

SMART ONLINE INC  
Form 10-Q  
November 16, 2009

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 September 30, 2009

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 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.

Large accelerated filer

Accelerated filer

Edgar Filing: SMART ONLINE INC - Form 10-Q

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 November 11, 2009, there were 18,332,542 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 September 30, 2009

TABLE OF CONTENTS

		Page No.
<b>PART I – FINANCIAL INFORMATION</b>		
Item 1.	Financial Statements	
	Consolidated Balance Sheets as of September 30, 2009 (unaudited) and December 31, 2008	3
	Consolidated Statements of Operations (unaudited) for the three and nine months ended September 30, 2009 and 2008	4
	Consolidated Statements of Cash Flows (unaudited) for the nine months ended September 30, 2009 and 2008	5
	Notes to Consolidated 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	29
Item 4.	Controls and Procedures	29
Item 4T.	Controls and Procedures	29
<b>PART II – OTHER INFORMATION</b>		
Item 1.	Legal Proceedings	30
Item 1A.	Risk Factors	31
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	36
Item 6.	Exhibits	36
	Signatures	37

## PART I – FINANCIAL INFORMATION

## Item 1. Financial Statements

SMART ONLINE, INC.  
CONSOLIDATED BALANCE SHEETS

	September 30, 2009 (unaudited)	December 31, 2008
<b>ASSETS</b>		
Current Assets:		
Cash and Cash Equivalents	\$ 18,749	\$ 18,602
Accounts Receivable, Net	10,510	184,930
Note Receivable	-	60,000
Prepaid Expenses	274,069	289,372
<b>Total current assets</b>	<b>303,328</b>	<b>552,904</b>
Property and equipment, net	267,716	365,993
Capitalized software, net	468,056	261,221
Note Receivable, non-current	-	372,317
Prepaid expenses, non-current	147,600	258,301
Intangible assets, net	599,309	1,410,245
Other assets	2,087	1,736
<b>TOTAL ASSETS</b>	<b>\$ 1,788,096</b>	<b>\$ 3,222,717</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)</b>		
Current liabilities		
Accounts payable	\$ 752,337	\$ 398,237
Notes payable (See Note 3)	2,504,850	2,341,177
Deferred revenue (See Note 2)	166,142	323,976
Accrued liabilities (See Note 2)	2,107,751	478,917
<b>Total current liabilities</b>	<b>5,531,080</b>	<b>3,542,307</b>
Long-term liabilities:		
Long-term portion of notes payable (See Note 3)	8,042,838	5,327,211
Deferred revenue (See Note 2)	37,018	67,353
<b>Total long-term liabilities</b>	<b>8,079,856</b>	<b>5,394,564</b>
<b>Total liabilities</b>	<b>13,610,936</b>	<b>8,936,871</b>
Commitments and contingencies (See Note 4)		
Stockholders' equity (deficit):		
Preferred stock, 0.001 par value, 5,000,000 shares authorized, no shares issued and outstanding at September 30, 2009 and December 31, 2008		
Common Stock, \$.001 par value, 45,000,000 shares authorized, 18,332,542 and 18,333,601 shares Issued and Outstanding at September 30, 2009 and December 31, 2008 respectively.	18,333	18,334
Additional paid-in capital	67,032,729	66,945,588
Accumulated deficit	(78,873,902)	(72,678,076)
<b>Total Stockholders' Deficit</b>	<b>(11,822,840)</b>	<b>(5,714,154)</b>
<b>TOTAL LIABILITIES AND STOCKHOLDERS' DEFICIT</b>	<b>\$ 1,788,096</b>	<b>\$ 3,222,717</b>

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



SMART ONLINE, INC.  
CONSOLIDATED STATEMENTS OF OPERATIONS  
(Unaudited)

	Three Months Ended		Nine Months Ended	
	September 30, 2009	September 30, 2008	September 30, 2009	September 30, 2008
<b>REVENUES:</b>				
Subscription fees	\$ 908,007	\$ 642,880	\$ 2,049,930	\$ 2,132,787
Professional service fees	63,200	574,970	261,699	2,011,497
License fees	11,250	291,250	33,750	395,000
Hosting fees	33,751	70,856	139,005	166,534
Other revenue	26,300	31,501	100,777	108,432
Total revenues	1,042,508	1,611,457	2,585,161	4,814,250
<b>COST OF REVENUES</b>	430,967	409,414	1,125,901	1,768,609
<b>GROSS PROFIT</b>	611,541	1,202,043	1,459,260	3,045,641
<b>OPERATING EXPENSES:</b>				
General and administrative	2,355,353	1,115,398	4,112,993	3,456,054
Sales and marketing	929,617	733,369	2,136,256	2,200,857
Research and development	36,406	887,657	540,232	1,798,190
Loss on Impairment	-	-	438,286	
(Gain) loss on disposal of assets, net	(12,307)	-	(22,574)	-
Total operating expenses	3,309,069	2,736,424	7,205,135	7,455,101
<b>LOSS FROM OPERATIONS</b>	(2,697,528)	(1,534,381)	(5,745,875)	(4,409,460)
<b>OTHER INCOME (EXPENSE):</b>				
Interest expense, net	(169,609)	(150,510)	(455,951)	(519,746)
Gain on legal settlements, net	-	291,407	6,000	386,710
Other Income	-	1,064	-	17,133
Total other expense	(169,609)	141,961	(449,951)	(115,903)
<b>NET LOSS</b>	\$ (2,867,137)	\$ (1,392,420)	\$ (6,195,826)	\$ (4,525,363)
<b>NET LOSS PER COMMON SHARE:</b>				
Basic and fully diluted	\$ (0.16)	\$ (0.08)	\$ (0.34)	\$ (0.25)
<b>WEIGHTED-AVERAGE NUMBER OF SHARES USED IN COMPUTING NET LOSS PER COMMON SHARE</b>				
Basic and fully diluted	18,332,542	18,378,940	18,332,653	18,282,180

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

SMART ONLINE, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Unaudited)

	Nine Months Ended September 30, 2009	Nine Months Ended September 30, 2008
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net Loss	\$ (6,195,826)	\$ (4,525,363)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	462,761	638,930
Amortization of deferred financing costs	-	301,249
Bad debt expense	2,207,685	266,875
Stock-based compensation expense	88,235	341,722
Loss on impairment of intangible assets	438,228	-
Gain on disposal of assets	(22,574)	(3,729)
Changes in assets and liabilities:		
Accounts receivable	213,010	(120,108)
Notes receivable	(3,228,038)	(148,236)
Costs in excess of billings	-	-
Prepaid expenses	126,004	(544,297)
Other assets	(352)	36,660
Deferred revenue	(188,170)	(330,686)
Accounts payable	1,768,181	10,836
Accrued and other expenses	1,627,739	96,189
Net cash used in operating activities	(2,703,117)	(3,979,958)
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchases of furniture and equipment	(14,565)	(293,656)
Capitalized software	(206,835)	(120,191)
Proceeds from sale of furniture and equipment	45,362	13,564
Net Cash used in Investing Activities	(176,038)	(400,283)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Repayments on notes payable	(5,068,063)	(5,022,392)
Debt borrowings	7,947,365	5,861,924
Issuance of common Stock	-	97,500
Net cash provided by financing activities	2,879,302	937,032
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	147	(3,443,209)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	18,602	3,473,959
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$ 18,749	\$ 30,750
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	\$ 461,360	\$ 243,168
Taxes	\$ 10	\$ 38,905
Supplemental schedule of non-cash financing activities:		
Conversion of debt to equity	\$ -	\$ 228,546

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



SMART ONLINE, INC.  
NOTES TO CONSOLIDATED 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 (One Biz™) 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 sophisticated and complex website consulting and development services, primarily in the e-commerce retail and direct-selling organization industries. The Company maintains a website that offers additional information about these capabilities as well as certain corporate information at [www.smartonline.com](http://www.smartonline.com).

Basis of Presentation - The financial statements as of and for the three and nine months ended September 30, 2009 and 2008 included in this Quarterly Report on Form 10-Q are unaudited. The balance sheet as of December 31, 2008 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, 2008 filed with the Securities and Exchange Commission (the "SEC") on March 30, 2009 (the "2008 Annual Report").

The financial statements have been prepared in accordance with United State Generally Accepted Accounting Principles ("US 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 September 30, 2009, and its results of operations and cash flows for the three and nine months ended September 30, 2009 and 2008. The results for the three and nine months ended September 30, 2009 are not necessarily indicative of the results to be expected for the fiscal year ending December 31, 2009.

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 and nine months ended September 30, 2009 and 2008, the Company incurred net losses as well as negative cash flows, is involved in a class action lawsuit (See Note 4, "Commitments and Contingencies," in the 2008 Annual Report), and the repayment of the legal fees advanced on behalf of former officers and employees who were convicted in Federal Court 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 November 6, 2009, the Company does have a commitment from its convertible secured subordinated noteholders to purchase up to an additional \$6.25 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 \$6.25 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 future plans include the introduction of its new One Biz™ platform, the development of additional new products and applications, and further enhancement of its existing small-business applications and tools. The Company's continuation as a going concern depends upon its capability 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 and nine months ended September 30, 2009 are consistent with those used for the years ended December 31, 2008 and 2007. Accordingly, please refer to the 2008 Annual Report for the Company's significant accounting policies.

Use of Estimates - The preparation of financial statements in conformity with US 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.

Page 6 of 37

---

Fair Value of Financial Instruments - US GAAP requires disclosures of fair value information about financial instruments, whether or not recognized in the balance sheet, for which it is practical 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.

Principles of Consolidation - The accompanying financial statements for the three and nine months ended September 30, 2008 include the accounts of the Company and its former wholly owned subsidiaries, Smart CRM, Inc. ("Smart CRM") and Smart Commerce, Inc. ("Smart Commerce"). All significant intercompany accounts and transactions have been eliminated. Subsidiary accounts are included only from the date of acquisition forward. On December 31, 2008, each of Smart CRM and Smart Commerce were merged into the Company.

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 Interim 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 the second quarter of 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. During the third quarter of 2008, this 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 in the third quarter of 2007 that called for contractual payments against a note receivable upon delivery and acceptance of a custom application. The Company and the customer are currently in discussions with respect to whether the application was delivered as per the specifications, and the customer has not commenced payment subject to the outcome of these discussions.

Based on these criteria, management determined that at September 30, 2009, an allowance for doubtful accounts of \$2,193,776 was required, comprising the full outstanding balance of the direct-selling organization customer's account and contract receivable and the entire amount of the real estate services customer's note receivable. The total allowance for doubtful accounts includes the additional reserve for bad debt of \$1,804,207 for the possibility that it will not be able to collect the amount of these legal expenses that the Company will be required to advance on behalf of Michael Nouri and Eric Reza Nouri, both of whom were convicted on criminal charges brought by the US Department of Justice. The total identified to date equals \$1,804,207. The amount could exceed \$2,400,000.

Intangible Assets - Intangible assets consist primarily of assets obtained through the acquisitions of iMart Incorporated (“iMart”) in 2005 and include customer bases, acquired technology non-compete agreements, trademarks, and trade names. The Company also owns several copyrights and trademarks related to products, names, and logos used throughout its non-acquired product lines. All assets are amortized on a straight-line basis over their estimated useful lives with the exception of the iMart trade name, which is deemed by management to have an indefinite life and is not amortized. During the nine month period ending September 30, 2009, we impaired the value of a portion of the customer base intangible asset due to the fact that the Company is no longer doing business with the customer.

Revenue Recognition - The Company derives revenue primarily from subscription fees charged to customers accessing its SaaS applications; the perpetual or term licensing of software platforms or applications; and professional services, consisting of consulting, development, 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 the US GAAP, as amended. 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.

US GAAP provide 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. collectability 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 collectability 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 US 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 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 private-label 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 or the aggregating entity. Any payments received in advance of the subscription period are accrued as deferred revenue and amortized over the subscription period.

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 the services are provided in accordance with US GAAP that includes the right to use software stored on another entity's hardware.

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 US 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.

Software Development Costs - Current US GAAP requires 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, the Company had not developed detailed design plans for its 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. 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, resulted in the continued expensing of underlying costs as research and development.

Beginning in May 2008, the Company determined that it was strategically desirable to develop an industry standard platform and enhance the current SaaS applications. A detailed design plan indicated that the product was technologically feasible, and in July 2008, development commenced. All related costs from that point in time are being capitalized in accordance with current US GAAP. The first release of the revised product took place in July 2009. At that time additional development costs were no longer capitalized and the costs capitalized to that point are now being amortized.

Advertising Costs - The Company expenses all advertising costs as they are incurred. The amounts charged to sales and marketing expense during the third quarter of 2009 and 2008 were \$3,000 and \$7,795, respectively. During the first nine months of 2009 and 2008, these amounts were \$4,032 and \$20,205, respectively.

Net Loss Per Share - Basic net loss per share is computed using the weighted-average number of common shares outstanding during the relevant periods. Diluted net loss per share is computed using the weighted-average number of common and dilutive common equivalent shares outstanding during the relevant periods. Common equivalent shares consist of convertible notes, stock options, and warrants that are computed using the treasury stock method.

Stock-Based Compensation - The Company adopted US GAAP provisions related to share based payments which requires companies to expense the value of employee stock options, restricted stock, and similar awards and applies to all such securities outstanding and vested.

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 following is a summary of the Company's stock-based compensation expense for the periods indicated:

Edgar Filing: SMART ONLINE INC - Form 10-Q

	Three Months Ended		Nine Months Ended	
	September 30,	September 30,	September 30,	September 30,
	2009	2008	2009	2008
Compensation expense included in G&A expense related to stock options	\$ 5,191	\$ 30,995	\$ 40,155	\$ 106,199
Compensation expense included in G&A expense related to restricted stock awards	560	50,583	48,080	235,523
Total expense	\$ 5,751	\$ 81,578	\$ 88,235	\$ 341,722

Page 9 of 37

---



The fair value of option grants under the Company's equity compensation plan and other stock option issuances during the three months and nine months ended September 30, 2009 and 2008 were estimated using the Black-Scholes option-pricing model with the following weighted-average assumptions:

	Three Months Ended		Nine Months Ended	
	September 30, 2009	September 30, 2008	September 30, 2009	September 30, 2008
Dividend yield	0.0%	0.0%	0.0%	0.0%
Expected volatility	70%	40%	69%	46%
Risk-free interest rate	2.37%	4.39%	2.30%	4.43%
Expected lives (years)	4.0	4.3	4.0	4.4

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. Expected volatility is partially based on the historical volatility of the Company's common stock since the end of the prior fiscal year as well as management's expectations for future volatility. The risk-free interest rate is based on the published yield available on U.S. treasury issues with an equivalent term remaining equal to the expected life of the option.

The following is a summary of the stock option activity for the nine months ended September 30, 2009:

	Shares	Weighted Average Exercise Price
BALANCE, December 31, 2008	271,250	\$ 5.89
Granted	40,000	1.10
Forfeited	(173,750)	5.81
Exercised	0	-
BALANCE, September 30, 2009	137,500	\$ 4.32

Recently Issued Accounting Pronouncements -. The current US GAAP concerning the life of intangible assets require, 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.

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. ASSETS & LIABILITIES

### Prepaid Expenses

In July 2008, the Company entered into a 36-month sublease agreement with Advantis Real Estate Services Company for approximately 9,837 square feet of office space in Durham, North Carolina, into which the Company relocated its headquarters in September 2008. 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 twelve months classified as non-current, and is being amortized to rent expense over the term of the lease. The Company's prepaid sublease with Advantis Real Estate Services Company includes an expiration date of September 2011. On November 3, 2009, the

Company received notice from the prime landlord of the office space that the Company's sub-landlord, Advantis Real Estate Services Company, had defaulted on the prime lease, thereby giving the prime landlord the right to terminate the Company's sublease, and that the prime landlord was seeking to renegotiate the occupancy terms for the Company's office space. The Company is currently engaged in discussions with the prime landlord to lease the office space from the prime landlord on a prime lease basis.

## Intangible Assets

The following table summarizes information about intangible assets at September 30, 2009:

Asset Category	Value Assigned	Residual Value	Weighted Average Amortization Period (in Years)	Accumulated Amortization	Carrying Value
Customer base	\$ 1,012,421	\$ -	6.2	\$ 801,464	\$ 210,957
Acquired technology	501,264	-	3.0	501,264	-
Non-compete agreements	801,785	-	4.0	793,433	8,352
Trademarks and copyrights	52,372	-	9.7	52,372	-
Trade name	380,000	N/A	N/A	N/A	380,000
Totals	\$ 2,747,842	\$ -		\$ 2,148,533	\$ 599,309

## Accrued Liabilities

At September 30, 2009, the Company had accrued liabilities totaling \$2,107,751. This amount consisted primarily of \$117,102 of liability accrued related to the development of the Company's custom accounting application; \$1,804,207 related to legal expenses associated with the Company's former officers and employees (see Note 4, "Commitments and Contingencies"); \$24,518 for tax-related liabilities associated with the vesting of restricted stock; \$10,043 of loss estimated on a long-term customer contract; \$25,685 of accrued payroll; \$87,688 of convertible note interest payable and other liabilities of \$36,617.

At December 31, 2008, accrued liabilities totaled \$478,917. This amount consisted primarily of \$117,102 of liability related to the above-noted development of the Company's custom accounting application; \$137,500 related to legal reserves (see Note 4, "Commitments and Contingencies"); \$30,198 for tax-related liabilities associated with the vesting of restricted stock; \$30,903 of loss estimated on a long-term customer contract; \$79,300 of cash collected through the Company's merchant account on behalf of a customer; \$54,467 of convertible note interest payable and other liabilities of \$29,447.

## Deferred Revenue

Deferred revenue comprises the following items:

- Subscription Fees - short-term and long-term portions of cash received related to one- or two-year subscriptions for domain names and/or email accounts
- License Fees - licensing revenue where customers did not meet all the criteria of US GAAP. Such deferred revenue will be recognized as cash is delivered or collectability becomes probable.

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

	September 30, 2009	December 31, 2008
Subscription fees	\$ 56,010	\$ 89,852
License fees	75,000	108,750
Professional service fees	72,150	192,727
Totals	\$ 203,160	\$ 391,329

Edgar Filing: SMART ONLINE INC - Form 10-Q

Current portion	\$	166,142	\$	323,976
Non-current portion		37,018		67,353
Totals	\$	203,160	\$	391,329

Page 11 of 37

---

### 3. NOTES PAYABLE

#### Convertible Notes

As of September 30, 2009, the Company had \$7.85 million aggregate principal amount of convertible secured subordinated notes due November 14, 2010 (the “notes”) outstanding, after the \$200,000 reduction of such current outstanding debt on account of the sale-leaseback described in item 4, Commitments and Contingencies, below. 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 amount of notes in future closings upon approval and call by the Company’s Board of Directors. On August 12, 2008, the Company exercised its option to sell \$1.5 million aggregate principal amount of notes with substantially the same terms and conditions as the Initial Notes (the “Additional 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, the Company sold \$500,000 aggregate principal amount of notes (the “New Notes”) to two new investors with substantially the same terms and conditions as the previously outstanding notes.

On each of January 6, 2009, February 24, 2009, April 3, 2009, and June 2, 2009 the Company sold a note in the principal amount of \$500,000 (total \$2,000,000) to a current noteholder with substantially the same terms and conditions as the previously outstanding notes.

On each of July 16, 2009, August 26, 2009, September 8, 2009, October 5, 2009 and October 9, 2009 the Company sold a note in the principal amount of \$250,000 (total \$1,250,000) to a current noteholder with substantially the same terms and conditions as the previously outstanding notes. On November 6, 2009 the Company sold a note in the principal amount of \$500,000 to a current noteholder with substantially the same terms and conditions.

Also on February 24, 2009, 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 notes to new investors 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.

The Company is 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. The Company is 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.

On the earlier of November 14, 2010 or a merger or acquisition or other transaction pursuant to which existing stockholders of the Company hold less than 50% of the surviving entity, or the sale of all or substantially all of the Company’s 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.

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.

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 of 1933, as amended (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 investors in the Initial Notes include (i) The Blueline Fund, which originally recommended Philippe Pouponnot, a former director of the Company, for appointment to the Company's Board of Directors; (ii) Atlas Capital SA ("Atlas"), an affiliate of the Company that originally recommended Shlomo Elia, one of the Company's current directors, for appointment to the Board of Directors; (iii) Crystal Management Ltd. ("Crystal"), which is owned by Doron Roethler, who subsequently served as Chairman of the Company's Board of Directors from December 2007 until December 9, 2008 and Chairman and Interim President and Chief Executive Officer from December 9, 2008 until May 19, 2009, and serves as the noteholders' bond representative; and (iv) William Furr, who is the father of Thomas Furr, who, at the time, was one of the Company's directors and executive officers. The investors in the Additional Notes are Atlas and Crystal. The investors in the New Notes are not affiliated with the Company. . Atlas purchased \$6,800,000 and Union Bancaire Privee purchased \$500,000 of the \$9,050,000 aggregate principal amount of notes issued through November 11, 2009.

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.

#### Line of Credit

On November 14, 2006, the Company entered into a revolving credit arrangement with Wachovia Bank, NA ("Wachovia") for \$1.3 million to be used for general working capital. Any advances made on the line of credit were to be paid off no later than August 1, 2007, with monthly payments of accrued interest on any outstanding balance commencing on December 1, 2006. The interest accrued on the unpaid principal balance at the LIBOR Market Index Rate plus 0.9%. The line of credit was secured by the Company's deposit account at Wachovia and an irrevocable standby letter of credit in the amount of \$1.3 million issued by HSBC Private Bank (Suisse) SA ("HSBC") with Atlas, a current stockholder, as account party.

On January 24, 2007, the Company entered into an amendment to its line of credit with Wachovia to increase the available principal from \$1.3 million to \$2.5 million and to extend the maturity date from August 1, 2007 to August 1, 2008. The amended line of credit was secured by the Company's deposit account at Wachovia and a modified irrevocable standby letter of credit in the amount of \$2.5 million issued by HSBC with Atlas as account party. On February 15, 2008, the Company repaid the full outstanding principal balance of \$2,052,000 and accrued interest of \$2,890.

On February 20, 2008, the Company entered into a revolving credit arrangement with Paragon Commercial Bank ("Paragon") that is renewable on an annual basis subject to mutual approval. The line of credit advanced by Paragon is \$2.47 million and can be used for general working capital. Any advances made on the line of credit were to be paid off

no later than February 19, 2009, subject to extension due to renewal, with monthly payments being applied first to accrued interest and then to principal. The interest accrued 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 with Atlas as account party that expires 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 the Company, these payments may be made in cash or by issuing shares of the Company's common stock at a set per-share price of \$2.50.

On February 19, 2009, the Company renewed its revolving credit arrangement with Paragon. Any advances made on the line of credit must be paid off no later than February 19, 2010. Interest shall accrue on the unpaid principal balance at the Wall Street Journal's published Prime Rate, but at no time shall the interest rate be less than 5.5%. As of November 10, 2009, the Company had an outstanding balance of \$2.05 million under the line of credit. As of September 30, 2009, the Company had notes payable totaling \$10,547,688. The detail of these notes is as follows:



Note Description	Short-Term Portion	Long-Term Portion	TOTAL	Maturity	Rate
Paragon Commercial Bank credit line	\$ 2,401,124	\$ -	\$ 2,401,124	Feb '10	5.5%
Various capital leases	40,205	192,838	233,043	Various	8-19%
Insurance premium note	63,521	-	63,521	Jul '10	5.4%
Convertible notes	-	7,850,000	7,850,000	Nov '10	8.0%
<b>TOTAL</b>	<b>\$ 2,504,850</b>	<b>\$ 8,042,838</b>	<b>\$ 10,547,688</b>		

#### 4. COMMITMENTS AND CONTINGENCIES

##### Lease Commitments

The Company leases computer and office equipment under capital lease agreements that expire through August 2019. Total amounts financed under these capital leases were \$233,043 and \$53,517 at September 30, 2009 and December 31, 2008, respectively, net of accumulated amortization of \$39,121 and \$18,647, 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 balance sheets as of September 30, 2009 and December 31, 2008. See also Note 3, "Notes Payable."

In 2008, the Company entered into a non-cancelable sublease with a remaining term of 36 months to relocate its headquarters to another facility near Research Triangle Park, North Carolina. As described in Note 2, "Assets and Liabilities," the Company prepaid the lease and purchased existing furniture and fixtures for a lump-sum payment of \$500,000, of which \$450,080 was allocated to rent and is being amortized monthly over the remaining term of the lease. The Company also had a lease through October 2009 for an apartment near its headquarters that was utilized by its out of town executives and members of its Board of Directors. The lease was terminated as of August 4, 2009.

On September 4, 2009, the Company entered into a sale-leaseback agreement with the current bondholders. The bondholders paid a market rate cost of \$200,000 through the reduction of current outstanding debt in exchange for all of the Company's office furniture, equipment and computers. The bondholders then leased all furniture, equipment and computers back to the company over a ten (10) year period. The monthly lease payment under the agreement is \$2,427.

Rent expense for the nine months ended September 30, 2009 and 2008 was \$129,572 and \$243,218 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. As of September 30, 2009, the Company had paid \$470,834 and issued 3,473 shares of common stock related to this obligation.

##### Legal Proceedings

On May 29, 2009, Dennis Michael Nouri and Reza Eric Nouri (together, the "Nouris"), a former officer and employee of the Company, respectively, filed a complaint (the "Nouri Complaint") to bring a summary proceeding against the Company in the Court of Chancery of the State of Delaware. The Nouri Complaint sought to compel the Company to advance legal fees and costs in the amount of \$826,798 incurred by the Nouris in their defense of criminal proceedings brought against them by the United States, and in their defense of civil proceedings brought against them

by the Securities and Exchange Commission and the Company's stockholders, together with future verified expenses that will be incurred by the Nouris in defending the actions against them and the expenses incurred by the Nouris in prosecuting the advancement action against the Company.

On July 2, 2009, the Nouris were convicted of nine counts of criminal activity in a federal criminal action brought against them in the United States District Court for the Southern District of New York, and are presently awaiting sentence.

On July 29, 2009, the Court of Chancery granted summary judgment of the Nouris Complaint in favor of the Nouris. By order dated August 6, 2009, the Company is obligated to pay to the Nouris \$826,798 in advanced expenses for legal services performed by counsel to the Nouris through April 2009. The total amount of the legal fees the Company will ultimately be required to advance to the Nouris is expected to be in excess of \$2.4 million. Though the Nouris have entered into an undertaking that requires them to repay to the Company any amounts advanced by it in the event the Nouris are ultimately determined not to be entitled to indemnification for the expenses incurred, it is uncertain at this time that the Company will be able to recover such amounts advanced without considerable expense to the Company, or whether the Company will be able to recover any of the amounts advanced at all.

On September 24, 2009, the Nouris filed a Motion for Rule to Show Cause and the Appointment of a Receiver in the Court of Chancery of the State of Delaware against the Company (the "Motion"). The Motion, among other things, seeks the appointment of a receiver for the Company under Section 322 of the Delaware General Corporation Law on account of the Company's failure to pay the monetary judgment in the amount of \$826,798 entered against it by order of the Court of Chancery on August 6, 2009 for the advancement of legal expenses incurred by the Nouris in their defense of the foregoing criminal proceedings. The Company intends to vigorously contest the Motion.

Please refer to Part I, Item 3 of our annual report on Form 10-K for the fiscal year ending December 31, 2008 for a further description of material legal proceedings.

## 5. STOCKHOLDERS' EQUITY

### Preferred Stock

The Board of Directors is authorized, without further stockholder approval, subject to the approval of the Noteholders, 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 September 30, 2009.

### Common Stock

The Company is authorized to issue 45,000,000 shares of common stock, \$0.001 par value per share. As of September 30, 2009, it had 18,332,543 shares of common stock outstanding. Holders of common stock are entitled to one vote for each share held.

In January 2008, the Company issued 28,230 shares of common stock to a consulting firm as full payment of the outstanding obligation related to fees accrued for services rendered in conjunction with the 2005 acquisitions of iMart and Computility.

### 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 on August 2008. As of December

31, 2007, the deferred financing costs to be amortized to interest expense over the remaining eight months, or \$301,249, were classified as current assets. 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 for cash, it will result in gross proceeds to the Company of approximately \$1.2 million.

Under a Securities Purchase Agreement with two investors entered in connection with a 2007 private placement of the Company's common stock, 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 contain a provision for cashless exercise and must be exercised by February 21, 2010.

As part of the commission paid to Canaccord Adams, Inc. ("CA"), the Company's placement agent in the 2007 private placement transaction, 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.

As of September 30, 2009, 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, second and third quarters of 2009, no shares of restricted stock were issued. A total of 1,059 shares of restricted stock were canceled during the first three quarters of 2009 due to terminations and payment of employee tax obligations resulting from share vesting. At September 30, 2009, there was no 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 six months ended September 30, 2009:

	Shares	Weighted Average Exercise Price
BALANCE, December 31, 2008	271,250	\$ 5.89
Granted	40,000	1.10
Exercised	-	-
Canceled	(173,750)	5.81
BALANCE, September 30, 2009	137,500	\$ 4.32

The following table summarizes information about stock options outstanding at September 30, 2009:

Exercise Price	Number of Options Outstanding	Average Remaining Contractual Life (Years)	Currently Exercisable	
			Weighted Average Exercise Price	Number of Shares
From \$2.50 to \$3.50	85,000	6.3	\$ 3.15	85,000
\$5.00	25,000	6.0	\$ 5.00	25,000
From \$8.61 to \$9.00	27,500	6.5	\$ 8.73	27,500
Totals	137,500	3.6	\$ 6.10	137,500

At September 30, 2009, there remains \$19,469 of unvested expense yet to be recorded related to all options outstanding.

Dividends

The Company has not paid any cash dividends through September 30, 2009.

6. MAJOR CUSTOMERS AND CONCENTRATION OF CREDIT RISK

The Company derives a significant portion of its revenues from certain customer relationships. The following is a summary of customers that represent greater than ten percent of total revenues for their respective time periods:

Page 16 of 37

---

		Three Months Ended September 30, 2009	
	Revenue Type	Revenues	% of Total Revenues
Customer A	Subscription fees	\$ 850,788	82%
Customer B	Professional service fees	411	-%
Customer C	Subscription fees	74,465	7%
Customer D	Professional service fees	75,150	7
Others	Various	41,694	4%
Total		\$ 1,042,508	100%

		Three Months Ended September 30, 2008	
	Revenue Type	Revenues	% of Total Revenues
Customer A	Subscription fees	\$ 385,198	24%
Customer B	Professional service fees	465,750	29%
Customer C	Subscription fees	213,384	13%
Customer D	Professional service fees	-	-%
Others	Various	547,125	34%
Total		\$ 1,611,457	100%

		Nine Months Ended September 30, 2009	
	Revenue Type	Revenues	% of Total Revenues
Customer A	Subscription fees	\$ 1,698,885	66%
Customer B	Professional service fees	222,725	9%
Customer C	Subscription fees	291,819	11%
Customer D	Professional service fees	114,328	4%
Others	Various	257,404	10%
Total		\$ 2,585,161	100%

		Nine Months Ended September 30, 2008	
	Revenue Type	Revenues	% of Total Revenues
Customer A	Subscription fees	\$ 1,098,966	23%
Customer B	Professional service fees	1,250,747	26%
Customer C	Subscription fees	882,387	18%
Customer D	Professional service fees	-	-%
Others	Various	1,582,150	33%
Total		\$ 4,814,250	100%

As of September 30, 2009, two customers accounted for 62% and 38% of accounts receivable, respectively. As of December 31, 2008, one customer accounted for 93% of accounts receivable.

## 7. SUBSEQUENT EVENTS

### Convertible Note Financing.

On each of October 5, 2009 and October 9, 2009 the Company sold a note in the principal amount of \$250,000 (total \$500,000) to current noteholders with substantially the same terms and conditions as the previously outstanding notes. On November 6, 2009 the Company sold a note in the principal amount of \$500,000 to a current noteholder with substantially the same terms and conditions. The Company will be obligated to pay interest on the New Notes at an annualized rate of 8% payable in quarterly installments commencing three months after the closing date. The Company plans to use the proceeds to meet ongoing working capital and capital spending requirements.

The Company's corporate headquarters and research and development facility is located in Durham, North Carolina near Research Triangle Park and consists of approximately 9,837 square feet of office space held under a prepaid sublease with an expiration date of September 2011. On November 3, 2009, the Company received notice from the prime landlord of the office space that the Company's sub-landlord had defaulted on the prime lease, thereby giving the prime landlord the right to terminate the Company's sublease, and that the prime landlord was seeking to renegotiate the occupancy terms for the Company's office space. The Company is currently engaged in discussions with the prime landlord to lease the office space from the prime landlord on a prime lease basis.

We have evaluated subsequent events through November 12, 2009.

### 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," and elsewhere in this report, 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.

#### Overview

#### Overview

Through our OneBiz™ platform, we develop and markets software products and services targeted to small businesses that are delivered via a Software-as-a-Service, or SaaS, model. We also provide website consulting and custom software development services, primarily in the e-commerce retail and direct-selling organization industries. 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 that these relationships provide a cost and time effective process for us to market to a diverse and fragmented yet very sizeable small-business sector. In addition to our channel partner strategy, we also offer our SaaS 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 software development model as well as the potential applicability of currently available development technologies. The outcome of this analysis was 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 are currently being optimized, but also other applications expected to arise from collaborative partnerships with third-party developers and service providers. In addition, potential emerging-market opportunities in the small-business segment designed to leverage social networking and community building were identified. Our management team believes that, but cannot assure, this platform and associated applications will provide opportunities for new sources of revenue, including an increase in subscription fees. As we near completion of the development of its industry-standard platform, as evidenced by the release of OneBiz™ 1.1, in July 2009, the Company has begun increasing its emphasis on the sales and marketing of the new platform.

In light of our operating strategy involving the industry-standard platform, the consolidation of all operations into our North Carolina headquarters, and other factors including certain income tax advantages, it was concluded in the latter part of 2008 that it was no longer necessary to operate with the Smart Commerce, Inc. and Smart CRM, Inc. subsidiaries. As a result, an upstream merger was completed as of December 31, 2008 that merged those subsidiaries with the parent corporation

## Sources of Revenue

We derive revenues from the following sources:

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

The Company's 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 portal 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 or the aggregating entity. We are focusing our efforts on enlisting new channel partners as well as diversifying with vertical intermediaries in various industries.

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

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. Hosting and maintenance fees are generated as the services are provided.

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 salaries associated with maintaining and supporting integration and syndication partners, the cost of domain name and email registrations, and the cost of external hosting facilities associated with maintaining and supporting our partners and end user customers.

## Operating Expenses

During the fourth quarter of 2009, executive management intends to continue the restructuring of the operations team that began early in the third quarter of 2009, including additions to the software development and sales and marketing

functions. The restructuring that is taking place was precipitated by the departure of several executive management personnel in May 2009; as noted in our public filings.

Additionally, management is undertaking the issuance of a series of releases of our OneBiz platform in the fourth quarter of 2009 and the first quarter of 2010. These releases will be designed to include additional functionality and integration, as well as to include the addition of new applications we believe will be attractive to small businesses. The restructuring in sales and marketing is designed to accelerate the penetration of the small company market by continuing to enhance our channel partner marketing strategy.

We continue to strengthen our iMart product offering which includes the custom design and implementation of our direct selling and network marketing customers' complex e-commerce web sites. In addition to the typical "product purchase" tools that are featured in most e-commerce web sites, our capability includes such features as back office inventory management, back office multiple commission calculations, back office affiliate rebate calculations, bar code scanning for event management, individualized independent distributor marketing tools including a personalized web site and unique domain ID, and back office team management functions for "network trees". We plan to place increased sale and marketing emphasis on the iMart product offering.

**General and Administrative.** General and administrative expenses consist of salaries and related expenses for executive, finance and accounting, legal, human resources, and information technology personnel; professional fees; depreciation and amortization expenses; insurance; and other corporate expenses, including facilities costs. We anticipate general and administrative expenses will increase as we incur additional professional fees and insurance costs related to the growth of our business and our operations as a public company. We expect to continue to incur material costs in 2009 related to the civil and criminal complaints filed in September 2007, described in detail in Part I, Item 3, "Legal Proceedings," in our Annual Report on Form 10-K for the year ended December 31, 2008 and Part II, Item 1, "Legal Proceedings," in this report and the Quarterly Reports on Form 10-Q for the quarterly periods ended March 31, 2009 and June 30, 2009.

**Sales and Marketing.** 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 in the third quarter and will continue to do so during the fourth quarter of 2009. As we implement our sales and marketing strategy to take our enhanced products to market, we also expect associated costs to increase in the balance of 2009 due to targeting new partnerships, development of channel partner enablement programs, 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.** Current US GAAP requires 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. 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, resulted in the continued 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 enhance our current SaaS applications. A detailed design plan indicated that the product was technologically feasible. In July 2008, development commenced, and all related costs from this point in time are being capitalized in accordance with current US GAAP. 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. As we complete the core development of our new applications during the balance of 2009, we expect that future research and development expenses will decrease in both absolute and relative dollars.

**Stock-Based Expenses.** Our operating expenses include stock-based expenses related to options, restricted stock awards, and warrants issued to employees and non-employees. In the past, these charges have been significant and are reflected in our historical financial results. Effective January 1, 2006, we adopted US GAAP provisions relating to the treatment of share-based payment, which 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 consolidated financial statements, which we prepared in accordance with accounting principles generally accepted in the United States. 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 and sales returns, 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. Management has consistently applied the same critical accounting policies and estimates which are fully described in our Annual Report on Form 10-K for the year ended December 31, 2008.

We derive revenue primarily from subscription fees charged to customers accessing our SaaS applications; the perpetual or term licensing of software platforms or applications; and professional services, consisting of consulting, development, 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 current US GAAP pronouncements. 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 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 we determine that certain elements are essential to the functionality of other elements within the arrangement, we defer revenue until all elements necessary to the functionality of the customer is provided. The determination of whether the arrangement involves significant development, modification, or customization could be complex and require the use of judgment by our management.

Provisions of US GAAP provide that if 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 the judgment of our management, and the amount and timing of revenue recognition may change if different assessments are made.

Under other provisions of current US GAAP related to revenue arrangements with multiple deliverables, 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, 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 our 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 price and of a longer term. As such, we account for these services 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, 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 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 private-label 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 or the aggregating entity. Any payments received in advance of the subscription period are accrued as deferred revenue and amortized over the subscription period.

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 the services are provided in accordance with current US GAAP provisions relating to arrangements that include the right to use software stored on another entity's hardware .

**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 we make such determination.

**Impairment of Long-Lived Assets** – We record our long-lived assets, such as property and equipment, at cost. We review the carrying value of our long-lived assets for possible impairment at the earlier of annually in the fourth quarter or whenever events or changes in circumstances indicate that the carrying amount of assets may not be recoverable as provided for in the current US GAAP relating to the accounting for the impairment or disposal of long-lived assets. We measure the recoverability of assets to be held and used by comparing the carrying amount of the asset to future net undiscounted 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 of 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 the first, second or third quarter of 2009, or in 2008 and 2007, 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 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.

#### Overview of Results of Operations for the Three Months Ended September 30, 2009 and September 30, 2008

Total revenues were \$1,042,508 for the three months ended September 30, 2009 compared to \$1,611,457 for the same period in 2008, representing a decrease of \$568,949, or 35%. Gross profit decreased \$590,502, or 49%, to \$611,541 from \$1,202,043. Operating expenses increased \$572,645 or 21%, to 3,309,069 from \$2,736,424. Net loss increased \$1,474,717, or 106%, to \$2,867,137 from \$1,392,420.





Edgar Filing: SMART ONLINE INC - Form 10-Q

The following table sets forth our consolidated statements of operations data expressed as a percentage of revenues for the periods indicated:

	September 30, 2009	Three Months Ended % of Revenue	September 30, 2008	% of Revenue
<b>REVENUES</b>				
Subscription Fees	\$ 908,007	87.1%	\$ 642,880	39.9%
Professional service fees	63,200	6.1%	574,970	35.7%
License fees	11,250	1.1%	291,250	18.1%
Hosting Fees	33,751	3.2%	70,856	4.4%
Other revenue	26,300	2.5%	31,501	2.0%
<b>Total Revenues</b>	<b>1,042,508</b>	<b>100.0%</b>	<b>1,611,457</b>	<b>100.0%</b>
<b>COST OF REVENUES</b>	<b>430,967</b>	<b>41.3%</b>	<b>409,414</b>	<b>25.4%</b>
<b>GROSS PROFIT</b>	<b>611,541</b>	<b>58.7%</b>	<b>1,202,043</b>	<b>74.6%</b>
<b>OPERATING EXPENSES</b>				
General and administrative	2,355,353	225.9%	1,115,398	69.2%
Sales and marketing	929,617	89.2%	733,369	45.5%
Research and development	36,406	3.5%	887,657	55.1%
(Gain)/ Loss disposal of assets	(12,307)	-1.2%	-	0.0%
<b>Total operating expenses</b>	<b>3,309,069</b>	<b>317.4%</b>	<b>2,736,424</b>	<b>169.8%</b>
<b>Total other income (expense)</b>				
Interest Expense (net)	(169,609)	-16.3%	(150,510)	-9.3%
Gain on legal settlements (net)	-	0.0%	291,407	18.1%
Other income	-	0.0%	1,064	0.1%
<b>Total Other Income (Expense)</b>	<b>(169,609)</b>	<b>-16.3%</b>	<b>141,961</b>	<b>8.8%</b>
<b>NET LOSS</b>	<b>\$ (2,867,137)</b>	<b>-275.0%</b>	<b>\$ (1,392,420)</b>	<b>-86.4%</b>

Comparison of the Results of Operations for the Three Months Ended September 30, 2009 and September 30, 2008

**Revenues.** Total revenues for the three months ended September 30, 2009 were \$1,042,508 compared to \$1,611,457 for the same period in 2008, representing a decrease of \$568,949, or 35%. This overall decrease in revenues was primarily attributable to decreases in professional service fees and license fees, offset in part by an increase in subscription fees.

**Subscription Fees -** Subscription fees for the three months ended September 30, 2009 were \$908,007 compared to \$642,880 for the same period in 2008, representing an increase of \$265,127, or 41%. This increase is primarily due to an increase in active subscribers to whom we provide e-commerce, domain name, email services, and related event ticket sale services for use as members of one of our primary customers, a direct-selling organization.

**Professional Service Fees -** Professional service fees for the three months ended September 30, 2009 were \$63,200 compared to \$574,970 for the same period in 2008, representing a decrease of \$511,770, or 89%. This decrease is

primarily due to the loss a major customer to whom we provided professional services.

License Fees - License fees for the three months ended September 30, 2009 were \$11,250 compared to \$291,250 for the same period in 2008, representing a decrease of \$280,000, or 96%. This decrease is primarily due to the fact that there were no new licenses provided during the third quarter of 2009.

Other Revenue - Other revenue for the three months ended September 30, 2009 totaled \$26,300 compared to \$31,501 for the same period in 2008. This revenue is generated from non-core activities. We expect these revenue streams to continue to be insignificant in the future as we continue our strategy of focusing on the growth of our subscription and license revenues.

#### Cost of Revenues

Cost of revenues for the three months ended September 30, 2009 was \$430,967 compared to \$409,414 for the same period in 2008, representing an increase of \$21,553, or 5%. This increase is primarily due to more domain name registrations, credit card processing fees, and business card printing for members of our direct-selling organization customers.

## Operating Expenses

Operating expenses for the three months ended September 30, 2009 were \$3,309,069 compared to \$2,736,424 for the same period in 2008, representing an increase of 572,645, or 21%. This increase was primarily attributable to the write-off of approximately \$1.8 million related to the reserve for uncollectable amounts due from the advancement of legal fees for the defense in criminal proceedings against Dennis Michael Nouri and Reza Eric Nouri, a former officer and employee of the Company. The expense is offset by a significant reduction in the amount of research and development expense as well as the reduction of administrative salaries and other operating expenses.

General and Administrative - General and administrative expenses for the three months ended September 30, 2009 were \$2,355,353 compared to \$1,115,398 for the same period in 2008, representing an increase of \$1,239,955, or 111%. The increase was primarily attributable to the establishment of a \$1,804,763 bad-debt reserve for the estimated uncollectable amounts due from the advancement of legal fees for the defense in criminal proceedings against Dennis Michael Nouri and Reza Eric Nouri, a former officer and employee of the Company. The amount of bad debt expense for the prior period was \$221,875. The increase is offset by a decrease in administrative salaries of \$116,000, a decrease in the amount of amortization expense of \$75,000, and reduction of other administrative expenses.

Sales and Marketing - Sales and marketing expenses for the three months ended September 30, 2009 were \$929,617 compared to \$733,369 for the same period in 2008, representing an increase of \$196,248, or 27%. This increase is primarily attributable to the increase in revenue sharing expense of \$405,300 with one of our primary customers, a direct-selling organization. The total increase is offset by a reduction in wages of \$110,000 and other expenses of \$99,000.

Research and Development - Research and development expenses for the three months ended September 30, 2009 were \$36,406 compared to \$887,657 for the same period in 2008, representing a decrease of \$851,251, or 96%. This decrease is primarily due to the fact that a new version of the OneBiz product was released in July of 2009 and the ongoing development expenses are now classified as part of the cost of operations.

## Other Income (Expense)

We incurred net interest expense of \$169,609 for the three months ended September 30, 2009 compared to net interest expense of \$150,510 for the same period in 2008, representing an increase of \$19,099, or 13%. During the three months ended September 30, 2009, we carried a higher balance on our line of credit with Paragon Commercial Bank and borrowed additional funds from the bond noteholders.

## Overview of Results of Operations for the Nine Months Ended September 30, 2009 and September 30, 2008

Total revenues were \$2,585,161 for the nine months ended September 30, 2009 compared to \$4,814,250 for the same period in 2008, representing a decrease of \$2,229,089, or 46%. Gross profit decreased \$1,586,381, or 52%, to \$1,459,260 from \$3,045,641. Operating expenses decreased \$249,966, or 3%, to \$7,205,135 from \$7,455,101. Net loss increased \$1,670,463, or 37%, to \$6,195,826 from \$4,525,363.

The following table sets forth our consolidated statements of operations data expressed as a percentage of revenues for the periods indicated:

September 30, 2009	Nine Months Ended		
	% of Revenue	September 30, 2008	% of Revenue

Edgar Filing: SMART ONLINE INC - Form 10-Q

<b>REVENUES</b>				
Subscription Fees	\$ 2,049,930	79.3%	\$ 2,132,787	44.3%
Professional service fees	261,699	10.1%	2,011,497	41.8%
License fees	33,750	1.3%	395,000	8.2%
Hosting Fees	139,005	5.4%	166,534	3.5%
Other revenue	100,777	3.9%	108,432	2.3%
<b>Total Revenues</b>	<b>2,585,161</b>	<b>100.0%</b>	<b>4,814,250</b>	<b>100.0%</b>
<b>COST OF REVENUES</b>				
	1,125,901	43.6%	1,768,609	36.7%
<b>GROSS PROFIT</b>				
	1,459,260	56.4%	3,045,641	63.3%
<b>OPERATING EXPENSES</b>				
General and administrative	4,112,993	159.1%	3,456,054	71.8%
Sales and marketing	2,136,256	82.6%	2,200,857	45.7%
Research and development	540,232	20.9%	1,798,190	37.4%
(Gain)/ Loss disposal of assets	415,654	16.1%	-	0.0%
<b>Total operating expenses</b>	<b>7,205,135</b>	<b>278.7%</b>	<b>7,455,101</b>	<b>154.9%</b>
<b>Total other income (expense)</b>				
Interest Expense (net)	(455,951)	-17.6%	(519,746)	-10.8%
Gain on legal settlements (net)	6,000	0.2%	386,710	8.0%
Other income			17,133	0.4%
<b>Total Other Income (Expense)</b>	<b>(449,951)</b>	<b>-17.4%</b>	<b>(115,903)</b>	<b>-2.4%</b>
<b>NET LOSS</b>	<b>\$ (6,195,826)</b>	<b>-239.7%</b>	<b>\$ (4,525,363)</b>	<b>-94.0%</b>

Comparison of the Results of Operations for the Nine Months Ended September 30, 2009 and September 30, 2008

Revenues. Total revenues for the nine months ended September 30, 2009 were \$2,585,161 compared to \$4,814,250 for the same period in 2008, representing a decrease of \$2,229,089, or 46%. This overall decrease in revenues was primarily attributable to an increase in professional service fees.

Subscription Fees – Subscription fees for the nine months ended September 30, 2009 were \$2,049,930 compared to \$2,132,787 for the same period in 2008, representing a decrease of \$82,857, or 4%. This decrease was due to a reduction in membership revenue from a multi-level marketing organization that terminated its relationship with our Company in June 2009.

Professional Service Fees - Professional service fees for the nine months ended September 30, 2009 were \$261,699 compared to \$2,011,497 for the same period in 2008, representing a decrease of \$1,749,798, or 87%. This decrease was due to the loss of a major customer as reported in the report for the quarter ending June 30, 2009.

License Fees - License fees for the nine months ended September 30, 2009 were \$33,750 compared to \$395,000 for the same period in 2008, representing a decrease of \$361,250, or 91%. The license revenue for the first nine months of 2008 was primarily related to a single license agreement signed during 2007 under which \$100,000 of the fee was collected during the first quarter of 2008, but for which the revenue was deferred at December 31, 2007 in accordance with the provisions of current US GAAP; the ratable recognition of \$30,000 of a term license that commenced in June 2008; and the recognition of \$280,000 in September 2008 relating to a perpetual license. The license revenue for the first nine months of 2009 relates to a single perpetual license agreement.

Hosting Fees – Hosting fees for the nine months ended September 30, 2009 were \$139,005 as compared to \$ 166,534 for the same period in 2008, representing a decrease of \$27,529 or 17%. The decrease relates to the reduction in hosting services required by the customer that no longer uses our Company's services as described in Professional Service fees above.

Other Revenue - Other revenue for the nine months ended September 30, 2009 totaled \$100,777 compared to \$108,432 for the same period in 2008. This revenue is generated from non-core activities. We expect these revenue streams to continue to be insignificant in the future as we continue our strategy of focusing on the growth of our subscription and license revenues.

#### Cost of Revenues

Cost of revenues for the nine months ended September 30, 2009 was \$1,125,901 compared to \$1,768,609 for the same period in 2008, representing a decrease of \$642,708, or 36%. This decrease was primarily the result of the decrease of development personnel previously involved with the development and servicing of the major customer that left the Company during 2009

#### Operating Expenses

Operating expenses for the nine months ended September 30, 2009 were \$7,205,135 compared to \$7,455,101 for the same period in 2008, representing a decrease of \$249,966, or 3%. This decrease was primarily attributable to a decrease in research and development expenses because the OneBiz product was released in July 2009.

General and Administrative - General and administrative expenses for the nine months ended September 30, 2009 were \$4,112,993 compared to \$3,456,054 for the same period in 2008, representing an increase of \$656,939, or 19%. The increase was primarily attributable to the establishment of \$1,804,763 bad-debt reserve for the estimated uncollectable amounts due from the advancement of legal fees for the defense in criminal proceedings against Dennis Michael Nouri and Reza Eric Nouri, a former officer and employee of the Company. The increase is offset by a decrease in administrative salaries of \$852,000, a decrease in the amount of amortization expense of \$181,000, a decrease in rent of \$114,000 and reduction of other administrative expenses.

Sales and Marketing - Sales and marketing expenses for the nine months ended September 30, 2009 were \$2,136,256 compared to \$2,200,857 for the same period in 2008, representing a decrease of \$64,601, or 3%. The decrease is primarily attributable to \$244,000 decrease in payroll and benefit expense, decrease of \$51,000 in travel related expense, decrease of \$49,000 in recruiting, advertising and lead generation costs, decrease in computer and office expenses of \$52,000, offset by an increase in revenue sharing costs with customers of \$331,400.

Research and Development - Research and development expenses for the nine months ended September 30, 2009 were \$540,232 compared to \$1,798,190 for the same period in 2008, representing a decrease of \$1,257,958, or 70%. This decrease is primarily due to the reduction of ongoing development expense associated with the OneBiz product that was released in July 2009. The continuing maintenance and upgrade expense is now treated as part of the Cost of Revenues.

Impairment of Assets and Gain (loss) in Disposal of Assets – During the nine month period ending September 30, 2009 the Company recognized a loss from the reduction of the value of an intangible asset in the amount of \$438,228, the amount is offset by the gain from the sale of fixed assets during 2009. The net result of the transactions is \$415,654.

#### Other Income (Expense)

We incurred net interest expense of \$455,951 for the nine months ended September 30, 2009 compared to net interest expense of \$519,746 for the same period in 2008, representing a decrease of \$63,795, or 12%. Interest expense totaled \$494,582 and \$562,430 and interest income totaled \$38,631 and \$42,684 during the first nine months of 2008 and 2007, respectively. Interest expense decreased as a result of the use of cash flow during the nine month period to reduce the outstanding balance on the line of credit whenever possible.

During the first nine months of 2009, we recognized \$6,000 in other income from a gain due to legal settlements, as compared to net gain of \$386,710 for the gain on legal settlements with our insurance carrier as described in Note 4, “Commitments and Contingencies,” to the consolidated financial statements in this report.

#### 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 third quarter of 2009 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 \$52,000,000 in net operating loss carryforwards, which may be utilized to offset future taxable income.

#### Liquidity and Capital Resources

At September 30, 2009, our principal sources of liquidity were cash and cash equivalents totaling \$18,749 and current accounts receivable of \$10,510. As of November 6, 2009, our principal sources of liquidity were cash and cash equivalents totaling approximately \$69,000 and accounts receivable of approximately \$19,262. As of September 30,

2009, we had drawn approximately \$2.4 million on our \$2.47 million line of credit with Paragon, leaving approximately \$70,000 available under the line of credit for our operations. As of November 10, 2009, we had drawn approximately \$2.05 million on the Paragon line of credit, leaving approximately \$420,000 available under the line of credit for our operations, and we expect to continue to draw down on this line of credit as needed for working capital purposes. During the third quarter of 2008, management established automated sweeps among its accounts at Paragon whereby all available cash at the end of each day is used to pay down the line of credit with Paragon, the purpose of which is to reduce our interest expense. This line of credit expires in February 2010 but is renewable if the underlying irrevocable standby letter of credit remains in force. This letter of credit is currently scheduled to expire in February 2010. As of November 12 2009, we also have the ability to call up to approximately \$6.25 million of additional funding from our convertible noteholders. On each of October 5, 2009 and October 9, 2009 the Company sold a note in the principal amount of \$250,000 (total \$500,000) to a current noteholder with substantially the same terms and conditions as the previously outstanding notes. On November 6, 2009 the Company sold a note in the principal amount of \$500,000 to a current noteholder with substantially the same terms and conditions.



During the quarter ended September 30, 2009, our working capital deficit increased by approximately \$1,979,000 to approximately \$5,227,000 compared to a working capital deficit of \$2,989,000 at December 31, 2008. As described more fully below, the working capital deficit at September 30, 2009 is primarily attributable to negative cash flows from operations, including a \$213,010 decrease in accounts receivable, a \$3,228,038 increase in notes receivable, and a \$126,004 decrease in prepaid expenses during the first nine months of 2009.

**Cash Flow from Operations.** Cash used in operations for the nine months ended September 30, 2009 totaled \$2,703,117, down from \$3,979,958 for the same period in 2008. This decrease is primarily due to the increase in accounts payable and accrued expenses offset by the net increase in notes receivable and the related bad debt expense.

**Cash Flow from Investing Activities.** Cash used in investing activities for the nine months ended September 30, 2009 totaled \$176,038, down from \$400,238 for the same period in 2008. This decrease is primarily due to the fact that the Company acquired less computer equipment and capitalized less software development in the first nine months of 2009 compared to the same period in 2008.

**Cash Flow from Financing Activities.** Cash provided by financing activities for the nine months ended September 30, 2009 totaled \$2,879,302, up from \$937,032 for the same period in 2008. This increase is primarily due to cash raised in 2009 from debt borrowings to help fund operations.

**Debt Financing.** On February 20, 2008, the Company entered into a revolving credit arrangement with Paragon that is subject to annual renewal subject to mutual approval. The line of credit advanced by Paragon is \$2.47 million and can be used for general working capital. Any advances made on the line of credit must be paid off no later than February 19, 2010, subject to extension due to renewal, with monthly payments being applied first to accrued interest and then to principal. The interest shall accrue on the unpaid principal balance at the Wall Street Journal's published prime rate, but at no time shall the interest rate be less than 5.5%. As of September 30, 2009, the line of credit was secured by an irrevocable standby letter of credit in the amount of \$2.5 million issued by HSBC with Atlas as account party, expiring February 18, 2010. The Company also has agreed with Atlas that in the event of our default in the repayment of the line of credit that results in the letter of credit being drawn, the Company will reimburse Atlas any sums that Atlas is required to pay under such letter of credit. At the Company's discretion, these payments may be made in cash or by issuing shares of our common stock at a set per-share price of \$2.50.

This line of credit replaces our line of credit with Wachovia. As an incentive for the letter of credit from Atlas to secure the Wachovia line of credit, the Company 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 the Company is in default under the terms of the line of credit with Wachovia. In consideration for Atlas providing the Paragon letter of credit, the Company 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 the Company is in default under the terms of the line of credit with Paragon.

As of September 30, 2009, the Company had \$7.85 million aggregate principal amount of convertible secured subordinated notes due November 14, 2010 outstanding. On November 14, 2007, in an initial closing, the Company sold \$3.3 million aggregate principal amount of secured subordinated convertible notes due November 14, 2010, or the initial notes. In addition, the noteholders committed to purchase on a pro rata basis up to \$5.2 million aggregate principal of secured subordinated notes in future closings upon approval and call by our Board of Directors. On August 12, 2008, the Company exercised its option to sell \$1.5 million aggregate principal of additional secured subordinated notes due November 14, 2010, or the additional notes, and together with the initial notes, the notes, 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 outstanding agreed to increase the aggregate principal amount of secured subordinated convertible notes that they are committed to purchase from \$8.5 million to \$15.3 million. On November 21, 2008, the Company sold \$500,000 aggregate principal amount of notes, or

the new notes, to two new investors with substantially the same terms and conditions as the previously outstanding notes. On each of January 6, 2009 and February 24, 2009, the Company sold \$500,000 aggregate principal amount of notes to a current noteholder with substantially the same terms and conditions as the previously outstanding notes. Additional notes with similar terms of \$500,000 each were sold on April 3, 2009 and June 2, 2009. On each of July 16, 2009, August 26, 2009, September 8, 2009, October 5, 2009 and October 9, 2009 the Company sold \$250,000 aggregate principal amount of notes to current noteholders with substantially the same terms and conditions as the previously outstanding notes. On November 6, 2009 the Company sold \$500,000 aggregate principal amount of notes to a current noteholder with substantially the same terms and conditions as the previously outstanding notes.

Also on February 24, 2009, the noteholders holding a majority of the aggregate principal amount of the notes outstanding agreed that we may sell up to \$6 million aggregate principal amount of notes to new investors 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.

The Company is obligated to pay interest on the initial notes and the additional notes at an annualized rate of 8% payable in quarterly installments commencing three months after the purchase date of the notes. The Company is 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.

On the earlier of the maturity date of November 14, 2010 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 our 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 our 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 our 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.

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 that were our existing stockholders. The investors in 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, who subsequently became Chairman of our Board of Directors and 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 investors in the additional notes are Atlas and Crystal Management Ltd.

In addition, 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.

On November 6, 2007, Canaccord Adams Inc. agreed to waive any rights it held under its January 2007 engagement letter with us that it may have with respect to the convertible note offering, including the right to receive any fees in connection with the offering.

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 convertible notes, and bank lines of credit. We must continue to rely on these sources until we are able to generate sufficient revenue to fund our operations. We believe that anticipated cash flows from operations, funds available from our existing line of credit, and additional issuances of notes, together with cash on hand, and the anticipated extension of the due date for the existing notes 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.

## Recent Developments

On each of October 2, 2009 and October 5, 2009 the Company sold \$250,000 aggregate principal amount of notes to a current noteholder with substantially the same terms and conditions as the previously outstanding notes. On November 6, 2009 the Company sold \$500,000 aggregate principal amount of notes to a current noteholder with substantially the same terms and conditions as the previously outstanding notes, as described in Note 3, "Notes Payable."

As previously reported in the Company's Form 8-K filed on June 4, 2009, Dennis Michael Nouri and Reza Eric Nouri (together, the "Nouris"), a former officer and employee of the Company, respectively, filed a complaint (the "Nouri Complaint") to bring a summary proceeding against the Company in the Court of Chancery of the State of Delaware. The Nouri Complaint sought to compel the Company to advance legal fees and costs in the amount of \$826,798 incurred by the Nouris in their defense of criminal proceedings brought against them by the United States, and in their defense of civil proceedings brought against them by the Securities and Exchange Commission and the Company's stockholders, together with future verified expenses that will be incurred by the Nouris in defending the actions against them and the expenses incurred by the Nouris in prosecuting the advancement action against the Company.

On July 29, 2009, the Court of Chancery granted summary judgment of the Nouri Complaint in favor of the Nouris. By order dated August 6, 2009, the Company is obligated to pay to the Nouris \$826,798 in advanced expenses for legal services performed by counsel to the Nouris through April 2009. The total amount of the legal fees the Company will ultimately be required to advance to the Nouris is expected to be in excess of \$2.4 million. Though the Nouris have entered into an undertaking that requires them to repay to the Company any amounts advanced by it in the event the Nouris are ultimately determined not to be entitled to indemnification for the expenses incurred, it is uncertain at this time that the Company will be able to recover such amounts advanced without considerable expense to the Company, or whether the Company will be able to recover any of the amounts advanced at all.

The Company's corporate headquarters and research and development facility is located in Durham, North Carolina near Research Triangle Park and consists of approximately 9,837 square feet of office space held under a prepaid sublease with an expiration date of September 2011. On November 3, 2009, the Company received notice from the prime landlord of the office space that the Company's sub-landlord had defaulted on the prime lease, thereby giving the prime landlord the right to terminate the Company's sublease, and that the prime landlord was seeking to renegotiate the occupancy terms for the Company's office space. The Company is currently engaged in discussions with the prime landlord to lease the office space from the prime landlord on a prime lease basis.

Please refer to Part I, Item 3 of our Annual Report on Form 10-K for the fiscal year ended December 31, 2008 for a further description of material legal proceedings.

### 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, has evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. 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 such evaluation, our Interim Chief Executive Officer and Interim Chief Financial Officer concluded that, as of the end of the period covered by this Quarterly Report on Form 10-Q, our disclosure controls and procedures were effective at the reasonable assurance level.

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. 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 September 30, 2009 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, 2008 and Part II, Item 1 of our Quarterly Reports on Form 10-Q for the quarterly periods ended March 31, 2009 and June 30, 2009 for a description of material legal proceedings, including the proceedings discussed below.

As previously reported in the Company's Form 8-K filed on June 4, 2009, Dennis Michael Nouri and Reza Eric Nouri (together, the "Nouris"), a former officer and employee of the Company, respectively, filed a complaint (the "Nouri Complaint") to bring a summary proceeding against the Company in the Court of Chancery of the State of Delaware. The Nouri Complaint sought to compel the Company to advance legal fees and costs in the amount of \$826,798 incurred by the Nouris in their defense of criminal proceedings brought against them by the United States, and in their defense of civil proceedings brought against them by the Securities and Exchange Commission and the Company's stockholders, together with future verified expenses that will be incurred by the Nouris in defending the actions against them and the expenses incurred by the Nouris in prosecuting the advancement action against the Company.

On July 29, 2009, the Court of Chancery granted summary judgment of the Nouri Complaint in favor of the Nouris. By order dated August 6, 2009, the Company is obligated to pay to the Nouris \$826,798 in advanced expenses for legal services performed by counsel to the Nouris through April 2009. The total amount of the legal fees the Company will ultimately be required to advance to the Nouris is expected to be in excess of \$2.4 million, which amount has been included in the accounts payable of the Company as of September 30, 2009. A current note receivable is recorded for the same amount due from the individuals. Though the Nouris have entered into an undertaking that requires them to repay to the Company any amounts advanced by it in the event the Nouris are ultimately determined not to be entitled to indemnification for the expenses incurred, it is uncertain at this time that the Company will be able to recover such amounts advanced without considerable expense to the Company, or whether the Company will be able to recover any of the amounts advanced at all.

On October 18, 2007, Robyn L. Gooden filed a purported class action lawsuit in the United States District Court for the Middle District of North Carolina naming us, certain of our current and former officers and directors, Maxim Group, LLC, and Jesup & Lamont Securities Corp. as defendants. The lawsuit was filed on behalf of all persons other than the defendants who purchased our securities from May 2, 2005 through September 28, 2007 and were damaged. The complaint asserts violations of federal securities laws, including violations of Section 10(b) of the Exchange Act and Rule 10b-5. The complaint asserts that the defendants made material and misleading statements with the intent to mislead the investing public and conspired in a fraudulent scheme to manipulate trading in the our stock, allegedly causing plaintiffs to purchase the stock at an inflated price. The complaint requests certification of the plaintiff as class representative and seeks, among other relief, unspecified compensatory damages including interest, plus reasonable costs and expenses including counsel fees and expert fees. On June 24, 2008, the court entered an order appointing a lead plaintiff for the class action. On September 8, 2008, the plaintiff filed an amended complaint which added additional defendants who had served as our directors or officers during the class period as well as our independent auditor.

At this time, we are not able to determine the likely outcome of our currently pending legal matters, nor can we estimate our 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.

Page 30 of 37

---



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 and in other sections of this document and our other filings. These risks and uncertainties are not the only ones we face. Additional risks and uncertainties not presently known to us, which we currently deem immaterial, or that are similar to those faced by other companies in our industry or business in general may also affect our business. If any of the risks described below actually occurs, 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, including our revolving line of credit with Paragon and convertible note financing, and the anticipated extension of the due date for the existing notes should fund our operations for the next 12 to 18 months. As of November 10, 2009, we have approximately \$420,000 available on our line of credit and \$6.25 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, the charges filed against a former officer and a former employee by the SEC and the United States Attorney General, and the pending shareholder class action lawsuit may 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 and the convertible note financing both have maturity dates in February and November 2010. Should we be unable to repay the principal then due or extend maturity dates or obtain capital from new or renegotiated capital funding sources, we will be unable to sustain our business. As of November 10, 2009, we have approximately \$2.05 million outstanding on our line of credit and \$8.5 million aggregate principal amount of convertible notes outstanding.

Our independent registered public accountants for fiscal 2008 indicated that they have substantial doubts that we can continue as a going concern. Their 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.

Sherb & Co., LLP, our independent registered public accountants for fiscal 2008, has expressed substantial doubt in their report included with our Annual Report on Form 10-K for the year ended December 31, 2008 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 entire investment. You should consider our independent registered public accountants' comments when determining if an investment in us is suitable.

If we are unable to renegotiate an extension of the due date for the outstanding bond debt, obtain conversion of the debt to preferred stock or identify alternate financing sources, the Company will be forced to liquidate our business.

As of November 12, 2009, the Company has \$8,950,000 of outstanding debt due the bondholders. The current terms of the bonds indicate a due date of November 14, 2010. If the Company is unable to repay the amount of the principal on the due date or unable to renegotiate an extension of the due date for the outstanding bond debt, obtain conversion of the debt to preferred stock or identify alternate financing sources, the Company may be forced to liquidate our business.

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 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 either 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 other software vendors and we 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 syndication 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 syndication 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 convertible secured subordinated 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 fraudulently to 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 preventive 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 action against us, 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 lawsuit filed against us by the SEC, the SEC and criminal actions filed against a former officer and a former employee, the class action lawsuit filed against us and certain current and former officers, directors, and employees, and the lawsuit filed by a former executive officer against us 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. 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 from the time they spend on our operations, including strategy development and implementation. These actions 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.

In addition, we face uncertainty regarding amounts that we may have to pay as indemnification to certain current and former officers, directors, and employees under our Bylaws and Delaware law with respect to these actions, and we may not recover all of these amounts from our directors' and officers' liability insurance policy carrier. Our Bylaws and Delaware law generally require us to advance legal expenses to, current and former officers, directors and employees against claims arising out of such person's status or activities as our officer, director or employee from such claims unless such person (i) did not act in good faith and in a manner the person reasonably believed to be in or not opposed to our best interests or (ii) had reasonable cause to believe his conduct was unlawful. Also there is a stockholder class action lawsuit pending against us and certain of our current and former officers, directors, and employees. The SEC, criminal, and stockholder actions are more fully described above under "Legal Proceedings" and in Part I, Item 3, "Legal Proceedings," in our Annual Report on Form 10-K for the year ended December 31, 2008..

Generally, we are required to advance defense expenses prior to any final adjudication of an individual's culpability. The expense of indemnifying our current and former directors, officers, and employees for their defense or related expenses in connection with the current actions may be significant. Our Bylaws require that any director, officer, employee, or agent requesting advancement of expenses enter into an undertaking with us to repay any amounts advanced unless it is ultimately determined that such person is entitled to be indemnified for the expenses incurred. This provides us with an opportunity, depending upon the final outcome of the matters and the Board's subsequent determination of such person's right to indemnity, to seek to recover amounts advanced by us. However, we may not be able to recover any amounts advanced if the person to whom the advancement was made lacks the financial resources to repay the amounts that have been advanced. If we are unable to recover the amounts advanced, or can do so only at great expense, our operations may be substantially harmed as a result of loss of capital.

As reported in the Form 8-K filed by the Company on June 4, 2009, our insurance coverage for advancement claims has been exhausted. As noted herein in Item 4, "Commitments and Contingencies – Legal Proceedings", by order dated August 6, 2009, the Company is obligated to pay to Dennis Michael Nouri and Reza Eric Nouri \$826,798 in advanced expenses for legal services performed by counsel to the Nouris through April 2009. The total amount of the legal fees the Company will ultimately be required to advance to the Nouris is expected to be in excess of \$2.4 million. In addition, a number of our current and former employees were asked to appear as witnesses in the criminal action and may seek advancement of legal expenses from us. Payment of these amounts would adversely impact our financial condition and results of operations, which could result in a significant reduction in the amounts available to fund working capital, capital expenditures, and other general corporate objectives and could ultimately require us to file for bankruptcy.

Finally, our insurance policies provide that, under certain conditions, our insurance carriers may have the right to seek recovery of any amounts they paid to us or the insured individuals. As of November 10, 2009, we do not know and can offer no assurances about whether these conditions will apply or whether the insurance carriers will change their position regarding coverage related to the current actions. Therefore, we can offer no assurances that our insurance carriers will not seek to recover any amounts paid under their policies from us or the individual insureds. If such recovery is sought, then we may have to expend considerable financial resources in defending and potentially settling or otherwise resolving such a claim, which could substantially reduce the amount of capital available to fund our operations and could ultimately require us to file for bankruptcy.

Our executive management team has undergone significant changes and is critical to the execution of our business plan and the loss of their services could severely impact negatively on our business.

Our executive management team has undergone significant changes since 2008, including the resignation of our Chief Executive Officer on December 9, 2008, the resignation of our Chairman of the Board and Interim Chief Executive Officer on May 19, 2009. It may be difficult to attract highly qualified candidates to serve on our executive management team on a permanent basis. 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.

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 Sarbanes-Oxley and new 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 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 the interests of minority stockholders.

Our officers, directors, and principal stockholders beneficially own or control a large percentage of our outstanding common stock. Certain of these principal stockholders hold warrants and convertible 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 to 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. The Chairman of our Board of Directors currently is serving as the bond representative.

Our officers, directors, and 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 to purchase an additional 1,176,471 shares of our common stock at \$3.00 per share 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 noteholders may elect to convert all, a part of, or none of their notes into shares of our common stock at variable conversion prices. In addition, we may raise funds in the future by issuing additional shares of common stock or other securities.



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 November 5, 2009 there were 18,332,542 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 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.

If we fail to evaluate, implement, and integrate strategic opportunities successfully, our business may suffer.

From time to time we evaluate strategic opportunities available to us for product, technology, or business acquisitions or dispositions. If we choose to make acquisitions or dispositions, we face certain risks, such as failure of an acquired business to meet our performance expectations, diversion of management attention, retention of existing customers of our current and acquired business, and difficulty in integrating or separating a business's operations, personnel, and financial and operating systems. We may not be able to successfully address these risks or any other problems that arise from our previous or future acquisitions or dispositions. Any failure to successfully evaluate strategic opportunities and address risks or other problems that arise related to any acquisition or disposition could adversely affect our business, results of operations, and financial condition.

Page 35 of 37

---

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

During the first, second and third quarter of fiscal 2009, we sold equity securities totaling \$219 and \$876, respectively that were not registered under the Securities Act, as described in our Current Reports on Form 8-K filed in connection with such transactions.

The following table lists all repurchases during the first and second and third quarters of fiscal 2009 of any of our securities registered under Section 12 of the Exchange Act by or on behalf of us or any affiliated purchaser.

## Issuer Purchases of Equity Securities

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares That May Yet Be Purchased Under the Plans or Programs
January 1 – January 31, 2009	-	\$ -	-	-
February 1 – February 28, 2009	-	\$ -	-	-
March 1 – March 31, 2009 (1)	146	\$ 1.50	-	-
April 1 – June 30, 2009	580	\$ 1.51	-	-
July 1 – September 30, 2009	-	-	-	-
Total	726	\$ 1.50	-	-

(1) Represents 146 and 580 shares repurchased in connection with tax withholding obligations under the 2004 Plan.

## 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
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 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 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.



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.

/s/ C. J. Meese, Jr.

C. J. Meese, Jr.

Interim Chief Executive Officer, President and  
Principal Executive Officer

Date: November 16, 2008

/s/ Thaddeus J. Shalek

Thaddeus J. Shalek

Interim Chief Financial Officer and  
Principal Accounting Officer

Date: November 16, 2008