

SMART ONLINE INC  
Form 10-Q  
May 14, 2010

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

---

FORM 10-Q

---

(Mark One)

- Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended March 31, 2010

OR

- Transition report pursuant to Section 13 of 15(d) of the Securities Exchange Act of 1934

Commission File Number: 001-32634

---

SMART ONLINE, INC.  
(Exact name of registrant as specified in its charter)

---

Delaware (State or other jurisdiction of incorporation or organization)	95-4439334 (I.R.S. Employer Identification No.)
4505 Emperor Blvd., Ste. 320 Durham, North Carolina (Address of principal executive offices)	27703 (Zip Code)
(919) 765-5000 (Registrant's telephone number, including area code)	

---

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days: Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, 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  No

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

Edgar Filing: SMART ONLINE INC - Form 10-Q

Large accelerated filer

Accelerated filer

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

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

As of May 11, 2010, there were approximately 18,342,542 shares of the registrant's common stock, par value \$0.001 per share, outstanding.

---

SMART ONLINE, INC.

FORM 10-Q

For the Quarterly Period Ended March 31, 2010

TABLE OF CONTENTS

	Page No.
<b>PART I – FINANCIAL INFORMATION</b>	
Item 1.	Financial Statements
	Balance Sheets as of March 31, 2010 (unaudited) and December 31, 2009
	3
	Statements of Operations (unaudited) for the three months ended March 31, 2010 and 2009
	4
	Statements of Cash Flows (unaudited) for the three months ended March 31, 2010 and 2009
	5
	Notes to Financial Statements (unaudited)
	6
Item 2.	Management’s Discussion and Analysis of Financial Condition and Results of Operations
	18
Item 3.	Quantitative and Qualitative Disclosures About Market Risk
	32
Item 4.	Controls and Procedures
	32
Item 4T.	Controls and Procedures
	32
<b>PART II – OTHER INFORMATION</b>	
Item 1.	Legal Proceedings
	33
Item 1A.	Risk Factors
	33
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds
	38
Item 6.	Exhibits
	39
	Signatures
	41

## PART I – FINANCIAL INFORMATION

## Item 1. Financial Statements

SMART ONLINE, INC.  
BALANCE SHEETS

	March 31, 2010 (unaudited)	December 31, 2009
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 22,477	\$ 119,796
Accounts receivable, net	-	13,056
Note receivable	-	-
Prepaid expenses	222,710	240,840
Total current assets	245,187	373,692
Property and equipment, net	243,075	258,450
Capitalized software, net	433,509	450,782
Unbilled receivable, non-current	-	-
Prepaid expenses, non-current	73,800	110,700
Intangible assets, net	150,000	150,000
Other assets	1,095	2,496
<b>TOTAL ASSETS</b>	<b>\$ 1,146,666</b>	<b>\$ 1,346,120</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)</b>		
Current liabilities:		
Accounts payable	\$ 752,800	\$ 518,309
Notes payable	2,147,183	1,964,281
Deferred revenue	27,215	40,115
Accrued liabilities – Nouri	1,802,379	1,802,379
Accrued liabilities	2,432,503	2,623,959
Total current liabilities	7,162,080	6,949,043
Long-term liabilities:		
Notes payable	10,279,790	9,785,255
Deferred revenue	11,940	5,601
Total long-term liabilities	10,291,730	9,790,856
Total liabilities	17,453,810	16,739,899
Commitments and contingencies		
Stockholders' equity (deficit):		
Preferred stock, \$0.001 par value, 5,000,000 shares authorized, no shares issued and outstanding at March 31, 2009 and December 31, 2008	-	-
Common stock, \$0.001 par value, 45,000,000 shares authorized, 18,342,542 and 18,333,122 shares issued and outstanding at March 31, 2010 and December 31, 2009, respectively	18,343	18,333
Additional paid-in capital	67,040,385	67,036,836
Accumulated deficit	(83,365,872)	(82,448,948)
Total stockholders' deficit	(16,307,144)	(15,393,779)
<b>TOTAL LIABILITIES AND STOCKHOLDERS' DEFICIT</b>	<b>\$ 1,146,666</b>	<b>\$ 1,346,120</b>

The accompanying notes are an integral part of these financial statements.

3

---

SMART ONLINE, INC.  
STATEMENTS OF OPERATIONS  
(unaudited)

	Three Months Ended	
	March 31, 2010	March 31, 2009
<b>REVENUES:</b>		
Subscription fees	\$ 136,258	\$ 241,782
Professional service fees	62,775	118,773
License fees	87,800	11,250
Hosting fees	44,272	72,211
Other revenue	32,795	37,671
Total revenues	363,900	481,687
<b>COST OF REVENUES</b>	<b>365,934</b>	<b>492,601</b>
<b>GROSS PROFIT</b>	<b>(2,034)</b>	<b>(10,914)</b>
<b>OPERATING EXPENSES:</b>		
Sales and marketing	152,635	299,539
Research and development	32,005	276,879
General and administrative	672,419	895,590
Total operating expenses	857,059	1,472,008
<b>LOSS FROM OPERATIONS</b>	<b>(859,093)</b>	<b>(1,482,922)</b>
<b>OTHER INCOME (EXPENSE):</b>		
Interest expense, net	(210,695)	(127,998)
Gain on legal settlements, net	152,863	6,000
Other income	-	10,267
Total other expense	(57,832)	(111,731)
<b>NET LOSS</b>	<b>\$ (916,925)</b>	<b>\$ (1,594,653)</b>
<b>NET LOSS PER COMMON SHARE:</b>		
Basic and fully diluted	\$ (0.05)	\$ (0.09)
<b>WEIGHTED-AVERAGE NUMBER OF SHARES USED IN COMPUTING NET LOSS PER COMMON SHARE:</b>		
Basic and fully diluted	18,342,542	18,333,518

The accompanying notes are an integral part of these financial statements.

SMART ONLINE, INC.  
STATEMENTS OF CASH FLOWS  
(unaudited)

	Three Months Ended	
	March 31, 2010	March 31, 2009
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net loss	\$ (916,925)	\$ (1,594,653)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	16,209	164,288
Amortization of deferred financing costs	-	-
Provision for doubtful accounts	179,517	223,993
Equity-based compensation	3,561	53,144
Gain on disposal of assets	-	(10,267)
Changes in assets and liabilities:		
Accounts receivable	(121,343)	44,435
Notes receivable	(45,118)	(3,250)
Prepaid expenses	55,029	79,556
Other assets	1,401	(1,251)
Accounts payable	234,492	10,417
Deferred revenue	(6,561)	(47,951)
Accrued and other expenses	(191,456)	196,647
Net cash used in operating activities	(791,194)	(884,892)
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchases of property and equipment	(835)	(14,565)
Proceeds from sale of equipment	-	45,362
Capitalized software	17,273	(114,078)
Net cash provided by (used in) investing activities	16,438	(83,281)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Proceeds from debt borrowings	1,982,698	2,925,511
Repayments of debt borrowings	(1,305,261)	(1,937,651)
Net cash provided by (used in) financing activities	677,437	987,860
<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	<b>(97,319)</b>	<b>19,687</b>
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>	<b>119,796</b>	<b>18,602</b>
<b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>	<b>\$ 22,477</b>	<b>\$ 38,289</b>
<b>Supplemental disclosures of cash flow information:</b>		
Cash paid during the period for:		
Interest	\$ 228,981	\$ 127,750
Income taxes	\$ -	\$ 10

The accompanying notes are an integral part of these financial statements.





SMART ONLINE, INC.  
NOTES TO FINANCIAL STATEMENTS  
(unaudited)

1. SUMMARY OF BUSINESS AND SIGNIFICANT ACCOUNTING POLICIES

Description of Business - Smart Online, Inc. (the "Company") was incorporated in the State of Delaware in 1993. The Company develops and markets software products and services targeted to small businesses that are delivered via a Software-as-a-Service ("SaaS") model. The Company sells its SaaS products and services primarily through private-label marketing partners. In addition, the Company provides website consulting services, primarily in the e-commerce retail and direct-selling organization industries. The Company maintains a website for potential partners containing certain corporate information located at [www.smartonline.com](http://www.smartonline.com).

Basis of Presentation - The financial statements as of and for the three months ended March 31, 2010 and 2009 included in this Quarterly Report on Form 10-Q are unaudited. The balance sheet as of December 31, 2009 is obtained from the audited financial statements as of that date. The accompanying statements should be read in conjunction with the audited financial statements and related notes, together with management's discussion and analysis of financial condition and results of operations, contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2009 filed with the Securities and Exchange Commission (the "SEC") on April 15, 2010 (the "2009 Annual Report").

The financial statements have been prepared in accordance with accounting principles generally accepted in the United States ("U.S. GAAP"). In the opinion of the Company's management, the unaudited statements in this Quarterly Report on Form 10-Q include all normal and recurring adjustments necessary for the fair presentation of the Company's statement of financial position as of March 31, 2010, and its results of operations and cash flows for the three months ended March 31, 2010 and 2009. The results for the three months ended March 31, 2010 are not necessarily indicative of the results to be expected for the fiscal year ending December 31, 2010.

The accompanying financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. During the three months ended March 31, 2010 and 2009, the Company incurred net losses as well as negative cash flows, is involved in a class action lawsuit (See Note 7, "Commitments and Contingencies," in the 2009 Annual Report), and had deficiencies in working capital. These factors indicate that the Company may be unable to continue as a going concern.

The financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or the amounts or classification of liabilities that might be necessary should the Company be unable to continue as a going concern. At May 11, 2010, the Company does have a commitment from its convertible secured subordinated noteholders to purchase up to an additional \$4.65 million in convertible notes upon approval and call by the Company's Board of Directors. There can be no assurance that, if the noteholders do not purchase the \$4.65 million in convertible notes, the Company will be able to obtain alternative funding. There can be no assurance that the Company's efforts to raise capital or increase revenue will be successful. If these efforts are unsuccessful, the Company may have to cease operations and liquidate the business. The Company's continuation as a going concern depends upon its ability to generate sufficient cash flows to meet its obligations on a timely basis, to obtain additional financing as may be required, and ultimately to attain profitable operations and positive cash flows.

Significant Accounting Policies - In the opinion of the Company's management, the significant accounting policies used for the three months ended March 31, 2010 are consistent with those used for the year ended December 31, 2009. Accordingly, please refer to the 2009 Annual Report for the Company's significant accounting policies.

Use of Estimates - The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions in the Company's financial statements and notes thereto. Significant estimates and assumptions made by management include the determination of the provision for income taxes, the fair market value of stock awards issued, and the period over which revenue is generated. Actual results could differ materially from those estimates.

**Fair Value of Financial Instruments** - U.S. GAAP requires disclosures of fair value information about financial instruments, whether or not recognized in the balance sheet, for which it is practicable to estimate that value. Due to the short period of time to maturity, the carrying amounts of cash equivalents, accounts receivable, accounts payable, accrued liabilities, and notes payable reported in the financial statements approximate the fair value.

**Reclassifications** - Certain prior year and comparative period amounts have been reclassified to conform to current year presentation. These reclassifications had no effect on previously reported net income or stockholders' equity.

**Segments** - Segmentation is based on an entity's internal organization and reporting of revenue and operating income based upon internal accounting methods commonly referred to as the "management approach." Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance. The Company's chief operating decision maker is its Chief Executive Officer, who reviews financial information presented on a consolidated basis. Accordingly, the Company has determined that it has a single reporting segment and operating unit structure.

**Concentration of Credit Risk** - Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of cash and accounts receivable. At times, cash balances may exceed the Federal Deposit Insurance Corporation ("FDIC") insurable limits. See Note 6, "Major Customers and Concentration of Credit Risk," for further discussion of risk within accounts receivable.

**Allowance for Doubtful Accounts** - The Company maintains an allowance for doubtful accounts for estimated losses resulting from the inability, failure, or refusal of its customers to make required payments. The need for an allowance for doubtful accounts is evaluated based on specifically identified amounts that management believes to be potentially uncollectible. If actual collections experience changes, revisions to the allowance may be required.

Additionally, from time to time the Company, as part of its negotiated contracts, has granted extended payment terms to its strategic partners. As payments become due under the terms of the contract, they are invoiced and reclassified as accounts receivable. During 2008, the Company entered into a web services agreement with a direct-selling organization customer that provided for extended payment terms related to both professional services and the grant of a software license. The customer began experiencing cash flow difficulties and has since significantly slowed its payments to the Company. In addition, the Company entered into a web services agreement with a real estate services customer and a mail-order pharmacy. There are significant amounts due and unpaid under the terms of their agreements and accordingly the Company has established reserves as described below.

Based on these criteria, management determined that at March 31, 2010, an allowance for doubtful accounts of \$1,002,028 was required for amounts due from customers. The allowance is comprised of the full outstanding balance of the direct-selling organization and mail-order pharmacy services customers' account receivable and the real estate customers' note receivable. In addition to the allowance for doubtful accounts from customers, the Company has established an allowance of \$1,798,595 related to the Nouri legal fee advance.

**Impairment of Long-Lived Assets** - We record our long-lived assets, such as intangibles, property and equipment, at cost. We review the carrying value of our indefinite lived intangibles for possible impairment at least annually in the fourth quarter, and all long-lived assets whenever events or changes in circumstances indicate that the carrying amount of assets may not be recoverable in accordance with the US GAAP. We measure the recoverability of assets to be held and used by comparing the carrying amount of the asset to the fair value. If we consider such assets to be impaired, we measure the impairment as the amount by which the carrying amount exceeds the fair value, and we recognize it as an operating expense in the period in which the determination is made. We report assets to be disposed at the lower of the carrying amount or fair value less costs to sell. Although we believe that the carrying values of our

long-lived assets are appropriately stated, changes in strategy or market conditions or significant technological developments could significantly impact these judgments and require adjustments to recorded asset balances.

In addition to the recoverability assessment, we also routinely review the remaining estimated useful lives of our long-lived assets. Any reduction in the useful-life assumption will result in increased depreciation and amortization expense in the period when such determinations are made, as well as in subsequent periods.

Revenue Recognition - The Company derives revenue primarily from subscription fees charged to customers accessing its SaaS applications; professional service fees, consisting primarily of consulting; the perpetual or term licensing of software platforms or applications; and hosting and maintenance services. These arrangements may include delivery in multiple-element arrangements if the customer purchases a combination of products and/or services. Because the Company licenses, sells, leases, or otherwise markets computer software, it uses the residual method pursuant to U.S. GAAP. This method allows the Company to recognize revenue for a delivered element when such element has vendor specific objective evidence (“VSOE”) of the fair value of the delivered element. If VSOE cannot be determined or maintained for an element, it could impact revenues as all or a portion of the revenue from the multiple-element arrangement may need to be deferred.

If multiple-element arrangements involve significant development, modification, or customization or if it is determined that certain elements are essential to the functionality of other elements within the arrangement, revenue is deferred until all elements necessary to the functionality are provided by the Company to a customer. The determination of whether the arrangement involves significant development, modification, or customization could be complex and require the use of judgment by management.

Under U.S. GAAP, provided the arrangement does not require significant development, modification, or customization, revenue is recognized when all of the following criteria have been met:

1. persuasive evidence of an arrangement exists
2. delivery has occurred
3. the fee is fixed or determinable
4. collectibility is probable

If at the inception of an arrangement the fee is not fixed or determinable, revenue is deferred until the arrangement fee becomes due and payable. If collectibility is deemed not probable, revenue is deferred until payment is received or collection becomes probable, whichever is earlier. The determination of whether fees are collectible requires judgment of management, and the amount and timing of revenue recognition may change if different assessments are made.

Under the provisions of U.S. GAAP, consulting, website design fees, and application development services are accounted for separately from the license of associated software platforms when these services have value to the customer and there is objective and reliable evidence of fair value of each deliverable. When accounted for separately, revenues are recognized as the services are rendered for time and material contracts, and when milestones are achieved and accepted by the customer for fixed-price or long-term contracts. The majority of the Company’s consulting service contracts are on a time and material basis and are typically billed monthly based upon standard professional service rates.

Application development services are typically fixed in price and of a longer term. As such, they are accounted for as long-term construction contracts that require revenue recognition to be based on estimates involving total costs to complete and the stage of completion. The assumptions and estimates made to determine the total costs and stage of completion may affect the timing of revenue recognition, with changes in estimates of progress to completion and costs to complete accounted for as cumulative catch-up adjustments. If the criteria for revenue recognition on construction-type contracts are not met, the associated costs of such projects are capitalized and included in costs in excess of billings on the balance sheet until such time that revenue recognition is permitted.



Subscription fees primarily consist of sales of subscriptions through private-label marketing partners to end users. We typically have a revenue-share arrangement with these marketing partners in order to encourage them to market our products and services to their customers. Subscriptions are generally payable on a monthly basis and are typically paid via credit card of the individual end user. We accrue any payments received in advance of the subscription period as deferred revenue and amortize them over the subscription period. In the past, we recognized all subscription revenue on a gross basis and in accordance with our policy to periodically review our accounting policies we determined that certain contracts require the reporting of subscription revenue on a gross basis and others on a net basis according to US GAAP. On that basis, we continue to report subscription revenue from certain contracts on a gross basis and others on a net basis. The net effect of this reclassification of expenses only impacts gross revenue and certain gross expenses; it does not change the net income.

Because our customers generally do not have the contractual right to take possession of the software we license or market at any time, we recognize revenue on hosting and maintenance fees as we provide the services in accordance with US GAAP.

**Deferred Revenue** - Deferred revenue consists of billings or payments received in advance of revenue recognition, and it is recognized as the revenue recognition criteria are met. Deferred revenue also includes certain professional service fees and license fees where all the criteria of U.S. GAAP were not met. Deferred revenue that will be recognized over the succeeding 12-month period is recorded as current and the remaining portion is recorded as non-current.

**Cost of Revenues** - Cost of revenues primarily is composed of costs related to third-party hosting services, salaries and associated costs of customer support and professional services personnel, credit card processing, depreciation of computer hardware and software used in revenue-producing activities, domain name and e-mail registrations, and allocated development expenses and general and administrative overhead.

The Company allocates development expenses to cost of revenues based on time spent by development personnel on revenue-producing customer projects and support activities. The Company allocates general and administrative overhead such as rent and occupancy expenses, depreciation, general office expenses, and insurance to all departments based on headcount. As such, general and administrative overhead expenses are reflected in cost of revenues and each operating expense category.

**Stock-Based Compensation** - Effective January 1, 2006, the Company began recognizing stock based compensation, using the Modified Prospective Approach based on the grant date fair value estimated in accordance with US GAAP. Under the Modified Prospective Approach, the amount of compensation cost recognized includes (i) compensation cost for all share-based payments granted prior to, but not yet vested as of, January 1, 2006, and (ii) compensation cost for all share-based payments that are granted subsequent to January 1, 2006. Stock-based compensation is recognized on the straight-line method over the requisite service period. Total stock-based compensation expense recognized was \$3,561 and \$53,144 for the quarters ended March 31, 2010 and 2009 respectively. No stock-based compensation was capitalized in the consolidated financial statements.

In computing the impact of stock-based compensation expense, the fair value of each award is estimated on the date of grant based on the Black-Scholes option-pricing model utilizing certain assumptions for a risk-free interest rate, volatility, and expected remaining lives of the awards. The assumptions used in calculating the fair value of share-based payment awards represent management's best estimates, but these estimates involve inherent uncertainties and the application of management's judgment. As a result, if factors change and the Company uses different assumptions, the Company's stock-based compensation expense could be materially different in the future. In addition, the Company is required to estimate the expected forfeiture rate and only recognize expense for those shares expected to vest. In estimating the Company's forfeiture rate, the Company analyzed its historical forfeiture rate, the remaining

lives of unvested options, and the amount of vested options as a percentage of total options outstanding. If the Company's actual forfeiture rate is materially different from its estimate, or if the Company reevaluates the forfeiture rate in the future, the stock-based compensation expense could be significantly different from what the Company has recorded in the current period.

The fair value of option grants under the Company's equity compensation plan during the years ended December 31, 2009 and 2008 were estimated using the following weighted average assumptions:



	Three Months Ended March 31,	
	2010	2009
Dividend yield	0.0%	0.0%
Expected volatility	98.7%	100.5%
Risk-free interest rate	3.19%	2.00%
Expected lives (years)	4.0	4.0

Dividend yield – The Company has never declared or paid dividends on its common stock and does not anticipate paying dividends in the foreseeable future.

Expected volatility – Volatility is a measure of the amount by which a financial variable such as share price has fluctuated (historical volatility) or is expected to fluctuate (expected volatility) during a period. The Company used the Company's monthly historical volatility since April 2005 to calculate the expected volatility.

Risk - free interest rate – The risk-free interest rate is based on the published yield available on U.S. Treasury issues with a remaining term similar to the expected life of the option.

Expected lives – The expected lives of the options represent the estimated period of time until exercise or forfeiture and are based on historical experience of similar awards.

Net Loss Per Share - Basic net loss per share is computed by dividing net loss by the weighted average number of common shares outstanding during the periods. Diluted net loss per share is computed using the weighted average number of common and dilutive common equivalent shares outstanding during the periods. Common equivalent shares consist of convertible notes, stock options, and warrants that are computed using the treasury stock method. Shares issuable upon the exercise of stock options and warrants, totaling 1,913,615 on March 31, 2010, were excluded from the calculation of common equivalent shares, as the impact was anti-dilutive.

Recently Issued Accounting Pronouncements - In April 2008, the US Financial Accounting Standards Board suggested rules concerning the determination of the useful life of intangible assets. The standard requires entities to consider their own historical experience in renewing or extending similar arrangements when developing assumptions regarding the useful lives of intangible assets and also mandates certain related disclosure requirements. The rules are effective for fiscal years beginning after December 15, 2008, with early adoption prohibited. The Company has adopted the rules.

All other new and recently issued, but not yet, effective, accounting pronouncements have been deemed to be not relevant to the Company and therefore are not expected to have any impact once adopted.

## 2. BALANCE SHEET ACCOUNTS

### Prepaid Expenses

In 2008, the Company entered into a non-cancelable sublease for approximately 9,837 square feet of office space, restructured as a prime lease beginning May 1, 2010 with a termination date of September 30, 2011, for its North Carolina headquarters. The agreement included the conveyance of certain furniture to the Company without a stated value and required a lump-sum, upfront payment of \$500,000 that was made in September 2008. Management has assessed the fair market value of the furniture to be approximately \$50,000, and this amount was capitalized and is subject to depreciation in accordance with the Company's fixed asset policies. The remainder of the payment was recorded as prepaid expense; with the portion, relating to rent for periods beyond the next 12 months classified as non-current, and is being amortized to rent expense over the term of the lease.

Intangible Assets

The following table summarizes information about intangible assets at March 31, 2010:

10

---

Asset Category	Value Assigned	Weighted Average Amortization Period (in Years)	Impairments	Accumulated Amortization and Prior Impairment	Carrying Value
Customer bases	\$ 1,944,347	6.2	-	\$ 1,944,347	\$ -
Acquired technology	501,264	3.0	-	501,264	-
Non-compete agreements	801,785	4.0	-	801,785	-
Trademarks and copyrights	52,372	9.7	-	52,372	-
Trade name	380,000	N/A	-	230,000	150,000
Totals	\$ 3,679,768	-	-	\$ 3,529,768	\$ 150,000

We record our long-lived assets, such as intangibles, property and equipment, at cost. We review the carrying value of our indefinite lived intangibles for possible impairment at least annually in the fourth quarter, and all long-lived assets whenever events or changes in circumstances indicate that the carrying amount of assets may not be recoverable in accordance with the US GAAP. We measure the recoverability of assets to be held and used by comparing the carrying amount of the asset to future net discounted cash flows expected to be generated by the asset. If we consider such assets to be impaired, we measure the impairment as the amount by which the carrying amount exceeds the fair value, and we recognize it as an operating expense in the period in which the determination is made. We report assets to be disposed at the lower of the carrying amount or fair value less costs to sell. Although we believe that the carrying values of our long-lived assets are appropriately stated, changes in strategy or market conditions or significant technological developments could significantly impact these judgments and require adjustments to recorded asset balances.

#### Accrued Liabilities

At March 31, 2010 and December 31, 2009, the Company has recorded a total of unpaid legal expense obligations of \$1,802,379 in connection with the Nouri Matters (defined below) based on invoices received from the law firms of Dennis Michael Nouri and Reza Eric Nouri (together, the "Nouris") through March 31, 2010 which figure does not include invoices generated but not yet received. The Company and the Nouris have been engaged in settlement negotiations for the settlement of the Nouris' advancement and indemnification claims (the "Nouri Matters") against the Company, but no definitive agreement has yet been signed.

At March 31, 2010, the Company had accrued liabilities totaling \$2,432,503. This amount consisted of the following: \$2,145,716 of liability related to the estimated cost of settlement for the class action lawsuit, after giving effect to certain settlement payments made during the first quarter totaling \$157,000, that was filed against the Company during 2007 (the "Class Action"), pursuant to the terms of a tentative settlement agreement reached between the Company and the lead plaintiff in the class action; \$75,436 of liability related to the development of the Company's custom accounting application; \$50,594 related to hosting services; \$31,804 for liabilities associated with the settlement of office rent negotiations; \$3,791 for other professional services; \$20,887 for accrued payroll; and \$104,275 of convertible note interest payable.

At December 31, 2009, the Company had accrued liabilities totaling \$2,623,959. This amount consisted primarily of \$2,302,158 of liability related to the estimated cost of settlement for the Class Action law suit based upon the tentative settlement agreement reached between the Company and the lead plaintiff in the class action, plus other accrued legal fees, \$75,436 of liability related to the development of the Company's custom accounting application; \$50,594 related to hosting services; \$18,174 for liabilities associated with the settlement of office rent negotiations \$3,791 for other professional services, \$71,159 for accrued payroll and \$102,647 of convertible note interest payable.

Deferred Revenue

Deferred Revenue - Deferred revenue consists of billings or payments received in advance of revenue recognition, and it is recognized as the revenue recognition criteria are met. Deferred revenue also includes certain professional services fees and licensing revenues where all the criteria described earlier were not met. Deferred revenue that will be recognized over the succeeding 12-month period is recorded as current and the remaining portion is recorded as noncurrent.

The components of deferred revenue for the periods indicated were as follows:

	March 31, 2010	December 31, 2009
Subscription fees	\$ 39,155	\$ 40,115
License fees	-	5,601
Totals	\$ 39,155	\$ 45,716
Current portion	\$ 27,215	\$ 40,115
Non-current portion	11,940	5,601
Totals	\$ 39,155	\$ 45,716

### 3. NOTES PAYABLE

#### Convertible Notes

On November 14, 2007, in an initial closing, the Company sold \$3.3 million aggregate principal amount of convertible secured subordinated notes (as amended, the “Notes”) under the Convertible Secured Subordinated Note Purchase Agreement, dated November 14, 2007 (as amended, the “Note Purchase Agreement”). The Notes bear an 8% interest rate and interest is paid quarterly.

In addition, at the initial closing, the noteholders committed to purchase on a pro rata basis up to \$5.2 million aggregate principal of Notes in future closings upon approval and call by our Board of Directors. On August 12, 2008, we exercised our option to sell \$1.5 million aggregate principal of Notes (the “Additional Notes”) to existing noteholders, with substantially the same terms and conditions as the Notes sold in the initial closing (the “Initial Notes”). In connection with the sale of the Additional Notes, the noteholders holding a majority of the aggregate principal amount of the Notes then outstanding agreed to increase the aggregate principal amount of Notes that they are committed to purchase from \$8.5 million to \$15.3 million. On November 21, 2008, we sold \$500,000 aggregate principal amount of Notes to two new convertible noteholders (the “New Notes”), with substantially the same terms and conditions as the Initial Notes and the Additional Notes. At December 31, 2008, \$5.3 million aggregate principal amount of Notes were outstanding.

On January 6, 2009, the Company sold \$500,000 aggregate principal amount of Notes to Atlas Capital SA (“Atlas”), on substantially the same terms and conditions as the previously issued Notes.

On February 24, 2009, the Company sold \$500,000 aggregate principal amount of Notes to Atlas on substantially the same terms and conditions as the previously issued Notes. On the same date, the noteholders holding a majority of the aggregate principal amount of the Notes outstanding agreed that the Company may sell up to \$6 million aggregate principal amount of Additional Notes to new convertible noteholders or existing noteholders at any time on or before December 31, 2009 with a maturity date of November 14, 2010 or later. In addition, the maturity date definition for each of the Notes was changed from November 14, 2010 to the date upon which the Note is due and payable, which was the earlier of (1) November 14, 2010, (2) a change of control, or (3) if an event of default occurs, the date upon which noteholders accelerate the indebtedness evidenced by the Notes. The formula for calculating the conversion price of the Notes was also amended such that the conversion price of each outstanding note and any additional note sold in the future would be the same and set at the lowest applicable conversion price, as described below.

On each of April 3, 2009 and June 2, 2009, the Company sold a Note in the principal amount of \$500,000 to Atlas on substantially the same terms and conditions as the previously issued Notes. On each of July 16, 2009, August 26, 2009, September 8, 2009, and October 5, 2009, the Company sold a Note in the principal amount of \$250,000 to Atlas on substantially the same terms and conditions as the previously issued Notes. On October 9, 2009, the Company sold

a Note in the principal amount of \$250,000 to UBP, Union Bancaire Privee, an existing noteholder, on substantially the same terms and conditions as the previously issued Notes. On November 6, 2009, the Company sold a Note to Atlas in the principal amount of \$500,000, on December 23, 2009 the Company sold a Note to Atlas in the principal amount of \$750,000, and on February 11, 2010, the Company sold a Note to Atlas in the principal amount of \$500,000, all upon substantially the same terms and conditions as the previously issued Notes.

On March 5, 2010, the Company and Atlas, as the holder of a majority of the aggregate outstanding principal amount of the Notes (the "Requisite Percentage Holder"), together with other noteholders, entered into the Fourth Amendment to Convertible Secured Subordinated Note Purchase Agreement, Second Amendment to Convertible Secured Subordinated Promissory Notes and Third Amendment to Registration Rights Agreement (the "Fourth Amendment"). The Fourth Amendment extends the original maturity date of the Notes from November 14, 2010 to November 14, 2013, and amends the Note Purchase Agreement and the Registration Rights Agreement, dated November 14, 2007, to reflect this extension.

The Fourth Amendment extends the original maturity date of the Notes from November 14, 2010 to November 14, 2013, and amends the Note Purchase Agreement and the Registration Rights Agreement, dated November 14, 2007, to reflect this extension.

The Fourth Amendment further provides that on the earlier of the maturity date of November 14, 2013 or a merger or acquisition or other transaction pursuant to which our existing stockholders hold less than 50% of the surviving entity, or the sale of all or substantially all of our assets, or similar transaction, or event of default, each noteholder in its sole discretion shall have the option to:

- convert the principal then outstanding on its notes into shares of the Company's common stock, or
- receive immediate repayment in cash of the notes, including any accrued and unpaid interest.

On April 1, 2010, the Company sold a Note to Atlas in the principal amount of \$350,000, due November 14, 2013, upon substantially the same terms and conditions as the previously issued Notes

If a noteholder elects to convert its Notes on the maturity date, the conversion price will be the lowest "applicable conversion price" determined for each Note. The "applicable conversion price" for each Note shall be calculated by multiplying 120% by the lowest of:

- the average of the high and low prices of the Company's common stock on the OTC Bulletin Board averaged over the five trading days prior to the closing date of the issuance of such Note,
- if the Company's common stock is not traded on the Over-The-Counter market, the closing price of the common stock reported on the Nasdaq National Market or the principal exchange on which the common stock is listed, averaged over the five trading days prior to the closing date of the issuance of such note, or
- the closing price of the Company's common stock on the OTC Bulletin Board, the Nasdaq National Market or the principal exchange on which the common stock is listed, as applicable, on the trading day immediately preceding the date such note is converted,

Payment of the Notes will be automatically accelerated if the Company enters voluntary or involuntary bankruptcy or insolvency proceedings.

The Notes and the common stock into which they may be converted have not been registered under the Securities Act or the securities laws of any other jurisdiction. As a result, offers and sales of the Notes were made pursuant to Regulation D of the Securities Act and only made to accredited investors. The noteholders of the Initial Notes include (i) The Blueline Fund, or Blueline, which originally recommended Philippe Pouponnot, one of our former directors, for appointment to the Board of Directors; (ii) Atlas, an affiliate that originally recommended Shlomo Elia, one of our current directors, for appointment to the Board of Directors; (iii) Crystal Management Ltd., which is owned by Doron Roethler, the former Chairman of our Board of Directors and former Interim Chief Executive Officer and who currently serves as the noteholders' bond representative; and (iv) William Furr, who is the father of Thomas Furr, who, at the time, was one of our directors and executive officers. The noteholders of the Additional Notes are Atlas and Crystal Management Ltd. The noteholders of the New Notes are not affiliated with the Company.

If the Company proposes to file a registration statement to register any of its common stock under the Securities Act in connection with the public offering of such securities solely for cash, subject to certain limitations, the Company shall give each noteholder who has converted its notes into common stock the opportunity to include such shares of converted common stock in the registration. The Company has agreed to bear the expenses for any of these registrations, exclusive of any stock transfer taxes, underwriting discounts, and commissions.

No fees to third parties are payable in connection with the sale of Notes.

#### Lines of Credit

On February 20, 2008, the Company entered into a revolving credit arrangement with Paragon Commercial Bank ("Paragon") that was renewable on an annual basis subject to mutual approval and delivered to Paragon a secured

promissory note, dated February 20, 2008 (the "Paragon Note") . The total line of credit advanced by Paragon is \$2.5 million and can be used for general working capital. Any advances made on the line of credit were required to be paid off no later than February 19, 2009, with monthly payments being applied first to accrued interest and then to principal. Interest accrues on the unpaid principal balance at the Wall Street Journal's published Prime Rate minus one-half percent. The line of credit is secured by an irrevocable standby letter of credit in the amount of \$2.5 million issued by HSBC Private Bank (Suisse) SA ("HSBC") with Atlas, a current stockholder, as account party that was scheduled to expire on February 18, 2010. The Company also has agreed with Atlas that in the event of a default by the Company in the repayment of the line of credit that results in the letter of credit being drawn, the Company shall reimburse Atlas any sums that Atlas is required to pay under such letter of credit. At the sole discretion of Atlas, these payments may be made in cash by issuing shares of the Company's common stock at a set per-share price of \$2.50 or the issuance of additional bonds.

On February 25, 2010, the Company entered into a Modification Agreement (the "Modification Agreement") with Paragon, with an effective date of February 22, 2010, relating to the Paragon Note. The Modification Agreement (i) extends the maturity date of the Paragon Note from February 11, 2010 to August 11, 2010, and (ii) changes the interest rate from a variable annual rate equal to The Wall Street Journal Prime Rate, with a floor of 5.50%, to a fixed annual rate of 6.50%. The Company has been advised that, effective January 28, 2010, the expiration date of the standby letter of credit in the amount of \$2,500,000 issued by HSBC securing the Paragon Note has been extended from February 18, 2010 to September 17, 2010.



As of March 31, 2010, the Company had notes payable totaling \$12,426,973. The detail of these notes is as follows:

Note Description	Short-Term Portion	Long-Term Portion	Total	Maturity	Rate
Paragon Commercial Bank credit line	\$ 2,093,283	\$ -	\$ 2,093,283	Aug 2010	Prime, not less than 6.5%
Insurance premium note	21,460	-	21,460	Jun 2010	5.4%
Various capital leases	32,440	179,790	212,230	Various	8.0-18.9%
Convertible notes	-	10,100,000	10,100,000	Nov 2013	8.0%
Totals	\$ 2,147,183	\$ 10,279,790	\$ 12,426,973		

#### 4. COMMITMENTS AND CONTINGENCIES

##### Lease Commitments

The Company leases computers, office equipment and office furniture under capital lease agreements that expire through July 2019. Total amounts financed under these capital leases were \$272,164 and \$72,164 at March 31, 2010 and 2009, respectively, net of accumulated amortization of \$59,933 and \$24,883, respectively. The current and non-current portions of the capital leases have been recorded in current and long-term portions of notes payable on the consolidated balance sheets as of March 31, 2010 and 2009. See also Note 3, "Notes Payable."

In 2008, the Company entered into a non-cancellable sublease to relocate its North Carolina headquarters to another facility near Research Triangle Park, under which the Company prepaid rent in the total amount of \$450,080 and purchased existing furniture and fixtures for an additional \$49,920, which furniture and fixtures were capitalized for depreciation purposes. Effective May 1, 2010, the sublease was restructured as a direct lease with the owner of the property, with a termination date of September 30, 2011 (the "Lease"). After taking into account the monthly amortization of prepaid rent, the Company is obligated to make minimum monthly rent payments in the amount of \$4,208.13 during the term of the Lease, together with a percentage of operating expenses. The Company includes the prepaid rent amount of \$450,080 as an asset being amortized monthly over the remaining term of the Lease.

Rent expense for the three months ended March 31, 2010 and 2009 was \$53,765 and \$43,889, respectively.

## Development Agreement

In August 2005, the Company entered into a software assignment and development agreement with the developer of a customized accounting software application. In connection with this agreement, the developer would be paid up to \$512,500 and issued up to 32,395 shares of the Company's common stock based upon the developer attaining certain milestones. This agreement was modified on March 26, 2008 to adjust the total number of shares issuable under the agreement to 29,014. In 2008, the Company had paid \$470,834 and issued 3,473 shares of common stock related to this obligation.

## Legal Proceedings

At this time, the Company is not able to determine the likely outcome of the Company's current pending legal matters. Management has made an initial estimate based upon a tentative agreement for settlement of the Class Action, its settlement discussions regarding the Nouri Matters, and its knowledge, its experience and input from legal counsel, and the Company has accrued approximately \$3,948,095 of additional legal reserves and costs. Such amounts will be adjusted in future periods as more information becomes available. If an unfavorable resolution of any of these matters occurs, the Company's business, results of operations, and financial condition could be materially adversely affected.

## 5. STOCKHOLDERS' EQUITY

### Preferred Stock

The Board of Directors is authorized, without further stockholder approval, to issue up to 5,000,000 shares of \$0.001 par value preferred stock in one or more series and to fix the rights, preferences, privileges, and restrictions applicable to such shares, including dividend rights, conversion rights, terms of redemption, and liquidation preferences, and to fix the number of shares constituting any series and the designations of such series. There were no shares of preferred stock outstanding at March 31, 2010.

### Common Stock

The Company is authorized to issue 45,000,000 shares of common stock, \$0.001 par value per share. As of March 31, 2010, it had 18,342,542 shares of common stock outstanding. Holders of common stock are entitled to one vote for each share held.

In March 2010, the Company issued 10,000 shares of restricted common stock to Mr. Shlomo Elia, for service as a Board Member.

### Warrants

As incentive to modify a letter of credit relating to the Wachovia line of credit (see Note 3, "Notes Payable"), the Company entered into a Stock Purchase Warrant and Agreement (the "Warrant Agreement") with Atlas on January 15, 2007. Under the terms of the Warrant Agreement, Atlas received a warrant containing a provision for cashless exercise to purchase up to 444,444 shares of the Company's common stock at \$2.70 per share at the termination of the line of credit or if the Company is in default under the terms of the line of credit with Wachovia. The fair value of the warrant was \$734,303 as measured using the Black-Scholes option-pricing model at the time the warrant was issued. This amount was recorded as deferred financing costs and was amortized to interest expense in the amount of \$37,657 per month over the remaining period of the modified line of credit, which expired in August 2008. In consideration for Atlas providing the Paragon line of credit (see Note 3 "Notes Payable"), the Company agreed to amend the Warrant

Agreement to provide that the warrant is exercisable within 30 business days of the termination of the Paragon line of credit or if the Company is in default under the terms of the line of credit. If the warrant is exercised in full, it will result in gross proceeds to the Company of approximately \$1,200,000.

In a transaction that closed on February 21, 2007, we sold an aggregate of 2,352,941 shares of our common stock to two new investors in a private placement. The shares were sold at \$2.55 per share pursuant to a Securities Purchase Agreement, or the SPA, between the Company and each of the investors. Under the SPA, the Investors were issued warrants for the purchase of an aggregate of 1,176,471 shares of common stock at an exercise price of \$3.00 per share. These warrants expired February 21, 2010.

As part of the commission paid to Canaccord Adams, Inc. ("CA"), the Company's placement agent in the transaction that closed in February 2007, CA was issued a warrant to purchase 35,000 shares of the Company's common stock at an exercise price of \$2.55 per share. This warrant contains a provision for cashless exercise and must be exercised by February 21, 2012. CA and the Company also entered into a Registration Rights Agreement (the "CA RRA"). Under the CA RRA, the shares issuable upon exercise of the warrant must be included on the same registration statement the Company was obligated to file under the Investor RRA described above, but CA was not entitled to any penalties for late registration or effectiveness.

As of March 31, 2010, warrants to purchase up to 1,655,915 shares were outstanding.

### Equity Compensation Plans

The Company adopted its 2004 Equity Compensation Plan (the “2004 Plan”) as of March 31, 2004. The 2004 Plan provides for the grant of incentive stock options, non-statutory stock options, restricted stock, and other direct stock awards to employees (including officers) and directors of the Company as well as to certain consultants and advisors. In June 2007, the Company temporarily limited the issuance of shares of its common stock reserved under the 2004 Plan to awards of restricted or unrestricted stock and in June 2008 again made options available for grant under the 2004 Plan. The total number of shares of common stock reserved for issuance under the 2004 plan is 5,000,000 shares, subject to adjustment in the event of a stock split, stock dividend, recapitalization, or similar capital change.

Restricted Stock – During the first quarter of 2010, 10,000 shares of restricted stock were issued. At March 31, 2010, there remains \$62,577 of unvested expense yet to be recorded related to all restricted stock outstanding.

Stock Options – The exercise price for incentive stock options granted under the 2004 Plan is required to be no less than the fair market value of the common stock on the date the option is granted, except for options granted to 10% stockholders, which are required to have an exercise price of not less than 110% of the fair market value of the common stock on the date the option is granted. Incentive stock options typically have a maximum term of ten years, except for option grants to 10% stockholders, which are subject to a maximum term of five years. Non-statutory stock options have a term determined by either the Board of Directors or the Compensation Committee. Options granted under the 2004 Plan are not transferable, except by will and the laws of descent and distribution.

The following is a summary of the stock option activity for the three months ended March 31, 2010:

	Shares	Weighted Average Exercise Price
BALANCE, December 31, 2009	132,500	\$ 4.43
Granted	125,000	1.14
Exercised	-	-
Canceled	-	-
BALANCE, March 31, 2010	257,500	\$ 2.83

The following table summarizes information about stock options outstanding at March 31, 2010:

Exercise Price	Number of Options Outstanding	Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Currently Exercisable	
				Number of Shares	Weighted Average Exercise Price
\$ 1.14	125,000	5.0	\$ 1.14	-	\$ -
From \$2.50 to \$3.50	85,000	6.8	\$ 3.15	83,750	\$ 3.16
\$ 5.00	25,000	4.3	\$ 5.00	20,000	\$ 5.00
From \$8.61 to \$9.00	22,500	3.5	\$ 8.61	18,000	\$ 8.61
Totals	257,500	3.6	\$ 2.84	121,750	\$ 4.27



At March 31, 2010, there remains \$54,333 of unvested expense yet to be recorded related to all options outstanding.

Dividends - The Company has not paid any cash dividends through March 31, 2010.

## 6. MAJOR CUSTOMERS AND CONCENTRATION OF CREDIT RISK

Financial instruments that potentially subject the Company to credit risk principally consist of trade receivables. The Company believes the concentration of credit risk in its trade receivables is substantially mitigated by ongoing credit evaluation processes, relatively short collection terms, and the nature of the Company's customer base, primarily mid- and large-size corporations with significant financial histories. Collateral is not generally required from customers. The need for an allowance for doubtful accounts is determined based upon factors surrounding the credit risk of specific customers, historical trends, and other information.

A significant portion of revenues is derived from certain customer relationships. The following is a summary of customers that represent greater than 10% of total revenues:

	Revenue Type	Three Months Ended March 31, 2010	
		Revenues	% of Total Revenues
Customer A	Subscription fees	\$ -	-%
Customer B	Subscription fees	111,882	31%
Customer C	Subscription fees	52,440	14%
Others	Various	199,578	55%
<b>Total</b>		<b>\$ 363,900</b>	<b>100%</b>

	Revenue Type	Three Months Ended March 31, 2009	
		Revenues	% of Total Revenues
Customer A	Professional service fees	\$ 156,700	33%
Customer B	Subscription fees	106,294	22%
Customer C	Subscription fees	125,503	26%
Others	Various	93,190	19%
<b>Total</b>		<b>\$ 481,687</b>	<b>100%</b>

As of March 31, 2010, we had current accounts receivable of \$511,593 and a note receivable from a customer of \$490,435, both of which are fully reserved. As of December 31, 2009, one customer accounted for 91% of accounts receivable.

## 7. SUBSEQUENT EVENTS

On April 1, 2010, the Company sold \$350,000 aggregate principal amount of convertible secured subordinated notes due November 14, 2013 to Atlas with substantially the same terms and conditions as the previously outstanding notes, as described in Note 3, "Notes Payable."

In 2008, the Company entered into a non-cancellable sublease to relocate its North Carolina headquarters to another facility near Research Triangle Park, under which the Company prepaid rent in the total amount of \$450,080 and purchased existing furniture and fixtures for an additional \$49,920, which furniture and fixtures were capitalized for

depreciation purposes. Effective May 1, 2010, the sublease was restructured as a direct lease with the owner of the property, with a termination date of September 30, 2011 (the "Lease"). After taking into account the monthly amortization of prepaid rent, the Company is obligated to make minimum monthly rent payments in the amount of \$4,208.13 during the term of the Lease, together with a percentage of operating expenses. The Company includes the prepaid rent amount of \$450,080 as an asset being amortized monthly over the remaining term of the Lease.

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

Information set forth in this Quarterly Report on Form 10-Q contains various forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, or the Securities Act, and Section 21E of the Securities Exchange Act of 1934, or the Exchange Act. Forward-looking statements consist of, among other things, trend analyses, statements regarding future events, future financial performance, our plan to build our business and the related expenses, our anticipated growth, trends in our business, the effect of interest rate fluctuations on our business, the potential impact of current litigation or any future litigation, the potential availability of tax assets in the future and related matters, and the sufficiency of our capital resources, all of which are based on current expectations, estimates, and forecasts, and the beliefs and assumptions of our management. Words such as "expect," "anticipate," "project," "intend," "plan," "estimate," variations of such words, and similar expressions also are intended to identify such forward-looking statements. These forward-looking statements are subject to risks, uncertainties, and assumptions that are difficult to predict. Therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. Readers are directed to risks and uncertainties identified under Part II, Item 1A, "Risk Factors," for factors that may cause actual results to be different than those expressed in these forward-looking statements. Except as required by law, we undertake no obligation to revise or update publicly any forward-looking statements for any reason.

The following discussion is designed to provide a better understanding of our unaudited financial statements, including a brief discussion of our business and products, key factors that impacted our performance, and a summary of our operating results. The following discussion should be read in conjunction with the unaudited financial statements and the notes thereto included in Part I, Item 1 of this Quarterly Report on Form 10-Q, and the consolidated financial statements and notes thereto and Management's Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-K for the year ended December 31, 2009. Historical results and percentage relationships among any amounts in the financial statements are not necessarily indicative of trends in operating results for any future periods.

#### Overview

We develop and market software products and services targeted to small businesses that are delivered via a SaaS model. We also provide website consulting services, primarily in the e-commerce retail industry. We reach small businesses primarily through arrangements with channel partners that private label our software applications and market them to their customer bases through their corporate websites. We believe these relationships provide a cost- and time-efficient way to market to a diverse and fragmented yet very sizeable small-business sector. We also offer our products directly to end-user small businesses through our OneBiz® branded website.

In the second half of 2007, we commenced an overall evaluation of our business model as well as our current technologies, the outcome of which was our decision to develop a core industry-standard platform for small business with an architecture designed to integrate with a virtually unlimited number of other applications, services, and existing infrastructures. These applications would include not only our own small-business applications, which we are currently optimizing, but also other applications we expect to arise from collaborative partnerships with third-party developers and service providers. In addition, we identified emerging-market opportunities in the small-business segment to leverage social networking and community building. We are currently refining and integrating these capabilities into the core platform to be readily available in a "plug-and-play" fashion to meet any anticipated customer need or desire. On July 14, 2009, we announced the release of OneBiz 1.1, a suite of web-based business management tools designed for small business owners to operate and grow their businesses. We believe that this platform and associated applications will provide opportunities for new sources of revenue, including an increase in our subscription fees. We also believe, because the platform is designed to follow industry-standard protocol, that the customization efforts and associated timeline previously necessary to meet a particular customer's requirements will



diminish significantly, allowing us to shorten the sale-to-revenue cycle. As we neared completion of the development of our industry-standard platform, we began shifting our focus from development toward the sales and marketing of the new platform in the fourth quarter of 2008 and continued the effort throughout 2010.

#### Sources of Revenue

We derive revenues from the following sources:

- Subscription fees – monthly fees charged to customers for access to our SaaS applications
- Professional service fees – fees related to consulting services, some of which complement our other products and applications
- License fees – fees charged for perpetual or term licensing of platforms or applications
- Hosting fees – fees charged for providing network accessibility for our customers using our customized platforms
- Other revenues – revenues generated from non-core activities such as syndication and integration fees; original equipment manufacturer, or OEM, contracts; and miscellaneous other revenues

Our current primary focus is to target those established companies that have both a substantial base of small-business customers as well as a recognizable and trusted brand name in specific market segments. Our goal is to enter into partnerships with these established companies whereby they private label our products and offer them to their small-business customers. We believe the combination of the magnitude of their customer bases and their trusted brand names and recognition will help drive our subscription volume.

Subscription fees primarily consist of sales of subscriptions through private-label marketing partners to end users. We typically have a revenue-share arrangement with these private-label marketing partners in order to encourage them to market our products and services to their customers. We make subscription sales either on a subscription or on a “for fee” basis. Applications for which subscriptions are available vary from our own direct sale website, OneBiz®, to the websites of our partners. Subscriptions are generally payable on a monthly basis and are typically paid via credit card of the individual end user. We are focusing our efforts on enlisting new channel partners as well as diversifying with vertical intermediaries in various industries. In the past, we recognized all subscription revenue on a gross basis and in accordance with our policy to periodically review our accounting policies we recognized that certain contracts require the reporting of subscription revenue on a gross basis and others on a net basis according to US GAAP. On that basis, we continue to report subscription revenue from certain contracts on a gross basis and others on a net basis. The net effect of this reclassification of expenses only impacts gross revenue and certain gross expenses; it does not change the net income. We discuss this matter in more depth in Footnote 1 to the financial statements.

We generate professional service fees from our consulting services. For example, a partner may request that we re-design its website to better accommodate our products or to improve its own website traffic. We typically bill professional service fees on a time and material basis.

License fees consist of perpetual or term license agreements for the use of the Smart Online platform or any of our applications.

Hosting fees are charged for providing our customers with network accessibility.

Other revenues primarily consist of non-core revenue sources such as syndication and integration fees, miscellaneous web services, and OEM revenue generated through sales of our applications bundled with products offered by other manufacturers.

### Cost of Revenues

Cost of revenues primarily is composed of costs related to third-party hosting services, salaries and associated costs of customer support and professional services personnel, credit card processing, depreciation of computer hardware and software used in revenue-producing activities, domain name and e-mail registrations, and allocated development expenses and general and administrative overhead.

We allocate development expenses to cost of revenues based on time spent by development personnel on revenue-producing customer projects and support activities. We allocate general and administrative overhead such as rent and occupancy expenses, depreciation, general office expenses, and insurance to all departments based on headcount. As such, general and administrative overhead expenses are reflected in cost of revenues and each operating expense category.

### Operating Expenses

In previous years, we primarily focused our efforts on basic product development and integration. In the early part of 2007, we also began to focus on licensing our platform products and applications. During 2008, our primary business initiatives included increasing subscription fee revenue and professional services revenue, making organizational improvements, concentrating our development efforts on enhancements and customization of our platforms and applications, and shifting our strategic focus to the sales and marketing of our products. In 2009, we launched our new industry-standard platform, OneBiz, along with enhanced applications targeted to small businesses and devoted significant resources to the sale and marketing of these applications through both channel partners and direct sales efforts.

General and Administrative – General and administrative expenses are composed primarily of costs associated with our executive, finance and accounting, legal, human resources, and information technology personnel and consist of salaries and related compensation costs; professional services (such as outside legal counsel fees, audit, and other compliance costs); depreciation and amortization; facilities and insurance costs; and travel and other costs. We anticipate general and administrative expenses will decrease in 2010 as the legal expenses and other professional fees we incurred in 2009 will be reduced due to the tentative settlements recently reached in certain legal matters.

Sales and Marketing – Sales and marketing expenses are composed primarily of costs associated with our sales and marketing activities and consist of salaries and related compensation costs of our sales and marketing personnel, travel and other costs, and marketing and advertising expenses. In the past, sales and marketing expenses also included the amounts we paid to our marketing partners as part of the subscription revenue received; in the past, the subscription revenue was presented as a gross amount as was the amount included in the sales and marketing category. As part of our ongoing review of accounting pronouncements, we have reclassified the revenues and sales and marketing expenses to reflect net revenue and expense – see footnote 1 to the financial statements for further details. Historically, we spent limited funds on marketing, advertising, and public relations, particularly due to our business model of partnering with established companies with extensive small-business customer bases. In June 2008, we engaged a public relations firm and, as a result, our public relations expenses increased during the latter part of 2008 and 2009. As we continue to execute our sales and marketing strategy to take our enhanced products to market, we expect associated costs to increase in 2010 due to targeting new partnerships, development of channel partner enablement programs, advertising campaigns, additional sales and marketing personnel, and the various percentages of revenues we may be required to pay to future partners as marketing fees.

Research and Development – Research and development expenses include costs associated with the development of new products, enhancements of existing products, and general technology research. These costs are composed primarily of salaries and related compensation costs of our research and development personnel as well as outside consultant costs.

Professional accounting standards require capitalization of certain software development costs subsequent to the establishment of technological feasibility, with costs incurred prior to this time expensed as research and development. Technological feasibility is established when all planning, designing, coding, and testing activities that are necessary to establish that the product can be produced to meet its design specifications have been completed. Historically, we had not developed detailed design plans for our SaaS applications, and the costs incurred between the completion of a working model of these applications and the point at which the products were ready for general release had been insignificant. As a result of these factors, combined with the historically low revenue generated by the sale of the applications that do not support the net realizable value of any capitalized costs, we continued the expensing of underlying costs as research and development.

Beginning in May 2008, we determined that it was strategically desirable to develop an industry-standard platform and to enhance our current SaaS applications. A detailed design plan indicated that the product was technologically feasible. In July 2008, we commenced development, and from that point in time, we have been capitalizing all related costs in accordance with accounting principles. Because of our scalable and secure multi-user architecture, we are able to provide all customers with a service based on a single version of our application. As a result, we do not have to maintain multiple versions, which enables us to incur relatively low development costs as compared to traditional enterprise software business models. We completed the core development of our new applications during 2009 and we expect that future research and development expenses will decrease in both absolute and relative dollars as we amortize the capitalized costs associated with the new platform and reduce our personnel to a core group focused on enhancements and custom development work for customers.

Stock-Based Expenses – Our operating expenses include stock-based expenses related to options, restricted stock awards, and warrants issued to employees and non-employees. These charges have been significant and are reflected in our historical financial results. Effective January 1, 2006, we adopted accounting standards that resulted and will continue to result in material costs on a prospective basis as long as a significant number of options are outstanding. In June 2007, we limited the issuance of awards under our 2004 Equity Compensation Plan, or the 2004 Plan, to awards of restricted or unrestricted stock. In June 2008, we made options available for grant under the 2004 Plan once again, primarily due to the adverse tax consequences to recipients of restricted stock upon the lapsing of restrictions.

## Critical Accounting Policies and Estimates

Our discussion and analysis of financial condition and results of operations are based upon our financial statements, which we prepared in accordance with United States Generally Accepted Accounting Principles (“US GAAP”). The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues, and expenses and related disclosures of contingent assets and liabilities. “Critical accounting policies and estimates” are defined as those most important to the financial statement presentation and that require the most difficult, subjective, or complex judgments. We base our estimates on historical experience and on various other factors that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Under different assumptions and/or conditions, actual results of operations may materially differ. We periodically reevaluate our critical accounting policies and estimates, including those related to revenue recognition, provision for doubtful accounts, expected lives of customer relationships, useful lives of intangible assets and property and equipment, provision for income taxes, valuation of deferred tax assets and liabilities, and contingencies and litigation reserves. We believe the following critical accounting policies involve the most significant judgments and estimates used in the preparation of our consolidated financial statements.

Revenue Recognition – We derive revenue primarily from subscription fees charged to customers accessing our SaaS applications; professional service fees, consisting primarily of consulting; the perpetual or term licensing of software platforms or applications; and hosting and maintenance services. These arrangements may include delivery in multiple-element arrangements if the customer purchases a combination of products and/or services. Because we license, sell, lease, or otherwise market computer software, we use the residual method pursuant to US GAAP. This method allows us to recognize revenue for a delivered element when such element has vendor specific objective evidence, or VSOE, of the fair value of the delivered element. If we cannot determine or maintain VSOE for an element, it could impact revenues, as we may need to defer all or a portion of the revenue from the multiple-element arrangement.

If multiple-element arrangements involve significant development, modification, or customization, or if we determine that certain elements are essential to the functionality of other elements within the arrangement, we defer revenue until we provide to the customer all elements necessary to the functionality. The determination of whether the arrangement involves significant development, modification, or customization could be complex and require the use of judgment by our management.

Under US GAAP, provided the arrangement does not require significant development, modification, or customization, we recognize revenue when all of the following criteria have been met:

1. persuasive evidence of an arrangement exists
2. delivery has occurred
3. the fee is fixed or determinable
4. collectability is probable

If at the inception of an arrangement the fee is not fixed or determinable, we defer revenue until the arrangement fee becomes due and payable. If we deem collectability not probable, we defer revenue until we receive payment or collection becomes probable, whichever is earlier. The determination of whether fees are collectible requires judgment of our management, and the amount and timing of revenue recognition may change if different assessments are made.

We account for consulting, website design fees and application development services separately from the license of associated software platforms when these services have value to the customer and there is objective and reliable evidence of fair value of each deliverable. When accounted for separately, we recognize revenue as the services are rendered for time and material contracts, and when milestones are achieved and accepted by the customer for fixed price or long-term contracts. The majority of our consulting service contracts are on a time and material basis, and we typically bill our customers monthly based upon standard professional service rates.

Application development services are typically fixed price and of a longer term. As such, we account for them as long-term construction contracts that require us to recognize revenue based on estimates involving total costs to complete and the stage of completion. Our assumptions and estimates made to determine the total costs and stage of completion may affect the timing of revenue recognition, with changes in estimates of progress to completion and costs to complete accounted for as cumulative catch-up adjustments. If the criteria for revenue recognition on construction-type contracts are not met, we capitalize the associated costs of such projects and include them in costs in excess of billings on the balance sheet until such time that we are permitted to recognize revenue.



Subscription fees primarily consist of sales of subscriptions through private-label marketing partners to end users. We typically have a revenue-share arrangement with these marketing partners in order to encourage them to market our products and services to their customers. Subscriptions are generally payable on a monthly basis and are typically paid via credit card of the individual end user. We accrue any payments received in advance of the subscription period as deferred revenue and amortize them over the subscription period. In the past, we recognized all subscription revenue on a gross basis and in accordance with our policy to periodically review our accounting policies we determined that certain contracts require the reporting of subscription revenue on a gross basis and others on a net basis according to US GAAP. On that basis, we continue to report subscription revenue from certain contracts on a gross basis and others on a net basis. The net effect of this reclassification of expenses only impacts gross revenue and certain gross expenses; it does not change the net income.

Because our customers generally do not have the contractual right to take possession of the software we license or market at any time, we recognize revenue on hosting and maintenance fees as we provide the services in accordance with US GAAP.

**Provision for Doubtful Accounts** – We maintain an allowance for doubtful accounts for estimated losses resulting from the inability, failure, or refusal of our customers to make required payments. We evaluate the need for an allowance for doubtful accounts based on specifically identified amounts that we believe to be potentially uncollectible. Although we believe that, our allowances are adequate, if the financial conditions of our customers deteriorate, resulting in an impairment of their ability to make payments, or if we underestimate the allowances required, additional allowances may be necessary, which will result in increased expense in the period in which such determination is made.

**Impairment of Long-Lived Assets** – We record our long-lived assets, such as intangibles, property and equipment, at cost. We review the carrying value of our indefinite lived intangibles for possible impairment at least annually in the fourth quarter, and all long-lived assets whenever events or changes in circumstances indicate that the carrying amount of assets may not be recoverable in accordance with the US GAAP. We measure the recoverability of assets to be held and used by comparing the carrying amount of the asset to the fair value. If we consider such assets to be impaired, we measure the impairment as the amount by which the carrying amount exceeds the fair value, and we recognize it as an operating expense in the period in which the determination is made. We report assets to be disposed at the lower of the carrying amount or fair value less costs to sell. Although we believe that the carrying values of our long-lived assets are appropriately stated, changes in strategy or market conditions or significant technological developments could significantly impact these judgments and require adjustments to recorded asset balances.

In addition to the recoverability assessment, we also routinely review the remaining estimated useful lives of our long-lived assets. Any reduction in the useful-life assumption will result in increased depreciation and amortization expense in the period when such determinations are made, as well as in subsequent periods.

**Income Taxes** – We are required to estimate our income taxes in each of the jurisdictions in which we operate. This involves estimating our current tax liabilities in each jurisdiction, including the impact, if any, of additional taxes resulting from tax examinations, as well as making judgments regarding our ability to realize our deferred tax assets. Such judgments can involve complex issues and may require an extended period to resolve. In the event we determine that we will not be able to realize all or part of our net deferred tax assets, we would make an adjustment in the period we make such determination. We recorded no income tax expense in 2009 and 2008, as we have experienced significant operating losses to date. If utilized, we may apply the benefit of our total net operating loss carryforwards to reduce future tax expense. Since our utilization of these deferred tax assets is dependent on future profits, which are not assured, we have recorded a valuation allowance equal to the net deferred tax assets. These carryforwards would also be subject to limitations, as prescribed by applicable tax laws. As a result of prior equity financings and the equity issued in conjunction with certain acquisitions, we have incurred ownership changes, as defined by applicable tax laws. Accordingly, our use of the acquired net operating loss carryforwards may be limited. Further, to the extent that



Edgar Filing: SMART ONLINE INC - Form 10-Q

any single-year loss is not utilized to the full amount of the limitation, such unused loss is carried over to subsequent years until the earlier of its utilization or the expiration of the relevant carryforward period.

Results of Operations for the Three Months Ended March 31, 2010 and March 31, 2009

The following table sets forth certain statements of operations data for the periods indicated:

	Three Months Ended March 31, 2010		Three Months Ended March 31, 2009	
	Dollars	% of Revenue	Dollars	% of Revenue
Total revenues	\$ 363,900	100.0%	\$ 481,687	100.0%
Cost of revenues	365,934	100.5%	492,601	102.3%
Gross profit	\$ (2,034)	-0.5%	\$ (10,914)	-2.3%
Operating expenses	857,059	235.5%	1,472,008	305.6%
Loss from operations	\$ (859,093)	-236.0%	\$ (1,482,922)	-307.9%
Other income (expense), net	(57,832)	-15.9%	(111,731)	-23.2%
Net loss	\$ (916,925)	-251.9%	\$ (1,594,653)	-331.1%
Net loss per common share	\$ (0.05)		\$ (0.09)	

## Revenues

Revenues for the three months ended March 31, 2010 and 2009 comprise the following:

	Three Months Ended March 31,		Change	
	2010	2009	Dollars	Percent
Subscription fees	\$ 136,258	\$ 241,782	\$ (105,524)	-44%
Professional service fees	62,775	118,773	(55,998)	-47%
License fees	87,800	11,250	76,550	680%
Hosting fees	44,272	72,211	(27,939)	-39%
Other revenue	32,795	37,671	(4,876)	-13%
Total revenues	\$ 363,900	\$ 481,687	\$ (117,787)	-24%

Revenues decreased 24% to \$364,000 for the three months ended March 31, 2010 from \$482,000 for the same period in 2009. Our overall decrease in revenues was driven by substantial declines in subscription fees, professional service fees, and hosting fees. Select items are discussed in detail below.

## Subscription Fees

Revenues from subscription fees for the three months ended March 31, 2010 and 2009 are as follows:

	Three Months Ended March 31,		Change	
	2010	2009	Dollars	Percent
Subscription fees	\$ 136,258	\$ 241,782	\$ (105,524)	-44%
Percent of total revenues	37.4%	50.2%		

Revenues from subscription fees decreased 44% to \$136,000 for the three months ended March 31, 2010 from \$242,000 for the same period in 2009. This decline is primarily attributable to the ongoing migration of one direct-selling organization customer to its own technology solution that has resulted in a continuous decline in subscription fees.

## Professional Service Fees

Revenues from professional service fees for the three months ended March 31, 2010 and 2009 are as follows:

	Three Months Ended March 31,		Change	
	2010	2009	Dollars	Percent
Professional service fees	\$ 62,775	118,773	(55,998)	-47%
Percent of total revenues	19.5%	24.7%		

Revenues from professional service fees decreased 47% to \$63,000 for the three months ended March 31, 2010 from \$119,000 for the same period in 2009. This decrease is primarily due to a significant decline in web consulting services provided to customers during the first quarter of 2010.



## License Fees

Revenues from license fees for the three months ended March 31, 2010 and 2009 are as follows:

	Three Months Ended March 31,		Change	
	2010	2009	Dollars	Percent
License fees	\$ 87,800	11,250	76,550	680%
Percent of total revenues	24.1%	2.3%		

Revenues from license fees increased 680% to \$88,000 for the three months ended March 31, 2010 from \$11,000 for the same period in 2009. License fee revenue recognized in the first quarter of 2010 comprised the ratable recognition of a term license that commenced in December 2009. License fee revenue recognized in the first quarter of 2009 comprised three installments of a license agreement to a single customer.

## Hosting Fees

Revenues from hosting fees for the three months ended March 31, 2010 and 2009 are as follows:

	Three Months Ended March 31,		Change	
	2010	2009	Dollars	Percent
Hosting fees	\$ 44,272	72,211	(27,939)	-39%
Percent of total revenues	12.2%	15.0%		

Revenues from hosting fees decreased 39% to \$44,000 for the three months ended March 31, 2010 from \$72,000 for the same period in 2009. This decrease is primarily due to the loss of a major customer offset by the increase in fees from a customer who went into live production in early 2010. We expect hosting fees to increase on an overall basis as we add new channel partners and expand our base of subscribing end users.

## Other Revenue

Revenues from other sources for the three months ended March 31, 2010 and 2009 are as follows:

	Three Months Ended March 31,		Change	
	2010	2009	Dollars	Percent
Other revenue	\$ 32,795	37,671	(4,876)	-13%
Percent of total revenues	9.0%	7.8%		

Revenues from non-core activities decreased 13% to \$33,000 for the three months ended March 31, 2010 from \$38,000 for the same period in 2009. This decrease is primarily attributable to lower billed credit card and payment gateway fees resulting from the loss of a major customer. We expect these revenue streams to continue to be insignificant in the future as we focus on the growth of our subscription fees revenue.

## Cost of Revenues

Cost of revenues for the three months ended March 31, 2010 and 2009 are as follows:



	Three Months Ended		Change	
	March 31,		Dollars	Percent
	2010	2009		
Cost of revenues	\$ 365,934	\$ 492,601	\$ (126,667)	-26%
Percent of total revenues	100.5%	102.3%		

Cost of revenues decreased 26% to \$366,000 for the three months ended March 31, 2010 from \$493,000 for the same period in 2009. This decrease is the result of lower professional services costs associated with professional service fees revenue, which is generally billed on a time and material basis. In addition, we have allocated lower amounts of development and general and administrative expenses as a result of an overall reduction in those areas.

### Operating Expenses

Operating expenses for the three months ended March 31, 2010 and 2009 comprise the following:

	Three Months Ended		Change	
	March 31,		Dollars	Percent
	2010	2009		
Sales and marketing	\$ 152,635	\$ 299,539	\$ (146,904)	-49%
Research and development	32,005	276,879	(244,874)	-88%
General and administrative	672,419	895,590	(223,171)	-31%
Total operating expenses	\$ 857,059	\$ 1,472,008	\$ (614,949)	-42%

Operating expenses decreased 42% to \$857,000 for the three months ended March 31, 2010 from \$1,472,000 for the same period in 2009. This decrease is the direct result of our concerted efforts during the latter part of 2009 and into 2010 to reduce operating expenses by improving efficiencies and eliminating unnecessary costs. Select items are discussed in detail below.

### Sales and Marketing

Sales and marketing expenses for the three months ended March 31, 2010 and 2009 are as follows:

	Three Months Ended		Change	
	March 31,		Dollars	Percent
	2010	2009		
Sales and marketing	\$ 152,635	\$ 299,539	\$ (146,904)	-49%
Percent of total revenues	41.9%	62.2%		

Sales and marketing expenses decreased 49% to \$153,000 for the three months ended March 31, 2010 from \$300,000 for the same period in 2009. This variance is primarily attributable to reductions of \$115,000 associated with staff reductions, \$7,000 of business travel and marketing related costs and \$24,000 in revenue sharing expenses for one customer

### Research and Development

Research and development expenses for the three months ended March 31, 2010 and 2009 are as follows:



	Three Months Ended		Change	
	March 31,		Dollars	Percent
	2010	2009		
Research and development	\$ 32,005	276,879	(244,874)	-88%
Percent of total revenues	8.8%	57.5%		

Research and development expenses decreased 88% to \$32,000 for the three months ended March 31, 2010 from \$277,000 for the same period in 2009. This decrease is primarily attributable to \$223,000 reduction in employee wages and related costs due to staff reductions and a \$22,000 reduction of outside contractor fees incurred during the first quarter of 2010.

#### General and Administrative

General and administrative expenses for the three months ended March 31, 2010 and 2009 are as follows:

	Three Months Ended		Change	
	March 31,		Dollars	Percent
	2010	2009		
General and administrative	\$ 672,419	895,590	(223,171)	-25%
Percent of total revenues	184.8%	185.9%		

General and administrative expenses decreased 25% to \$672,000 for the three months ended March 31, 2010 from \$896,000 for the same period in 2009. This decrease is primarily attributable to reductions of \$126,000 in personnel costs due to lower headcount; \$144,000 in depreciation and amortization related expenses as a result of prior period impairment of intangible asset values, \$23,000 in specialized accounting and tax service expenses, \$7,000 of insurance and utilities, offset by an increase of \$75,000 of additional legal expense due to the ongoing Class Action case and the Nouri Matters.

#### Other Income (Expense)

Other income (expense) for the three months ended March 31, 2010 and 2009 comprise the following:

	Three Months Ended		Change	
	March 31,		Dollars	Percent
	2010	2009		
Interest expense, net	\$ (210,695)	\$ (127,998)	\$ (82,697)	-65%
Gain on disposal of assets, net	-	10,267	(10,267)	-100%
Gain on legal settlements, net	152,863	6,000	146,863	2,448 %
Other expense	-	-	-	-%
Total other expense	\$ (57,832)	\$ (111,731)	\$ 53,889	-48%

Net other expense decreased 48% to \$58,000 for the three months ended March 31, 2010 from \$112,000 for the same period in 2009. This net decrease was primarily attributable to an increase in the gain on legal settlements, which is discussed in detail below.

#### Interest Expense, Net

Interest expense, net of interest income, for the three months ended March 31, 2010 and 2009 is as follows:



Edgar Filing: SMART ONLINE INC - Form 10-Q

	Three Months Ended		Change	
	2010	2009	Dollars	Percent
Interest expense, net	\$ (210,695)	\$ (127,998)	\$ (82,697)	-65%
Percent of total revenues	57.9%	26.6%		

Net interest expense increased 65% to \$211,000 for the three months ended March 31, 2010 from \$128,000 for the same period in 2009. This increase is primarily attributable to additional draw of amounts from the bondholders throughout 2009 and continuing into 2010.

Interest Expense, Net

Interest expense, net of interest income, for the three months ended March 31, 2010 and 2009 is as follows:

	Three Months Ended		Change	
	2010	2009	Dollars	Percent
Gain on legal settlements, net	152,863	6,000	146,863	2,448%
Percent of total revenues	42.0%	1.2%		

Gain on legal settlements increased 2,448% to \$153,000 for the three months ended March 31, 2010 from \$6,000 for the same period in 2009. This increase is primarily attributable to negotiations and settlement of outstanding legal fees associated with the ongoing litigation issues.

#### Provision for Income Taxes

We have not recorded a provision for income tax expense because we have been generating net losses. Furthermore, we have not recorded an income tax benefit for the first quarter of 2010 primarily due to continued substantial uncertainty based on objective evidence regarding our ability to realize our deferred tax assets, thereby warranting a full valuation allowance in our financial statements. We have approximately \$48.2 million in net operating loss carryforwards, which may be utilized to offset future taxable income.

Utilization of our net operating loss carryforwards may be subject to substantial annual limitation due to the ownership change limitations provided by the Internal Revenue Code of 1986, as amended, and similar state provisions. Such an annual limitation could result in the expiration of the net operating loss carryforwards before utilization.

#### Liquidity and Capital Resources

##### Overview

We require cash to fund our operating expenses and working capital requirements, including outlays for capital expenditures and debt service. As of March 31, 2010, our principal sources of liquidity were cash and cash equivalents totaling \$22,000 and current accounts receivable of \$511,593, which is fully reserved, as compared to \$120,000 of cash and cash equivalents and \$13,000 in accounts receivable as of December 31, 2009. We maintain a low cash balance because of automated sweeps among our accounts at Paragon whereby all available cash at the end of each day is used to pay down our line of credit with Paragon, the purpose of which is to reduce our interest expense. As of March 31, 2010, we had drawn approximately \$2,100,000 on the \$2,470,000 line of credit, leaving approximately \$377,000 available under the line of credit for our operations. Deferred revenue at March 31, 2010 was \$39,000 as compared to \$46,000 at December 31, 2009.

As of May 11, 2010, our principal sources of liquidity were cash and cash equivalents totaling approximately \$441,000 and \$512,000 of accounts receivable, which is fully reserved. In addition, we had drawn approximately \$2,007,000 on the Paragon line of credit, leaving approximately \$463,000 available under the line of credit for operations. As of May 11, 2010, we also have a commitment from our convertible secured subordinated noteholders to purchase up to an additional \$4.65 million in Notes upon approval and call by our Board of Directors.

##### Cash Flows

During the three months ended March 31, 2010, our working capital deficit increased by approximately \$300,000 to \$6,916,893 from a working capital deficit of \$6,575,351 at December 31, 2009. As described more fully below, the working capital deficit at March 31, 2010 is primarily attributable to negative cash flows from operations, offset in part by net debt borrowings.



## Cash Flows from Operating Activities

	Three Months Ended		Change	
	2010	2009	Dollars	Percent
Net cash used in operating activities	\$ 791,194	\$ 884,892	\$ (93,698)	-11%

Net cash used in operating activities decreased 11% to \$791,000 for the three months ended March 31, 2010 from \$885,000 for the same period in 2009. This decrease is primarily attributable to a lower net loss for the period, a decrease in accounts receivable, and an increase in accrued liabilities, offset in part by an increase in prepaid expenses and decreases in accounts payable and deferred revenue.

## Cash Flows from Investing Activities

	Three Months Ended		Change	
	2010	2009	Dollars	Percent
Net cash provided by (used in) investing activities	\$ 16,438	\$ (83,281)	\$ 99,719	120%

Net cash provided by investing activities increased 120% to \$16,000 for the three months ended March 31, 2010 from net cash used in investing activities of \$83,000 for the same period in 2009. This net cash provided is attributable to the amortization of capitalized software costs related to our new industry-standard platform offset by the purchase of \$835 of equipment compared to the \$128,000 of investment in capitalized software and equipment for the same period in 2009 offset, in part, by proceeds from the sale of equipment to a customer.

## Cash Flows from Financing Activities

	Three Months Ended		Change	
	2010	2009	Dollars	Percent
Net cash provided by (used in) financing activities	\$ 677,437	\$ 987,860	\$ 310,423	31%

Net cash provided by financing activities decreased 31% to \$677,000 for the three months ended March 31, 2010 from net cash provided by financing activities of \$988,000 for the same period in 2009. This net source of cash is primarily due to net increase in debt borrowings in the first quarter of 2010.

The net cash for the first quarter of 2010 from our financing activities was generated through debt financing, as described below.

## Debt Financing.

## Revolving Credit Facility

On February 20, 2008, the Company entered into a new revolving credit arrangement with Paragon and delivered to Paragon the Paragon Note. The Paragon Note was renewed as of February 22, 2010, pursuant to the Modification Agreement between Paragon and the Company, which extended the maturity date from February 11, 2010 to August 11, 2010 and changed the interest rate on the Paragon Note from a variable annual rate equal to The Wall Street Journal Prime Rate, with a floor of 5.50%, to a fixed annual rate of 6.50%. The total line of credit advanced by Paragon remains \$2.5 million and can be used for general working capital. The line of credit is secured by an

irrevocable standby letter of credit in the amount of \$2.5 million issued by HSBC with Atlas as account party, with an expiration date of September 17, 2010, which was extended from the prior expiration date of February 18, 2010.

As an incentive for the letter of credit from Atlas to secure the Wachovia line of credit, we had entered into a stock purchase warrant and agreement with Atlas. Under the terms of the agreement, Atlas received a warrant to purchase up to 444,444 shares of our common stock at \$2.70 per share within 30 business days of the termination of the Wachovia line of credit or if we are in default under the terms of the line of credit with Wachovia. In consideration for Atlas providing the letter of credit to Paragon, we agreed to amend the agreement to provide that the warrant is exercisable within 30 business days of the termination of the Paragon line of credit or if we are in default under the terms of the line of credit with Paragon.

Furthermore, in connection with establishing the Paragon line of credit, Atlas and the Company entered into a Reimbursement Agreement, dated November 14, 2006 (as amended, the "Reimbursement Agreement") to provide that, in the event of a default by the Company in the repayment of the Paragon Note that results in the letter of credit being drawn, the Company will reimburse Atlas any sums that Atlas is required to pay under the letter of credit in either cash or stock, at the Company's election. On January 19, 2010, Atlas and the Company entered into the Second Amendment to the Reimbursement Agreement (the "Second Amendment") to provide that at the sole discretion of Atlas, any such payments to Atlas may be made in cash, common stock of the Company, or convertible reimbursement notes.

The Company entered into the Second Amendment in partial consideration for a waiver from Atlas as the Requisite Percentage Holder. Sales of Notes to the convertible noteholders are subject to certain conditions, including the absence of events or conditions that could reasonably be expected to have a material adverse effect on the ability of the Company to perform its obligations under the Note Purchase Agreement. The agent for the convertible noteholders had advised the Company that the Company's obligations to the Nouris may constitute such a material adverse effect. However, Atlas, as the Requisite Percentage Holder, advised the Company that it would be willing to waive the foregoing funding conditions relating to the judgment if, and for so long as, the Nouris do not actively pursue enforcement of such judgment, and, in addition, if the Company entered into the Second Amendment.

## Convertible Notes

On November 14, 2007, in an initial closing, the Company sold \$3.3 million aggregate principal amount of Notes (the "Initial Notes"). In addition, the noteholders committed to purchase on a pro rata basis up to \$5.2 million aggregate principal of Notes in future closings upon approval and call by our Board of Directors. On August 12, 2008, we exercised our option to sell \$1.5 million aggregate principal of additional Notes (the "Additional Notes") to existing noteholders, with substantially the same terms and conditions as the Initial Notes. In connection with the sale of the Additional Notes, the noteholders holding a majority of the aggregate principal amount of the Notes then outstanding agreed to increase the aggregate principal amount of Notes that they are committed to purchase from \$8.5 million to \$15.3 million. On November 21, 2008, we sold \$500,000 aggregate principal amount of additional Notes due November 14, 2010, to two new convertible noteholders, with substantially the same terms and conditions as the Initial Notes and the Additional Notes. At December 31, 2008, \$5.3 million aggregate principal amount of Notes were outstanding.

On January 6, 2009, the Company sold \$500,000 aggregate principal amount of Notes to Atlas, on substantially the same terms and conditions as the previously issued Notes.

On February 24, 2009, the Company sold \$500,000 aggregate principal amount of Notes to Atlas on substantially the same terms and conditions as the previously issued Notes. On the same date, the noteholders holding a majority of the aggregate principal amount of the Notes outstanding agreed that the Company may sell up to \$6 million aggregate principal amount of Additional Notes to new convertible noteholders or existing noteholders at any time on or before December 31, 2009 with a maturity date of November 14, 2010 or later. In addition, the maturity date definition for each of the Notes was changed from November 14, 2010 to the date upon which the note is due and payable, which is the earlier of (1) November 14, 2010, (2) a change of control, or (3) if an event of default occurs, the date upon which noteholders accelerate the indebtedness evidenced by the Notes. The formula for calculating the conversion price of the Notes was also amended such that the conversion price of each outstanding note and any additional note sold in the future would be the same and set at the lowest applicable conversion price, as described below.

On each of April 3, 2009 and June 2, 2009, the Company sold a Note in the principal amount of \$500,000 to Atlas on substantially the same terms and conditions as the previously issued Notes. On each of July 16, 2009, August 26, 2009, September 8, 2009, and October 5, 2009, the Company sold a Note in the principal amount of \$250,000 to Atlas on substantially the same terms and conditions as the previously issued Notes. On October 9, 2009, the Company sold a Note in the principal amount of \$250,000 to UBP, Union Bancaire Privee, an existing noteholder, on substantially the same terms and conditions as the previously issued Notes. On November 6, 2009, the Company sold a Note to Atlas in the principal amount of \$500,000, on December 23, 2009 the Company sold a Note to Atlas in the principal amount of \$750,000, and on February 11, 2010, the Company sold a Note to Atlas in the principal amount of \$500,000, all upon substantially the same terms and conditions as the previously issued Notes

On March 5, 2010, the Company and the Requisite Percentage Holder, among other convertible noteholders, entered into the Fourth Amendment. The Fourth Amendment extends the original maturity date of the Notes from November 14, 2010 to November 14, 2013, and amends the Note Purchase Agreement and the Registration Rights Agreement, dated November 14, 2007, to reflect this extension, as reported on the Form 8-K filed by the Company on March 10, 2010.

On April 1, 2010, the Company sold a Note to Atlas in the principal amount of \$350,000, due November 14, 2013, upon substantially the same terms and conditions as the previously issued Notes.

On the earlier of the maturity date of November 14, 2013 or a merger or acquisition or other transaction pursuant to which our existing stockholders hold less than 50% of the surviving entity, or the sale of all or substantially all of our

assets, or similar transaction, or event of default, each noteholder in its sole discretion shall have the option to:

- convert the principal then outstanding on its notes into shares of our common stock, or
- receive immediate repayment in cash of the notes, including any accrued and unpaid interest.

If a noteholder elects to convert its Notes under these circumstances, the conversion price will be the lowest “applicable conversion price” determined for each Note. The “applicable conversion price” for each Note shall be calculated by multiplying 120% by the lowest of

- the average of the high and low prices of the Company’s common stock on the OTC Bulletin Board averaged over the five trading days prior to the closing date of the issuance of such Note,
- if the Company’s common stock is not traded on the Over-The-Counter market, the closing price of the common stock reported on the Nasdaq National Market or the principal exchange on which the common stock is listed, averaged over the five trading days prior to the closing date of the issuance of such Note, or
- the closing price of the Company’s common stock on the OTC Bulletin Board, the Nasdaq National Market, or the principal exchange on which the common stock is listed, as applicable, on the trading day immediately preceding the date such Note is converted, in each case as adjusted for stock splits, dividends or combinations, recapitalizations, or similar events.

We are obligated to pay interest on the notes at an annualized rate of 8% payable in quarterly installments commencing three months after the purchase date of the Notes. We are not permitted to prepay the Notes without approval of the holders of at least a majority of the principal amount of the notes then outstanding.

Payment of the Notes will be automatically accelerated if we enter voluntary or involuntary bankruptcy or insolvency proceedings.

The Notes and the common stock into which they may be converted have not been registered under the Securities Act or the securities laws of any other jurisdiction. As a result, offers and sales of the Notes were made pursuant to Regulation D of the Securities Act and only made to accredited investors. The noteholders of the Initial Notes include (i) Blueline, which originally recommended Philippe Pouponnot, one of our former directors, for appointment to the Board of Directors; (ii) Atlas, an affiliate that originally recommended Shlomo Elia, one of our current directors, for appointment to the Board of Directors; (iii) Crystal Management Ltd., which is owned by Doron Roethler, the former Chairman of our Board of Directors and former Interim Chief Executive Officer and who currently serves as the noteholders’ bond representative; and (iv) William Furr, who is the father of Thomas Furr, who, at the time, was one of our directors and executive officers. The noteholders of the Additional Notes are Atlas and Crystal Management Ltd. The noteholders the New Notes are not affiliated with the Company.

If we propose to file a registration statement to register any of its common stock under the Securities Act in connection with the public offering of such securities solely for cash, subject to certain limitations, we must give each noteholder who has converted its notes into common stock the opportunity to include such shares of converted common stock in the registration. We have agreed to bear the expenses for any of these registrations, exclusive of any stock transfer taxes, underwriting discounts, and commissions.

No fees are payable in connection with the offering of Notes.

We have not yet achieved positive cash flows from operations, and our main sources of funds for our operations are the sale of securities in private placements, the sale of additional Notes, and bank lines of credit. We must continue to rely on these sources until we are able to generate sufficient cash from revenues to fund our operations. We believe that anticipated cash flows from operations, funds available from our existing line of credit (which expires August 2010, as described above), replacement of the existing line of credit and additional issuances of notes, together with cash on hand, will provide sufficient funds to finance our operations at least for the next 12 to 18 months, depending on our ability to achieve strategic goals outlined in our annual operating budget approved by our Board of Directors. Changes in our operating plans, lower than anticipated sales, increased expenses, or other events may cause us to seek additional equity or debt financing in future periods. There can be no guarantee that financing will be available on acceptable terms or at all. Additional equity financing could be dilutive to the holders of our common stock, and additional debt financing, if available, could impose greater cash payment obligations and more covenants and operating restrictions. If the tentative Class Action settlement is finalized, current shareholders will be further diluted due to the issuance of an additional 1,475,000 shares of common stock pursuant to the terms of the tentative agreement.



## Going Concern

Our independent registered public accountants have issued an explanatory paragraph in their report included in our Annual Report on Form 10-K for the year ended December 31, 2009 in which they express substantial doubt as to our ability to continue as a going concern. The financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or the amounts or classification of liabilities that might be necessary should we be unable to continue as a going concern. Our continuation as a going concern depends on our ability to generate sufficient cash flows to meet our obligations on a timely basis, to obtain additional financing that is currently required, and ultimately to attain profitable operations and positive cash flows. There can be no assurance that our efforts to raise capital or increase revenue will be successful. If our efforts are unsuccessful, we may have to cease operations and liquidate our business.

## Recent Developments

On April 1, 2010, we sold \$350,000 aggregate principal amount of Notes to Atlas with substantially the same terms and conditions as the previously outstanding Notes.

In 2008, the Company entered into a non-cancellable sublease to relocate its North Carolina headquarters to another facility near Research Triangle Park, under which the Company prepaid rent in the total amount of \$450,080 and purchased existing furniture and fixtures for an additional \$49,920, which furniture and fixtures were capitalized for depreciation purposes. Effective May 1, 2010, the sublease was restructured as a direct lease with the owner of the property, with a termination date of September 30, 2011 (the "Lease"). After taking into account the monthly amortization of prepaid rent, the Company is obligated to make minimum monthly rent payments in the amount of \$4,208.13 during the term of the Lease, together with a percentage of operating expenses. The Company includes the prepaid rent amount of \$450,080 as an asset being amortized monthly over the remaining term of the Lease.

### Item 3. Quantitative and Qualitative Disclosures About Market Risk

Not applicable.

### Item 4. Controls and Procedures

Not applicable.

### Item 4T. Controls and Procedures

Our management, with the participation of our interim Chief Executive Officer and interim Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of March 31, 2010. The term "disclosure controls and procedures," as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, as ours are designed to do, and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of March 31, 2010, our interim Chief

Executive Officer and interim Chief Financial Officer concluded that, as of such date, our disclosure controls and procedures were not effective at the reasonable assurance level due to the material weaknesses described below.

We routinely review our internal control over financial reporting and from time to time make changes intended to enhance the effectiveness of our internal control over financial reporting.

Review of our revenue recognition procedures during the fourth quarter of 2009 caused the restatement of financial statements for the first three quarters of 2009 and three quarters of 2008. The restatement included the presentation of net subscription revenue as compared to the gross subscription revenue. In the past we recognized all subscription revenue on a gross basis and in accordance with our policy to periodically review our accounting procedures we identified the fact that certain contracts require the reporting of subscription revenue on a gross basis and others on a net basis according to US GAAP. As a result of our review, we continue to report subscription revenue from certain contracts on a gross basis and others on a net basis. The net effect of this reclassification of expenses only impacts gross revenue and certain gross expenses; it does not change the net income.

In order to address the material weakness we have implemented a system whereby each new contract entered into by the company must be reviewed and approved by the Chief Financial Officer.

We will continue to evaluate the effectiveness of our disclosure controls and procedures and internal control over financial reporting on an ongoing basis and will take action as appropriate. There have been no changes to our internal control over financial reporting, as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act, during the three months ended March 31, 2010 that we believe materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II – OTHER INFORMATION

### Item 1. Legal Proceedings

Please refer to Part I, Item 3 of our Annual Report on Form 10-K for the fiscal year ended December 31, 2009 for a description of material legal proceedings.

At this time, except as discussed above, we are not able to determine the outcome of the legal matters described above, nor can we estimate our entire potential financial exposure. If an unfavorable resolution of any of these matters occurs, our business, results of operations, and financial condition could be materially adversely affected

### Item 1A. Risk Factors

We operate in a dynamic and rapidly changing business environment that involves substantial risk and uncertainty, and these risks may change over time. The following discussion addresses some of the risks and uncertainties that could cause, or contribute to causing, actual results to differ materially from expectations. In evaluating our business, you should pay particular attention to the descriptions of risks and uncertainties described below. If any of these risks actually occur, our business, financial condition, or results of operations could be materially and adversely affected.

Historically, we have operated at a loss, and we continue to do so.

We have had recurring losses from operations and continue to have negative cash flows. If we do not become cash flow positive through additional financing or growth, we may have to cease operations and liquidate our business. Our working capital, which is dependent on our convertible note financing facility, should fund our operations for the next 12 to 18 months. As of April 14, 2010, we have approximately \$405,000 available on our line of credit and approximately \$4.65 million available through our convertible note financing. Factors such as the commercial success of our existing services and products, the timing and success of any new services and products, the progress of our research and development efforts, our results of operations, the status of competitive services and products, the timing and success of potential strategic alliances or potential opportunities to acquire technologies or assets, and expenses on account of lawsuits brought by a former officer and a former employee for advancement of indemnification expenses and the tentative settlement of the shareholder class action lawsuit (see Part II, Item I, Legal Proceedings, above) will require us to seek additional funding sooner than we expect. If we fail to raise sufficient financing, we will not be able to implement our business plan and may not be able to sustain our business.

In addition, our current primary credit facilities consisting of the Paragon line of credit with a due date of August 14, 2010 and the convertible note financing with a maturity date in November 2013. Should we be unable to repay the principal then due from operations or from new or renegotiated capital funding sources, we may not be able to sustain our business. As of April 14, 2010, we have approximately \$2.0 million outstanding on our line of credit and \$10.45 million aggregate principal amount of convertible Notes outstanding, net of a \$200,000 reduction in connection with the Company's sale/leaseback of equipment in September 2009.

Our independent registered public accountants indicate that they have substantial doubts that we can continue as a going concern. Our independent registered public accountants' opinion may negatively affect our ability to raise additional funds, among other things. If we fail to raise sufficient capital, we will not be able to implement our business plan, we may have to liquidate our business, and you may lose your investment.

Cherry, Bekaert & Holland, L.L.P. our independent registered public accountants have expressed substantial doubt in their report included with our Annual Report on Form 10-K for the year ended December 31, 2009 about our ability to

continue as a going concern given our recurring losses from operations and deficiencies in working capital and equity, which are described in the first risk factor above. This opinion could materially limit our ability to raise additional funds by issuing new debt or equity securities or otherwise. If we fail to raise sufficient capital, we will not be able to implement our business plan, we may have to liquidate our business, and you may lose your investment. You should consider our independent registered public accountants' comments when determining if an investment in us is suitable.

Current economic uncertainties in the global economy could adversely impact our growth, results of operations, and our ability to forecast future business.

Since 2008 there has been a downturn in the global economy, slower economic activity, decreased consumer confidence, reduced corporate profits and capital spending, adverse business conditions, and liquidity concerns. These conditions make it difficult for our customers and us to accurately forecast and plan future business activities, and they could cause our customers to slow or defer spending on our products and services, which would delay and lengthen sales cycles, or change their willingness to enter into longer-term licensing and support arrangements with us. Furthermore, during challenging economic times our customers may face issues gaining timely access to sufficient credit, which could result in an impairment of their ability to make timely payments to us. If that were to occur, we may be required to increase our allowance for doubtful accounts and our results would be negatively impacted.

We may also face difficulties in obtaining additional credit or renewing existing credit at favorable terms, or at all, which could impact our ability to fund our operations or to meet debt repayment requirements as they come due.

We cannot predict the timing, strength, or duration of any economic slowdown or subsequent economic recovery. If the downturn in the general economy or markets in which we operate persists or worsens from present levels, our business, financial condition, and results of operations could be materially and adversely affected.

Our business is dependent upon the development and market acceptance of our applications.

Our future financial performance and revenue growth will depend, in part, upon the successful development, integration, introduction, and customer acceptance of our software applications. Thereafter, other new products, whether developed or acquired, and enhanced versions of our existing applications will be critically important to our business. Our business could be harmed if we fail to deliver timely enhancements to our current and future solutions that our customers desire. We also must continually modify and enhance our services and products to keep pace with market demands regarding hardware and software platforms, database technology, information security, and electronic commerce technical standards. Our business could be harmed if we fail to achieve the improved performance that customers want with respect to our current and future product offerings. There can be no assurance that our products will achieve widespread market penetration or that we will derive significant revenues from the sale or licensing of our platforms or applications.

We have not yet demonstrated that we have a successful business model.

We have invested significantly in infrastructure, operations, and strategic relationships to support our SaaS delivery model, which represents a significant departure from the delivery strategies that we and other software vendors have traditionally employed. To maintain positive margins for our small-business services, our revenues will need to continue to grow more rapidly than the cost of such revenues. We anticipate that our future financial performance and revenue growth will depend, in large part, upon our Internet-based SaaS business model and the results of our sales efforts to reach agreements with marketing partners with small-business customer bases, but this business model may become ineffective due to forces beyond our control that we do not currently anticipate. Although we currently have various agreements and continue to enter into new agreements, our success depends in part on the ultimate success of our marketing partners and referral partners and their ability to market our products and services successfully. Our partners are not obligated to provide potential customers to us and may have difficulty retaining customers within certain markets that we serve. In addition, some of these third parties have entered, and may continue to enter, into strategic relationships with our competitors. Further, many of our strategic partners have multiple strategic relationships, and they may not regard us as significant for their businesses. Our strategic partners may terminate their respective relationships with us, pursue other partnerships or relationships, or attempt to develop or acquire products or services that compete with our products or services. Our strategic partners also may interfere with our ability to

enter into other desirable strategic relationships. If we are unable to maintain our existing strategic relationships or enter into additional strategic relationships, we will have to devote substantially more resources to the distribution, sales, and marketing of our products and services.

In addition, our end users currently do not sign long-term contracts. They have no obligation to renew their subscriptions for our services after the expiration of their initial subscription period and, in fact, they have often elected not to do so. Our end users also may renew for a lower-priced edition of our services or for fewer users. These factors make it difficult to accurately predict customer renewal rates. Our customers' renewal rates may decline or fluctuate as a result of a number of factors, including when we begin charging for our services, their dissatisfaction with our services, and their capability to continue their operations and spending levels. If our customers do not renew their subscriptions for our services or we are not able to increase the number of subscribers, our revenue may decline and our business will suffer.

Failure to comply with the provisions of our debt financing arrangements could have a material adverse effect on us.

Our revolving line of credit from Paragon is secured by an irrevocable standby letter of credit issued by HSBC with Atlas as account party. Our secured subordinated convertible notes are secured by a first priority lien on all of our unencumbered assets.

If an event of default occurs under our debt financing arrangements and remains uncured, then the lender could foreclose on the assets securing the debt. If that were to occur, it would have a substantial adverse effect on our business. In addition, making the principal and interest payments on these debt arrangements may drain our financial resources or cause other material harm to our business.

If our security measures are breached and unauthorized access is obtained to our customers' data or our data, our service may be perceived as not being secure, customers may curtail or stop using our service, and we may incur significant legal and financial exposure and liabilities.

Our service involves the storage and transmission of customers' proprietary information. If our security measures are breached as a result of third-party action, employee error, malfeasance or otherwise and, as a result, unauthorized access is obtained to our customers' data or our data, our reputation could be damaged, our business may suffer, and we could incur significant liability. In addition, third parties may attempt to fraudulently induce employees or customers to disclose sensitive information such as user names, passwords, or other information in order to gain access to our customers' data or our data, which could result in significant legal and financial exposure and a loss of confidence in the security of our service that would harm our future business prospects. Because the techniques used to obtain unauthorized access, or to sabotage systems, change frequently and generally are not recognized until launched against a target, we may be unable to anticipate these techniques or to implement adequate preventative measures. If an actual or perceived breach of our security occurs, the market perception of the effectiveness of our security measures could be harmed and we could lose sales and customers. In addition, our new industry-standard platform may allow access by third-party technology providers to access customer data. Because we do not control the transmissions between our customers and third-party technology providers, or the processing of such data by third-party technology providers, we cannot ensure the complete integrity or security of such transmissions or processing.

The SEC and criminal actions brought against certain former employees, and related stockholder and other lawsuits have damaged our business, and they could damage our business in the future.

The SEC lawsuit and criminal actions filed against a former officer and a former employee, and the class action lawsuit filed against us and certain current and former officers, directors, and employees have harmed our business in many ways and may cause further harm in the future. Since the initiation of these actions, our ability to raise financing from new investors on favorable terms has suffered due to the lack of liquidity of our stock, the questions raised by these actions, and the resulting drop in the price of our common stock. As a result, we may not raise sufficient financing, if necessary, in the future.

Legal and other fees related to these actions have also reduced our available cash for operations. We make no assurance that we will not continue to experience additional harm as a result of these matters. The time spent by our management team and directors dealing with issues related to these actions detracts, and despite the tentative settlement of the Class Action continue to detract from the time they spend on our operations, including strategy development and implementation. These actions, more fully described in Part I, Item 3, "Legal Proceedings" in the Annual Report on Form 10-K for the year ended December 31, 2009, also have harmed our reputation in the business community, jeopardized our relationships with vendors and customers, and decreased our ability to attract qualified personnel, especially given the media coverage of these events.



Compliance with regulations governing public company corporate governance and reporting is uncertain and expensive.

As a public company, we have incurred and will continue to incur significant legal, accounting, and other expenses that we did not incur as a private company. We incur costs associated with our public company reporting requirements and with corporate governance and disclosure requirements, including requirements under the Sarbanes-Oxley Act of 2002, or Sarbanes-Oxley, and rules implemented by the SEC and the Financial Industry Regulatory Authority, or FINRA. We expect these rules and regulations to increase our legal and financial compliance costs and to make some activities more time consuming and costly.

We currently are required to comply with the requirements of Section 404 of Sarbanes-Oxley involving management's assessment of our internal control over financial reporting, and our independent accountant's audit of our internal control over financial reporting is required for fiscal year 2010. To comply with these requirements, we are evaluating and testing our internal controls, and where necessary, taking remedial actions, to allow management to report on, and our independent auditors to attest to, our internal control over financial reporting. As a result, we have incurred and will continue to incur expenses and diversion of management's time and attention from the daily operations of the business, which may increase our operating expenses and impair our ability to achieve profitability.

Officers, directors, and principal stockholders control us. This might lead them to make decisions that do not align with interests of minority stockholders.

Our principal stockholders beneficially own or control a large percentage of our outstanding common stock. Certain of these principal stockholders hold warrants and Notes, which may be exercised or converted into additional shares of our common stock under certain conditions. The convertible noteholders have designated a bond representative to act as their agent. We have agreed that the bond representative shall be granted access to our facilities and personnel during normal business hours, shall have the right to attend all meetings of our Board of Directors and its committees, and shall receive all materials provided to our Board of Directors or any committee of our Board. In addition, so long as the notes are outstanding, we have agreed that we will not take certain material corporate actions without approval of the bond representative.

Our principal stockholders, acting together, would have the ability to control substantially all matters submitted to our stockholders for approval (including the election and removal of directors and any merger, consolidation, or sale of all or substantially all of our assets) and to control our management and affairs. Accordingly, this concentration of ownership may have the effect of delaying, deferring, or preventing a change in control of us; impeding a merger, consolidation, takeover, or other business combination involving us; or discouraging a potential acquirer from making a tender offer or otherwise attempting to obtain control of us, which in turn could materially and adversely affect the market price of our common stock.

Any issuance of shares of our common stock in the future could have a dilutive effect on the value of our existing stockholders' shares.

We may issue shares of our common stock in the future for a variety of reasons. For example, under the terms of our stock purchase warrant and agreement with Atlas, it may elect to purchase up to 444,444 shares of our common stock at \$2.70 per share upon termination of, or if we are in breach under the terms of, our line of credit with Paragon. In connection with our private financing in February 2007, we issued warrants to the Investors (defined below) to purchase an additional 1,176,471 shares of our common stock at \$3.00 per share (which warrants were not exercised and have expired in February 2010) and a warrant to our placement agent in that transaction to purchase 35,000 shares of our common stock at \$2.55 per share. Upon maturity of their convertible Notes, our convertible noteholders may elect to convert all, a part of, or none of their Notes into shares of our common stock at a floating conversion price. In addition, we may raise funds in the future by issuing additional shares of common stock or other securities.

Under the tentative Class Action settlement, the settlement consideration would include 1,475,000 shares of Company common stock. Under the terms of the tentative settlement agreement, counsel for the settlement class may sell some or all of the common stock received in the settlement before distribution to the class, subject to the limitation that it cannot sell more than 10,000 shares on one day or 50,000 shares in 30 calendar days. This issuance and sale may have a further dilutive effect on the value of the Company's outstanding shares.

If we raise additional funds through the issuance of equity securities or debt convertible into equity securities, the percentage of stock ownership by our existing stockholders would be reduced. In addition, such securities could have rights, preferences, and privileges senior to those of our current stockholders, which could substantially decrease the value of our securities owned by them. Depending on the share price we are able to obtain, we may have to sell a significant number of shares in order to raise the necessary amount of capital. Our stockholders may experience dilution in the value of their shares as a result.

Shares eligible for public sale could adversely affect our stock price.

Future sales of substantial amounts of our shares in the public market, or the appearance that a large number of our shares are available for sale, could adversely affect market prices prevailing from time to time and could impair our ability to raise capital through the sale of our securities. At April 8, 2010, 18,332,543 shares of our common stock were issued and outstanding, and a significant number of shares may be issued upon the exercise of outstanding options, warrants, and convertible notes.

In addition, our stock historically has been very thinly traded. Our stock price may decline if the resale of shares under Rule 144, in addition to the resale of registered shares, at any time in the future exceeds the market demand for our stock.

Our stock price is likely to be highly volatile and may decline.

The trading prices of the securities of technology companies have been highly volatile. Accordingly, the trading price of our common stock has been and is likely to continue to be subject to wide fluctuations. Further, our common stock has a limited trading history. Factors affecting the trading price of our common stock generally include the risk factors described in this report.

In addition, the stock market from time to time has experienced extreme price and volume fluctuations that have affected the trading prices of many emerging growth companies. Such fluctuations have often been unrelated or disproportionate to the operating performance of these companies. These broad trading fluctuations could adversely affect the trading price of our common stock.

Our securities may be subject to “penny stock” rules, which could adversely affect our stock price and make it more difficult for our stockholders to resell their stock.

The SEC has adopted rules that regulate broker-dealer practices in connection with transactions in penny stocks. Penny stocks are generally equity securities with a price of less than \$5.00 per share (other than securities registered on certain national securities exchanges or quotation systems, provided that reports with respect to transactions in such securities are provided by the exchange or quotation system pursuant to an effective transaction reporting plan approved by the SEC).

The penny stock rules require a broker-dealer, prior to a transaction in a penny stock not otherwise exempt from those rules, to deliver a standardized risk disclosure document prescribed by the SEC and certain other information related to the penny stock, the broker-dealer’s compensation in the transaction, and the other penny stocks in the customer’s account.

In addition, the penny stock rules require that, prior to a transaction in a penny stock not otherwise exempt from those rules, the broker-dealer must make a special written determination that the penny stock is a suitable investment for the purchaser and receive the purchaser’s written acknowledgment of the receipt of a risk disclosure statement, a written agreement related to transactions involving penny stocks, and a signed and dated copy of a written suitability statement. These disclosure requirements could have the effect of reducing the trading activity in the secondary market for our stock because it will be subject to these penny stock rules. Therefore, stockholders may have difficulty selling those securities.

The executive management team is critical to the execution of our business plan, and the frequency of management turnover has been disruptive to the success of the business.

Our executive management team has undergone significant changes during 2008 and 2009, including the resignation of our former Chief Executive Officer in December 2008, our former interim Chief Executive Officers in May 2009 and November 2009 and the resignation of our former Chief Financial Officer in May 2009, among others. . Furthermore, in light of the prior SEC charges filed against us, and the related adverse publicity from the criminal trial and conviction of the Nouris, it may be difficult to attract highly qualified candidates to serve on our executive management team. If we cannot attract and retain qualified personnel and integrate new members of our executive management team effectively into our business, then our business and financial results may suffer. In addition, all of our executive team works at the same location, which could make us vulnerable to the loss of our entire team in the

event of a natural or other disaster. We do not maintain key man insurance policies on any of our employees.

Our line of credit with Paragon Bank expires on August 14, 2010.

Paragon Bank has extended our line of credit until August 14, 2010. If we are unable to establish a new line of credit, we may have difficulty dealing with cash flow activities of daily business operations that will be disruptive to the future success of the business

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

On February 11, 2010, the Company sold a Note to Atlas in the principal amount of \$500,000, upon substantially the same terms and conditions as the previously issued Notes, as described in Part I, Item 1, Note 3, Notes Payable, of this Quarterly Report on Form 10-Q.

There were no repurchases of any securities during the first quarter of fiscal 2010.

Item 3. Default Upon Securities

None.

Item 4. (Removed and Reserved)

Item 5. Other Information

None.

Item 6. Exhibits

The following exhibits are being filed herewith and are numbered in accordance with Item 601 of Regulation S-K:

Exhibit No.	Description
-------------	-------------

EXHIBIT INDEX

Exhibit No.	Description
3.1	Sixth Amended and Restated Bylaws (incorporated herein by reference to Exhibit 3.1 to our Current Report on Form 8-K, as filed with the SEC on January 20, 2010)
4.1	Fourth Amendment to Convertible Secured Subordinated Note Purchase Agreement, Second Amendment to Convertible Secured Subordinated Promissory Notes and Third Amendment to Registration Rights Agreement, dated March 5, 2010, by and among Smart Online, Inc. and certain investors (incorporated herein by reference to Exhibit 4.8 to our Annual Report on Form 10-K, as filed with the SEC on April 15, 2010)
4.2	Form of Convertible Secured Subordinated Promissory Note to be issued post March 5, 2010 (incorporated herein by reference to Exhibit 4.9 to our Annual Report on Form 10-K, as filed with the SEC on April 15, 2010)
10.1	Form of revised Non-Qualified Stock Option Agreement under Smart Online, Inc.'s 2004 Equity Compensation Plan (incorporated herein by reference to Exhibit 10.6 to our Annual Report on Form 10-K, as filed with the SEC on April 15, 2010)
10.2	Form of revised Restricted Stock Agreement under Smart Online, Inc.'s 2004 Equity Compensation Plan (Non-Employee Director) (incorporated herein by reference to Exhibit 10.12 to our Annual Report on Form 10-K, as filed with the SEC on April 15, 2010)
10.3	Smart Online, Inc. Revised Board Compensation Policy, effective March 26, 2010 (incorporated herein by reference to Exhibit 10.21 to our Annual Report on Form 10-K, as filed with the SEC on April 15, 2010)
10.4	Modification Agreement, made as of February 22, 2010, between Smart Online, Inc. and Paragon Commercial Bank (incorporated herein by reference to Exhibit 10.35 to our Annual Report on Form 10-K, as filed with the SEC on April 15, 2010)
10.5	Second Amendment to Reimbursement Agreement, dated January 19, 2010, by and between Smart Online, Inc. and Atlas Capital, SA (incorporated herein by reference to Exhibit 10.38 to our Annual Report on Form 10-K, as filed with the SEC on April 15, 2010)
31.1	Certification of Principal Executive Officer Pursuant to Rule 13a-14(a) as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Principal Financial Officer/Principal Accounting Officer Pursuant to Rule 13a-14(a) as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Principal Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. This exhibit is being furnished pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not, except to the extent required by that Act, be deemed to be incorporated by reference into any document or filed herewith for the purposes of liability under the Securities Exchange Act of 1934, as amended, or the Securities Act of 1933, as amended, as the case may be.
32.2	Certification of Principal Financial Officer/Principal Accounting Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. This exhibit is being

Edgar Filing: SMART ONLINE INC - Form 10-Q

furnished pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not, except to the extent required by that Act, be deemed to be incorporated by reference into any document or filed herewith for the purposes of liability under the Securities Exchange Act of 1934, as amended, or the Securities Act of 1933, as amended, as the case may be.



SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

SMART ONLINE, INC.

May 14, 2010

By: /s/ Dror Zoreff  
Dror Zoreff  
Interim Chief Executive Officer

May 14, 2010

By: /s/ Thaddeus J. Shalek  
Thaddeus J. Shalek  
Interim Chief Financial Officer

EXHIBIT INDEX

Exhibit No.	Description
3.1	Sixth Amended and Restated Bylaws (incorporated herein by reference to Exhibit 3.1 to our Current Report on Form 8-K, as filed with the SEC on January 20, 2010)
4.1	Fourth Amendment to Convertible Secured Subordinated Note Purchase Agreement, Second Amendment to Convertible Secured Subordinated Promissory Notes and Third Amendment to Registration Rights Agreement, dated March 5, 2010, by and among Smart Online, Inc. and certain investors (incorporated herein by reference to Exhibit 4.8 to our Annual Report on Form 10-K, as filed with the SEC on April 15, 2010)
4.2	Form of Convertible Secured Subordinated Promissory Note to be issued post March 5, 2010 (incorporated herein by reference to Exhibit 4.9 to our Annual Report on Form 10-K, as filed with the SEC on April 15, 2010)
10.1	Form of revised Non-Qualified Stock Option Agreement under Smart Online, Inc.'s 2004 Equity Compensation Plan (incorporated herein by reference to Exhibit 10.6 to our Annual Report on Form 10-K, as filed with the SEC on April 15, 2010)
10.2	Form of revised Restricted Stock Agreement under Smart Online, Inc.'s 2004 Equity Compensation Plan (Non-Employee Director) (incorporated herein by reference to Exhibit 10.12 to our Annual Report on Form 10-K, as filed with the SEC on April 15, 2010)
10.3	Smart Online, Inc. Revised Board Compensation Policy, effective March 26, 2010 (incorporated herein by reference to Exhibit 10.21 to our Annual Report on Form 10-K, as filed with the SEC on April 15, 2010)
10.4	Modification Agreement, made as of February 22, 2010, between Smart Online, Inc. and Paragon Commercial Bank (incorporated herein by reference to Exhibit 10.35 to our Annual Report on Form 10-K, as filed with the SEC on April 15, 2010)
10.5	Second Amendment to Reimbursement Agreement, dated January 19, 2010, by and between Smart Online, Inc. and Atlas Capital, SA (incorporated herein by reference to Exhibit 10.38 to our Annual Report on Form 10-K, as filed with the SEC on April 15, 2010)
31.1	Certification of Principal Executive Officer Pursuant to Rule 13a-14(a) as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Principal Financial Officer/Principal Accounting Officer Pursuant to Rule 13a-14(a) as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Principal Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. This exhibit is being furnished pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not, except to the extent required by that Act, be deemed to be incorporated by reference into any document or filed herewith for the purposes of liability under the Securities Exchange Act of 1934, as amended, or the Securities Act of 1933, as amended, as the case may be.

- 32.2 Certification of Principal Financial Officer/Principal Accounting Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. This exhibit is being furnished pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not, except to the extent required by that Act, be deemed to be incorporated by reference into any document or filed herewith for the purposes of liability under the Securities Exchange Act of 1934, as amended, or the Securities Act of 1933, as amended, as the case may be.