SMART ONLINE INC
Form 10-Q
November 12, 2008

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2008

OR

o **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)

2530 Meridian Parkway, 2nd Floor, Durham, North Carolina 27713
(Former name, former address and former fiscal year, if changed since last report)

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 x No o

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

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

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

As of November 10, 2008, there were approximately 18,408,723 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, 2008

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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements

SMART ONLINE, INC.
CONSOLIDATED BALANCE SHEETS

	September 30, 2008 (unaudited)	December 31, 2007
ASSETS		
Current assets:		
Cash and cash equivalents	$ 30,751	$ 3,473,959
Accounts receivable, net	483,302	815,102
Contract receivable, net	160,000	-
Note receivable	60,000	55,000
Prepaid expenses	339,982	90,886
Deferred financing costs	-	301,249
Total current assets	1,074,035	4,736,196
Property and equipment, net	373,473	174,619
Capitalized software, net	120,191	-
Contract receivable, net, non-current	25,033	-
Note receivable, non-current	368,236	225,000
Prepaid expenses, non-current	295,201	-
Intangible assets, net	2,328,092	2,882,055
Goodwill	2,696,642	2,696,642
Other assets	23,651	60,311
TOTAL ASSETS	$ 7,304,554	$ 10,774,823
LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)		
Current liabilities:		
Accounts payable	$ 639,206	$ 628,370
Notes payable	1,606,981	2,287,682
Deferred revenue	164,459	329,805
Accrued liabilities	477,647	603,338
Total current liabilities	2,888,293	3,849,195
Long-term liabilities:		
Notes payable	4,834,136	3,313,903
Deferred revenue	81,972	247,312
Total long-term liabilities	4,916,108	3,561,215
Total liabilities	7,804,401	7,410,410
Commitments and contingencies		
Stockholders' equity (deficit):		
Common stock, $0.001 par value, 45,000,000 shares authorized, 18,410,389 and 18,159,768 shares issued and outstanding at September 30, 2008 and December 31, 2007, respectively	18,410	18,160
Additional paid-in capital	66,863,031	66,202,179
Accumulated deficit	(67,381,288)	(62,855,926)
Total stockholders' equity (deficit)	(499,847)	3,364,413
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)	$ 7,304,554	$ 10,774,823

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, 2008	September 30, 2007	September 30, 2008	September 30, 2007
REVENUES:				
Subscription fees	$ 642,880	$ 830,660	$ 2,132,787	$ 2,040,243
Professional service fees	620,826	378,068	2,129,710	984,548
License fees	291,250	200,000	395,000	480,000
Other revenue	31,412	20,467	77,387	70,720
Total revenues	$ 1,586,368	$ $1,429,195	$ 4,734,884	$ 3,575,511
COST OF REVENUES	$ 223,569	$ 168,035	$ 636,430	$ 355,942
GROSS PROFIT	$ 1,362,799	$ 1,261,160	$ 4,098,454	$ 3,219,569
OPERATING EXPENSES:				
General and administrative	1,246,207	1,398,170	3,823,099	3,567,385
Sales and marketing	709,906	635,201	2,137,375	1,563,653
Research and development	941,067	636,780	2,547,439	1,908,644
Total operating expenses	$ 2,897,180	$ 2,670,151	$ 8,507,913	$ 7,039,682
LOSS FROM OPERATIONS	(1,534,381)	(1,408,991)	(4,409,459)	(3,820,113)
OTHER INCOME (EXPENSE):				
Interest expense, net	(150,510)	(139,124)	(519,746)	(400,910)
Legal reserve and debt forgiveness, net	-	(39,477)	-	(34,877)
Gain on legal settlements, net	291,407	-	386,710	-
Other income	1,064	24,866	17,133	168,672
Total other income (expense)	$ 141,961	$ (153,735)	$ (115,903)	$ (267,115)
NET LOSS	$ (1,392,420)	(1,562,726)	$ (4,525,362)	$ (4,087,228)
NET LOSS PER COMMON SHARE:				
Basic and fully diluted	$ (0.08)	(0.09)	(0.25)	(0.24)
WEIGHTED-AVERAGE NUMBER OF SHARES USED IN COMPUTING NET LOSS PER COMMON SHARE:				
Basic and fully diluted	18,378,940	17,292,639	18,282,180	17,002,827

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, 2008	Nine Months Ended September 30, 2007
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (4,525,362)	$ (4,087,228)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	638,930	631,267
Amortization of deferred financing costs	301,249	320,083
Provision for accounts and contract receivable allowances	266,875	-
Stock-based compensation	341,722	574,343
Registration rights penalty	-	(320,632)
Gain on debt forgiveness	-	(215,123)
Gain on disposal of assets	(3,729)	-
Changes in assets and liabilities:		
Accounts receivable	(120,108)	(716,154)
Notes receivable	(148,236)	(280,000)
Prepaid expenses	(544,297)	(18,634)
Other assets	36,660	(32,271)
Deferred revenue	(330,686)	410,179
Accounts payable	10,836	85,290
Accrued and other expenses	96,189	329,643
Net cash used in operating activities	$ (3,979,957)	$ (3,319,237)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of furniture and equipment	(293,656)	(86,549)
Purchase of trade name	-	(2,033)
Proceeds from sale of furniture and equipment	13,564	-
Capitalized software	(120,191)	-
Net cash used in investing activities	$ (400,283)	$ (88,582)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Repayments on notes payable	(5,022,392)	(1,784,272)
Debt borrowings	5,861,924	1,472,850
Issuance of common stock	97,500	5,748,607
Expenses related to Form S-1 filing	-	(128,244)
Net cash provided by (used in) financing activities	$ 937,032	$ 5,308,941
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	$ (3,443,208)	$ 1,901,122
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	3,473,959	326,905
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 30,751	$ 2,228,027
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	$ 243,168	$ 247,400
Taxes	$ 38,905	$ -

Supplemental schedule of non-cash financing activities:				
Conversion of debt to equity	$	228,546	$	-
Shares issued in settlement of registration rights penalties	$	-	$	144,351

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

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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 targeted to small businesses that are delivered via a Software-as-a-Service ("SaaS") model. The Company sells its SaaS products and services primarily through private-label marketing partners. In addition, the Company provides website consulting services, primarily in the e-commerce retail industry. The Company maintains a website for potential partners containing certain corporate information located at www.smartonline.com.

Basis of Presentation - The financial statements as of and for the three and nine months ended September 30, 2008 and 2007 included in this Quarterly Report on Form 10-Q are unaudited. The balance sheet as of December 31, 2007 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, 2007 filed with the Securities and Exchange Commission (the "SEC") on March 25, 2008 (the "2007 Annual Report").

The financial statements have been prepared in accordance with accounting principles generally accepted in the United States ("U.S. GAAP"). In the opinion of the Company's management, the unaudited statements in this Quarterly Report on Form 10-Q include all normal and recurring adjustments necessary for the fair presentation of the Company's statement of financial position as of September 30, 2008, and its results of operations and cash flows for the three and nine months ended September 30, 2008 and 2007. The results for the three and nine months ended September 30, 2008 are not necessarily indicative of the results to be expected for the fiscal year ending December 31, 2008.

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, 2008 are consistent with those used for the years ended December 31, 2007 and 2006. Accordingly, please refer to the 2007 Annual Report for the Company's significant accounting policies.

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 consolidated financial statements include the accounts of the Company and its 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.

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 American Institute of Certified Public Accountants ("AICPA") Statement of Position 97-2, *Software Revenue Recognition* ("SOP 97-2"), 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.

Under SOP 97-2, provided the arrangement does not require significant development, modification, or customization, revenue is recognized when all of the following criteria have been met:

1. persuasive evidence of an arrangement exists

2. delivery has occurred

3. the fee is fixed or determinable

4. collectibility is probable

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

Under the provisions of Emerging Issues Task Force Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*, 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 Emerging Issues Task Force Issue No. 00-3, *Application of AICPA Statement of Position 97-2 to Arrangements That Include the Right to Use Software Stored on Another Entity's Hardware*.

Fiscal Year - The Company's fiscal year ends December 31. References to fiscal 2007, for example, refer to the fiscal year ending December 31, 2007.

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

those estimates.

Software Development Costs - Statement of Financial Accounting Standards ("SFAS") No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed* ("SFAS No. 86"), 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 SFAS No. 86.

Impairment of Long-Lived Assets - Long-lived assets and certain identifiable intangibles are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by comparing the carrying amount of an asset to future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured as the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed are reported at the lower of the carrying amount or fair value less costs to sell.

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 2008 and 2007 were $7,795 and $11,133, respectively. During the first nine months of 2008 and 2007, these amounts were $20,205 and $26,802, 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 SFAS No. 123 (revised 2004), *Share-Based Payment* (“SFAS No. 123R”), 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:

	Three Months Ended		Nine Months Ended	
	September 30, 2008	September 30, 2007	September 30, 2008	September 30, 2007
Compensation expense included in G&A expense related to stock options	$ 30,995	$ 146,860	$ 106,199	$ 458,328
Compensation expense included in G&A expense related to restricted stock awards	50,583	47,466	235,523	116,016
Total SFAS No. 123R expense	$ 81,578	$ 194,326	$ 341,722	$ 574,344

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, 2008 and 2007 were estimated using the Black-Scholes option-pricing model with the following weighted-average assumptions:

	Three Months Ended		Nine Months Ended	
	September 30, 2008	September 30, 2007	September 30, 2008	September 30, 2007
Dividend yield	0.0%	0.0%	0.0%	0.0%
Expected volatility	40%	150%	46%	150%
Risk-free interest rate	4.39%	4.59%	4.43%	4.59%
Expected lives (years)	4.3	4.5	4.4	4.6

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, 2008:

	Shares	Weighted Average Exercise Price
BALANCE, December 31, 2007	1,644,300	$ 5.07
Granted	35,000	3.19
Forfeited	(1,036,400)	5.80
Exercised	(325,000)	1.40
BALANCE, September 30, 2008	317,900	$ 6.22

Recently Issued Accounting Pronouncements - In April 2008, the Financial Accounting Standards Board ("FASB") issued FASB Staff Position No. 142-3, *Determination of the Useful Life of Intangible Assets* ("FSP 142-3"). The standard requires entities to consider their own historical experience in renewing or extending similar arrangements when developing assumptions regarding the useful lives of intangible assets and also mandates certain related disclosure requirements. FSP 142-3 is effective for fiscal years beginning after December 15, 2008, with early adoption prohibited. The Company is currently evaluating the impact of the pending adoption of FSP 142-3 on its consolidated financial statements.

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. SEGMENT INFORMATION

Prior to 2008, the Company operated as two segments. During late 2007 and the first quarter of 2008, management realigned certain production and development functions and eliminated redundant administrative functions and now reports the consolidated business as a single business segment. The Company's chief operating decision maker is its Chief Executive Officer, who reviews financial information presented on a consolidated basis. Accordingly, in accordance with SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, the Company has determined that it has a single reporting segment and operating unit structure, specifically the provision of an on-demand suite of integrated business management software services.

During 2007, the two segments were the Company's core operations (the "Smart Online segment") and the operations of the Company's wholly-owned subsidiary Smart Commerce (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 subscription, integration, and syndication channels. The Smart Commerce segment derived its revenues primarily from subscriptions to the Company's multi-channel e-commerce systems, including domain name registration and e-mail solutions, e-commerce solutions, website design, and website hosting, as well as consulting services. The Company 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.

3. ASSETS & LIABILITIES

Accounts Receivable, Net

The Company typically invoices its customers on a monthly basis for professional services and either upfront or annually for licenses. Management evaluates the need for an allowance for doubtful accounts based on specifically identified amounts believed to be uncollectible. Management also records an additional allowance based on its assessment of the general financial conditions affecting the Company's customer base. If actual collections experience changes, revisions to the allowance may be required. Based on these criteria, management determined that no allowance for doubtful accounts was required as of December 31, 2007, and management has recorded an allowance of $81,842 as of September 30, 2008.

Contract Receivable, Net

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 new 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 slowed its payments to the Company. Based on this, management has recorded an allowance for doubtful accounts of $185,033, representing one half of the outstanding balance, as it continues to work with the customer to resume contractual payments. As of September 30, 2008, the Company has classified $25,033 of this net receivable as non-current.

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.

Deferred Financing Costs

To assist the Company in securing a modification to its line of credit with Wachovia Bank, NA (“Wachovia”), Atlas Capital, SA (“Atlas”) provided Wachovia with a standby letter of credit. In exchange for Atlas providing Wachovia with the modified letter of credit, on January 15, 2007 the Company issued Atlas a warrant to purchase 444,444 shares of common stock at $2.70 per share. The fair value of that 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 was scheduled to expire in August 2008. In February 2008, the Wachovia line of credit was replaced by a new line of credit with Paragon Commercial Bank (“Paragon”) as described in Note 4, “Notes Payable.” Atlas agreed to provide Paragon a new standby letter of credit and the Company agreed to amend the Atlas 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 with Paragon. As of September 30, 2008, the deferred financing costs were fully amortized to interest expense.

Capitalized Software, Net

SFAS No. 86 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. In July 2008, development commenced, and as of September 30, 2008, $120,191 in associated costs were capitalized in accordance with SFAS No. 86. As this platform is still under development, the Company has recognized no amortization expense as of September 30, 2008.

Accrued Liabilities

At December 31, 2007, the Company had accrued liabilities totaling $603,338. This amount consisted primarily of $204,000 of liability accrued related to the development of the Company’s custom accounting application; $250,000 related to legal reserves (see Note 7, “Commitments and Contingencies”); $45,308 due a customer for overpayment of its account; $30,040 of accrued commissions; and $33,733 of convertible note interest payable.

At September 30, 2008, accrued liabilities totaled $477,647. This amount consisted primarily of $120,666 of liability related to the above-noted development of the Company’s custom accounting application; $137,500 related to legal reserves (see Note 7, “Commitments and Contingencies”); $26,335 for tax-related liabilities associated with the vesting of restricted stock; $96,602 of loss estimated on a long-term customer contract; $18,360 of accrued commissions; and $51,934 of convertible note interest payable.

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 SOP 97-2. Such deferred revenue will be recognized as cash is delivered or collectibility becomes probable.

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

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	September 30, 2008	December 31, 2007
Subscription fees	$ 126,431	$ 197,117
License fees	120,000	380,000
BALANCE	$ 246,431	$ 577,117
Current portion	$ 164,459	$ 329,805
Non-current portion	81,972	247,312
Total	$ 246,431	$ 577,117

4. NOTES PAYABLE

Convertible Notes

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 (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 the Company’s 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, with substantially the same terms and conditions as the Initial Notes (the “Additional Notes,” and collectively with the Initial Notes, the “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, of which $4.8 million is currently outstanding.

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 on February 14, 2008 and November 12, 2008, respectively. 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 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 of notes:

- issued in the initial closing on November 14, 2007 shall be $3.05; and
- issued on August 12, 2008 shall be the lower of $3.05 or the average of the closing bid and asked prices of shares of the Company’s common stock quoted in the Over-The-Counter Market Summary (or, if the Company’s shares are traded on the Nasdaq Stock Market or another exchange, the closing price of shares of the Company’s common stock quoted on such exchange) averaged over five trading days prior to the closing date of the sale of the Additional Notes.

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 that were the Company's existing stockholders. 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, 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 became Chairman of the Company's 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 the Company's directors and executive officers. The investors in the Additional Notes are Atlas and Crystal.

In addition, 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.

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

Line of Credit

As of December 31, 2007, the Company owed $2,052,000 under a line of credit with Wachovia. 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. 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, 2009, 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 minus one-half percent. The line of credit is secured by an irrevocable standby letter of credit in the amount of $2.5 million issued by HSBC Private Bank (Suisse) SA with Atlas, a current stockholder and affiliate of the Company, as account party. This letter of credit expires on February 18, 2010, and the Paragon letter of credit is renewable so long as the letter of credit remains in force. 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.

In consideration for Atlas providing the Paragon letter of credit, the Company agreed to amend the warrant agreement with Atlas 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.

As of September 30, 2008, the Company had notes payable totaling $6,441,117. The detail of these notes is as follows:

Note Description	Short-Term Portion	Long-Term Portion	TOTAL	Maturity	Rate
Paragon Commercial Bank credit line	$ 1,517,929	$ -	$ 1,517,929	Feb '09	Prime less 0.5%
Various capital leases	25,403	34,136	59,539	Various	11-19%
Insurance premium note	63,649	-	63,649	Jul '09	6.1%
Convertible notes	-	4,800,000	4,800,000	Nov '10	8.0%
TOTAL	$ 1,606,981	$ 4,834,136	$ 6,441,117		

5. STOCKHOLDERS' EQUITY

Common Stock

During the nine months ended September 30, 2008, 70,000 shares of restricted stock were issued. These restricted stock awards included 32,000 shares issued to the newly appointed Chief Operating Officer. The Chief Operating Officer received an additional 3,000 shares of restricted stock that had been previously promised to him in connection with his initial hiring in an August 2007 offer letter. Additionally, in June 2008 certain members of the Board of Directors received restricted stock awards that accounted for the remaining 35,000 shares of restricted stock issued.

During the first nine months of 2008 and in conjunction with their termination of employment, the Company accelerated vesting with respect to 31,250 shares of restricted stock previously issued to the Company's former Chief Financial Officer, former Chief Operating Officer, and former in-house legal counsel. The Company recorded $92,281 of expense related to the accelerated vesting of these shares including $31,500 that had been accrued during the fourth quarter of 2007. Additionally, net of the accelerated vesting discussed above, 53,341 shares of restricted stock were accounted for as forfeited during the first nine months of 2008 due to resignations, terminations, payment of employee tax obligations resulting from share vesting, and conversions to stock options. The forfeited shares included 15,625 shares issued to the former Chief Operating Officer, 10,000 shares issued to the former Chief Financial Officer, 7,500 shares issued to a former director, 7,500 shares exchanged by a current director for stock options, 2,051 shares issued to employees used to satisfy tax obligations, and 10,665 shares issued to former employees.

In a transaction that closed on February 21, 2007, the Company sold an aggregate of 2,352,941 shares of its common stock to two new investors (the "Investors"). The private placement shares were sold at $2.55 per share pursuant to a Securities Purchase Agreement (the "SPA") between the Company and each of the Investors. The aggregate gross proceeds to the Company were $6 million, and the Company incurred issuance costs of approximately $637,000. Under the SPA, the Company issued the Investors 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, if at all, by February 21, 2010.

The Company and each of the Investors also entered into a Registration Rights Agreement (the "Investor RRA") whereby the Company had an obligation to register the shares for resale by the Investors by filing a registration statement within 30 days of the closing of the private placement, and to have the registration statement declared effective 60 days after actual filing, or 90 days after actual filing if the SEC reviewed the registration statement. If a registration statement was not timely filed or declared effective by the date set forth in the Investor RRA, the Company would have been obligated to pay a cash penalty of 1% of the purchase price on the day after the filing or declaration of effectiveness was due, and 0.5% of the purchase price per every 30-day period thereafter, to be prorated for partial periods, until the Company fulfilled these obligations. Under no circumstances could the aggregate penalty for late registration or effectiveness exceed 10% of the aggregate purchase price. Under the terms of the Investor RRA, the Company could not offer for sale or sell any securities until May 22, 2007, subject to certain limited exceptions, unless, in the opinion of the Company's counsel, such offer or sale did not jeopardize the availability of exemptions from the registration and qualification requirements under applicable securities laws with respect to this placement. On March 28, 2007, the Company entered into an amendment to the Investor RRA with each Investor to extend the registration filing obligation date by an additional eleven calendar days. On April 3, 2007, the Company filed the registration statement within the extended filing obligation period, thereby avoiding the first potential penalty. Effective July 2, 2007, the Company entered into another amendment to the Investor RRA to extend the registration effectiveness obligation date to July 31, 2007. On July 31, 2007, the SEC declared the registration statement effective. Accordingly, the Company met all of its requirements under the amended Investor RRA and no penalties were incurred.

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

As incentive to modify a letter of credit relating to the Wachovia line of credit (see Note 4, "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 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. In connection with entering the line of credit with Paragon on February 20, 2008, the Warrant Agreement was amended to provide that the warrant is exercisable within 30 business days of the termination of the Paragon line of credit or if the Company is in default under the terms of the line of credit. If the warrant is exercised in full, it will result in gross proceeds to the Company of approximately $1,200,000.

On March 29, 2007, the Company issued 55,666 shares of its common stock to certain investors as registration penalties for its failure to timely file a registration statement covering shares owned by those investors as required pursuant to amendments to registration rights agreements between such investors and the Company. On July 20, 2007, the Company issued 27,427 additional shares as registration penalties to certain investors who did not enter into amendments to certain registration rights agreements.

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 Incorporated and Computility, Inc. At December 31, 2007, these obligations were included in the current portion of notes payable and in accrued liabilities in the amounts of $228,359 and $187, respectively.

Equity Compensation Plans

In June 2007, the Company temporarily limited the issuance of shares of its common stock reserved under the 2004 Equity Compensation Plan to awards of restricted or unrestricted stock and in June 2008 again made options available for grant under the plan. In January 2008, a former officer of the Company exercised options to purchase 69,930 shares of the Company’s common stock in a cashless exercise whereby the former officer tendered to the Company 38,462 shares of common stock previously held by the former officer. In June 2008, the same former officer exercised options to purchase 180,070 shares of the Company’s common stock in a cashless exercise whereby the former officer tendered to the Company 80,469 shares of the Company’s common stock previously held by the former officer. Also in June 2008, a member of the Board of Directors was granted an option to purchase 20,000 shares of common stock under the 2004 Equity Compensation Plan. In September 2008, a member of the Board of Directors was granted an option to purchase 15,000 shares of common stock under the 2004 Equity Compensation Plan in exchange for the forfeiture of 7,500 shares of restricted stock. During the first nine months of 2008, options to purchase 1,036,400 shares of common stock at prices ranging from $1.43 to $9.82 were forfeited by former employees, officers, directors, and consultants of the Company.

The following table summarizes information about stock options outstanding at September 30, 2008:

Exercise Price	Number of Shares Outstanding	Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Currently Exercisable Number of Shares	Currently Exercisable Weighted Average Exercise Price
From $2.50 to $3.50	100,000	7.5	$ 3.20	66,000	$ 3.19
$5.00	31,200	6.4	$ 5.00	21,200	$ 5.00
$7.00	75,000	7.0	$ 7.00	75,000	$ 7.00
From $8.61 to $9.00	111,500	6.6	$ 8.74	63,300	$ 8.72
$9.60	200	7.0	$ 9.60	120	$ 9.60

Dividends

The Company has not paid any cash dividends through September 30, 2008.

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:

	Revenue Type	Three Months Ended September 30, 2008 Revenues	% of Total Revenues
Customer A	Subscription fees	$ 360,109	23%
Customer B	Subscription fees	213,384	14%
Customer C	Professional services	465,750	29%
Customer D	License fees/professional services	400,000	25%
Others	Various	147,125	9%
Total		$ 1,586,368	100%

	Revenue Type	Three Months Ended September 30, 2007 Revenues	% of Total Revenues
Customer B	Subscription fees	$ 425,778	30%
Customer C	Professional services	327,937	23%
Customer E	License fees/professional services	218,330	15%
Others	Various	457,150	32%
Total		$ 1,429,195	100%

	Revenue Type	Nine Months Ended September 30, 2008 Revenues	% of Total Revenues
Customer A	Subscription fees	$ 1,019,600	22%
Customer B	Subscription fees	882,387	19%
Customer C	Professional services	1,250,747	26%
Others	Various	1,582,150	33%
Total		$ 4,734,884	100%

	Revenue Type	Nine Months Ended September 30, 2007 Revenues	% of Total Revenues
Customer B	Subscription fees	$ 1,562,319	44%
Customer C	Professional services	754,493	21%
Others	Various	1,258,699	35%
Total		$ 3,575,511	100%

As of September 30, 2008, two customers accounted for 63% and 21% of net receivables, respectively. As of December 31, 2007, the Company had three customers that accounted for 42%, 28% and 17% of net receivables,

respectively.

7. COMMITMENTS AND CONTINGENCIES

Please refer to Part I, Item 3 of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2007 and Part II, Item 1 of the Company's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2008 for a description of material legal proceedings, including the proceedings discussed below.

The Company is subject to claims and suits that arise from time to time in the ordinary course of business.

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. As of September 30, 2008, the Company had paid $470,834 and issued 3,473 shares of common stock related to this obligation.

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 the Company, certain of its 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 the Company's 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 Securities Exchange Act of 1934, as amended, 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 Company's 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 directors or officers of the Company during the class period as well the Company's independent auditor.

During April 2008, the Company received approximately $95,000 in insurance reimbursement for previously disputed legal expenses primarily related to previously disclosed SEC matters. During August 2008, the Company and the insurance carrier agreed that the carrier would reimburse it $300,000 for previously disputed legal expenses primarily related to its previously disclosed SEC matters. The reimbursement covered all disputed Company expenses prior to September 11, 2007 as well as certain enumerated invoices in dispute for the balance of 2007, and it was received by the Company. Because the outcome of the dispute was unclear, the Company expensed all legal costs with respect to the SEC matters and the Company's 2006 internal investigation as incurred. For the nine months ended September 30, 2008, both reimbursements have been recorded in the consolidated statements of operations as a gain on legal settlements.

On July 14, 2008, the Company filed a civil action against a former employee in the General Court of Justice, Superior Court Division, Durham County, North Carolina. The complaint alleged that the former employee embezzled funds from the Company in the amount of $105,600 and asserted claims for conversion and unfair trade practices. The lawsuit sought recovery for the embezzled funds, plus punitive damages or treble damages, interest, and attorneys' fees. On August 25, 2008, the Company obtained a judgment against the former employee in the amount of $105,599.94, trebled to $316,799.82 pursuant to the North Carolina Unfair and Deceptive Trade Practice Statute, plus interest at 8% from the date of filing the complaint, and all court costs and reasonable attorneys' fees existing as of the date of the judgment and as may accrue from time to time until the judgment is paid in full. The Company is in the process of attempting to collect on the judgment.

At this time, the Company is not able to determine the likely outcome of the Company's current pending legal matters, nor can it estimate its potential financial exposure. Management has made an initial estimate based upon its

knowledge, experience, and input from legal counsel, and the Company has accrued approximately $137,500 of legal reserves. Such reserves will be adjusted in future periods as more information becomes available. If an unfavorable resolution of any of these matters occurs, the Company's business, results of operations, and financial condition could be materially adversely affected.

8. SUBSEQUENT EVENTS

Convertible Note Financing. On November 12, 2008, the Company notified all current noteholders that it has exercised its option to sell $1.5 million aggregate principal of additional secured subordinated notes due November 14, 2010 (the "New Notes") with substantially the same terms and conditions as the outstanding notes, as described in Note 4, "Notes Payable," above, in a closing to occur on or before December 31, 2008. 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.

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

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. 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.

Prior to 2008, we operated our company as two segments. During late 2007 and the first quarter of 2008, management realigned certain production and development functions and eliminated redundant administrative functions and now reports the consolidated business as a single business segment. During 2007, the two segments were our core operations, or the Smart Online segment, and the operations of our wholly-owned subsidiary Smart Commerce, Inc., 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 derived its revenues primarily from subscriptions to our multi-channel e-commerce systems, including 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. We continue to evaluate the factors that will form the basis of our segmentation going forward.

During 2007, we began providing software solutions and services to sizeable small business markets dealing with regulatory demands that could not be met adequately by existing low-cost and easy-to-use software solutions. These efforts have led to the launch of software solutions for partners in the food safety, multi-level marketing, and real estate industries. We are continuing to target other segments in the small business industry that may require such regulatory-focused software solutions and services and to market our experience with developing software solutions and services to meet these needs.

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 the 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. Because the platform is designed to follow industry standard protocol, we also believe 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 near completion of the development of our industry standard platform, we are shifting our focus from development toward the sales and marketing of the new platform in the fourth quarter of 2008.

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

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 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

For the balance of 2008, we expect our primary business initiatives to include increasing subscription fee 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.

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 2008 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, 2007 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, 2008 and June 30, 2008.

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 2008. 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 2008 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. Statement of Financial Accounting Standard ("SFAS") No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*, or SFAS No. 86, 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 SFAS No. 86. 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 2008, we expect that future research and development expenses will decrease in both absolute and relative dollars as we continue to capitalize 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 SFAS No. 123 (revised 2004), *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, 2007.

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 American Institute of Certified Public Accountants Statement of Position 97-2, *Software Revenue Recognition*, or SOP 97-2, as amended. 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.

Under SOP 97-2, 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. collectibility 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 collectibility 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 the provisions of Emerging Issues Task Force Issue No. 00-21, *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 Emerging Issues Task Force Issue No. 00-3, *Application of AICPA Statement of Position 97-2 to Arrangements That Include the Right to Use Software Stored on Another Entity's Hardware*.

We are currently facing legal actions from stockholders that relate to the charges filed against our former Chief Executive Officer described in Part II, Item 1, "Legal Proceedings," in this report. 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. Management has made an initial estimate based upon its knowledge, experience, and input from legal counsel, and we have accrued approximately $137,500 of legal reserves. Such reserves will be adjusted in future periods as more information becomes available.

Overview of Results of Operations for the Three Months Ended September 30, 2008 and September 30, 2007

Total revenues were $1,586,000 for the three months ended September 30, 2008 compared to $1,429,000 for the same period in 2007, representing an increase of $157,000, or 11%. Gross profit increased $102,000, or 8%, to $1,363,000 from $1,261,000. Operating expenses increased $227,000, or 9%, to $2,897,000 from $2,670,000. Net loss decreased $171,000, or 11%, to $1,392,000 from $1,563,000.

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

	Three Months Ended September 30, 2008	**Three Months Ended September 30, 2007**
REVENUES:		
Subscription fees	41%	58%
Professional service fees	39%	26%
License fees	18%	14%
Other revenue	2%	2%
Total revenues	100%	100%
COST OF REVENUES	14%	12%

GROSS PROFIT	86%	88%
OPERATING EXPENSES:		
General and administrative	79%	98%
Sales and marketing	45%	44%
Research and development		