

SMART ONLINE INC
Form 10-K
April 15, 2010

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

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2009

or

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

For the transition period from _____ to _____

Commission file number 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)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class
N/A

Name of each exchange on which registered
N/A

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, \$0.001 par value

(Title of Class)

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

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

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

The aggregate market value of common stock held by non-affiliates of the registrant as of June 30, 2009 was approximately \$28,415,412 (based on the closing sale price of \$1.55 per share).

The number of shares of the registrant's Common Stock, \$0.001 par value per share, outstanding as of April 14, 2010 was 18,332,543.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive Proxy Statement to be delivered to stockholders in connection with the Annual Meeting of Stockholders to be held June 22, 2010 are incorporated by reference into Part III.

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PART I

Special Note Regarding Forward-Looking Statements

This Annual Report on Form 10-K contains 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, regarding our plans, objectives, expectations, intentions, future financial performance, future financial condition, and other statements that are not historical facts. You can identify these statements by our use of the future tense, or by forward-looking words such as “may,” “will,” “expect,” “anticipate,” “believe,” “intend,” “estimate,” “continue,” and similar words and phrases. Examples of sections containing forward-looking statements include Part I, Item 1, “Business” and Part II, Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operations.” 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 in Part I, 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.

Item 1. Business

General

In this Annual Report on Form 10-K, we refer to Smart Online, Inc. as “Smart Online,” the “Company,” “us,” “we,” and “our.” Smart Online was incorporated in Delaware in August 1993 and became a public company through a self-registration in February 2005. Smart Online’s common stock trades on the OTC Bulletin Board, or the OTCBB, under the symbol “SOLN.”

We develop and market 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 services, primarily in the e-commerce retail industry. In the past we reached small businesses primarily through arrangements with channel partners that private label our software applications and marketed them to their customer bases through their corporate websites. We believe these relationships provide a cost- and time-efficient way to market to a diverse and fragmented yet very sizeable small-business sector. We continue to cultivate new channel partners that will facilitate our efforts. We also offer our products directly to end-user small businesses through our OneBiz® branded website.

History

During the early stages of our development, we offered application-specific software using the “shrink-wrapped” method of distribution of diskettes and CD-ROMs, primarily through large office supply retailers. In 2000, we undertook a significant shift in our business strategy by moving away from the development and sale of shrink-wrapped software products and began developing SaaS applications for sale over the Internet.

Unlike the shrink-wrapped distribution method that requires the end user to install, configure, and maintain hardware, software, and network services internally to support the software applications, or the ASP model that permits access to the software resident on a server by a user from one dedicated PC, our proprietary multi-tenant SaaS applications allow small businesses to subscribe and access those applications via a browser from any PC on an as-needed basis, with no installation or maintenance required by the end user.

In October 2005, we acquired substantially all of the assets of Computility, Inc., or Computility, an Iowa-based, privately held developer and distributor of sales force automation and customer relationship management, or SFA/CRM, software applications. We operated this business under the name Smart CRM, Inc. (d/b/a Computility), or Smart CRM. Upon our integration of Smart CRM's SFA/CRM application into our OneBiz ® platform, we determined that the remaining operations of Smart CRM, specifically consulting and network management, were not integral to our ongoing operations and business model.

The Smart CRM assets sold to Alliance included the SFA/CRM software application developed and sold by Smart CRM and its predecessor-in-interest, Computility. We retained all rights relating to the derivative SFA/CRM SaaS application developed by us with Smart CRM and incorporated into our SaaS offerings.

In October 2005, we purchased all of the capital stock of iMart Incorporated, or iMart, a Michigan-based company providing multi-channel e-commerce systems. Subsequently, we operated this business as our wholly owned subsidiary, Smart Commerce, Inc., or Smart Commerce.

In 2007, we operated our company as two segments. The two segments were our core operations, or the Smart Online segment, and the operations of our wholly owned subsidiary Smart Commerce, or the Smart Commerce segment. The Smart Online segment generated revenues from the development and distribution of Internet-delivered SaaS small-business applications through a variety of channels. The Smart Commerce segment generated revenues primarily from subscriptions to our multi-channel e-commerce systems, including domain name registration and e-mail solutions, e-commerce solutions, and website design, as well as website hosting and consulting services. We included costs that were not allocated to specific segments, such as corporate general and administrative expenses and share-based compensation expenses, in the Smart Online segment. During late 2007 and the first quarter of 2008, we realigned certain production and development functions and eliminated redundant administrative functions and now report the consolidated business as a single business segment.

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

In light of our new 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, we concluded in the latter part of 2008 that it was no longer necessary to operate with the Smart Commerce and Smart CRM subsidiaries. As a result, an upstream merger was completed as of December 31, 2008 that merged the subsidiaries with the parent corporation.

Principal Products and Services

Our principal products and services include:

- SaaS applications for business management, web marketing, and e-commerce;
- Software business tools that assist customers in developing written content; and
- Services that are designed to complement our product offerings and allow us to create custom business solutions that fit our end users’ and channel partners’ needs.

Our SaaS applications are designed to allow end users to access and work on information securely from any location where an Internet browser can be accessed. These applications include:

e-Commerce – Our e-commerce applications are designed to give customers the capability to conduct transactions online. These applications also include inventory query, shopping cart, financial transactions, shipping, domain name registration and business-to-business communication for small businesses. We provide consulting services such as website design and launch, among others, in connection with these applications. Our e-commerce offerings are designed to help direct marketers increase sales, better leverage corporate resources, and deliver superior customer service.

Our OneBiz® platform applications include

SFA/CRM – Our SFA/CRM application allows end users to create standardized processes to define their sales approach, create marketing plans, and monitor and guide sales activities. Users can utilize the customer service management feature to create, monitor, and track service requests. In addition, users can display and present their business data with built-in report templates designed to provide information on sales activity, pipeline activity, revenue, and other relevant business data.

Business Dashboard – Our Business Dashboard application provides a snapshot of real-time business data in a single view, allowing users to monitor key information about their company and employees. Examples of business information that end users may view on the dashboard include a list of key documents for the user, daily events scheduled, product shipments, and a list of new employees. The dashboard displays different information to each user based upon his or her job function and access levels within the company.

Accounting – Our Accounting application is targeted for end users that want to create and maintain their accounting records online in a secure fashion, but do not have the resources or desire to utilize traditional accounting applications designed for larger businesses. The Accounting application enables a user to create invoices, record payments, print checks, produce real-time financial statements and reports, as well as manage accounts receivable and payable.

Human Resource Center – Our Human Resource, or HR, Center application is designed to allow companies to manage their daily human resources needs, including employee information, HR documents, performance reviews, and compensation. The HR Center application also allows employers to manage the attendance records of each employee by creating and assigning vacation, sick leave, civil leave, and leave under other policies to each employee. The application allows an end-user manager to monitor and approve or decline time-off requests and automatically track how much time each employee has available on a per-policy basis.

Calendar – Our Calendar application is a full-function, easy-to-use online calendar. The Calendar application features daily, weekly, and monthly views, together with a mini calendar that allows the end user to quickly browse to any date. Automated e-mail reminders can be scheduled, indicating notification of an upcoming event. In addition, employees may collaborate with their colleagues by sharing their calendars and events. This application also includes a to-do list to set up tasks, assign priorities and due dates, and mark tasks as complete.

Contacts – Our Contacts application is designed to provide users with an online business contact management system. Contacts can be sorted by group or alphabetically and may be shared among colleagues. End users can add, edit, and remove contact groups as needed, or they can use the default set of groups.

We also provide services that are designed to complement our product offerings and allow us to create custom business solutions that fit our channel partners' needs. These services include business consulting, graphic design, website content syndication, specialized compensation calculations, online order management, domain name registration, personalized e-mail creation, and warehouse order fulfillment.

Mode of Operations

Software-as-a-Service Model – We follow the SaaS model for delivering our products and services to end users. The on-demand SaaS model developed using multi-tenant architecture enables end users to visit a website and use the SaaS applications, all via a web browser, with no installation, no special information technology knowledge, and no maintenance. The SaaS application is transformed into a service that can be used anytime and anywhere by the end user. Multi-tenant SaaS applications also permit us to add needed functionality to our applications in one location for the benefit of all end users. This capability allows us to provide upgrades universally.

Integration and Sharing – Our SaaS applications have the capability to allow sharing of information (with selectivity and control options) among members of an organization. Each company that subscribes to our SaaS applications can have multiple members or employees who share information with one another. Information entered by one employee can be shared and modified by one or more other employees who have the appropriate access authority.

Target Market and Sales Channels

Our consistent focus has been to design software products and services to help start and run small businesses in a more efficient and cost-effective manner. The small-business market is diverse and fragmented, yet very large and, we believe, underserved. We have focused on offering a wide range of software products that combine simplicity and affordability and that meet the needs of small businesses with capabilities that typically can be afforded only by much larger companies. We follow a two-prong approach to target these small business and entrepreneurial end users that access our software products and services via the Internet. The first is an indirect approach via marketing partners that are vertical intermediaries in industries such as agriculture, finance, telecommunications, direct selling, retail, and technology as channels to reach these small-business customers. The second is a direct approach via a website we develop and maintain where our applications and business tools are marketed and sold via monthly subscription under the OneBiz ® brand.

Principal Customers

During 2009, we consider four customers as our major customers, and the loss of any one of these customers could have a material adverse effect on our business. Two of these customers terminated their relationship with Company during 2009.

UR Association, or URA, is a multi-level-marketing organization that sells memberships and subscriptions to independent business owners, or IBOs. The net of the subscriptions from these IBOs represented approximately 29% of our revenues for the year ended December 31, 2009. URA became a customer in 2007 and represented 10% of our revenues in 2008. Since our revenue is derived from the IBOs, URA can directly influence the memberships and actions of the IBOs, this revenue has been netted for purposes of this Annual Report on Form 10-K.

1-800-Pharmacy, Inc. is a mail-order pharmacy that offers customers access both through a toll-free number and website, and gives customers rebates on their pharmaceutical and health & beauty purchases, as well as credit for referring others. 1-800-Pharmacy accounted for approximately 13% of our revenues for the year ended December 31, 2009. 1-800-Pharmacy became a customer in 2007 and represented 3% of our revenues in 2008.

Britt Worldwide, or BWB, is a multi-level-marketing entity that indirectly controls a significant number of IBOs, who currently subscribe to our services. The aggregate of the subscriptions from these IBOs represented approximately 25% of our revenues for the year ended December 31, 2009. BWB became a customer after we acquired iMart in October 2005 and represented 27% of our revenues in 2008. Although our revenue is derived from the IBOs, BWB can influence the actions of the IBOs, so this revenue has been aggregated for purposes of this Annual Report on Form 10-K. During 2009, BWB terminated its primary relationship with our Company, as of December 31, 2009. Notwithstanding such termination, several IBO's have chosen to retain their subscription for our services.

Vera Bradley Designs, Inc., or Vera Bradley, is a manufacturer of high quality handbags, luggage, and other accessories, accounted for approximately 19% of our revenues for the year ended December 31, 2009. Vera Bradley became a customer in 2006 and represented 35% of our revenues in 2008. During 2009, Vera Bradley terminated its Services Agreement relationship with our Company. The fees for services and licensing paid by Vera Bradley under the Services Agreement were \$1,358,892 in 2008 and \$275,111 for 2009.

Research and Development

In the second half of 2007, as part of a general restructuring, we began to conduct an evaluation of our technology, platforms, and applications in an effort to document and improve upon our current product offerings and determine which applications, if any, should be discontinued. During 2008, we decided to develop an industry-standard platform that would allow significant technological flexibility with current and future customers. We devoted a substantial amount of time and effort in 2008 and 2009 to developing this platform, updating and migrating our business applications and tools to the new platform, and enhancing the user interface of the products. In addition, during 2009, we continued the development work of SaaS applications for the not-for profit segment of the marketplace. We call this our LoyaltyClicks™ product.

Our research and development costs were approximately \$0.6 million and \$2.0 million in 2009 and 2008, respectively. We have not engaged in any customer-sponsored research and development.

Competition

The market for small-business software applications in both the traditional and SaaS environments is highly competitive and subject to rapid changes in technology and delivery. The direct competition we face depends on the software application within our platforms and the delivery model capabilities of our competitors.

We have two primary categories of competitors: large companies that offer a wide range of products for small- to medium-size businesses, and companies that offer only one or two software products that compete with our broad range of software products. Our principal direct competition is a number of very large vendors of SaaS applications for small businesses that sell many products similar to ours. These competitors include, but are not limited to, Microsoft, Oracle, NetSuite, Intuit, SAP, Sage, Yahoo!, and Google.

Companies that offer only one or two products that compete with our suite of SaaS applications include:

- Accounting software applications: NetSuite, Intuit, SAP, Sage, Microsoft, ZOHIO and others
- Human resource software applications: ADP, Sage, and others
- SFA/CRM applications: Microsoft, Sage, salesforce.com, NetSuite, and others
- e-Commerce solutions: Register.com, GoDaddy.com, 1and1 Internet, eBay's Storefront, Yahoo! Store, Microsoft, NetSuite, Intuit, and others

We also expect to face competition from new entrants marketing SaaS applications similar to ours to small businesses.

Although we believe we offer highly competitive services and software, many of our competitors do or may have greater resources and a larger number of total customers for their products and services. In addition, a number of our competitors already sell certain products to our current and potential customers, as well as to systems integrators and other vendors and service providers. These competitors may be able to respond more quickly to new or emerging technologies and changes in customer requirements, or to devote greater resources to the development, promotion, and sale of their products, than we can. It is also possible that new competitors or alliances among competitors or other third parties may emerge and rapidly acquire market share. Increased competition may result in price reductions, reduced gross margins, and change in market share, any of which could adversely impact our revenue and profitability targets and timetables.

On each competitive front, we seek to compete against these larger and better-financed companies primarily by offering an extensive suite of SaaS applications that are useful to small businesses. We believe we offer more SaaS applications and features specifically targeted to small businesses than most of our competitors. We also believe a distinctive value proposition we offer is the integration of our applications. To meet our business objectives, we will need to continue to develop high quality and competitively priced new applications for our SaaS offerings. If we are unable to do so, our revenue and profitability targets and timetables could be adversely impacted.

To compete effectively in the SaaS market, we leverage the marketing resources and small-business customer relationships of our private-label marketing partners that sell our SaaS applications by offering innovative and value-added products and services.

Intellectual Property

Our success depends, in part, upon our proprietary technology, processes, trade secrets, and other proprietary information and our ability to protect this information from unauthorized disclosure and use. We rely on a

combination of copyright, trade secret, and trademark laws, confidentiality procedures, contractual provisions, and other similar measures to protect our proprietary information. We do not own any issued patents or have any patent applications pending. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy or design around certain aspects of our SaaS offerings or to obtain and use information that we regard as proprietary, and third parties may attempt to develop similar technology independently. In addition, the laws of some foreign countries do not protect our proprietary rights to the same extent as do the laws of the United States, and we expect that it will become more difficult to monitor use of our products if we develop an international presence.

We have registered copyrights, trademarks, and registered service marks on several products and data services. These marks include, but are not limited to Smart Online ®, OneBiz ®, Smart Attorney ®, Smart Business Plan ®, Smart Marketing Plan ®, iMart TM, and OneDomain ®.

As part of our efforts to protect our proprietary information, we enter into license agreements with our customers and nondisclosure agreements with certain of our employees, consultants, and corporate partners. These agreements generally contain restrictions on disclosure, use, and transfer of our proprietary information for a period of three years. We also employ various physical and technological security measures to protect our software source codes, technology, and other proprietary information.

Employees

As of December 31, 2009, we had 28 full-time employees. No employees are known by us to be represented by a collective bargaining agreement, and we have never experienced a strike or similar work stoppage.

Directors and Executive Officers of the Company

The members of our current Board of Directors are the following:

Dror Zoreff

Chairman of the Board and Interim President and Chief Executive Officer: President and CEO of Donor Management Services, Inc., a New York-based company that provides major donors, corporations, and foundations a unique set of tools and services to ensure their charitable gifts are properly used and achieve the desired impact.

Shlomo Elia

Director of 3Pen Ltd., a private holding company focusing on business opportunities in Internet infrastructure and telecommunications.

Amir Elbaz

Mr. Elbaz currently advises technology and renewable energy companies on business strategy, restructuring and business development initiatives. Mr. Elbaz served as the Executive Vice President & Chief Financial Officer of Lithium Technology Corporation (“LTC”) until November 2008. Mr. Elbaz joined LTC in 2006 to oversee finances and marketing, as well as business development.

C. James Meese, Jr.

President of Business Development Associates, Inc., a boutique investment bank that provides enterprise level strategic advisory services to middle market companies for business initiatives such as acquisitions, divestitures, valuations, interim company management, growth capitalization and corporate governance.

Our current executive officers are the following:

Dror Zoreff

Interim President and Chief Executive Officer

Thaddeus Shalek

Interim Chief Financial Officer

Available Information

Our corporate information is accessible through our main web portal at www.smartonline.com. We are not including the information contained on our website as a part of, or incorporating it by reference into, this Annual Report on Form 10-K. Although we endeavor to keep our website current and accurate, there can be no guarantees that the information on our website is up to date or correct. We make available, free of charge, access to all reports filed with the U.S. Securities and Exchange Commission, or SEC, including our Annual Reports on Form 10-K, our Quarterly Reports on Form 10-Q, our Current Reports on Form 8-K, and amendments to these reports, filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act, as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC. These reports may be accessed by following the link under “About Us - Investor Relations” on our website.

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. These risks and uncertainties are not the only ones we face. Additional risks and uncertainties not presently known to us that 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 occur, our business, financial condition, or results of operations could be materially and adversely affected.

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

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

In addition, our current primary credit facilities consist of the Paragon line of credit with a due date of August 14, 2010 and the convertible note financing with a maturity date in November 2013. Should we be unable to repay the principal then due from operations or from new or renegotiated capital funding sources, we may not be able to sustain our business. As of April 14, 2010, we have approximately \$2.0 million outstanding on our line of credit and \$10.65 million aggregate principal amount of convertible Notes outstanding.

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

Cherry, Bekaert & Holland, L.L.P. our independent registered public accountants have expressed substantial doubt in their reports included with this Annual Report on Form 10-K about our ability to continue as a going concern given our recurring losses from operations and deficiencies in working capital and equity, which are described in the first risk factor above. This opinion could materially limit our ability to raise additional funds by issuing new debt or equity securities or otherwise. If we fail to raise sufficient capital, we will not be able to implement our business plan, we may have to liquidate our business, and you may lose your investment. You should consider our independent registered public accountants' comments when determining if an investment in us is suitable.

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

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

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

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

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

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

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

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

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

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

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

Our revolving line of credit from Paragon is secured by an irrevocable standby letter of credit issued by HSBC Private Bank (Suisse) SA, or HSBC, with Atlas Capital SA, or Atlas, as account party. Our secured subordinated convertible notes are secured by a first priority lien on all of our unencumbered assets.

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

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

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

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

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

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

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

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

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

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

Our principal stockholders beneficially own or control a large percentage of our outstanding common stock. Certain of these principal stockholders hold warrants and 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 shall receive all materials provided to our Board of Directors or any committee of our Board. In addition, so long as the notes are outstanding, we have agreed that we will not take certain material corporate actions without approval of the bond representative.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Item 1B. Unresolved Staff Comments

Not applicable.

Item 2. Properties

Our 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 that expires in September 2011.

Item 3. Legal Proceedings

Gooden v. Smart Online, Inc. – 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. and Sherb & Co. (our former independent registered accounting firm) 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 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 that added additional defendants who had served as our directors or officers during the class period as well as our independent auditor. The Company and the lead plaintiff in the action have been engaged in settlement negotiations, and have recently reached an agreement in principle and tentative settlement which has not yet been signed providing for the settlement of the securities class action on the following terms. The settlement, once signed, would be subject to court approval. The tentative settlement contemplates a cash payment of \$350,000 to be made by the Company and the issuance to the class of 1,475,000 shares of Company common stock, in consideration for which all claims against the settling defendants would be dismissed with prejudice, with no admission of fault or wrongdoing by the Company or the other defendants. The Company's additional charge to expenses for 2009 as a result of this tentative settlement is approximately \$2,150,000.

Nouri Indemnification Claims - On July 2, 2009, Dennis Michael Nouri, a former officer of Smart Online, Inc. (the “Company”), and Reza Eric Nouri, a former employee of the Company (together, 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 involving a fraudulent scheme to manipulate the Company’s stock price, and are presently awaiting sentencing. On September 24, 2009, the Nouris filed a motion in the Court of Chancery of the State of Delaware against the Company seeking the appointment of a receiver for the Company for the purpose of collecting on account of the Company’s failure to pay a judgment in the amount of \$826,798 entered against it by order of the Court of Chancery on August 6, 2009 (the “Order”) for the advancement of legal expenses 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. Such legal expenses were in addition to legal fees and costs of over \$1.3 million paid by the Company’s insurance carrier for the benefit of the Nouris in these matters prior to entry of the Order, which insurance coverage has since been exhausted. The terms of the Order were previously reported in the Form 10-Q filed by the Company for the quarterly period ended June 30, 2009. The Company has recorded a total of unpaid legal expense obligations of \$1,798,595 for this matter based on invoices received from the Nouris’ law firms through March 31, 2010 which figure does not

include invoices generated but not yet received. The Company and the Nouris have been engaged in settlement negotiations for the settlement of the Nouris' advancement and indemnification claims against the Company, but no definitive agreement has yet been signed.

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

Item 4. Submission of Matters to a Vote of Security Holders

Not applicable.

PART II

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

Our common stock is quoted on the OTCBB under the symbol "SOLN." The following table sets forth the range of high and low sales prices of our common stock quoted on the OTCBB for the quarterly periods indicated.

	High	Low
Year Ended December 31, 2008:		
First Quarter	\$ 2.60	\$ 1.65
Second Quarter	\$ 3.40	\$ 1.32
Third Quarter	\$ 3.30	\$ 1.95
Fourth Quarter	\$ 3.15	\$ 1.50
Year Ended December 31, 2009:		
First Quarter	\$ 2.60	\$ 1.10
Second Quarter	\$ 2.00	\$ 1.01
Third Quarter	\$ 1.70	\$ 0.41
Fourth Quarter	\$ 1.50	\$ 1.11

At April 14, 2010, there were 198 holders of record of our common stock.

We have never declared or paid any cash dividends on our common stock and do not intend to declare or pay dividends for the foreseeable future. As long as our convertible notes are outstanding, we must receive approval from the agent designated by the noteholders in order to pay any dividend on our capital stock.

During 2009, by private placements of convertible notes to accredited investors under Regulation D, equity securities were sold that were not registered under the Securities Act, as described in our quarterly reports on Form 10-Q and current reports on Form 8-K filed in connection with such transactions, and more fully described in Part II, Item VII, "Management's Discussion and Analysis of Financial Condition and Results of Operations", under the sub-heading Debt Financing, in this Annual Report on Form 10-K.

The following table lists all repurchases during the fourth quarter of 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 (1)	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
October 1 – October 31, 2009	-	\$ -	-	-
November 1 – November 30, 2009	-	\$ -	-	-
December 1 – December 31, 2009	-	\$ -	-	-
Total	-	\$ -	-	-

Item 6. Selected Financial Data

Not applicable.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Executive Summary

The following discussion is designed to provide a better understanding of our consolidated financial statements, including a brief discussion of our business and products, key factors that impacted our performance, and a summary of our operating results. This executive summary should be read in conjunction with the more detailed discussion and analysis of our financial condition and results of operations in this Item 7; Item 1A, “Risk Factors”; and our consolidated financial statements and the notes thereto included in Item 8, “Financial Statements and Supplementary Data.”

Overview

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

In the second half of 2007, we commenced an overall evaluation of our business model as well as our current technologies, the outcome of which was our decision to develop a core industry-standard platform for small business with an architecture designed to integrate with a virtually unlimited number of other applications, services, and existing infrastructures. These applications would include not only our own small-business applications, which we are currently optimizing, but also other applications we expect to arise from collaborative partnerships with third-party developers and service providers. In addition, we identified emerging-market opportunities in the small-business segment to leverage social networking and community building. We are currently refining and integrating these capabilities into the core platform to be readily available in a “plug-and-play” fashion to meet any anticipated customer need or desire. On July 14, 2009, we announced the release of OneBiz 1.1, a suite of web-based business management tools designed for small business owners to operate and grow their businesses. We believe that this platform and associated applications will provide opportunities for new sources of revenue, including an increase in our subscription fees. We also believe, because the platform is designed to follow industry-standard protocol, that the customization efforts and associated timeline previously necessary to meet a particular customer’s requirements will diminish significantly, allowing us to shorten the sale-to-revenue cycle. As we neared completion of the development of our industry-standard platform, we began shifting our focus from development toward the sales and marketing of the new platform in the fourth quarter of 2008 and continued the effort throughout 2009.

In light of our new 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, we concluded in the latter part of 2008 that it was no longer necessary to operate with the Smart Commerce and Smart CRM subsidiaries. As a result, an upstream merger was completed as of December 31, 2008 that merged the 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
- Professional service fees – fees related to consulting services, some of which complement our other products and applications
- License fees – fees charged for perpetual or term licensing of platforms or applications
- Hosting fees – fees charged for providing network accessibility for our customers using our customized platforms
-

Other revenues – revenues generated from non-core activities such as syndication and integration fees; original equipment manufacturer, or OEM, contracts; and miscellaneous other revenues

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

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

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

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

Hosting fees charged for providing our customers with network accessibility.

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

Cost of Revenues

Cost of revenues primarily is composed of salaries associated with maintaining and supporting customers, the cost of domain name and e-mail registrations, and the cost of external facilities where our applications and our customers’ customized applications are hosted.

Operating Expenses

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

General and Administrative – General and administrative expenses are composed primarily of costs associated with our executive, finance and accounting, legal, human resources, and information technology personnel and consist of salaries and related compensation costs; professional services (such as outside legal counsel fees, audit, and other compliance costs); depreciation and amortization; facilities and insurance costs; and travel and other costs. We anticipate general and administrative expenses will decrease in 2010 as the legal expenses and other professional fees we incurred in 2009 to resolve outstanding matters from previous years and to assist with the transition between permanent financial officers are offset in part by an increase in costs related to the growth of our business and to our operations as a public company.

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

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

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

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

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

Critical Accounting Policies and Estimates

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

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

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

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

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

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

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

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

Subscription fees primarily consist of sales of subscriptions through private-label marketing partners to end users. We typically have a revenue-share arrangement with these marketing partners in order to encourage them to market our products and services to their customers. Subscriptions are generally payable on a monthly basis and are typically paid via credit card of the individual end user. We accrue any payments received in advance of the subscription period as deferred revenue and amortize them over the subscription period. In the past we recognized all subscription revenue on a gross basis and in accordance with our policy to periodically review our accounting policies we determined that certain contracts require the reporting of subscription revenue on a gross basis and others on a net basis according to US GAAP. On that basis, we continue to report subscription revenue from certain contracts on a gross basis and others on a net basis. The net effect of this reclassification of expenses only impacts gross revenue and certain gross expenses; it does not change the net income. We discuss this matter in more depth in Footnote 13 to the financial statements.

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

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

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