect continued sales growth from the website products and for these products to be a long-term source of growth for the Company.

Lead Management

Lead management revenues are generated from start-up and subscription fees for the use of the Company’s lead management product, Footstepsä, which was obtained with the acquisition of Channel Blade. Lead management revenues were just under $1,000,000 in fiscal 2010. The fiscal 2010 lead management revenue growth was the result of recognizing a full year’s worth of revenue, versus three months in fiscal 2009, as well as new sales of the product. Management anticipates continued significant growth in lead management revenues, stemming from both increased year over year sales as well as strong customer renewal rates. Footstepsä currently enjoys a dominant position in the marine and RV verticals; however, management believes that the product has applicability in ARI's other key vertical markets as well and hopes to leverage this product in those vertical markets going forward.

Other Revenues

Other revenues are generated from the provision of internet marketing campaigns through our SES product, professional services related to software customization and website hosting fees, as well as other services. The growth in other revenues in fiscal 2010 was driven by the increased sales of the SES product, which was new in fiscal 2009. The growth in SES was partially offset by a significant decline in professional service revenues for custom software and website development. Management anticipates significant continued growth from the SES product, as well as a continued decline in professional services revenue from customization projects as we have been focusing our sales efforts on our subscription-based recurring revenue products.

Index

Cost of Revenues, Gross Profit and Gross Margin

We classify as cost of revenues those costs that are directly attributable to the provision of services to our customers. These costs can be generally classified as follows:

Software amortization, which represents the periodic amortization of costs for internally developed or purchased software sold to our customers;

Direct labor, used in the provision of catalog and marketing professional services; and

Other direct costs, which represent amounts paid to third party vendors directly attributable to the services we provide our customers.

The table below breaks out fiscal 2010 and fiscal 2009 cost of revenues into each of these three expense categories (in thousands):

	2010	%		2009	%	
Net revenues	$ 21,484			$ 17,560		
Cost of revenues:						
Amortization of capitalized software costs	1,054	4.9	%	876	5.0	%
Direct labor	1,395	6.5	%	1,586	9.0	%
Other direct costs	1,904	8.9	%	938	5.3	%
Total cost of revenues	4,353	20.3	%	3,400	19.4	%
Gross profit	$ 17,131	79.7	%	$ 14,160	80.6	%

Overall gross profit was $17,131,000 in fiscal 2010, versus $14,160,000 in fiscal 2009. The gross profit increase was solely the result of the increase in revenues over this same period, as gross margin fell slightly. Overall gross margin was 79.7% in fiscal 2010, which was approximately one percentage point lower than fiscal 2009. This decline resulted from the increase in SES revenues. Gross margin on this product is lower than on ARI’s subscription-based business, due to a higher amount of third party vendor costs incurred relative to ARI’s other products. Excluding SES, overall gross margin in fiscal 2010 was 82.9%, a 1.6 percentage point increase over fiscal 2009. A large portion of this increase was driven by the decline in direct labor costs. The amount of direct labor costs incurred in fiscal 2009 were atypical and resulted from a significant amount of non-billable work performed, which did not reoccur in fiscal 2010.

Operating Expenses

The table below summarizes the Company’s operating expenses by expense category for fiscal 2010 and fiscal 2009 (in thousands).

	2010	% of Revenue		2009	% of Revenue		% Change	
Sales and marketing	$4,786	22.3	%	$3,419	19.5	%	40.0	%
Customer operations and support	3,469	16.1	%	2,785	15.9	%	24.6	%
Software development and technical support (1)	1,415	6.6	%	1,534	8.7	%	-7.8	%

General and administrative	4,879	22.7	%	4,212	24.0	%	15.8	%
Restructuring	437	2.0	%	-	0.0	%	n/a	
Depreciation and amortization (2)	1,640	7.6	%	1,101	6.3	%	49.0	%
Net operating expenses	$16,626	77.4	%	$13,051	74.3	%	27.4	%

(1) Net of capitalized software development costs of $1,328 and $815 in fiscal 2010 and fiscal 2009, respectively.

(2) Exclusive of amortization of software products of $1,054 and $876 in fiscal 2010 and fiscal 2009, respectively, which are included in cost of revenue.

Index

Summary

Overall operating expenses were $16,626,000 in fiscal 2010, an increase of $3,575,000, or 27.4%, over fiscal 2009. This increase, which was experienced in essentially every expense classification, was primarily the result of our acquisition of Channel Blade in April 2009. When compared to fiscal 2009's pro forma results of operations, operating expenses declined $212,000 year over year. Furthermore, excluding the restructuring charges incurred in the fourth quarter of fiscal 2010, the decline was $649,000. Management attributes this decline to several key factors. First, other than integration efforts related to the combined technology infrastructure, the integration of Channel Blade operations is essentially complete, and resulted in significant cost savings in fiscal 2010. The data center consolidation efforts, which have begun in fiscal 2011, will generate additional cost savings beginning in fiscal 2012.

Second, given the relatively flat organic growth in fiscal 2010 as well as the customer renewal trends previously discussed, management focused on tightly controlling operating costs throughout the year. We anticipate operating expenses to remain relatively flat going into fiscal 2011, as we will continue to seek opportunities for savings and efficiencies.

Sales and Marketing Expenses

Sales and marketing expenses consist primarily of personnel and related costs, including sales commissions, for our sales and marketing employees, and also include the cost of marketing programs and trade show attendance. Marketing programs consist of lead generation and direct marketing, advertising, events and meeting costs, public relations, brand building and product management activities. Sales and marketing expenses increased in fiscal 2010, primarily due to sales labor associated with the Channel Blade operations, but the increase also includes costs associated with a fiscal 2010 marketing and branding campaign. Sales and marketing will continue to be one of our largest expenses, as we intend to continue to invest in sales and marketing to pursue new customers and expand relationships with our existing customers. However, management expects sales and marketing costs to remain flat in fiscal 2011, and to gradually decline as a percentage of revenues over time.

Customer Operations and Support

Customer operations and support expenses are composed of server room operations, software maintenance agreements for our core network, and personnel and related costs for our customer support employees. Customer operations and support costs increased in fiscal 2010, due to the costs associated with the Channel Blade operations. Management expects customer operations and support costs to remain relatively flat in fiscal 2011, and to decline as a percentage of revenue in future years as we continue to consolidate our data centers into one centralized facility, while retaining the appropriate backup facilities.

Software Development and Technical Support

Software development and technical support expenses consist primarily of personnel and related costs for the design and development of our software products and for escalated technical support. Our development and technical support staff have three essential responsibilities, the accounting treatment of which varies dependent upon the work performed. Costs associated with internal software development efforts are typically capitalized as software product costs and amortized over the estimated useful life of the product; professional services performed for customers related to software customization projects are classified as cost of revenues; and all other activities are considered operating expenses and included within the software development and technical support expense category. The table below summarizes our software development and technical support costs in fiscal 2010 and fiscal 2009 (in thousands):

	2010	2009
Total software development and technical support costs	$ 4,138	$ 3,935
Less: amount capitalized as software development	(1,328)	(815)
Less: direct labor classified as cost of revenues	(1,395)	(1,586)
Net software development and technical support costs classified as operating expenses	$ 1,415	$ 1,534

We expect fluctuations in the amount of software development and technical support costs classified as operating expenses from period to period, as the mix of development and customization activities will change based on customer requirements, even if total software development and technical support departmental costs remain relatively constant.

Index

Although a large focus in fiscal 2010 was the integration of the Channel Blade acquisition, product enhancement and innovation remains a cornerstone of the Company's strategy. During fiscal 2010 we capitalized $1,328,000 of software development costs, versus $815,000 in fiscal 2009. As discussed earlier, we anticipate several significant product upgrades and enhancements in fiscal 2011, which we expect will generate additional future revenues for the Company. Management anticipates the level of spending on software development and technical support to remain relatively flat in fiscal 2011, and we will continue to strive to increase the amount of these costs spent on future product development.

General and Administrative

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. General and administrative costs increased from $4,212,000 in fiscal 2009 to $4,879,000 in fiscal 2010. The majority of this increase is due to the addition of Channel Blade operations; however, we also incurred consulting costs related to our Sarbanes Oxley related efforts during the year, elected to increase certain insurance coverages, and experienced increased bad debt expense due to the aforementioned bankruptcies, primarily in the marine industry.

As a percentage of revenues, general and administrative costs declined from 24.0% in fiscal 2009 to 22.7% in fiscal 2010. This decline is due to the cost savings achieved from the integration of Channel Blade into ARI's operations as well as a concerted effort by management throughout fiscal 2010 to manage spending tightly. Management expects general and administrative expenses to remain relatively flat in fiscal 2011 and to continue to decrease, as a percentage of revenues, in fiscal 2011 and beyond as the business continues to grow and the Company leverages its reduced cost structure.

Depreciation and Amortization

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 assets are a component of cost of revenues. Depreciation and amortization expense increased nearly 50% in fiscal 2010, which was due to the additional depreciation expense recorded on fixed assets related to the Channel Blade operations, as well as the additional amortization expense from intangible assets recorded at the time of the Channel Blade acquisition.

Restructuring

As discussed previously, in July 2010 the Company undertook a workforce reduction and business improvement initiative, which included the divestiture of AFIS, the write off of certain assets related to non-core operations, and a headcount reduction. The Company incurred restructuring charges of $437,000 related to this initiative. The results of operations of AFIS were reclassified as a discontinued operation in the Company's consolidated financial statements. Details of the fiscal 2010 restructuring expense are below (in thousands):

Severance and related benefits	$147
Net future lease costs	101
Software and equipment dispositions	189
Total restructuring costs	$437

All remaining cash payments related to severance and net future lease costs will be expended in fiscal 2011.

Interest Expense

Interest expense was $649,000 in fiscal 2010, versus $214,000 last year. The increase is primarily the result of the interest incurred on the $5,000,000 note payable related to the acquisition of Channel Blade, but also stems from an increase in the outstanding line of credit balance.

Income Taxes

We have unused net operating loss carryforwards for federal income tax purposes of approximately $17,862,000 expiring through 2020 and as such generally only incur alternative minimum taxes. We performed an assessment of the likelihood that net deferred tax assets will be realized from future taxable income at the end of our fiscal year and, as a result of this assessment, we increased the amount of our deferred tax asset, which was the primary reason we realized a tax benefit in fiscal 2010 of $1,294,000. Refer to Note 11 of the consolidated financial statements for further discussion.

Index

Discontinued Operations

As part of our business improvement initiative at the end of fiscal 2010, AFIS, which offered dealer finance and insurance ("F&I") services, was sold to F&I Smart LLC. The divestiture resulted in a loss from discontinued operations of $1,000. The results of operations of AFIS have been reflected as a discontinued operation in our consolidated financial statements for all periods presented. The results of operations of AFIS were previously reported within the United States business segment. The Company will continue to look for opportunities to divest any operations that management deems as non-essential to the Company's core strategy. The table below summarizes the results of operations of AFIS, by quarter, since the inception of the business in April 2009 (in thousands).

	Quarter Ended:			Quarter Ended:				
	April 30, 2009	July 31, 2009	Fiscal 2009	October 31, 2009	January 31, 2010	April 30, 2010	July 31, 2010	Fiscal 2010
Revenues	$11	$66	$77	$33	$ 21	$26	$56	$136
Cost of sales	-	12	12	3	2	4	4	13
Operating expenses	24	382	406	193	182	151	250	776
Operating loss	(13)	(328)	(341)	(163)	(163)	(129)	(198)	(653)
Loss on sale	-	-	-	-	-	-	(1)	(1)
Income tax benefit	-	-	-	-	-	-	262	262
Net loss	$(13)	$(328)	$(341)	$(163)	$ (163)	$(129)	$63	$(392)

Liquidity and Capital Resources

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

	2010	2009
Net cash provided by operating activities	$ 1,624	$ 2,745
Net cash used in investing activities	(1,891)	(2,219)
Net cash provided by (used in) financing activities	550	(968)
Effect of foreign currency exchange rate changes on cash	5	6
Net change in cash	$ 288	$ (436)
Cash at end of period	$ 938	$ 650

Cash

At July 31, 2010, the Company had a cash balance of $938,000, compared to $650,000 at July 31, 2009. Management believes that current cash balances, as well as the existing availability under the Company's line of credit with JPMorgan Chase, are sufficient to fund the Company's needs over the next twelve months.

Net cash provided by operations declined in fiscal 2010, compared to fiscal 2009, due to several factors. First, AFIS, which has subsequently been sold and classified as a discontinued operation, incurred an operating loss of approximately $653,000 in fiscal 2010. Second, we incurred costs related to the integration of Channel Blade. Although many of these costs were incurred in the first half of fiscal 2010, ongoing costs remain related to the consolidation of technology platforms. Although we expect costs related to the integration of Channel Blade to continue throughout the first half fiscal 2011, management believes these efforts will provide the platform for growth in the Company's core products, and will also provide our customers with a significant improvement in network performance and capacity.

Cash used for investing activities decreased in fiscal 2010, compared to fiscal 2009. In fiscal 2009, ARI completed the acquisition of Channel Blade and AFIS completed the acquisition of PSOG. There were no acquisitions in fiscal 2010. However, we did increase our investment in software development in fiscal 2010. Management expects cash used in investing activities to fluctuate from period to period based on the level of software development activities as well as the timing of acquisitions.

Index

The Company generated cash from financing activities of $550,000 in fiscal 2010, which resulted from additional borrowings on the line of credit as well as from proceeds from the lease financing for improvements made to our corporate office. In fiscal 2009, the Company used $968,000 for financing activities, as the Company paid down debt and a portion of the outstanding balance on the line of credit.

Debt

We issued a $5,000,000 secured promissory note in connection with the April 27, 2009 acquisition of Channel Blade. The annual interest rate on the note was 10% for the first year and 14% thereafter. If we had pre-paid a minimum principal amount of $3,000,000 on or before April 27, 2010, the interest rate would have remained at 10% for the remainder of the note's term. Accrued interest only is due quarterly commencing July 31, 2009 through April 30, 2011. Twenty equal quarterly payments, which will include principal and interest, will then be due, commencing August 1, 2011. Management anticipates that the Company will be able to make all payments due under the current provisions of the note.

We issued $700,000 of notes and $400,000 of future non-interest bearing contingent payments in connection with the January 26, 2007 acquisition of OC-Net, Inc. As of July 31, 2010, all outstanding amounts due on the note and all contingent payments have been made.

On July 9, 2004, ARI entered into a line of credit agreement with JPMorgan Chase, N.A. which, as amended, permits us to borrow an amount equal to 80% of the book value of all eligible accounts receivable plus 45% of the value of all eligible open renewal orders (provided the renewal rate is at least 85%) minus $75,000, up to $2,000,000. Eligible accounts include certain non-foreign accounts receivable which are outstanding for fewer than 90 days from the invoice date.

The note bears interest at 1% per annum above the prime rate (effective rate of 4.25% as of July 31, 2010) plus an additional 3%, at the bank's option, upon the occurrence of any default under the note. The interest rate is subject to a floor equal to the sum of (i) 2.5%; plus (ii) the quotient of: (a) the one month LIBOR rate divided by (b) one minus the maximum aggregate reserve requirement imposed under Regulation D of the Board of Governors of the Federal Reserve System (effective floor of 2.8% as of July 31, 2010). The agreement includes a non-usage fee of 0.25% per annum on any unused portion of the line of credit. The line of credit terminates June 30, 2012 and is secured by substantially all of the Company's assets. The line of credit limits repurchases of common stock, the payment of dividends, liens on assets and new indebtedness. It also contains a financial covenant requiring us to maintain a minimum debt service coverage ratio of 1.2 to 1.0, with which we were in compliance at July 31, 2010. There was $1,025,000 and $500,000 principal outstanding on the line of credit at July 31, 2010 and July 31, 2009, respectively. There was $975,000 remaining and eligible per the terms of the agreement on the line of credit at July 31, 2010.

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

Acquisitions

Since 1995 the Company has had a formal corporate development program aimed at identifying, evaluating and closing acquisitions that augment and strengthen the Company's market position, product offerings, and personnel resources. Since the program's inception, nine business acquisitions and one software asset acquisition have been completed. All of these acquisitions have been fully integrated into the Company's operations, except Channel Blade, our most recent acquisition, whose operations remain subject to a data center consolidation.

On April 27, 2009, the Company acquired substantially all of the assets of Channel Blade, the leading provider of websites, lead management and marketing automation solutions in the marine and RV markets. Consideration for the acquisition included approximately $500,000 in cash, 615,385 shares of the Company’s common stock at a market price of $0.75 per share, $765,000 of assumed liabilities and a $5,000,000 note payable. The Company included the results of operations of Channel Blade for fiscal 2010 and a portion of fiscal 2009, in its consolidated financial statements.

In connection with the acquisition, the Company entered into one year employment agreements with Jon M. Lintvet and Charles Lewis (the “Employment Agreements”) to serve as Director of New Business Development and Director of Strategic Accounts- Marine and RV, respectively. These Employment Agreements have expired and both individuals remain employees of the Company.

On April 17, 2009, AFIS acquired the assets of PSOG, valued at approximately $85,000, in partial satisfaction of its debt to ARI of approximately $185,000, $149,000 of which we purchased from Keybank National Association on April 16, 2009. PSOG, located in Schenectady, NY and then led by Mark L. Taylor, had been offering outsourced F&I services to power sports, marine and RV customers in the Northeast United States since 1998. In connection with the acquisition, AFIS entered into a three year employment agreement with Mr. Taylor to serve as Director of F&I Business Development. Effective March 8, 2010, ARI and Mr. Taylor terminated the employment agreement and entered into an arrangement pursuant to which Mr. Taylor continued to provide any necessary transitional services to the Company for six months following the effective date. This agreement has expired.

Index

On July 27, 2010 ARI sold AFIS to F&I Smart LLC in a membership interest sale agreement (the "Subject Interests"). The sales price of the Subject Interests is a contingent amount based on dealer revenue beginning July 28, 2010 and ending on August 28, 2013. We have not accrued for any future contingent proceeds as we are not able to estimate the amounts at this time. The Company recognized a $1,000 loss on the sale of AFIS in the fourth quarter of fiscal 2010.

Critical Accounting Judgments

The Company's discussion and analysis of its financial condition and results of operations are based upon its financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States ("GAAP"). The preparation of financial statements in conformance with GAAP requires estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. The SEC has defined a company's critical accounting policies as the ones that are most important to the portrayal of a company's financial condition and results of operations, and which require the company to make its most difficult and subjective judgments, often as a result of the need to make estimates of matters that are inherently uncertain. Based on this definition, we have identified as the most critical accounting policies and judgments those addressed below. We also have other key accounting policies, which involve the use of estimates, judgments, and assumptions that are significant to understanding our results. For additional information, refer to Note 1 of the consolidated financial statements, which appear elsewhere within this report on Form 10-K. Although we believe that our estimates, assumptions, and judgments are reasonable, they are based upon information currently available. Actual results may differ significantly from these estimates under different assumptions, judgments, or conditions.

Revenue Recognition

Arrangements that include professional services are evaluated to determine whether those services are essential to the functionality of other elements of the arrangement. Types of services that are considered essential include customizing complex features and functionality in a product's base software code or developing complex interfaces within a customer's environment. When professional services are not considered essential, the revenue allocable to the professional services is recognized as the services are performed. When professional services are considered essential, revenue under the arrangement is recognized pursuant to contract accounting using the percentage-of-completion method with progress-to-completion measured based upon labor hours incurred. When the current estimates of total contract revenue and contract cost indicate a loss, a provision for the entire loss on the contract is made in the period the amount is determined.

Allowance for Doubtful Accounts

The Company maintains an allowance for doubtful accounts for estimated losses resulting from the inability of its customers to make required payments. The Company currently estimates a reserve for most amounts due over 90 days, unless there is reasonable assurance of collectability. If the financial condition of the Company's customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required. In fiscal 2010 and fiscal 2009 the Company increased its allowance for doubtful accounts due to various factors, including general economic conditions.

Impairment of Long-Lived Assets

Equipment and leasehold improvements, capitalized software product costs and other identifiable assets are reviewed for impairment annually, or whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. If the sum of the expected undiscounted cash flows is less than the carrying value of the related asset or group of assets, a loss is recognized for the difference between the fair value and carrying value of the asset or group of assets. During fiscal 2010 and fiscal 2009, the Company disposed of equipment and leasehold improvements with a cost basis of $1,220,000 and $5,309,000, respectively and recorded a loss on disposal of $10,000 and $47,000, respectively.

In fiscal 2010, the Company incurred an impairment charge of $48,000 on capitalized software, with a cost basis of $208,000, which was disposed of, and an additional impairment charge of $141,000 on assets that are still in use. These impairment charges are included in restructuring costs on the statement of operations. The Company did not incur any software impairment charges in fiscal 2009.

Deferred Income Taxes

The tax effect of the temporary differences between the book and tax basis of assets and liabilities and the estimated tax benefit from tax net operating losses is reported as deferred tax assets and liabilities in the balance sheet. An assessment of the likelihood that net deferred tax assets will be realized from future taxable income is performed. Because the ultimate realizability of deferred tax assets is highly subject to the outcome of future events, the amount established as a 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 statement of operations. We recognized a tax benefit of $1,294,000 from continuing operations in fiscal 2010, and a tax provision of $123,000 in fiscal 2009, both of which primarily resulted from a change in our estimated tax valuation allowance.

Index

Stock-Based Compensation

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 U.S. Treasury yields in effect at the time of grant. As stock-based compensation expense recognized in our results of operations is based on awards ultimately expected to vest, the amount has been reduced for estimated forfeitures based on our historical experience. Management reviews the critical assumptions used in the Black-Scholes model each quarter and adjusts those assumptions when necessary.

Goodwill and Other Intangible Assets

We periodically review the carrying value of goodwill to determine whether impairment may exist. As fully described in Note 1 to the Consolidated Financial Statements, we test goodwill for impairment using a two-step process prescribed by GAAP. The first step of the test is used to identify potential impairment by comparing the fair value of a reporting unit with its carrying amount, including goodwill. We determined that there is a single reporting unit for the purpose of goodwill impairment tests. We estimate the fair value of the reporting unit using various valuation techniques, with our primary techniques being a discounted cash flow valuation and control premium adjusted market capitalization. There are many estimates and assumptions involved in preparing a discounted cash flow analysis, including estimating future operating results, selecting a weighted average cost of capital to discount estimated future cash flows, anticipated long-term growth rates, and future profit margins.

Estimating the fair value of a reporting unit is an inherently subjective process. Changes in assumptions, estimates, and other inputs could result in the indication of potential impairment of a portion of the recorded goodwill. Management believes the assumptions, estimates, and other inputs used reflect their best efforts and are appropriate for valuing the reporting unit. Step 1 of the goodwill impairment test indicated that goodwill was not impaired in fiscal 2010 or fiscal 2009. As a result, step 2 of the test was not performed.

Impairment tests are also performed for those intangible assets with estimable useful lives if circumstances warrant a review. Due to the restructuring in the fourth quarter of fiscal 2010, the Company performed an impairment test on intangible assets with definite lives using estimated future cash flows from these assets for the remainder of their useful lives. There were no impairments to intangible assets with estimable useful lives in fiscal 2010 or fiscal 2009.

Quarterly Financial Data

The following table sets forth the unaudited results of operations for each of the eight quarterly periods ended July 31, 2010, prepared on a basis consistent with the audited financial statements, reflecting all normal recurring adjustments that are considered necessary. The quarterly information is as follows (in thousands, except per share data):

Quarterly Financial Data
(Unaudited - In thousands, except per share data)

	1st Quarter		2nd Quarter		3rd Quarter		4th Quarter	
	2010	2009	2010	2009	2010	2009	2010	2009
Net revenues	$5,437	$4,169	$5,334	$3,955	$5,352	$4,155	$5,361	$5,281
Gross margin	4,486	3,440	4,361	3,223	4,233	3,387	4,052	4,110
Income from continuing operations	324	256	339	56	155	239	350	214
	(163)	-	(163)	-	(129)	(13)	63	(328)

Discontinued operations								
Net income (loss)	$162	$256	$176	$56	$26	$226	$413	$(114)
Basic and diluted income from continuing operations per common share:								
Basic	$0.04	$0.04	$0.04	$0.01	$0.02	$0.03	$0.05	$0.03
Diluted	$0.04	$0.04	$0.04	$0.01	$0.02	$0.03	$0.05	$0.03
Basic and diluted net income per common share:								
Basic	$0.02	$0.04	$0.02	$0.01	$0.00	$0.03	$0.05	$(0.02)
Diluted	$0.02	$0.04	$0.02	$0.01	$0.00	$0.03	$0.06	$(0.02)

26

Index

Off-Balance Sheet Arrangements

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

Item 8. Financial Statements and Supplementary Data

Reference is made to the consolidated financial statements, the reports thereon and the notes thereto commencing after the signature page of this Report, which are incorporated herein by reference.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

Item 9A. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures designed to ensure that information required to be disclosed in our reports filed under the Exchange Act, as amended, is recorded, processed, summarized, and reported within the required time periods and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure.

As required by Rule 13a-15 under the Exchange Act, we have completed an evaluation, under the supervision and with the participation of our management, including the Chief Executive Officer and the Chief Financial Officer, of the effectiveness and the design and operation of our disclosure controls and procedures as of July 31, 2010. Based upon this evaluation, our management, including the Chief Executive Officer and the Chief Financial Officer, has concluded that our disclosure controls and procedures were effective as of July 31, 2010.

Management's Annual Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act. Under the supervision and with the participation of our management, including our Chief Executive Officer and the Chief Financial Officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in Internal Control over Financial Reporting – Guidance for Smaller Public Companies issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our evaluation under this framework, our management concluded that our internal control over financial reporting was effective as of July 31, 2010.

This annual report on Form 10-K does not include an attestation report of our independent registered public accounting firm regarding internal control over financial reporting. Internal control over financial reporting was not subject to attestation by our independent registered public accounting firm pursuant to the amendments to Rule 2-02(f) of Regulation S-X that exempts us from this attestation requirement based on our status as a non-accelerated filer. We are required to provide only management's report in this annual report on Form 10-K.

Changes in Internal Controls

There were no changes to the Company's internal control over financial reporting during the year ended July 31, 2010 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Index

Limitations on Effectiveness of Controls and Procedures

Our management, including our Chief Executive Officer and Chief Financial Officer, does not expect that our disclosure controls and procedures or our internal controls will prevent all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include, but are not limited to, the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

PART III

Item 10. Directors, Executive Officers, Promoters and Control Persons; Compliance with Section 16(a) of the Exchange Act

Information required by Item 10 of Part III is included in our Proxy Statement relating to our 2010 Annual Meeting of Shareholders, and is incorporated herein by reference.

Item 11. Executive Compensation

Information required by Item 11 of Part III is included in our Proxy Statement relating to our 2010 Annual Meeting of Shareholders, and is incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Information required by Item 12 of Part III is included in our Proxy Statement relating to our 2010 Annual Meeting of Shareholders, and is incorporated herein by reference.

Item 13. Certain Relationships and Related Transactions

Information required by Item 13 of Part III is included in our Proxy Statement relating to our 2010 Annual Meeting of Shareholders, and is incorporated herein by reference.

Item 14. Principal Accountant Fees and Services

Information required by Item 14 of Part III is included in our Proxy Statement relating to our 2010 Annual Meeting of Shareholders, and is incorporated herein by reference.

Index

PART IV

Item 15. Exhibits

2.1	Stock Purchase Agreement dated January 26, 2007, by and among OC-Net, Inc., the stockholders of OC-Net, Inc. and the Company, incorporated by reference to the Company's Current Report on Form 8-K filed on January 29, 2007.
2.2	Asset Purchase Agreement dated April 27, 2009 by and among the Company, Channel Blade Technologies Corp., Charles Lewis and Michael Sifen, incorporated by reference to Exhibit 2.1 of the Company's Form 8-K filed May 1, 2009.
3.1	Articles of Incorporation of the Company, as amended, incorporated herein by reference to Exhibit 3.1 of the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended April 30, 1999.
3.2	Articles of Amendment of the Company, incorporated herein by reference to Exhibit 3.2 of Form 8-K filed on August 18, 2003.
3.3	By-laws of the Company incorporated herein by reference to Exhibit 3.1 of the Company's Registration Statement on Form S-l (Reg. No. 33-43148).
4.1	Non-Negotiable Secured Subordinated Promissory Note payable to Channel Blade Technologies Corp., incorporated by reference to the Company's Form 8-K filed May 1, 2009.
4.2	The Company agrees to furnish to the Commission upon request copies of any agreements with respect to long term debt not exceeding 10% of the Company's consolidated assets.
10.1*	1991 Stock Option Plan, as amended, incorporated herein by reference to Exhibit 10.2 of the Company's Form 10-Q for the quarter ended January 31, 1999.
10.2*	1993 Director Stock Option Plan, as amended, incorporated herein by reference to Exhibit 10.3 of the Company's Form 10-Q for the quarter ended January 31, 1999.
10.3	Rights Agreement dated as of August 7, 2003, between the Company and American Stock Transfer & Trust Company, as Rights Agent, incorporated herein by reference to Exhibit 10.1 of Form 8-K filed on August 18, 2003.
10.4*	Summary of Executive Bonus Arrangements (Fiscal 2007), incorporated herein by reference to Exhibit 10.8 of the Company's Form 10-KSB for the fiscal year ended July 31, 2006.
10.5 *	Summary of Executive Bonus Arrangements (Fiscal 2010).
10.6	Credit Agreement dated July 9, 2004 between the Company and Bank One, NA, incorporated by reference to exhibit 10.14 of the Company's Form 10-K for the year ended July 31, 2004.

10.7	Amendment to Credit Agreement dated February 15, 2005, between the Company and JPMorgan Chase Bank, NA, successor by merger to Bank One, NA., incorporated herein by reference to Exhibit 10.14 of the Company's Form 10-KSB for the fiscal year ended July 31, 2005.
10.8	Continuing Security Agreement dated July 9, 2004, between the Company and JPMorgan Chase Bank, NA, successor by merger to Bank One, NA., incorporated by reference to Exhibit 10.15 of the Company's Form 10-KSB for the year ended July 31, 2004.
10.9	Line of credit note dated July 9, 2004 by the Company for $500,000, incorporated by reference to exhibit 10.16 of the Company's Form 10-KSB for the year ended July 31, 2005.
10.10	Note Modification Agreement dated February 15, 2005 to the Line of Credit Note dated July 9, 2004 by the Company for $500,000, incorporated herein by reference to Exhibit 10.17 of the Company's Form 10-KSB for the fiscal year ended July 31, 2005.
10.11	Note Modification Agreement dated October 26, 2006, to the Line of Credit Note dated July 9, 2004 by the Company for $1,000,000, incorporated herein by reference to Exhibit 10.1 of the Company's Form 8-K filed on October 31, 2006.
10.12	Note Modification Agreement dated April 25, 2006 to the Line of Credit Note dated July 9, 2004 by the Company for $500,000, incorporated herein by reference to Exhibit 10.16 of the Company's Form 10-KSB for the fiscal year ended July 31, 2006.
10.13	First Amendment to Rights Agreement dated November 10, 2005, between the Company and American Stock Transfer & Trust Company, as Rights Agent, incorporated by reference to Exhibit 10.1 of Form 8-K filed on November 14, 2005.

Index

10.14	Amendment to Credit Agreement dated May 10, 2007, between the Company and JP Morgan Chase Bank, NA, successor by merger to Bank One, NA, incorporated by reference to the Company's Form 10-QSB for the quarter ended April 30, 2007.
10.15	Note Modification Agreement dated May 10, 2007, between the Company and JP Morgan Chase Bank, NA, successor by merger to Bank One, NA, incorporated by reference to the Company's Form 10-QSB for the quarter ended April 30, 2007.
10.16	Note Modification Agreement dated April 25, 2008, between the Company and JP Morgan Chase Bank, NA, successor by merger to Bank One, NA.
10.17	Credit Agreement Amendment dated April 6, 2009, incorporated by reference to Form 10-Q for the quarter ended April 30, 2009.
10.18	Credit Agreement Amendment dated April 8, 2010, between the Company and JP Morgan Chase Bank, NA, incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed on June 18, 2010.
10.19*	Change of Control Agreement dated April 1, 2006 between the Company and Brian E. Dearing, incorporated by reference to Exhibit 10.1 of the Company's Form 10-QSB for the quarter ended October 31,

	2007.
10.20*	Change of Control Agreement dated September 13, 2006 between the Company and Roy W. Olivier, incorporated by reference to Exhibit 10.3 of the Company's Form 10-QSB for the quarter ended October 31, 2007.
10.21*	Change of Control Agreement dated July 31, 2008 between the Company and Robert J. Hipp, incorporated by reference to Exhibit 10.24 of the Company's Form 10-K for the year ended July 31, 2008.
10.22*	Employment Agreement dated March 13, 2008 between the Company and Brian E. Dearing, incorporated by reference to Exhibit 10.1 of the Company's Form 10-QSB for the quarter ended January 31, 2008.
10.23*	Amendment to Employment Agreement between the Company and Brian E. Dearing dated May 5, 2010, incorporated by reference to Exhibit 10.1 of the Company's Form 10-Q for the quarter ended April 30, 2010.
10.24*	Employment Agreement dated May 1, 2008 between the Company and Roy W. Olivier, incorporated by reference to Exhibit 10.1 of the Company's Form 8-K filed on May 2, 2008.
10.25*	2000 Stock Option Plan, as amended, incorporated by reference to Exhibit 10.1 of the

	Company's Form 10-Q for the quarter ended April 30, 2008.			
10.26*	Separation and Consulting Agreement dated June 16, 2009 between the Company and Kenneth S. Folberg, incorporated by reference to Exhibit 10.1 of the Company's Form 8-K filed on June 17, 2009.			
10.27*	Employment Agreement dated February 25, 2009 between the Company and Michael Tenpas, incorporated by reference to Exhibit 10.31 of the Company's Form 10-K for the year ended July 31, 2009.			
10.28*	Change of Control Agreement dated July 31, 2008 between the Company and Michael Tenpas, incorporated by reference to Exhibit 10.31 of the Company's Form 10-K for the year ended July 31, 2009.			
21.1	Subsidiaries of the Company.			
23.1	)			

Weighted average number of shares outstanding:			
Basic	28,838,000	23,257,000	21,887,000
Diluted	28,838,000	23,257,000	21,887,000

See accompanying notes to financial statements

BSD MEDICAL CORPORATION
Statements of Stockholders' Equity
Years Ended August 31, 2011, 2010 and 2009

	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Treasury Stock Shares	Treasury Stock Amount	Other Comprehensive Income (Loss)	Accumulated Deficit	Total
Balance, September 1, 2008	21,388,958	$21,389	$27,565,373	24,331	$(234)	$(2,141,416)	$(5,289,252)	$20,155,860
Common stock issued for:								
Services	32,915	33	105,147	-	-	-	-	105,180
Cashless option exercises	617,428	618	(618)	-	-	-	-	-
Stock-based compensation	-	-	1,117,839	-	-	-	-	1,117,839
Income tax provision from exercise of stock options	-	-	(194,436)	-	-	-	-	(194,436)
Unrealized gain on investments net of income tax	-	-	-	-	-	2,141,416	-	2,141,416
Net loss	-	-	-	-	-	-	(11,384,870)	(11,384,870)
Balance, August 31, 2009	22,039,301	22,040	28,593,305	24,331	(234)	-	(16,674,122)	11,940,989
Common stock issued for:								
Services	93,170	93	149,907	-	-	-	-	150,000
Cash, net of offering costs of $762,528	4,046,208	4,046	6,489,677	-	-	-	-	6,493,723
Stock-based compensation	-	-	990,461	-	-	-	-	990,461
Net loss	-	-	-	-	-	-	(7,456,948)	(7,456,948)
Balance, August 31, 2010	26,178,679	26,179	36,223,350	24,331	(234)	-	(24,131,070)	12,118,225

Common stock issued for:								
Services	36,538	36	150,129	-	-	-	-	150,165
Cash, net of offering costs of $744,844	1,750,000	1,750	9,700,906	-	-	-	-	9,702,656
Exercise of warrants for cash	1,501,134	1,501	2,987,905	-	-	-	-	2,989,406
Exercise of options for cash	213,000	213	331,907	-	-	-	-	332,120
Cashless option exercises	6,803	7	(7)	-	-	-	-	-
Stock-based compensation	-	-	1,064,539	-	-	-	-	1,064,539
Net loss	-	-	-	-	-	-	(5,285,517)	(5,285,517)
Balance, August 31, 2011	29,686,154	$29,686	$50,458,729	24,331	$(234)	$-	$(29,416,587)	$21,071,594

See accompanying notes to financial statements

BSD MEDICAL CORPORATION
Statements of Cash Flows

	Years Ended August 31,		
	2011	2010	2009
Cash flows from operating activities:			
Net loss	$(5,285,517)	$(7,456,948)	$(11,384,870)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	147,501	148,602	134,759
Stock issued for services	150,165	150,000	105,180
Stock-based compensation	1,064,539	990,461	1,117,839
Realized loss on investments	-	-	6,501,586
Decrease (increase) in:			
Receivables	(414,223)	(60,731)	846,589
Income tax receivable	50,000	1,365,758	(200,198)
Inventories	(167,960)	(443,778)	(369,323)
Other current assets	13,902	(40,514)	19,293
Increase (decrease) in:			
Accounts payable	104,854	(29,823)	5,300
Accrued liabilities	108,084	(324,159)	(37,698)
Customer deposits	-	-	(427,677)
Deferred revenue	71,430	21,557	45,406
Net cash used in operating activities	(4,157,225)	(5,679,575)	(3,643,814)
Cash flows from investing activities:			
Purchase of property and equipment	(214,554)	(122,521)	(36,478)
Sales of investments	-	-	10,150,957
Purchases of investments	-	-	(23,935)
Purchase of patents	-	-	(49,444)
Net cash (used in) provided by investing activities	(214,554)	(122,521)	10,041,100
Cash flows from financing activities:			
Net proceeds from the sale of common stock	9,702,656	6,493,723	-
Proceeds from the exercise of warrants	2,989,406	-	-
Proceeds from the exercise of options	332,120	-	-
Net cash provided by financing activities	13,024,182	6,493,723	-
Net increase in cash and cash equivalents	8,652,403	691,627	6,397,286
Cash and cash equivalents, beginning of year	8,483,565	7,791,938	1,394,652
Cash and cash equivalents, end of year	$17,135,968	$8,483,565	$7,791,938

See accompanying notes to financial statements

BSD MEDICAL CORPORATION
Notes to Financial Statements

Note 1: Organization and Significant Accounting Policies

Organization and Business – BSD Medical Corporation (the Company) was incorporated in the State of Delaware on July 3, 1986. We develop, manufacture, market, and service systems to treat cancer and benign diseases using heat therapy delivered using focused microwave and radiofrequency (RF) energy. Our product lines include both hyperthermia and ablation treatment systems. Our hyperthermia cancer treatment systems, which have been in use for several years in the United States, Europe and Asia, are used to treat certain tumors with heat (hyperthermia) while increasing the effectiveness of other therapies such as radiation therapy. Our microwave ablation system has been developed as a stand-alone therapy to ablate and destroy soft tissue. We have developed extensive intellectual property, multiple products in the market and well established distribution in the United States, Europe and Asia. Certain of our products have received regulatory approvals in the United States, Europe and China.

Cash and Cash Equivalents – Cash and cash equivalents consist of cash and investments with original maturities to the Company of three months or less.

Investments – Investments with scheduled maturities greater than three months, but not greater than one year, are recorded as short-term investments. As of August 31, 2011 and 2010, we had no investments. Investments are carried at fair value based on quoted market prices, with net unrealized gains and losses reported as other comprehensive income (loss) in stockholders' equity in our balance sheets. Realized gains and losses are included in our statements of comprehensive loss.

Accounts Receivable – Trade accounts receivable are carried at original invoice amount less an estimate made for doubtful receivables based on a review of all outstanding amounts on a monthly basis. Management estimates an allowance for doubtful accounts by identifying troubled accounts and by using historical experience applied to an aging of accounts. Trade accounts receivable are written off when deemed uncollectible. Recoveries of trade receivables previously written off are recorded when received. Interest is not charged on trade receivables that are outstanding beyond their due date.

Inventories – Parts and supplies inventories are stated at the lower of cost or market. Cost is determined using the average cost method. Work-in-process and finished goods are stated at the lower of the accumulated manufacturing costs or market. We maintain a reserve for obsolete inventories to reduce excess and obsolete inventories to their estimated net realizable value. The reserve was $100,000 at August 31, 2011 and 2010.

Property and Equipment – Property and equipment are stated at cost less accumulated depreciation. Depreciation is determined using the straight-line method over the following estimated useful lives of the assets.

Equipment	2 – 5 years
Rental equipment	5 years
Furniture and fixtures	5 years
Building improvements	15 years
Building	40 years

Expenditures for maintenance and repairs are expensed when incurred and betterments are capitalized. Gains and losses on sales of property and equipment are reflected in operations.

The cost and accumulated depreciation of property and equipment sold or otherwise retired are removed from the accounts and any related gain or loss on disposition is reflected in net income or loss for the period.

Patents – Patents are carried at cost and are being amortized over their remaining legal life, up to a period of 17 years.

Warranty Reserve – We provide limited warranties to our customers for products sold. Estimated future warranty obligations are accrued each period. As of August 31, 2011 and 2010, the accrued warranty reserve was $28,867 and $21,183, respectively. During the fiscal years ended August 31, 2011, 2010, and 2009, total warranty expense was $34,303, $28,509 and $58,002, respectively.

Income Taxes – We account for income taxes using the asset and liability method. Under the asset and liability method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

Income (Loss) Per Common Share – The computation of basic income (loss) per common share is based on the weighted average number of shares outstanding during each year.

The computation of diluted earnings per common share is based on the weighted average number of shares outstanding during the year, plus the common stock equivalents that would arise from the exercise of stock options and warrants outstanding, using the treasury stock method and the average market price per share during the year. Common stock equivalents are not included in the diluted loss per share calculation when their effect is anti-dilutive. Options and warrants to purchase 5,260,762, 5,236,043 and 2,379,087 shares of common stock at prices ranging from $1.20 to $7.95, $0.56 to $7.95, and $0.56 to $7.95 per share were outstanding at August 31, 2011, 2010 and 2009, respectively.

The shares used in the computation of the basic and diluted earnings per share are reconciled as follows:

	Years Ended August 31,		
	2011	2010	2009
Weighted average number of shares outstanding – basic	28,838,000	23,257,000	21,887,000
Dilutive effect of stock options and warrants	-	-	-
Weighted average number of shares outstanding, assuming dilution	28,838,000	23,257,000	21,887,000

Stock-Based Compensation - Stock-based compensation is measured at the grant date based on the value of the award granted using the Black-Scholes option pricing model, and recognized over the period in which the award vests. For stock awards no longer expected to vest, any previously recognized stock compensation expense is reversed in the period of termination. The stock-based compensation expense is allocated to the various categories of operating costs and expenses in a manner similar to the allocation of payroll expense.

Revenue Recognition – We recognize revenue from the sale of medical systems, the sale of parts and accessories related to the systems, equipment rental, providing training, and service support contracts. Total product sales, including related party product sales, were $2,581,275, $1,261,490 and $3,293,116 for the years ended August 31, 2011, 2010 and 2009, respectively. Equipment rental income was $110,207 for the year ended August 31,

2011. Total service and other revenues, including related party service and other revenues, were $345,993, $320,786 and $243,371 for the years ended August 31, 2011, 2010 and 2009, respectively.

Revenue from the sale of cancer treatment systems is recognized when a purchase order has been received, the system has been shipped, the selling price is fixed or determinable, and collection is reasonably assured. Most system sales are F.O.B. shipping point; therefore, shipment is deemed to have occurred when the product is delivered to the transportation carrier. Most system sales do not include installation. If installation is included as part of the contract, revenue is not recognized until installation has occurred, or until any remaining installation obligation is deemed to be perfunctory. Some sales of systems may include training as part of the sale. In such cases, the portion of the revenue related to the training, calculated based on the amount charged for training on a stand-alone basis, is deferred and recognized when the training has been provided. The sales of our cancer treatment systems do not require specific customer acceptance provisions and do not include the right of return except in cases where the product does not function as warranted by us. To date, returns have not been significant.

Revenue from the sale of consumable devices is recognized when a purchase order has been received, the devices have been shipped, the selling price is fixed or determinable, and collection is reasonably assured. Currently, our customers are not required to purchase a minimum number of disposable devices in connection with the purchase of our systems.

Revenue from training services is recorded when an agreement with the customer exists for such training, the training services have been provided, and collection is reasonably assured.

Revenue from service support contracts is recognized on a straight-line basis over the term of the contract, which approximates recognizing it as it is earned.

Revenue from equipment rental under an operating lease is recognized when billed in accordance with the lease agreement.

Our revenue recognition policy is the same for sales to both related parties and non-related parties. We provide the same products and services under the same terms for non-related parties as with related parties.

Sales to distributors are recognized in the same manner as sales to end-user customers.

Deferred revenue and customer deposits payable include amounts from service contracts as well as cash received for the sales of products, which have not been shipped.

Concentration of Credit Risk – Financial instruments that potentially subject us to concentration of credit risk consists primarily of trade receivables. In the normal course of business, we provide credit terms to our customers. Accordingly, we perform ongoing credit evaluations of our customers and maintain allowances for possible losses.

We have cash in the bank and short-term investments that exceed federally insured limits. We have not experienced any losses in such accounts.

Advertising and Promotion – Advertising and promotion costs, which are principally included in sales expenses, are expensed as incurred. Advertising and promotion expense was $275,393, $61,294 and $86,287 for the years ended August 31, 2011, 2010 and 2009, respectively.

Use of Estimates in the Preparation of Financial Statements – The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Comprehensive Income (Loss) – Comprehensive income (loss) consists of net income (loss) and the net change in other comprehensive income (loss) resulting from net unrealized gains and losses on our investments, and is reported in the accompanying statements of comprehensive loss.

Reclassifications – Certain amounts in the prior years have been reclassified to conform with the current year presentation.

Note 2: Detail of Certain Balance Sheet Accounts

Details of certain balance sheet accounts are as follows:

	August 31, 2011	2010
Accounts receivable:		
Trade receivables – non-related party	$ 416,495	$ 313,419
Other receivables	769	13,683
Accrued interest receivable	-	428
Allowance for doubtful accounts	(20,000)	(20,000)
	$ 397,264	$ 307,530
Inventories:		
Parts and supplies	$ 1,248,534	$ 1,164,697
Work-in-process	1,110,362	1,130,320
Finished goods	147,318	43,237
Reserve for obsolete inventories	(100,000)	(100,000)
	$ 2,406,214	$ 2,238,254
Accrued liabilities:		
Warranty reserve	$ 28,867	$ 21,183
Training and installation reserve	9,341	4,907
Accrued taxes payable	34,685	22,282
Payroll and other	259,111	175,548
	$ 332,004	$ 223,920

Note 3: Property and Equipment

Property and equipment consists of the following:

	August 31, 2011	August 31, 2010
Equipment	$ 1,314,814	$ 1,181,985
Rental equipment	58,940	-
Furniture and fixtures	298,576	298,576
Building improvements	47,005	24,220
Building	956,000	956,000
Land	244,000	244,000
	2,919,335	2,704,781
Less accumulated depreciation	(1,473,438)	(1,352,050)
	$ 1,445,897	$ 1,352,731

Depreciation expense for the years ended August 31, 2011, 2010 and 2009 totaled $121,388, $122,174 and $125,618, respectively.

Note 4: Patents

We have certain patents recorded net of accumulated amortization. The patents are being amortized on a straight-line basis over their remaining legal life, up to a period of 17 years. Amortization expense was $26,113, $26,428 and $9,141 for the years ended August 31, 2011, 2010, and 2009, respectively. Amortization expense relating to the patents for the next five years is expected to be as follows:

Year ending August 31,	
2012	$ 21,060
2013	993
2014	588
2015	588
2016	588
	$ 23,817

Note 5: Stockholders' Equity

The Company has 10,000,000 authorized shares of $.001 par value preferred stock. As of August 31, 2011 and 2010, there were no shares of preferred stock outstanding.

In February 2011, the stockholders of the Company approved an amendment to the Company's Amended and Restated Certificate of Incorporation to increase the number of shares of authorized $.001 par value common stock from 40,000,000 to 80,000,000.

Stock Offerings

On October 1, 2009, our universal shelf registration statement was declared effective by the SEC for the issuance of common stock, preferred stock, warrants, senior debt, subordinated debt and units up to an aggregate amount of $50.0 million. We may periodically offer one or more of these securities in amounts, prices and on terms to be announced when and if the securities are offered. At the time any of the securities covered by the registration statement are offered for sale, a prospectus supplement will be prepared and filed with the SEC containing specific information about the terms of any such offering. We have previously completed four offerings utilizing our universal shelf registration statement. Each of these offerings was completed during calendar year 2010.

On each of February 11, 2010, May 3, 2010, August 19, 2010, and November 15, 2010, we entered into a placement agency agreement (collectively, the “Agency Agreements”) with Roth Capital Partners, LLC (the “Placement Agent”), pursuant to which the Placement Agent agreed to use its reasonable efforts to arrange for the sale of shares of our common stock and warrants in registered direct public offerings. These offerings are referred to herein as the “February Offering,” “May Offering,” August Offering” and “November Offering” (each, an “Offering” and collectively the “2010 Offerings”). In connection with each of the Offerings, we and certain institutional investors also entered into securities purchase agreements (collectively, the “Purchase Agreements”) pursuant to which we agreed to sell shares of our common stock and warrants to purchase additional shares of our common stock to the investors. The common stock and warrants were sold in fixed combinations, with each combination consisting of one share of common stock and a warrant to purchase 0.75 shares of common stock (0.50 shares in the case of the November Offering). The warrants became exercisable six months and one day following the closing date of the Offering and will remain exercisable for five years thereafter. The exercise price of the warrants is subject to adjustment in the case of stock splits, stock dividends, combinations of shares and similar recapitalization transactions.

The number of shares of our common stock and number of shares of our common stock issuable upon exercise of the warrants as well as the purchase price per fixed combination and the exercise price associated with each warrant which were sold the 2010 Offerings are shown below:

2010 Offerings	Shares of Common Stock	Warrants – Shares of Common Stock Issuable upon Exercise of the Warrants	Purchase Price per Fixed Combination	Warrant Exercise Price (Per Share)
February Offering	1,176,471	882,354	$ 1.70	$ 2.04
May Offering	1,644,737	1,233,553	$ 1.52	$ 1.94
August Offering	1,225,000	918,750	$ 2.25	$ 3.27
November Offering	1,750,000	875,000	$ 5.97	$ 7.73

The Placement Agent was entitled to a cash fee of 6.5% of the gross proceeds paid to us for the securities we would sell in each of the Offerings. We would also reimburse the Placement Agent for all reasonable and documented out-of-pocket expenses that would be incurred by the Placement Agent in connection with each of the Offerings, which could not exceed in the case of each of the Offerings the lesser of (i) $75,000 ($30,000 in the case of November Offering and in the case of the February Offering, $75,000 less a $25,000 cash advance for expenses), or (ii) 8% of the gross proceeds of the Offering, less the Placement Agent’s placement fee (and in the case of the February Offering, also less the $25,000 cash advance for expenses). Each of the Agency Agreements contains customary representations, warranties and covenants by us. They also provide for customary indemnification by us and the Placement Agent for losses or damages arising out of or in connection with the sale of the securities being offered. We also agreed to indemnify the Placement Agent against liabilities under the Securities Act of 1933, as amended. We also agreed to contribute to payments the Placement Agent may be required to make in respect of such liabilities.

The exercisability of the warrants sold in the 2010 Offerings may be limited if, upon exercise, the holder or any of its affiliates would beneficially own more than 4.9% of our common stock.

We agreed with each of the purchasers that while the warrants are outstanding, we will not affect or enter into an agreement to affect a “Variable Rate Transaction,” which means a transaction in which we:

- issue or sell any convertible securities either (A) at a conversion, exercise or exchange rate or other price that is based upon and/or varies with the trading prices of, or quotations for, the shares of our common stock at any time after the initial issuance of such convertible securities, or (B) with a conversion, exercise or exchange price that is subject to being reset at some future date after the initial issuance of such convertible securities or upon the occurrence of specified or contingent events directly or indirectly related to our business or the market for our common stock, other than pursuant to a customary "weighted average" anti-dilution provision; or

- enter into any agreement (including, without limitation, an equity line of credit) whereby we may sell securities at a future determined price (other than standard and customary "preemptive" or "participation" rights).

We agreed with each of the purchasers if we issue securities within the 12 months following the closing of an Offering, the purchasers shall have the right to purchase all of the securities on the same terms, conditions and price provided for in the proposed issuance of securities.

We also agreed to indemnify each of the purchasers against certain losses resulting from our breach of any of our representations, warranties, or covenants under agreements with each of the purchasers, as well as under certain other circumstances described in the Purchase Agreements.

We closed the February Offering on February 17, 2010. The aggregate gross proceeds to us from the February Offering, before deducting fees to the Placement Agent and other offering expenses payable by us, were approximately $2 million. The net proceeds to us from the February Offering, after deducting placement agent fees and the offering expenses borne by us, were approximately $1.7 million.

We closed the May Offering on May 6, 2010. The aggregate gross proceeds to us from the May Offering, before deducting fees to the Placement Agent and other offering expenses payable by us, were approximately $2.5 million. The net proceeds to us from the May Offering, after deducting placement agent fees and the offering expenses borne by us, were approximately $2.3 million.

We closed the August Offering on August 24, 2010. The aggregate gross proceeds to us from the August Offering, before deducting fees to the Placement Agent and other offering expenses payable by us, were approximately $2.75 million. The net proceeds to us from the August Offering, after deducting placement agent fees and the offering expenses borne by us, were approximately $2.5 million.

We closed the November Offering on November 18, 2010. The aggregate gross proceeds to us from the November Offering, before deducting fees to the Placement Agent and other offering expenses payable by us, were approximately $10.45 million. The net proceeds to us from the November Offering, after deducting placement agent fees and the offering expenses borne by us, were approximately $9.7 million.

Warrant Exercises

During our fiscal year ended August 31, 2011, investors exercised warrants to purchase a total of 1,501,134 common shares, with net proceeds to the Company of approximately $3.0 million. As of November 14, 2011, we have issued 772,060 shares of our common stock as a result of the exercise of warrants issued in the February Offering, and 729,074 shares of our common stock as a result of the exercise of warrants issued in the May Offering.

A summary of the outstanding warrants issued in the stock offerings as of August 31, 2011 and changes during the year then ended is as follows:

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contract Term (Years)
Outstanding at August 31, 2010	3,034,657	$ 2.37	
Granted	875,000	7.73	
Exercised	(1,501,134)	1.99	
Forfeited or expired	-	-	
Outstanding and exercisable at August 31, 2011 (all exercisable)	2,408,523	$ 4.56	4.48

Note 6: Deferred Revenue

We have entered into certain service contracts for which we have received payment in advance. We are recognizing these service revenues over the life of the service agreements.

As of August 31, 2011 and 2010, we had deferred revenue of $234,372 and $162,942, respectively.

Note 7: Major Customers and Foreign Sales

We had the following customer revenue concentrations:

	Years Ended August 31, 2011	2010	2009
Customer A	35.01 %	19.55 %	17.05 %
Customer B	*	22.75 %	16.40 %
Customer C	*	*	13.73 %
Customer D	*	*	10.18 %
Customer E	*	19.15 %	*
Customer F	*	15.86 %	*
Customer G	*	12.04 %	*
Customer H	10.01 %	*	*

Customer I	10.01 %	*	*

*Sales to customers were less than 10%.

Export sales were $1,135,372, $678,893 and $1,668,547 in fiscal years 2011, 2010 and 2009, respectively.

During fiscal year 2011, export sales to Germany were approximately 35% of total sales. During fiscal year 2010, export sales to China and Germany were approximately 23% and 12% of total sales, respectively. During fiscal year 2009, export sales to China, Switzerland and Poland were approximately 16%, 13% and 14% of total sales, respectively.

Note 8: Related Party Transactions

During the years ended August 31, 2011, 2010, and 2009, we had sales of $1,063,495, $309,259 and $603,000, respectively, to entities controlled by a significant stockholder and member of the Board of Directors. These related party transactions represent 35%, 20% and 17% of total sales for each respective year.

At August 31, 2011 and 2010, receivables include $408,323 and $83,834, respectively, from these related parties.

Note 9: Income Taxes

The components of the income tax (provision) benefit are as follows:

	Years Ended August 31, 2011	2010	2009
Current:			
Federal	$ -	$ -	$ 1,346,000
State	(800)	6,571	33,000
	(800)	6,571	1,379,000
Deferred:			
Federal	-	-	(229,000)
	$ (800)	$ 6,571	$ 1,150,000

The income tax (provision) benefit differs from the amount computed at federal statutory rates as follows:

	Years Ended August 31, 2011	2010	2009
Income tax benefit at federal statutory rate	$ 1,797,000	$ 2,538,000	$ 4,262,000
Stock-based compensation	(249,000)	(205,000)	(252,000)
State income taxes, net of federal benefit	174,000	246,000	447,000
Research and development credit	102,000	209,000	309,000
Valuation allowance	(1,688,000)	(3,127,000)	(3,809,000)
Other	(136,800)	345,571	193,000

$	(800	)	$	6,571	$	1,150,000

Deferred tax assets (liabilities) are comprised of the following:

	August 31, 2011		2010
Current Asset:			
Accruals and reserves	$ 21,000		$ 54,000
Deferred revenue	87,000		60,000
Inventories	85,000		90,000
Research and development and other tax credits	1,651,000		1,676,000
Net operating loss carryforwards	5,903,000		5,165,000
Valuation allowance	(7,747,000)		(7,045,000)
	$ -		$ -
Long-Term Asset:			
Deferred compensation	$ 505,000		$ 426,000
Long-Term Liability:			
Depreciation and amortization	(9,000)		(16,000)
Valuation allowance	(496,000)		(410,000)
	$ -		$ -

The ultimate realization of the deferred tax assets is dependent, in part, upon the tax laws in effect, our future earnings, and other events. As of August 31, 2011, we recorded a valuation allowance of $7,747,000 against current deferred tax assets and a valuation allowance of $496,000 against net long-term deferred tax assets. The increase in the valuation allowance for the year ended August 31, 2011 relates primarily to our operating losses. In recording the valuation allowance, we were unable to conclude that it is more likely than not that our deferred tax assets will be realized.

At August 31, 2011, we had a net operating loss carryforward available to offset future taxable income of approximately $15,000,000, which will begin to expire in 2029. If substantial changes in the Company's ownership should occur, there would be an annual limitation of the amount of the net operating loss carryforward which could be utilized.

We perform a review of our material tax positions in accordance with recognition and measurement standards established by authoritative accounting literature, which requires a company to determine whether it is more likely than not that a tax position will be sustained upon examination based upon the technical merits of the position. If the more-likely-than-not threshold is met, a company must measure the tax position to determine the amount to recognize in the financial statements. Based upon our review and evaluation, during the years ended August 31, 2011, 2010 and 2009, we concluded the Company had no unrecognized tax benefit which would affect its effective tax rate if recognized.

We classify any interest and penalties arising from the underpayment of income taxes in our statements of comprehensive loss in other income (expense). As of August 31, 2011 and 2010, we had no accrued interest or penalties related to uncertain tax positions.

We file income tax returns in the U.S. federal jurisdiction and various state jurisdictions. U.S. federal income tax returns from the year ended August 31, 2006 through the year ended August 31, 2011 are subject to examination.

Note 10: Stock-Based Compensation

Our Third Amended and Restated 1998 Stock Incentive Plan (the "Plan") authorizes the granting of incentive stock options to certain key employees and non-employees who provide services to the Company. The Plan, as amended, provides for the granting of options for an aggregate of 6,337,300 shares. The options vest subject to management's discretion.

Our Fourth Amended and Restated 1998 Directors Stock Plan (the "Director Plan") provides an annual retainer of $60,000 to each non-employee director with the exception of the Audit Committee Chairman who is to receive $65,000. The cash portion of the compensation of $30,000 ($35,000 for the Audit Committee Chairman) is paid 50% twice each year, with $30,000 of compensation paid in common stock of the Company once each year. Prior to February 4, 2009, the annual compensation consisted of $15,000 cash ($20,000 for the Audit Committee Chairman) paid 50% twice each year, with $15,000 in common stock of the Company. Prior to February 4, 2009, the Director Plan also granted each non-employee outside director 30,000 options each year at an exercise price equal to the fair market value of the common stock at the date the option was granted. The options vest according to a set schedule over a five-year period and expire upon the director's termination, or after ten years from the date of grant. The Director Plan, as amended, allows for an aggregate of 1,750,000 shares to be granted.

Stock-based compensation cost is measured at the grant date based on the estimated value of the award granted, using the Black-Scholes option pricing model, and recognized over the period in which the award vests. For stock awards no longer expected to vest, any previously recognized stock compensation expense is reversed in the period of termination. The stock-based compensation expense has been allocated to the various categories of operating costs and expenses in a manner similar to the allocation of payroll expense as follows for the years ended August 31:

	2011	2010	2009
Cost of sales	$ 38,273	$ 40,617	$ 72,988
Research and development	185,406	174,026	186,690
Selling, general and administrative	840,860	775,818	858,161
Total	$ 1,064,539	$ 990,461	$ 1,117,839

During the year ended August 31, 2011, we granted 906,000 stock options to employees with exercise prices ranging from $3.53 to $4.81 per share and with one third vesting each year for the next three years. The weighted average estimated grant-date fair value per share of these stock options was $2.20, and our assumptions used in the Black-Scholes valuation model to determine this estimated fair value are shown below:

Expected volatility	64.76%
Expected dividends	0%
Expected term	5.6 Years
	2.07%

Risk-free
interest
rate

The expected volatility rate was estimated based on the historical volatility of our common stock. The expected term was estimated based on historical experience of stock option exercise and forfeitures. The risk-free interest rate is the rate provided by the U.S. Treasury for Daily Treasury Yield Curve Rates commonly referred to as “Constant Maturity Treasury” rate in effect at the time of grant with a remaining term equal to the expected option term.

Unrecognized stock-based compensation expense expected to be recognized over the estimated weighted-average amortization period of 1.64 years is approximately $2,652,000 at August 31, 2011.

A summary of the time-based stock option awards as of August 31, 2011, and changes during the year then ended, is as follows:

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contract Term (Years)	Aggregate Intrinsic Value
Outstanding at September 1, 2010	2,201,386	$ 3.19		
Granted	906,000	4.59		
Exercised	(221,547)	1.55		$ 725,230
Forfeited or expired	(33,600)	4.90		
Outstanding at August 31, 2011	2,852,239	$ 3.74	6.83	$ 1,423,668
Exercisable at August 31, 2011	1,097,467	$ 3.66	5.57	$ 678,118

The aggregate intrinsic value in the preceding table represents the total pretax intrinsic value, based on the Company's closing stock price of $2.93 as of August 31, 2011, which would have been received by the holders of in-the-money options had the option holders exercised their options as of that date.

During the year ended August 31, 2011, employees and directors exercised options to purchase a total of 221,547 common shares, with net proceeds to the Company of $332,120.

Note 11: Grant Awards

In November 2010, we were awarded two separate U.S. government grants under the Qualifying Therapeutic Discovery Project ("QTDP") Program. We submitted grant applications for our BSD-2000 Hyperthermia System and our MicroThermX® Microwave Ablation System, and both applications were approved for the maximum award for a single program of $244,479, or a total of $488,958. In order to qualify for the QTDP grants, the project must have the potential to develop new treatments that address "unmet medical needs" or chronic and acute diseases; reduce long-term health care costs; represent a significant advance in finding a cure for cancer; advance U.S. competitiveness in the fields of life, biological, and medical sciences; or create or sustain well-paying jobs, either directly or indirectly. The QTDP was created by Congress in March 2010 as part of the Patient Protection and Affordable Care Act and provides a tax credit or a grant equal to 50% of eligible costs and expenses for tax years 2009 and 2010.

Note 12: Realized Loss on Investments

We liquidated 100% of our investments in mutual funds in March and May 2009 and recognized a loss on investments in our statements of comprehensive loss of $6,501,586 for the year ended August 31, 2009. The cost basis of these investments was $16,652,543, determined on a specific identification basis. Proceeds of $10,150,957 from these sales of investments were deposited in money market funds.

Note 13: Supplemental Cash Flow Information

Actual amounts paid for interest and income taxes are as follows:

	Years Ended August 31, 2011	2010	2009
Interest expense	$ -	$ -	$ 1,675
Income taxes	$ 800	$ -	$ 17,132

During the year ended August 31, 2010 we had no non-cash financing and investing activities. We had the following non-cash financing and investing activities for the years ended August 31, 2011 and 2009:

During the year ended August 31, 2011, we:

- Increased common stock and decreased additional paid-in capital by $7.

During the year ended August 31, 2009, we:

- Decreased income tax receivable and additional paid-in capital by $194,436.
- Increased other comprehensive loss and decreased investments by $4,360,170.
- Increased common stock and decreased additional paid-in capital by $618.

Note 14: Commitments and Contingencies

We entered into an employment agreement with our Senior Vice President and Chief Technical Officer (“CTO”) dated November 2, 1988. The agreement sets the CTO’s annual base salary for each year until October 1, 1993 and provides that after October 1, 1993 the CTO’s annual base salary will be based upon a reasonable mutual agreement between the CTO and the Company. The CTO’s annual base salary was raised to $210,000 effective September 1, 2006. In the event of termination of the CTO’s employment with the Company without cause (as defined in the agreement) or the CTO’s resignation for good reason (as defined in the agreement), the agreement provides that the CTO will receive severance pay for a one-year period, which pay includes an extension of all of his rights, privileges and benefits as an employee (including medical insurance). The one-year severance pay shall be equal to the CTO’s average annual salary for the 12-month period immediately prior to the termination. The agreement also requires us to pay the CTO for any accrued, unused vacation at the time of termination. We are also obligated to pay the CTO $1,000 (or the equivalent value in stock options) for each newly issued patent obtained by us as a result of the CTO’s efforts (the CTO receives only $500 if multiple inventors are involved). The CTO’s agreement includes a non-competition covenant prohibiting him from competing with us for one year following his termination. We may continue the non-competition period for up to four additional years by notifying the CTO in writing and by continuing the severance payments for the additional years during which the non-competition period is extended.

We have an exclusive worldwide license for a unique temperature probe. The license has no determinable life. We pay royalties based upon sales of this probe. Accrued royalties were $700 and $1,225 as of August 31, 2011 and 2010, respectively. Royalty expense amounted to $3,535, $3,360 and $6,180 for the years ended August 31, 2011, 2010 and 2009, respectively.

Note 15: Recent Accounting Pronouncements

Accounting Standards Update ("ASU") No. 2011-05, Comprehensive Income (Topic 220): Presentation of Comprehensive Income, was issued in June 2011. This update eliminates the option to present the components of other comprehensive income in the statement of changes in equity and requires presentation of net income and other comprehensive income (and their respective components) either in a single continuous statement or in two separate but consecutive statements. The amendments in this update are to be applied retrospectively. For public entities, the amendments are effective for interim and annual periods beginning after December 15, 2011. Early adoption is permitted. The Company has adopted the practice of presenting a single continuous statement of net comprehensive loss.

ASU No. 2011-08, Intangibles – Goodwill and Other (Topic 350): Testing Goodwill for Impairment, was issued in September 2011. The objective of this update is to simplify how entities, both public and nonpublic, test goodwill for impairment. The amendments in the update permit an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test described in Topic 350. The more-likely-than-not threshold is defined as having a likelihood of more than 50 percent. Previous guidance under Topic 350 required an entity to test goodwill for impairment, on at least an annual basis, by comparing the fair value of a reporting unit with its carrying amount, including goodwill (step one). If the fair value of a reporting unit is less than its carrying amount, then the second step of the test must be performed to measure the amount of the impairment loss, if any. Under the amendments in this update, an entity is not required to calculate the fair value of a reporting unit unless the entity determines that it is more likely than not that its fair value is less than its carrying amount. This update is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011, or our fiscal quarter ending May 31, 2012. Early adoption is permitted. Since we currently have no reported goodwill balances, we do not believe the adoption of this pronouncement will have a material impact on our financial statements.

Note 16: Subsequent Events

Employee Stock Options - Subsequent to August 31, 2011, we granted 50,000 stock options to employees with an exercise price of $2.58 per share and with one third vesting each year for the next three years.