

SMART ONLINE INC
Form 10-K
March 30, 2007

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**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, 2006

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 333-119385

SMART ONLINE, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation)

95-4439334
(I.R.S. Employer
Identification No.)

2530 Meridian Parkway, 2nd
Floor
Durham, North Carolina
(Address of principal executive
offices)

27713
(Zip Code)

(919) 765-5000

(Registrant's telephone number, including area code)

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

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

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

Indicate by check mark 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, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer

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 March 15, 2007 was approximately \$24,010,000 (based on the closing sale price of \$2.80 per share).

The number of shares of the registrant's Common Stock, \$0.001 par value per share, outstanding as of March 15, 2007 was 17,766,971.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive Proxy Statement to be delivered to shareholders in connection with the Annual Meeting of Shareholders to be held June 21, 2007 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 12E 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

OVERVIEW

Smart Online, Inc. develops and markets products and services targeted to small businesses (less than 50 employees) that are delivered via a Software-as-a-Service, or SaaS, model. Our goal is to be the leading provider of on-demand SaaS applications for small businesses. We sell our products and services primarily through private label syndication and original equipment manufacturer, or OEM, distribution channels, although small businesses may purchase products and services directly through our main portal located at www.smartonline.com.

Our primary source of revenue currently comes from sales of our SaaS applications for business management, web marketing, and e-commerce, which represented 63%, 77%, and 55% of our revenue from continuing operations for the fiscal years ended December 31, 2006, 2005, and 2004, respectively. We derive revenue from sales of services that are designed to complement our product offerings and allow us to create custom business solutions that fit our end-users’ and our channel partners’ needs, which represented 35%, 19%, and 0% of our revenue from continuing operations for the fiscal years ended December 31, 2006, 2005, and 2004, respectively.

We offer two technology platforms that communicate via web service and serve as the foundation for delivery of our business solutions: OneBizSM and iDirect ArchitectureTM, or iDA. Each is described more fully below. Both platforms allow integrated applications to share data with the other products and/or services running on our platforms. Our products and services are primarily offered on a subscription basis using the on-demand SaaS model.

HISTORY

We were incorporated in Delaware in 1993 and initially offered our software applications using traditional distribution methods of diskettes and later CD-ROMs. In 2000, we moved away from the traditional distribution model and began primarily offering on-demand SaaS applications over the Internet. Unlike the traditional distribution method that requires a customer to install, configure, and maintain hardware, software, and network services internally to support the software applications, our proprietary SaaS applications allow small businesses to subscribe to a wide variety of applications that have been developed specifically for delivery over the Internet on an on-demand basis with very little or no installation or maintenance required.

During October 2005, we acquired substantially all of the assets of Computility, Inc., or Computility, a privately held developer and distributor of sales force automation and customer relationship management, or SFA/CRM, software applications based in Des Moines, Iowa. We operated this business under the name Smart CRM, Inc. (d/b/a Computility), or Smart CRM. Also during October 2005, we acquired all the stock of iMart Incorporated, or iMart, a privately held developer and distributor of multi-channel e-commerce systems based in Grand Rapids, Michigan. We operate this subsidiary as Smart Commerce.

Upon our integration of Smart CRM's SFA/CRM application into our OneBizSM platform, management determined that the remaining operations of Smart CRM, specifically consulting and network management, were not integral to our ongoing operations and business model. On September 29, 2006, we sold these non-integral Smart CRM assets to Alliance Technologies, Inc., or Alliance, and reclassified Smart CRM as a discontinued operation. For further information about this business closure, see Note 17, "Acquisitions & Dispositions" in our consolidated financial statements included in this report.

The Smart CRM assets sold to Alliance included the traditional 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 OneBizSM platform.

Consistent with SFAS No. 131, *Disclosures About Segments of an Enterprise and Related Information*, or SFAS No. 131, we have defined two reportable segments based on factors such as geography, products, customers, how operations are managed, and how our chief executive officer, the chief operating decision-maker, views results. Those segments are our core operations, or the Smart Online segment, and the operations of our wholly-owned subsidiary, or the Smart Commerce segment.

The Smart Commerce segment's revenues are derived primarily from the development and distribution of multi-channel e-commerce systems including domain name registration and e-mail solutions, e-commerce solutions, website design and website hosting. In 2006, our Smart Commerce segment generated 86% of our total consolidated revenue and 96% and 100% of our subscription and professional services revenue, respectively.

The Smart Online segment generates revenues from the development and distribution of internet-delivered SaaS small business applications through a variety of subscription, integration and syndication channels. In 2006, our Smart Online segment generated 14% of our total consolidated revenue and 100% of our integration and syndication revenue, and 4% of our subscription revenue.

We include costs such as corporate general and administrative expenses and share-based compensation expenses that are not allocated to specific segments in the Smart Online segment, which includes the parent or corporate segment.

During the period from 2000 to 2006, we were functioning primarily in a research and development mode as we adapted our products for the SaaS model. We began shifting our focus to the marketing of our most current products in the fourth quarter of 2006. During fiscal 2006, the operations we acquired following the iMart acquisition, which we operate as Smart Commerce, were revenue-generating operations. Accordingly, the majority of current revenues is generated by our Smart Commerce segment.

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 our channel partners' needs.

Business Management SaaS Applications

Our business management SaaS applications are designed to allow users to access and work on information securely from anywhere with an Internet browser. These applications include:

Business Dashboard: Our Business Dashboard application provides a snapshot of real-time business information in a single view, allowing users to monitor key business information about their company and employees. The dashboard automatically aggregates data from multiple sources and summarizes the information for the user quickly and efficiently. Examples of business information that users may view on the dashboard include: a list of key documents

for the user, daily events scheduled, FedEx packages shipped by a user, or a list of new employees. The dashboard is entirely role-based, and displays different information to each user based upon their role and access levels within the company.

Accounting: Our Accounting application is targeted for users that want to create and maintain their accounting books online in a secure fashion but do not have the time or resources to learn and understand the intricacies of traditional accounting applications designed for larger businesses. The Accounting application functions allow a user to create invoices, record payments, print checks, produce real-time financial statements and reports, as well as manage accounts receivable and payable.

SFA/CRM: Our SFA/CRM application is designed to allow users to create standardized processes to define their sales approach, create SFA marketing plans, and monitor and guide sales activities. Companies can utilize the customer service management feature to create, monitor, and track service requests and execute issue escalation and notification. Users can display and present their business data with built-in report templates designed to provide information on sales activity, pipeline funnels, revenue and other relevant business data.

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 other different policies to each individual employee. The application can monitor and approve or decline as needed 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 user to quickly browse to any other date. Users can set up automated email reminders at their convenience, indicating how early they would like to be notified of an upcoming event. In addition, users have the option to collaborate with their colleagues by sharing their calendar and events. This application also includes a to-do list, allowing users to setup tasks, assign priorities and due dates, and mark tasks as complete as they work through them.

Contacts: Our Contacts application is designed to provide users with an online business contact management system. Contacts can be sorted by group or alphabetically. Users also have the option to add, edit, and remove contact groups at their own convenience, or they can use the default set of groups that is already provided for them when they sign up. Furthermore, users have the option to share their contacts between colleagues. Using the intuitive sharing system built into the application, users select whether they would like a contact to remain private or shared.

e-Commerce: Our e-commerce applications, OneDomain™ and OneDomainX™, are designed to give customers the ability to conduct their business online and include website design and launch, inventory query, shopping cart, financial transactions, shipping, domain name registration and business to business communication for small businesses. Our e-commerce applications also include our Direct Marketing Architecture, or iDMA, which is a technology platform that is designed to help direct marketers increase sales, better leverage corporate resources, and deliver superior customer service, and our Direct Selling Architecture, or iDSA, which is a system available for direct selling and network marketing companies.

Business Tools

We offer a variety of business tools through our website to aid small businesses. Most of these tools are also available through the private-label sites of our partners. Our business tools include Business Plan Writer, Business Letters, Business and Legal Forms, Marketing Plan Writer, Job Description Writer, Employee Policy Manual Writer, Government Forms, and Business Guides.

Additional Services

These services are designed to complement our product offerings and allow us to create custom business solutions that fit our end-users' and our channel partners' needs. The services offered to our partners include business consulting, graphics design, website content syndication, specialized compensation calculation, inventory management, domain name registration, and personalized email creation, FedEx tracking, loan center, press release writing, business plan writing & evaluation, e-commerce tax services, e-mail marketing, web analytics, warehouse order fulfillment, and business and personal calculators.

MODE OF OPERATIONS

“Software-as-a-Service” Model

We follow the SaaS model for delivering our products and services to our customers. The Internet allows for delivery of software in new ways. For example, a company can download a software application instead of buying it from the local retail store. However, software purchased in this fashion still needs to be installed, updated, and the data backed-up, all by the end-user. The on-demand SaaS model eliminates these additional tasks. Instead, end users 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, anywhere by the end-user. Multi-tenant SaaS applications have the additional benefit of allowing functionality to be added to our applications in one place to the benefit of all users. This allows us to have easier maintenance, universal upgrading, and quick deployment of new features.

Revenue Stream

We charge small businesses who use our SaaS applications a subscriber fee on a monthly subscription basis, rather than the large upfront cost typically charged for traditional software applications.

Platforms

We have designed two technology platforms to serve as the foundation for delivery of our business solutions: OneBizSM and iDA.

OneBizSM is our business management platform offered through our main portal and through the sites of our private-label partners. This allows us to offer our proprietary products, as well as certain integration partner products, to our partners' small business customers in the "look" and "feel" of the partner's website. iDA is our web marketing and web selling platform offered through Smart Commerce. Both platforms communicate with each other via web services and have the ability to allow integrated applications to share data with the rest of the products and/or services running on our platforms. The platforms also allow users to seamlessly login to multiple SaaS applications/services without having to re-enter a user ID and password or navigate to another site. Both platforms use a modular methodology, which allows various components to be assembled for rapid new application development and enhancement. Our OneBizSM platform has a distinct profile feature that is created for every company when users sign up and register. This profile is continually updated based on operations performed and information requested by each company as its users operate on the platform.

Integration and Sharing

Our platforms allow end-users to share information (with selectivity and control options) with other members of their organization. Each user that subscribes to our platform can have multiple members or employees who share information with one another. Information entered by one user can be shared and modified by one or more other users, promoting collaboration within a company.

Several of the applications within our platforms are integrated with one another. Integration means that certain applications communicate and share information with other applications.

TARGET MARKET AND SALES CHANNELS

Our consistent focus from the beginning has been to design software products and services to help start and run small businesses. The small business market is diverse, fragmented, yet very large and, we believe, underserved. We define small businesses as those having less than 50 employees. Even within this definition, there exists a large variety of businesses. Therefore, we have focused on offering a wide range of software products that combine simplicity and affordability. We realize that many new small businesses will fail relatively quickly, which forces us to continuously seek out new end-users to replace existing end-user attrition. Another characteristic of small businesses is that they are typically late adopters of technology. Internet adoption is well past critical mass, and we believe the growth rate of small businesses using web-based applications will exceed the growth rate of large enterprises. These businesses may even leapfrog traditional software and go straight from paper-based management to a SaaS solution.

Although our ultimate end-users are small businesses and entrepreneurs who access our software products and services via the web, we use channel partners such as financial institutions, telecommunication companies, direct selling organizations, retailers, technology companies, and small business consultants as channels to reach small business customers. These partnerships can be constructed in a variety of formats - from resellers to co-branded offerings to private label or OEM solutions. We typically seek partnerships with organizations that already have a relationship with small businesses. We have successfully targeted our applications to direct selling organizations, financial companies as well as business media companies.

Our plan for 2007 is to increase our revenue through a combination of four sales and marketing initiatives:

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- soliciting additional syndication partners,
- actively managing relationships with our partners to increase sales,
- bundling our software in packages targeted to different types of industries within the small business market, and
 - introducing new applications and products of greater value to small businesses.

We have not yet implemented all of these marketing strategies, and others have not been implemented until recently. At this time, we cannot determine how successful these strategies will be.

We also plan to continue to update, enhance, and add to the functionality of our platforms, and add sales and marketing personnel to implement our syndication partner strategy.

PRINCIPAL CUSTOMERS

Currently, two customers are considered major customers the loss of whom could have a material adverse effect on our business. Both of these customers currently subscribe to the applications offered by, and purchase professional services from, our Smart Commerce segment.

Britt Worldwide, or BWB, is an entity that indirectly controls a significant number of independent business owners, or IBOs, who currently subscribe to our services. The aggregate of the subscriptions from these IBOs represented approximately 45% of our consolidated revenue for the fiscal year ended December 31, 2006. BWB was not a customer of ours in 2004, and was a customer of ours only after we acquired iMart in October 2005. Accordingly, BWB represented 0% and 15% of our revenues in 2004 and 2005, respectively. Although our revenue is derived from the IBO, because BWB can influence the actions of the IBOs, this revenue has been aggregated for purposes of this annual report on Form 10-K.

Vera Bradley Designs, Inc., or Vera Bradley, a manufacturer of high quality handbags, luggage and other accessories, is also a major customer. Vera Bradley accounted for approximately 28% of our consolidated revenues for fiscal year ended December 31, 2006. Vera Bradley was not a customer of ours in either 2004 or 2005, and therefore represented 0% of our revenue in those years.

RESEARCH & DEVELOPMENT

Between 1999 and 2000, we made a strategic decision to shift our focus from traditional software delivery to the SaaS model. From that point until the present, we have devoted substantially all of our development personnel's time and efforts toward the research and development of our OneBizSM platform and the associated applications. In the fourth quarter of 2006, we began to shift our focus from research and development to the marketing of our latest products.

In 2004, we spent approximately \$563,000 on research and development. In 2005, our research and development costs increased to approximately \$1.6 million as we increased our efforts to develop our OneBizSM applications for new partners. In 2006, our research and development costs were approximately \$2.0 million with the increase over 2005 primarily related to development efforts in Smart Commerce.

We have not engaged in any customer sponsored research and development.

COMPETITION

The market for small business software applications is highly competitive and subject to rapid change. 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 other companies that offer only one or two software products that compete with our broad range of software products.

Our principal direct competition comes from several large vendors of SaaS applications for small businesses that sell many products similar to ours. Most of these competitors also sell other products and services not specifically targeted to small businesses, although some of their products have been modified for small business use or are marketed as small business products. These competitors include, but are not limited to, Microsoft, Oracle, NetSuite, Intuit, SAP, Sage and Yahoo!.

We also expect to face competition from new entrants that will market SaaS applications similar to ours to small businesses. As we introduce more software products, we expect to encounter more competitors. 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 and others.
- Human resource software applications: Employease, Oracle, Sage and others.
- e-Commerce solutions: Register.com, GoDaddy.com, 1and1 Internet, Yahoo!, eBay's Storefront, Yahoo! Store, Microsoft, NetSuite, Homestead and others.
- SFA/CRM applications: Microsoft, Oracle, Sage, Salesforce.com, Netsuite, and others.

Although we believe we offer highly competitive services and software, many of our competitors have greater resources, and a larger number of total customers for their products and services. In addition, a number of our competitors sell many 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 harm our business.

On each competitive front, we seek to compete against these larger and better financed companies primarily by offering a 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 believe one distinctive value our applications offer is the integration of the applications. By integrating data sharing across applications through our platform, small businesses can enter or change data once. However, our individual applications must also be competitive with the applications offered by industry leaders in those specific segments which will require additional development work by us. If we are unable to develop new and enhances applications that are competitive, our business may be harmed.

We also plan to leverage our private label syndication partners to sell our SaaS applications to their small business customers. We offer these partners and potential partners the ability for large corporations to private-label our products to offer their small business customers value added products and services. While we may lack the marketing budget or resources to compete with industry giants, we believe our corporate syndication partners will allow us to compete effectively if we are able to motivate our partners to devote resources to selling subscriptions. This strategy will require us to hire additional personnel to develop and manage these relationships and to sign additional partners to private label our SaaS applications.

We also believe that our focus on delivering our products and service via the SaaS business model enables us to compete with these companies. This model requires very little initial investment by small businesses and we believe it is cost competitive with the products of many competitors over the long-term. SaaS applications provide our customers with access to their important business data from any location via the Internet and can be updated automatically and without a charge to the customer. This functionality enables us to continually improve the ease of use and performance of our SaaS applications as we receive feedback from our customers. However, this functionality may also make the SaaS model more attractive to competitors that currently offer their products through traditional methods of software delivery. As a result, we expect the number of competitors offering software via the SaaS model to increase in the future.

WORKING CAPITAL PRACTICES

Due to the nature of the model we have adopted for the delivery of our products, our working capital needs are primarily cash and equivalents and accounts receivable, which are necessary to support and sustain our operations. We do not carry any significant inventory nor do we maintain substantial reserves for returns or credit terms.

INTELLECTUAL PROPERTY RIGHTS

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 aspects of our products or to obtain and use information that we regard as proprietary, and third parties may attempt to develop similar technology independently. Policing unauthorized use of our products is difficult, particularly because the global nature of the Internet makes it difficult to control the ultimate destination or security of software or other data transmitted. While we are unable to determine the extent to which piracy of our software products exists, software piracy can be expected to be a persistent problem. In addition, the laws of some foreign countries do not protect our proprietary rights to as great an 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 increase our international presence.

We have registered copyrights, trademarks and registered service marks on more than a dozen products and data services. These marks include, but are not limited to: Smart Online, OneBiz, Smart Attorney, Smart Business Plan, iMart, 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. We also employ various physical security measures to protect our software source codes, technology, and other proprietary information.

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EMPLOYEES

As of March 15, 2007, we had 56 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.

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 Internet website current and accurate, there can be no guarantees that the information on the Internet website is up to date or correct. We make available free of charge through our website our annual reports on Form 10-K, quarterly reports on Form 10-Q, and current reports on Form 8-K, amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act, and beneficial ownership reports filed by officers, directors, and principal security holders under Section 16(a) of the Exchange Act as soon as reasonably practicable after we electronically file such material with, or furnish such material to, the SEC. These reports may be accessed by following the link under "Investors--SEC Filings" on our website.

ITEM 1A. RISK FACTORS

An investment in Smart Online involves significant risks. You should read the risks described below very carefully before deciding whether to invest in Smart Online. The following is a description of what we consider our key challenges and risks.

We operate in a dynamic and rapidly changing business environment that involves substantial risk and uncertainty and these risks may change over time. The following discussion addresses some of the risks and uncertainties that could cause, or contribute to causing, actual results to differ materially from expectations. In evaluating our business, you should pay particular attention to the descriptions of risks and uncertainties described below and in other sections of this document and our other filings. These risks and uncertainties are not the only ones we face. Additional risks and uncertainties not presently known to us, 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 occurs, our business, financial condition, or results of operations could be materially and adversely affected.

We have organized these factors into the following categories below:

- Our Financial Condition
- Our Products and Operations
- Our Market, Customers and Partners
- Our Officers, Directors, Employees and Stockholders
- Regulatory Matters that Affect Our Business
- Matters Related to the Market For Our Securities
- **Risks Associated with Our Financial Condition**

(1) We have had recurring losses from operations since inception, and have deficiencies in working capital and equity capital. If we do not rectify these deficiencies through additional financing or growth, we may have to cease operations and liquidate our business. Because we have only nominal tangible assets, you may lose your entire investment.

Through December 31, 2006, we have lost an aggregate of approximately \$57 million since inception on August 10, 1993. During the years ended December 31, 2006 and 2005, we incurred a net loss of approximately \$5.0 million and \$15.6 million, respectively. Losses do not include the pre-acquisition losses, or profit, of the two companies we acquired during the fourth quarter of 2005. At December 31, 2006, we had a \$3.8 million working capital deficit. Our working capital, including our line of credit and recent financing transaction for \$6 million, is not sufficient to fund our operations beyond July 2008, unless we substantially increase our revenue, limit expenses or raise substantial additional financing. Factors such as the suspension of trading of shares of our common stock by the SEC, and the resulting drop in share price, trading volume and liquidity; 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; and the timing and success of potential strategic alliances or potential opportunities to acquire technologies or assets may require us to seek additional funding sooner than we expect. If we fail to raise sufficient financing, we will not be able to implement our business plan, we may have to liquidate our business and you may lose your investment.