Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the fifty-two weeks ended January 29, 2011

o **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 0-23071

THE CHILDREN'S PLACE RETAIL STORES, INC.

(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	**31-1241495** (I.R.S. employer identification number)
500 Plaza Drive **Secaucus, New Jersey** (Address of Principal Executive Offices)	**07094** (Zip Code)

(201) 558-2400
(Registrant's Telephone Number, Including Area Code)

Securities registered pursuant to Section 12(b) of the Act: **Common Stock, $0.10 par value**

Name of each exchange on which registered: **Nasdaq Global Select Market**

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

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

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

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 ý   No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ý   No o

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 the 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. 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. (Check one):

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

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

The aggregate market value of common stock held by non-affiliates was $1,160,536,086 at the close of business on July 31, 2010 (the last business day of the registrant's fiscal 2010 second fiscal quarter) based on the closing price of the common stock as reported on the Nasdaq Global Select Market. For purposes of this disclosure, shares of common stock held by persons who hold more than 10% of the outstanding shares of common stock and shares held by executive officers and directors of the registrant have been excluded because such persons may be deemed affiliates. This determination of executive officer or affiliate status is not necessarily a conclusive determination for other purposes.

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date: Common Stock, par value $0.10 per share, outstanding at March 23, 2011: 26,004,400.

Documents Incorporated by Reference: Portions of The Children's Place Retail Stores, Inc. Definitive Proxy Statement for its Annual Meeting of Stockholders to be held in 2011 are incorporated by reference into Part III.

Table of Contents

THE CHILDREN'S PLACE RETAIL STORES, INC.

ANNUAL REPORT ON FORM 10-K
FOR THE FIFTY-TWO WEEKS ENDED JANUARY 29, 2011

TABLE OF CONTENTS

Table of Contents

SPECIAL NOTE REGARDING FORWARD LOOKING STATEMENTS

The Business section and other parts of this Annual Report on Form 10-K may contain certain forward-looking statements regarding future circumstances. Forward-looking statements provide current expectations of future events based on certain assumptions and include any statement that does not directly relate to any historical or current fact. Forward-looking statements can also be identified by words such as "anticipates," "believes," "estimates," "expects," "intends," "plans," "predicts," and similar terms. These forward-looking statements are based upon current expectations and assumptions of The Children's Place Retail Stores, Inc. (the "Company") and are subject to various risks and uncertainties that could cause actual results to differ materially from those contemplated in such forward-looking statements including, but not limited to, those discussed in the subsection entitled "Risk Factors" under Part I, Item 1A of this Annual Report on Form 10-K. Actual results, events, and performance may differ significantly from the results discussed in the forward-looking statements. Readers of this Annual Report on Form 10-K are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. The Company undertakes no obligation to release publicly any revisions to these forward-looking statements that may be made to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events. The inclusion of any statement in this Annual Report on Form 10-K does not constitute an admission by the Company or any other person that the events or circumstances described in such statement are material.

The following discussion should be read in conjunction with the Company's audited financial statements and notes thereto included elsewhere in this Annual Report on Form 10-K.

PART I

ITEM 1. BUSINESS

As used in this Annual Report on Form 10-K, references to the "Company", "The Children's Place", "we", "us", "our" and similar terms refer to The Children's Place Retail Stores, Inc. and its subsidiaries. Our fiscal year ends on the Saturday on or nearest to January 31. Other terms that are commonly used in this Annual Report on Form 10-K are defined as follows:

Fiscal 2010 *The fifty-two weeks ended January 29, 2011*

Fiscal 2009 *The fifty-two weeks ended January 30, 2010*

Fiscal 2008 *The fifty-two weeks ended January 31, 2009*

Fiscal 2007 *The fifty-two weeks ended February 2, 2008*

Fiscal 2011 *Our next fiscal year representing the fifty-two weeks ending January 28, 2012*

GAAP *Generally Accepted Accounting Principles*

Comparable Store Sales *Net sales, in constant currency, from stores that have been open at least 14 full months and that have not been substantially remodeled during that time*

Comparable Retail Sales *Comparable Store Sales plus comparable sales from our e-commerce store*

SEC *Securities and Exchange Commission*

FASB Financial Accounting Standards Board

FASB ASC FASB Accounting Standards Codification, which serves as the source for authoritative U.S. GAAP, except that rules and interpretive releases by the SEC are also sources of authoritative U.S. GAAP for SEC registrants

CPSA Consumer Product Safety Act

Table of Contents

CPSC *Consumer Products Safety Commission*

CPSIA *Consumer Product Safety Improvement Act of 2008*

General

The Children's Place Retail Stores, Inc. is the largest pure-play children's specialty apparel retailer in North America. We provide apparel, accessories and shoes for children from newborn to ten years old. We design, contract to manufacture and sell fashionable, high-quality, value-priced merchandise, virtually all of which is under the proprietary "The Children's Place" brand name. Our stores offer spacious, bright and airy shopping in a friendly and convenient environment for both children and adults. The Children's Place has differentiated departments and is dedicated to serving the wardrobe needs of Girls and Boys (sizes 4-14), Baby Girls and Boys (sizes 6 mos.-4T) and Newborn (sizes 0-12 mos.). Stores are distinctly merchandised to appeal to each age and gender segment and they provide for easy shopping of the latest collection available as we flow seasonal merchandise into our stores throughout the year. Our merchandise is also available at our online store located at *www.childrensplace.com*. Our customers are able to shop at our online store, at their convenience, and receive the same high quality, value-priced merchandise and customer service that are available in our physical stores.

The Children's Place Retail Stores, Inc. was incorporated in June 1988 operating fewer than 100 stores. At the time of our initial public offering in September 1997, we had grown to approximately 200 stores located in 26 states in the eastern half of the United States. By April 2003, we had grown to 656 stores and our geographical coverage included 47 states and a newly established presence in Canada. The growth of the Children's Place stores and brand has since continued, and as of January 29, 2011, we operated 995 stores throughout North America as well as our online store. During Fiscal 2010, we opened 67 stores compared to 38 in Fiscal 2009, and we closed 19 stores in Fiscal 2010, compared to eight in Fiscal 2009. Our store growth plan for Fiscal 2011 includes opening approximately 85 new The Children's Place stores and closing approximately 20.

Jane Elfers, who became our President and Chief Executive Officer on January 4, 2010, has outlined five key growth initiatives that we are executing, as follows:

1. *Improving the merchandise* The merchandise team is focused on modernizing the merchandise offerings and differentiating by age and gender. In addition, we are expanding our line of shoes and accessories sold in all stores, and plan to begin introducing "made-for-outlet" merchandise for our outlet stores, which represent approximately 13% of our total stores, during the second half of Fiscal 2011.

2. *Accelerating new store growth with a focus on Value Oriented Centers (VOCs)* VOCs currently account for approximately 9% of the fleet. During Fiscal 2010, we opened 67 stores of which 42 were VOCs. During Fiscal 2011, we plan to open 85 new stores of which approximately half will be VOCs, which have to date provided a higher return on investment as a result of favorable lease and build-out costs.

3. *Improving inventory management* Our goal is to have the right merchandise in the right store at the right time. As such, we realigned our planning and allocation organization into four channels: U.S. Place stores, U.S. Outlets, E-commerce and Canada stores. In Fiscal 2010, we began reducing initial inventory allocations to stores with more frequent replenishments.

4. *Sharpening our marketing message* We improved our marketing during Fiscal 2010 by providing clearer, streamlined messages focused on value and fashion. We have increased the frequency of our communications with customers through the internet. Our e-mail marketing reach during Fiscal 2010 was more than three times what it was during Fiscal 2009 and we are actively engaging customers through social media.

Table of Contents

5. *Driving e-commerce growth* E-commerce is a rapidly expanding channel with significant growth potential as moms are increasingly likely to shop online. We are focused on making continual site enhancements to improve the user experience. During the fourth quarter of Fiscal 2010, we began international shipping from our U.S. based e-commerce website.

Segment Reporting

After the disposal of our Disney Store Business during Fiscal 2008, management continued its reassessment of our internal reporting structure. At January 31, 2009, net sales of Canadian operations had grown by approximately 56% over the prior three fiscal years, and after the disposal of the Disney Store Business, its percentage of consolidated net sales had grown from approximately 9% to approximately 12%. Further, the fluctuations of the Canadian dollar relative to the U.S. dollar in recent years have had a significant impact on our Canadian operating results. Beginning in Fiscal 2009, our chief operating decision maker required, and we began reporting, discrete financial information for our Canadian operations.

We report segment data based on management responsibility: The Children's Place U.S. and The Children's Place Canada. Included in The Children's Place U.S. segment are our U.S. based stores, including Puerto Rico, and our e-commerce store, *www.childrensplace.com*. We measure our segment profitability based on operating income, defined as income from continuing operations before interest and taxes. Net sales and direct costs are recorded by each segment. Certain centrally managed inventory procurement functions such as production and design are allocated to each segment based upon usage. Corporate overhead, including executive management, finance, real estate, human resources, legal, and information technology services are allocated to the segments based primarily on net sales. Included in the allocation of corporate overhead is depreciation and amortization expense; however, the related assets are not allocated. We periodically review these allocations and adjust them based upon changes in business circumstances. Net sales from customers are derived primarily from merchandise sales and we have no customers that account for more than 10% of our net sales. The

Table of Contents

following tables show by segment our net sales and operating income for the past three fiscal years, and total assets as of January 29, 2011 and January 30, 2010 (in thousands):

	Fiscal Year Ended		
	January 29, 2011	January 30, 2010	January 31, 2009
Net sales:			
The Children's Place U.S.	$ 1,450,116	$ 1,441,562	$ 1,428,073
The Children's Place Canada	223,883	202,025	202,250
Total net sales	$ 1,673,999	$ 1,643,587	$ 1,630,323
Operating income:			
The Children's Place U.S.	$ 96,881	$ 90,873	$ 85,412
The Children's Place Canada	39,455	39,199	36,985
Total operating income	$ 136,336	$ 130,072	$ 122,397
Operating income as a percent of net sales			
The Children's Place U.S.	6.7%	6.3%	6.0%
The Children's Place Canada	17.6%	19.4%	18.3%
Total operating income as a percent of net sales	8.1%	7.9%	7.5%

	January 29, 2011	January 30, 2010
Total assets:		
The Children's Place U.S.	$ 720,951	$ 752,827
The Children's Place Canada	133,380	101,233
Total assets	$ 854,331	$ 854,060

All foreign net sales are in The Children's Place Canada segment while certain foreign expenses related to our buying operations are allocated between the two segments. Our foreign subsidiaries, primarily in Canada, have operating results based in foreign currencies and are thus subject to the fluctuations of the corresponding translation rates into U.S. dollars. Included in The Children's Place U.S. operating income for Fiscal 2009 is approximately $2.0 million of exit costs related to the relocation of the Company's e-commerce fulfillment center. We relocated our e-commerce fulfillment center from a leased facility in New Jersey to an owned facility in Alabama as a result of the continued growth in our e-commerce business.

The Disney Store Business

From November 2004 through April 2008, through four wholly owned subsidiaries, the Company operated the Disney Store retail chain in North America (the "Disney Store Business") under a license agreement (the "License Agreement") with the Walt Disney Company ("Disney"). On March 20, 2008, after a thorough review of the Disney Store Business, including its potential for earnings growth, its capital needs and its ability to fund such needs from its own resources, we decided to exit the Disney Store Business. On March 26, 2008, the Company's subsidiaries that operated the Disney Store Business, Hoop Holdings, LLC, Hoop Retail Stores, LLC, Hoop Canada Holdings, Inc. and Hoop Canada Inc. (collectively "Hoop"), each filed a voluntary petition for relief under bankruptcy provisions in their respective jurisdictions. On April 30, 2008, with approval of the respective bankruptcy courts, Hoop sold the Disney Store Business to affiliates of Disney, including a majority of the Disney stores and related assets and effectively ended the License Agreement. During the remainder of Fiscal 2008, those stores not acquired by Disney were closed, and the remaining affairs of Hoop were mostly wound down. For further discussion of the Disney Store Business, see Note 16 of the Notes to our Consolidated Financial Statements.

As a result of our decision to exit the Disney Store Business and in accordance with U.S. GAAP, we have reclassified the Disney Store Business as a discontinued operation in our consolidated financial statements for all periods presented. Related to the Disney Store Business during Fiscal 2010, Fiscal 2009 and Fiscal 2008, we recorded income (loss) from discontinued operations, net of income taxes of $(0.5) million, $(0.5) million and $8.4 million, respectively. Included in income (loss) from discontinued operations, net of income taxes for Fiscal 2008, are net sales of $129 million.

Key Capabilities

Our objective is to deliver trend-right, high-quality value-priced assortments for children ranging from newborn to age ten. Our expansive assortment offers one stop shopping across apparel, shoes and accessories. Our strategies to achieve this objective are as follows:

Merchandising Strategy

Our merchandising strategy is to offer a compelling assortment of apparel, shoes, and accessories that enable our customer to wardrobe their child. We strive to ensure that our assortments are modern and colorful, are balanced by category and lifestyle, and are fun and easy to put together. We build our deliveries by season and incorporate basics, key items, and fashion merchandise.

High Quality/Value Pricing

We believe that offering high quality, trend-right, age appropriate merchandise under "The Children's Place" brand name at value prices is our competitive advantage. We design and merchandise our apparel and accessories to offer a compelling value to our customers.

Brand Image

We strive to build our brand image and customer loyalty for "The Children's Place" by:

- Offering high-quality products and trend-right fashion at value prices;
- Providing colorful coordinated outfits and accessories for our customers' lifestyle needs;
- Creating strong merchandising and visual presentations to create a compelling in-store experience;
- Emphasizing our great value and fashion in marketing visuals to convey a consistent brand message across all channels;
- Leveraging our customer database to frequently communicate with our customers and tailor promotions to maximize customer satisfaction; and
- Providing exclusive assortments in our e-commerce and outlet channels to further expand our brand recognition.

The Children's Place branded products are sold exclusively in our stores and on our website.

Low-Cost Sourcing

We control the design, sourcing and production of The Children's Place branded products. We believe that this control is essential in assuring the consistency and quality of our merchandise, as well as our ability to deliver value to our customers. We have established long-standing relationships with most of our vendors and suppliers. Through these relationships and our extensive knowledge of low cost sourcing, we are able to offer our customers high-quality products at value prices. Our offices in Hong Kong, China, India and Bangladesh allow us to capitalize on new sourcing opportunities, increase our control over product quality, communicate efficiently and respond to changing business needs effectively.

Merchandising Process

The strong collaboration between the cross functional teams in Merchandising, Planning and Allocation, Sourcing and Design have enabled us to build and grow our brand. Cross functional teams are aligned by department.

Design

The Design team gathers information from trends, color services, international and domestic shopping trips, and trade shows. Findings and concepts are presented to the Merchandising team to initiate the cross functional building of a seasonal assortment.

Merchandising

Each quarter we develop seasonal strategies for each department and for each category within the department. The cross functional teams review prior season results and set the strategies in place for the future season. Merchandising builds a roadmap of our style needs based on historical information with the Design team's input. The Design and Merchandising teams work collaboratively throughout the sketch and sample reviews to ensure we are developing the appropriate balance of fashion and key items within the line.

Merchandise Planning and Allocation

The Merchandise Planning and Allocation organization works collaboratively with the Merchandising and Sourcing teams to develop annual and seasonal sales and margin plans to support our financial objectives and merchandising strategies. These plans are developed with consideration of our channels to ensure that we are maximizing key programs each season. Further, this team plans the flow of inventory to ensure that we are adequately supporting floor sets and key promotional periods. Special attention is paid to our store types as they differ in capacity. All allocation methods incorporate visual presentations as well as inventory levels and sales trends.

Sourcing and Procurement

We combine management's extensive apparel sourcing experience with a cost-based buying strategy to control merchandise costs, infuse quality features into our products and deliver value to our customers. We believe that our understanding of the economics of apparel manufacturing, including costs of materials and components enables us to identify cost-effective manufacturers and suppliers from which to source a continuous allotment of products and obtain high quality at low product cost.

Production, Quality, Control and Social Compliance

During Fiscal 2010, we engaged approximately 160 independent manufacturers located primarily in Asia. The availability of raw materials to these manufacturers is subject to price fluctuations due to global market trends. To support our inventory needs and to control merchandise costs, we continue to pursue global sourcing opportunities and consider such factors as product quality, cost, reliability of the manufacturer, service, product lead times, and other factors. We have no exclusive or long-term contracts with our manufacturers and typically transact business on an item-by-item basis under purchase orders at freight on board cost in U.S. dollars.

Table of Contents

During Fiscal 2010, we purchased approximately 48% of our total merchandise without the aid of commissioned buying agents. We believe our offices in Hong Kong, China, India and Bangladesh enable us to obtain favorable material and manufacturing costs and to quickly identify and act on new sourcing and supplier opportunities. Our Asian offices also facilitate our prototype sample production and enable us to foster stronger relationships with our suppliers, manufacturers, agents and trading companies. In addition, we are party to agency agreements with commissioned independent agents who assist in sourcing and pre-production approval, oversee production, provide quality inspection and ensure timely delivery of merchandise. During Fiscal 2010, we purchased approximately 28% of our products through the support of a commissioned, independent agent in Taiwan, and approximately 12% of our products through an independent Hong Kong-based trading company. We sourced approximately 40% of our total goods from China and approximately 15% each from Vietnam, Cambodia and Sub-Saharan Africa. We did not source more than 15% from any other country or region. Using our purchase order, advanced shipping notification and tracking systems, our independent agents and our sourcing department actively monitor the status of each purchase order from order confirmation to merchandise receipt.

We augment our manufacturers' testing requirements with our own in-house quality assurance laboratory to test and evaluate fabric, trimming materials and pre-production samples against a comprehensive range of physical performance standards before production begins. The quality control personnel in our Asian offices, independent agents and trading company visit the various manufacturing facilities to monitor the quality control and production process. Our Asian offices enhance our quality control by enabling us to monitor component and manufacturing quality at close range and address related problems at an early stage. With this focus on pre-production quality, we are generally able to detect and correct quality-related problems before bulk production begins. We do not accept finished goods until each purchase order receives formal certification of compliance from our own quality assurance associates, agents or appointed third party inspectors.

In addition to our quality control procedures, we administer a social compliance program designed to promote compliance with local legal regulations, as well as ethical and socially responsible business practices. This program is comprised of four components as follows:

Vendor Code of Conduct By formally acknowledging and agreeing to our code of conduct, our vendors affirm their commitment to integrate our corporate compliance standards into their manufacturing and sourcing practices. These standards cover the areas of: child labor, forced labor, coercion/harassment, non-discrimination, health and safety, compensation, environment, subcontracting, monitoring & compliance and publication.

Ongoing Monitoring Program We administer a corporate monitoring program as performed by our internal social compliance team and/or professional third party auditors who visit factory locations to assess the working conditions in all factories that manufacture The Children's Place products. The Ongoing Monitoring Program involves: (1) visual inspection of work facilities and dormitories; (2) interview of factory management regarding policies and practices; (3) interview of factory workers to verify workplace policies and practices; and (4) review of wage, hour, age and other records. At the conclusion of the factory audit/visit, our auditor will review the Corrective Action Plan Acknowledgement Report together with factory management.

Corrective Action Plan Acknowledgement Report ("CAPAR") The CAPAR contains findings from the factory visit for each of the areas covered by our standards, a remediation plan for any violations found (if applicable), as well as a re-audit timeframe. If violations are not remediated in accordance with the remediation plan, we cease using that factory or vendor.

Ongoing Training and Seminars We continually conduct training programs and seminars to communicate with our internal and external partners regarding the requirements of our program. Additionally, our social compliance team attends third party seminars, industry courses and training in the Corporate Social Responsibility area.

We require all entities that produce or manufacture The Children's Place merchandise to undergo a Social Compliance audit and demonstrate compliance with the requirements of our Vendor Code of Conduct. By requiring our manufacturers and suppliers to participate in our social compliance program, we are able to monitor factories to ensure that they operate using safe and humane working conditions, and that we are working with factory managers that appreciate and comply with socially responsible practices. Additionally, because our social compliance program requires us to be diligent about changes in local laws and other conditions (e.g., political instability) in the countries from which we source, we are able to make informed decisions about where we are sourcing our products and, prior to placing orders, analyze potential risks to our sourcing capabilities arising as a result of factors external to a factory's production capabilities. In the event that external risks to our sourcing capabilities arise with respect to one or more factories, our social compliance program helps to identify such risks early and enables us to source from another factory thereby mitigating the risk and reducing the potential disruption to our business.

Company Stores

The following section highlights various store information for The Children's Place brand as of January 29, 2011.

Existing Stores

As of January 29, 2011, we operated a total of 995 The Children's Place stores, most of which are clustered in and around major metropolitan areas, and our internet store at *www.childrensplace.com*. We have 618 stores located in malls, 202 in strip centers, 132 in outlet centers and 43 street stores. The following table sets forth the number of stores in each U.S. state, Puerto Rico and Canadian provinces as of the current and prior fiscal year end:

	Number of Stores	
Location	**January 29, 2011**	**January 30, 2010**
United States & Puerto Rico		
Alabama	11	9
Arizona	19	18
Arkansas	6	6
California	90	86
Colorado	14	14
Connecticut	14	14
Delaware	4	4
District of Columbia	1	1
Florida	44	46
Georgia	28	21
Hawaii	4	4
Idaho	1	1
Illinois	37	39
Indiana	19	19
Iowa	10	8
Kansas	5	5
Kentucky	12	8
Louisiana	14	14
Maine	4	4
Maryland	22	22
Massachusetts	23	24

Table of Contents

Location	Number of Stores January 29, 2011	January 30, 2010
Michigan	22	22
Minnesota	12	13
Mississippi	12	8
Missouri	14	13
Montana	1	1
Nebraska	3	2
New Hampshire	5	5
New Jersey	47	48
New Mexico	4	3
New York	79	79
Nevada	7	7
North Carolina	21	20
North Dakota	1	1
Ohio	31	30
Oklahoma	6	4
Oregon	9	9
Pennsylvania	48	49
Rhode Island	3	3
South Carolina	15	13
South Dakota	2	2
Tennessee	18	17
Texas	78	68
Utah	11	8
Vermont	1	1
Virginia	18	17
Washington	13	13
West Virginia	1	1
Wisconsin	12	13
Puerto Rico	16	16
Total United States & Puerto Rico	***892***	***853***
Canada		
Alberta	13	12
British Columbia	14	11
Manitoba	2	2
New Brunswick	3	3
Nova Scotia	3	2
Ontario	46	44
Prince Edward Island	1	1
Quebec	18	17
Saskatchewan	3	2
Total Canada	***103***	***94***
Total Stores	**995**	**947**

Table of Contents

Store Concepts

At The Children's Place, our store concepts consist of "Apple-Maple", "Technicolor", "Tech^2" and "Outlet" formats, as follows:

Apple-Maple These stores feature light wood floors, fixtures and trim. They are brightly lit, featuring floor-to-ceiling glass windows that are open and inviting. A customized grid system throughout the store's upper perimeter displays featured merchandise, marketing photographs and promotions. The average store is approximately 4,300 square feet and as of January 29, 2011, approximately 42% of our stores were of this concept.

Technicolor These stores have an atmosphere that is unique, bright, fun and use color to create boutique-like settings that differentiate the various departments within the store. These stores also feature more wall space than an Apple-Maple store allowing for enhanced merchandise presentation and ease of shopping. The average store is approximately 4,800 square feet and as of January 29, 2011, approximately 34% of our stores were of this concept.

Tech^2 These stores have the brand aesthetics of a Technicolor with the functionality of an Apple-Maple. The use of color to brand and create shop identifiers was maintained, while creating an open, brightly lit environment for customers. Tech^2 features darker ceilings and floors, along with crisp white floor-wall fixtures to ensure the product is the focal point. Tech^2 is a value engineered store which costs approximately 35% less to build than the Technicolor store. The average store is approximately 4,400 square feet and as of January 29, 2011, approximately 11% of our stores were of this concept. It is the Company's intention to use this format for new stores for the foreseeable future.

Outlet The average outlet store is approximately 7,600 square feet. As of January 29, 2011, approximately 13% of our stores were in this format. Our outlet stores are strategically placed within each market to provide a discount value alternative, including an assortment of "made for outlet" merchandise.

Store Expansion Program

Our store expansion program targets growing and underpenetrated markets where we believe that our brand can be successfully marketed. Prior to Fiscal 2009, this initiative had primarily focused on malls in highly populated areas. More than 60% of our stores are located in malls and we believe that our brand is well penetrated in these venues. During Fiscal 2009, we identified growth potential in smaller to mid-sized markets in VOCs, which is a center in which the anchor is a discount retailer. We believe that the lower build-out costs for our Tech^2 stores, as noted above, combined with lower lease costs associated with VOCs has enabled us to successfully penetrate these markets and will continue to provide us with a growth opportunity. We opened approximately 42 and 20 VOC stores during Fiscal 2010 and Fiscal 2009, respectively. Our store expansion program for Fiscal 2011 is to open approximately 85 new stores of which approximately half will be of the VOC variety.

Internet Sales ("e-commerce")

E-commerce growth remains one of our top strategic priorities. Over the past five years, e-commerce net sales have grown over 450%, from approximately $26.9 million in fiscal 2005 to approximately $151.2 million in Fiscal 2010, and now accounts for approximately 9% of our total net sales. We expect our e-commerce business to continue to grow in Fiscal 2011.

We are committed to delivering a world class, end-to-end user experience to our customers; from product assortment and website design to operations, fulfillment and customer service. We are further committed to delivering these experiences to our customers when, where and how they are looking to access the brand, accounting for cross-channel behavior, growth of mobile devices, and the growing

Table of Contents

interest in our brand from international audiences. As such, we will continue to make required investments in back-end infrastructure, as well as front-end technology to deliver on this commitment. We believe that the critical investments made over the past year in areas such as warehousing and distribution as well as customer service have improved our customers' experience.

Store Operations

The Children's Place store operations are organized into nine regions. We employ two Zone Vice Presidents who oversee our operations and to whom regional managers report. A regional manager oversees each region and has between seven and 10 district managers reporting to them. Each district manager is responsible for approximately nine to 17 stores. Our stores are staffed by a store management team and approximately 10 part-time sales associates, with additional part-time associates hired to support seasonal needs. Our store leadership teams spend a high percentage of their time on the store selling floors providing direction, motivation, and development to store personnel. To maximize selling productivity, our teams emphasize greeting, replenishment, presentation standards, procedures and controls. In order to motivate our store leadership, we offer a monthly incentive compensation plan that awards bonuses for achieving certain financial goals.

Seasonality

Our business is subject to seasonal influences, with heavier concentrations of sales during the back-to-school and holiday seasons. Our first quarter results are heavily dependent upon sales during the period leading up to the Easter holiday, third quarter results are dependent upon back-to-school sales, and our fourth quarter results are dependent upon sales during the holiday season. The following table shows the quarterly distribution, as a percentage of the full year, of net sales and operating income (loss) (in millions):

	First Quarter	**Second Quarter**	**Third Quarter**	**Fourth Quarter**	**Full Year**
Fiscal 2010					
Net sales	422.1	345.3	453.4	453.2	1,674.0
As a % of full year	**25.2%**	**20.6%**	**27.1%**	**27.1%**	**100.0%**
Operating Income (loss)	47.7	(13.1)	50.0	51.7	136.3
As a % of full year	**35.0%**	**(9.6)%**	**36.7%**	**37.9%**	**100.0%**
Fiscal 2009					
Net sales	401.9	315.7	463.2	462.8	1,643.6
As a % of full year	**24.5%**	**19.2%**	**28.2%**	**28.2%**	**100.0%**
Operating Income (loss)	36.0	(18.7)	64.8	48.0	130.1
As a % of full year	**27.7%**	**(14.4)%**	**49.8%**	**36.9%**	**100.0%**
Fiscal 2008					
Net sales	400.2	338.0	450.6	441.5	1,630.3
As a % of full year	**24.5%**	**20.7%**	**27.6%**	**27.1%**	**100.0%**
Operating Income(1)	34.0	4.9	50.9	32.5	122.4
As a % of full year	**27.8%**	**4.0%**	**41.6%**	**26.6%**	**100.0%**

(1) Does not add across due to rounding

For more information regarding the seasonality of our business, refer to Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations Quarterly Results and Seasonality.

Table of Contents

Marketing

We believe that The Children's Place is a well recognized brand, with a strong fashion offering and a compelling value proposition. We build on our brand recognition through a streamlined, multi-channel marketing campaign that aligns direct mail, store front windows, in-store marketing, internet marketing, and customer loyalty programs.

Our direct marketing program is a robust one that utilizes both off and on-line channels. Direct mail is targeted to our best customers, and serves as both a brand building and loyalty vehicle. The print program consists of catalogs containing branded lifestyle imagery, merchandise details and a discounted coupon as an added shopping incentive. This is complimented by an e-mail program that reiterates the branding and promotional messaging. We further deepen our value proposition and customer loyalty with "bouncebacks", which are coupons given to existing customers for redemption on a future purchase.

Additionally, we promote customer loyalty through The Children's Place private label credit card and other customer loyalty programs. Our discount programs offer customers additional exclusive discounts upon completion of cumulative purchase or visit thresholds. Our private label credit cards, pursuant to a merchant services agreement, are issued to our customers for use exclusively at The Children's Place stores, and credit is extended to such customers through a third-party financial institution on a non-recourse basis to us. Our private label credit card accounts for approximately 12% of our net sales.

All programs are aligned with one another and planned by geography and channel to ensure consistency and relevance. We believe that our marketing programs promote affinity and loyalty through specialized incentive programs and facilitate communications with our customers through the delivery of coupons and promotional materials.

Logistics

We support the distribution of product to our stores through four strategically located warehouses throughout North America. In the United States our warehouse facilities include a 525,000 square foot distribution center in New Jersey, a 250,000 square foot distribution center in California and a 700,000 square foot distribution center in Alabama. In Canada we operate a 95,000 square foot distribution center in Ontario. On occasion, we may lease additional facilities to support seasonal warehousing needs. As a result of the continued growth in our e-commerce business, the processing of online orders was relocated from our former 150,000 square foot online fulfillment center in New Jersey to our warehouse facilities in Alabama in June of 2009.

Competition

The children's apparel and accessories retail markets are highly competitive. We compete in substantially all of our markets with GapKids, babyGap and Old Navy (each of which is a division of The Gap, Inc.), Target Corporation, The Gymboree Corporation, Justice (a division of The Dress Barn, Inc.), Babies "R" Us and Toys "R" Us (each of which is a division of Toys "R" Us, Inc.), J.C. Penney Company, Inc., Sears (a division of Sears Holdings Corporation), Kohl's Corp. and other department stores as well as discount stores such as Wal-Mart Stores, Inc., and K-Mart (a division of Sears Holdings Corporation). In addition, given our expansion into the shoe category, we now compete with stores such as Stride Rite and Payless (each a part of Collective Brands, Inc.), as well as smaller shoe retailers. We also compete with a wide variety of specialty stores, other national and regional retail chains, catalog companies and Internet retailers. One or more of our competitors are present in substantially all of the areas in which we have stores.

Table of Contents

Trademarks and Service Marks

"The Children's Place," "babyPLACE," "Place," "The Place," "TCP," "PLC" and certain other marks have been registered as trademarks and/or service marks with the United States Patent and Trademark Office. The registration of the trademarks and the service marks may be renewed to extend the original registration period indefinitely, provided the marks are still in use. We intend to continue to use and protect our trademarks and service marks and maintain their registrations. We have also registered our trademarks in Canada and certain other countries and we are continuing to take steps to register our trademarks in other countries. We believe our trademarks and service marks have received broad recognition and are of significant value to our business.

Government Regulation

We are subject to federal, state and local laws and regulations affecting our business, including consumer protection and truth-in-advertising laws and regulations and zoning and occupancy ordinances that regulate retailers generally and/or govern the promotion and sale of merchandise and the operation of retail stores. We also are subject to similar international laws and regulations affecting our business. We believe that we are in material compliance with these laws and regulations.

We are committed to product quality and safety. We focus our efforts to adhere to all applicable laws and regulations affecting our business, including the provisions of the CPSIA, the Flammable Fabrics Act and the Textile Fiber Product Identification Act, and the regulations of the CPSC and various environmental laws and regulations. Each of our product styles currently covered by the CPSIA are appropriately tested to meet current standards. The cost of compliance with current requirements and any future requirements of the CPSC, new consumer product safety laws, or changes to existing laws could have a material adverse effect on our financial position, results of operations and cash flows. See Item 1A. Risk Factors "Product liability costs, related claims, and the cost of compliance with consumer product safety laws such as the CPSIA or our inability to comply with such laws could have a material adverse effect on our business and reputation." for additional information.

The substantial majority of our merchandise is manufactured by factories located outside of the United States. These products are imported and are subject to U.S. customs laws, which impose tariffs, anti-dumping and countervailing duties on imported products including textiles, apparel and shoes. We currently are not restricted by any such duties in the operation of our business. In addition, custom duties and tariffs do not comprise a material portion of the cost of our products.

Employees

As of January 29, 2011, we had approximately 20,800 employees, of whom approximately 1,600 were based at our corporate offices. We had approximately 3,200 full-time store employees and approximately 16,000 part-time and seasonal store employees. None of our employees are covered by a collective bargaining agreement. We believe we have good relations with our employees.

Internet Access to Reports

We are a public company and are subject to the informational requirements of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Accordingly, we file periodic reports, proxy statements and other information with the SEC. Such reports, proxy statements and other information may be obtained by visiting the Public Reference Room of the SEC at 100 F Street, NE, Room 1580, Washington, D.C. 20549 or by calling the SEC at 1-800-SEC-0330. In addition, the SEC maintains a website (http://www.sec.gov) that contains reports, proxy and information statements and other information regarding us and other issuers that file electronically.

Table of Contents

Our website address is *www.childrensplace.com*. We make available without charge, through our website, copies of our Proxy Statement, Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act as soon as reasonably practicable after such reports are filed with or furnished to the SEC. References in this document to our website are not and should not be considered part of this Annual Report on Form 10-K, and the information on our website is not incorporated by reference into this Annual Report on Form 10-K.

We also make available our corporate governance materials, including our corporate governance guidelines and our code of business conduct, on our website. If we make any substantive amendments to our code of business conduct or grant any waiver, including any implicit waiver, from a provision of the code for the benefit of our Chief Executive Officer, Principal Financial Officer, or our Principal Accounting Officer and Corporate Controller, we will disclose the nature of such amendment or waiver on that website or in a Current Report on Form 8-K.

ITEM 1A. RISK FACTORS

Investors in the Company should consider the following risk factors as well as the other information contained herein:

We may suffer adverse business consequences if we are unable to anticipate and respond to merchandise trends.

The apparel industry is subject to rapidly changing fashion trends and shifting consumer preferences. Our success depends in part on the ability of our new merchandising team to anticipate and respond to these changes. Our design, manufacturing and distribution process generally takes up to one year, during which time fashion trends and consumer preferences may change. Failure to anticipate, identify or respond to these changes could adversely affect customer acceptance of our products resulting in lower sales, increased inventory levels and/or lower margins, which could have a material adverse effect on our financial position, results of operations and cash flows.

We may be unable to properly plan inventory purchases or manage new or existing merchandise.

We maintain an inventory of merchandise in our stores and distribution centers, some of which we anticipate will be in high demand. During Fiscal 2010, a new team was put in place to manage the inventory allocation process. If inventory levels are in excess of customer demand, that may result in inventory write-downs or excessive markdowns and therefore, lower than planned margins. Conversely, if we underestimate consumer demand for our merchandise, particularly higher volume styles, or if our manufacturers fail to supply quality products in a timely manner, we may experience inventory shortages, which might result in lost sales, a negative impact on our customer relationships or diminished brand loyalty. Any of these, individually or in aggregation, could have a material adverse effect on our financial position, results of operations and cash flows.

Changes in Comparable Retail Sales results from period to period could have a material adverse effect on the market price of our common stock.

Numerous factors affect our Comparable Retail Sales results, including, among others, merchandise assortment, retail prices, fashion trends, weather conditions, macro-economic conditions, the retail sales environment and our success in executing our business strategies. Many of our stores are located in malls, and as such, a decrease in mall traffic could have a negative effect on our sales, which in turn would reduce our Comparable Retail Sales. During Fiscal 2010, we reported a Comparable Retail Sales decrease of 2.5% compared to a decrease of 2.1% in Fiscal 2009 and an increase of 4.7% Fiscal 2008. Our Comparable Retail Sales results have fluctuated significantly in the

Table of Contents

past and we anticipate that our Comparable Retail Sales will continue to fluctuate in the future, particularly in the current difficult economic climate, which may result in further declines in consumer spending. Moreover, Comparable Retail Sales for any particular period may decrease in the future. The investment community often follows Comparable Retail Sales results closely and fluctuations in these results may affect the price of our common stock. Accordingly, any significant variations in our Comparable Retail Sales results could have a material adverse effect on the market price of our common stock.

Fluctuations in the prices of raw materials could result in an increase in product costs and/or delivery costs.

Over the past year, we have seen significant increases in the cost of cotton. Continued increases in the price of cotton, or significant increases or volatility in the prices of other raw materials, including wool and other materials used in the production of fabric and accessories, as well as energy costs, could result in significant cost increases for our products as well as their distribution to our distribution centers, retail locations and to our customers. To the extent we are unable to offset any such increased costs through value engineering or price increases, it could have a material adverse effect on our net sales, financial position, results of operations and cash flows.

Our success depends upon the service and capabilities of our management team. Changes in management or in our organizational structure could have a material adverse effect on our business.

Over the past year, we had substantial change in key members of our senior management team. While we have managed through this transition successfully to date, leadership change can be inherently difficult to manage and may cause disruption to our business or further turnover in our workforce or management team. Senior level management establishes the "tone at the top" by which an environment of ethical values, operating style and management philosophy is fostered. Changes in management, or inadequate management, could lead to an environment that lacks integrity, inspiration, and/or a lack of commitment by the employees. The inability of our senior management team to maintain an adequate organizational structure and a proper "tone at the top", or the inability to attract additional qualified managers or other personnel, could have a material adverse effect on our business.

We may not be able to identify, evaluate or successfully execute business strategies.

We are continuously seeking new ways to further our brand recognition, expand our geographical coverage, and improve our operational processes. We have a store expansion program and are expanding our internet presence outside of the U.S. If we fail to allocate proper resources to these projects, if we fail to properly execute our plans, or if we fail to identify alternative strategies, it could have a material adverse effect on our financial position, results of operations and cash flows.

We face significant competition in the retail industry, which could impact our ability to compete successfully against existing or future competition.

The children's apparel retail market is highly competitive. We compete in substantially all of our markets with GapKids, babyGap and Old Navy (each of which is a division of The Gap, Inc.), Target Corporation, The Gymboree Corporation, Justice (a division of The Dress Barn, Inc.), Babies "R" Us and Toys "R" Us (each of which is a division of Toys "R" Us, Inc.), J.C. Penney Company, Inc., Sears (a division of Sears Holdings Corporation), Kohl's Corp. and other department stores as well as discount stores such as Wal-Mart Stores, Inc., and K-Mart (a division of Sears Holdings Corporation). In addition, given our expansion into the shoe category, we now compete with well-known national retailers such as Stride Rite and Payless (each a part of Collective Brands, Inc.) as well as smaller shoe retailers. We also compete with a wide variety of specialty stores, other national and regional retail chains, catalog companies and Internet retailers. One or more of our competitors are present in substantially all of the areas in which we have stores. Many of our competitors are larger than us and have access to significantly greater financial, marketing and other resources than we have. We may not be able to continue to compete successfully against existing or future competition.

Product liability costs, related claims, and the cost of compliance with consumer product safety laws such as the CPSIA or our inability to comply with such laws could have a material adverse effect on our business and reputation.

We are subject to regulation by the CPSC and similar state and international regulatory authorities. Although we test the products sold in our stores and on our website, concerns about product safety, including but not limited to concerns about those manufactured in China and/or developing countries, where substantially all of our merchandise is manufactured, may lead us to recall selected products, either voluntarily, or at the direction of a governmental authority or may lead to a lack of consumer acceptance. Product safety concerns, recalls, defects or errors could result in the rejection of our products by customers, damage to our reputation, lost sales, product liability litigation and increased costs, any or all of which could harm our business and have a material adverse effect on our financial position, results of operations and cash flows.

The CPSIA established new standards regarding lead and other substances used in products for children of age 12 and under, including apparel and accessories. Among other things, the CPSIA introduces new regulatory limits, testing, certification, packaging, labeling and advertising and reporting requirements with respect to such products and has increased penalties for violations thereof. Each of our product styles currently covered by the CPSIA are appropriately tested to meet current standards. The cost of compliance with current requirements and any future requirements of the CPSC, new consumer product safety laws, or changes to existing laws could have a material adverse effect on our financial position, results of operations and cash flows. In addition, any failure to comply with such requirements could result in significant penalties, require us to recall products and harm our reputation, any or all of which could have a material adverse effect on our business, reputation, and financial position, results of operations and cash flows.

We depend on our relationships with unaffiliated manufacturers, transportation companies, and independent agents. Our inability to maintain relationships with any of these entities, or the failure of any of their businesses, could adversely affect our business and results of operations.

We do not own or operate any manufacturing facilities, and therefore, are dependent upon independent third parties for the manufacture of all of our products. Our products are currently manufactured to our specifications, pursuant to purchase orders, by approximately 160 independent manufacturers located primarily in Asia. In addition, in Fiscal 2010, we sourced approximately 40% of our merchandise from China and approximately 15% each from Vietnam, Cambodia and Sub-Saharan Africa. We did not source more than 15% from any other country or region. We have no exclusive or long-term contracts with our manufacturers and compete with other companies for manufacturing facilities. We purchased approximately 12% of our products in Fiscal 2010 through a Hong Kong-based trading company, with whom we have no formal written agreement, using negotiated purchase orders. We also purchased approximately 28% of our products in Fiscal 2010 through the support of a single, commissioned agent in Taiwan. Although we believe that we have established close relationships with our trading company, independent agents and principal manufacturers, the inability to maintain such relationships or to find additional sources to support our current needs and future growth could have a material adverse effect on our business.

Our merchandise is shipped directly from manufacturers through third parties to our distribution and fulfillment centers and to our stores. Our operating results depend in large part on the orderly operation of our receiving and distribution process, which depends on manufacturers' adherence to shipping schedules and our effective management of our distribution facilities and capacity. Furthermore, it is possible that events beyond our control, such as political unrest, a terrorist act,

Table of Contents

military action, strike, natural disaster or other disruption, could result in delays in delivery of merchandise to our stores. Any such event could have a material adverse effect on our business.

If our trading company, independent agents, principal manufacturers or freight operators experience negative financial consequences, the inability to use these sources or find additional financially stable sources to support our current manufacturing and distribution needs and future growth in a timely manner could have a material adverse effect on our business.

Any of the above risks, individually or in aggregation, could negatively impact our financial position, results of operations and cash flows.

Because we purchase our products internationally, our business is sensitive to risks associated with international business.

Our merchandise is purchased from foreign suppliers, of which China is the single largest representing approximately 40% of our imported merchandise. As a result, we are subject to the various risks of doing business in foreign markets and importing merchandise from abroad, such as:

- foreign governmental regulations;
- financial or political instability;
- pressure from non-governmental organizations;
- customer acceptance of foreign produced merchandise;
- new legislation relating to import quotas or other restrictions that may limit the import of our merchandise;
- imposition of duties, taxes, and other charges on imports;
- fluctuation in the value of the U.S. dollar against foreign currencies;
- significant delays in the delivery of cargo due to port security considerations;
- disruption of imports by labor disputes and local business practices;
- increased cost of transportation; and
- failure of an unaffiliated manufacturer to comply with local laws, including labor laws or ethical labor practices.

In an attempt to mitigate the above risks within any one country, we maintain relationships with many manufacturers in various countries. However, we still import approximately 40% of our merchandise from China. In recent years, there has been much media scrutiny and well-publicized failures of the safety of a wide range of imported products manufactured in China. A continuation of such publicity or similar problems may lead consumers to avoid such goods. We cannot predict the effect that this, or the other factors noted above, in another country from which we import products could have on our business arrangements with foreign manufacturing sources. If any of these factors rendered the conduct of business in a particular country undesirable or impractical, or if our current foreign manufacturing sources ceased doing business with us for any reason, it could have a material adverse effect on our business.

We require our independent manufacturers to operate in compliance with applicable laws and our internal requirements. Our purchasing guidelines promote ethical business practices and we monitor compliance with them; however we do not control these manufacturers or their labor practices. Any violation of labor or other laws by one of the independent manufacturers we use or any divergence of an independent manufacturer's labor practices from standards generally accepted as ethical in the United States and Canada could have a material adverse effect on our business.

Table of Contents

Any of the above risks, individually or in aggregation, could negatively impact our financial position, results of operations and cash flows.

Because certain of our subsidiaries operate outside of the United States, some of our revenues, product costs and other expenses are subject to foreign economic and currency risks.

We have store operations in Canada and buying operations in various locations in Asia, primarily Hong Kong and Shanghai, China. We cannot guarantee that we will be able to address in a timely manner the risks of conducting operations in countries outside of the U.S., such as governmental requirements over merchandise importation, employment, taxation and multi-lingual requirements. Our failure to address such risks in a timely manner or at all could adversely affect our business and financial position, results of operations and cash flows.

The currency market has seen significant volatility in the value of the U.S. Dollar against other foreign currencies. While our business is primarily conducted in U.S. dollars, we purchase substantially all of our products overseas, and we generate significant revenues in Canada. Cost increases caused by currency exchange rate fluctuations could make our products less competitive or have a material adverse effect on our profitability. Currency exchange rate fluctuations could also disrupt the business of the third party manufacturers that produce our products by making their purchases of raw materials more expensive and more difficult to finance.

Approximately 13% of our consolidated net sales and operating expenses are transacted in foreign currencies. As a result, fluctuations in exchange rates impact the amount of our reported sales and expenses, which could have a material adverse effect on our financial position, results of operations and cash flows. Additionally, we have foreign currency denominated receivables and payables that, to date, have not been hedged against foreign currency fluctuations. When settled, these receivables and payables could result in significant transaction gains or losses.

Pending legal and regulatory actions are inherent in our businesses and could adversely affect our results of operations or financial position or harm our businesses or reputation.

We are, and in the future may be, subject to legal and regulatory actions in the ordinary course of our business. Material pending litigation and regulatory matters affecting us, and certain risks to our businesses presented by such matters, are discussed under Item 3 Legal Proceedings of Part I of this Annual Report on Form 10-K. Some of these proceedings have been brought on behalf of various alleged classes of complainants. In certain of these matters, the plaintiffs are seeking large and/or indeterminate amounts, including punitive or exemplary damages. Substantial legal liability in these or future legal or regulatory actions could have a material adverse affect on us or cause us reputational harm, which in turn could harm our business prospects.

Our litigation and regulatory matters are subject to many uncertainties, and given their complexity and scope, their outcome cannot be predicted. Our reserves for litigation and regulatory matters may prove to be inadequate. It is possible that our results of operations or cash flows in a particular quarterly or annual period could be materially affected by an ultimate unfavorable resolution of pending litigation and regulatory matters depending, in part, upon the results of operations or cash flows for such period. In light of the unpredictability of our litigation and regulatory matters, it is also possible that in certain cases an ultimately unfavorable resolution of one or more pending litigation or regulatory matters could have a material adverse effect on our financial position, results of operations and cash flows.

Table of Contents

A material disruption in, failure of, or inability to upgrade, our information technology systems could adversely affect our business or results of operations and cash flows.

We rely on various information systems to manage our operations and we regularly make investments to upgrade, enhance or replace such systems. Over the next fiscal year, we will begin implementing a new core merchandising system. Transitioning to new systems, integrating new systems into current systems, or any disruptions or malfunctions affecting our information systems could cause critical information upon which we rely to be delayed, unreliable, corrupted, insufficient or inaccessible. Any of these potential issues, individually or in aggregation, could have a material adverse effect on our business, financial position, results of operations and cash flows.

We depend on generating sufficient cash flows, together with our existing cash balances and availability under our credit facility to fund our ongoing operations, capital expenditures and debt service requirements.

Our ability to fund our ongoing operations, planned capital expenditures, share repurchase programs and potential debt service requirements will depend on our ability to generate cash flows. Our cash flows are dependent on many factors, including:

- seasonal fluctuations in our net sales and net income, which typically are lowest in the second fiscal quarter;
- the timing of inventory purchases for upcoming seasons, particularly in the second fiscal quarter as our sales are lowest and we are purchasing merchandise for the back-to-school season;
- vendor and other supplier terms and related conditions, which may be less favorable to us as a smaller company in comparison to larger companies; and
- general business conditions, economic uncertainty or slowdown, including the continuing significant weakness in the overall economy.

Most of these factors are beyond our control. It is difficult to assess the impact that the general economic downturn will continue to have on consumer spending and our financial results. However, we believe that it will continue to result in reduced spending by our customers, which would reduce our revenues and our cash flows from operating activities from those that otherwise would have been generated. In addition, steps that we may take to limit cash outlays, such as delaying the purchase of inventory, may not be successful or could delay the arrival of merchandise for future selling seasons, which could reduce our net sales or profitability. If we are unable to generate sufficient cash flows, we may not be able to fund our ongoing operations, planned capital expenditures and potential debt service requirements and we may be required to seek additional sources of liquidity.

If our landlords should suffer financial difficulty or if we are unable to successfully negotiate acceptable lease terms, it could have an adverse effect on our business and results of operations and cash flows.

We have accelerated our new store growth with a focus on value oriented centers, which are estimated to represent approximately half of Fiscal 2011 new store openings. Currently, approximately 62% of our stores are located in malls, approximately 20% are located in strip centers, approximately 13% are located in outlet centers and approximately 5% are located in street stores. If any of our landlords should suffer financial difficulty, it could render them unable to fulfill their duties under our lease agreements. Such duties include providing a sufficient number of mall co-tenants, common area maintenance, utilities, and payment of real estate taxes. While we have certain remedies under our lease agreements, the loss of business that could result if a shopping center should close or if customer traffic were to significantly decline as a result of lost tenants or improper care of the facilities could have a material adverse effect on our financial position, results of operations and cash flows.

Table of Contents

We generally lease our stores for initial terms of five to 10 years. If we are unable to continue to negotiate acceptable lease and renewal terms, it could have a material adverse effect on our financial position, results of operations and cash flows.

If we are unable to open and operate new stores successfully, our future operating results will be adversely impacted.

We anticipate opening approximately 85 stores during Fiscal 2011. Our ability to open and operate new stores successfully depends on many factors, including, among others, the availability of suitable store locations, the ability to negotiate acceptable lease terms, the ability to timely complete necessary construction, the ability to successfully integrate new stores into our existing operations, the ability to hire and train store personnel and the ability to recognize and respond to regional and climate-related differences in customer preferences.

We cannot guarantee that we will achieve our planned expansion on a timely and profitable basis or that we will be able to achieve results similar to those achieved in existing locations in prior periods. In Fiscal 2010, our total store base grew approximately 5% compared to 3% during Fiscal 2009, and is anticipated to grow approximately 7% in Fiscal 2011. Operating margins may also be adversely affected during periods in which we have incurred expenses in anticipation of new store openings.

We need to continually evaluate the adequacy of our store management and our information and distribution systems to manage our planned expansion. Any failure to successfully and profitably execute our expansion plans could have a material adverse effect on our financial position, results of operations and cash flows.

Our failure to successfully manage our e-commerce business could have a negative impact on our business.

The operation of our e-commerce business depends on our ability to maintain the efficient and uninterrupted operation of our online order-taking and fulfillment operations. Risks associated with our e-commerce business include:

- disruptions in telephone service or power outages;
- risks associated with the failure of the computer systems that operate our website including, among others, inadequate system capacity, computer viruses, human error, changes in programming, security breaches, system upgrades or migration of these services to new systems;
- reliance on third parties for computer hardware and software as well as delivery of merchandise to our customers;
- rapid technology changes;
- credit card fraud;
- the diversion of sales from our physical stores;
- natural disasters or adverse weather conditions;
- changes in applicable federal and state regulations;
- liability for online content; and
- consumer privacy concerns.

Problems in any one or more of these areas could have a material adverse effect on our sales, financial position, results of operations and cash flows and could damage our reputation and brand.

A privacy breach or failure to comply with privacy laws could adversely affect our business.

The protection of customer, employee, and company data is critical. The regulatory environment surrounding information security and privacy is demanding, with the frequent imposition of new and changing requirements. In addition, customers have a high expectation that we will adequately protect their personal information. A significant breach of customer, employee, or company data or our failure to comply with federal, state and local privacy laws could damage our reputation and result in lost sales, fines, and/or lawsuits.

Despite our considerable efforts and technology to secure our computer network, security could be compromised, confidential information, such as customer credit card numbers, could be misappropriated, or system disruptions could occur. Our systems and procedures meet the Payment Card Industry ("PCI") data security standards, which require periodic audits by independent third parties to assess compliance. Failure to comply with the security requirements or rectify a security issue may result in fines and the imposition of restrictions on our ability to accept payment by credit or debit cards. There can be no assurance that we will be able to satisfy PCI security standards. In addition, PCI is controlled by a limited number of vendors who have the ability to impose changes in PCI's fee structure and operational requirements on us without negotiation. Such changes in fees and operational requirements may result in our failure to comply with PCI security standards, as well as significant unanticipated expenses.

Changes in federal, state or local law, or our failure to comply with such laws, could increase our expenses and expose us to legal risks.

Our business is subject to a wide array of laws and regulations. Significant legislative or regulatory changes that impact our relationship with our workforce could increase our expenses and adversely affect our operations. None of our employees are currently represented by a collective bargaining agreement. However, from time to time there have been efforts to organize our employees at various locations. There is no assurance that our employees will not unionize in the future, particularly if legislation is passed that facilitates unionization. Changes in other regulatory areas, such as consumer credit, privacy and information security, product safety or environmental protection, among others, could cause our expenses to increase. In addition, if we fail to comply with applicable laws and regulations, particularly wage and hour laws and privacy laws, we could be subject to legal risk, including government enforcement action and class action civil litigation, which could have a material adverse effect on our financial position, results of operations and cash flows. Changes in tax laws, the interpretation of existing laws, or our failure to sustain our reporting positions on examination could adversely affect our effective tax rate.

Legislative actions and new accounting pronouncements could result in us having to increase our administrative expenses to remain compliant.

In order to comply with the Sarbanes-Oxley Act of 2002 and any subsequent guidance that may come from the Public Company Accounting Oversight Board ("PCAOB"), future changes in listing standards by the Nasdaq Stock Market, or future accounting guidance or disclosure requirements by the SEC, we may be required to enhance our internal controls, hire additional personnel and utilize additional outside legal, accounting and advisory services, all of which could cause our general and administrative expenses to increase.

The SEC is exploring the possibility of requiring all U.S. companies to prepare its financial statements in accordance with International Financial Reporting Standards. The FASB is currently working on a project with its international counterpart, the International Accounting Standards Board, to converge U.S. and International GAAP into one uniform set of accounting rules. The cost of implementing a potentially vast change of financial reporting rules could be material. The effect of changing accounting rules on our financial statements could also be significant. Changes to our financial position, results of operations or cash flows could impact our debt covenant ratios or a lender's perception of our financial statements causing an adverse impact on our ability to obtain credit, or could impact investor analyses and perceptions of our business causing the market value of our stock to decrease. In addition, any changes in the current accounting rules, including legislative and other proposals could increase the expenses we report under U.S. GAAP and have a material adverse effect on our financial position, results of operations and cash flows.

Tax Matters could impact our results of operations and financial condition.

We are subject to income taxes in the United States and foreign jurisdictions, including Canada and Hong Kong. Our provision for income taxes and cash tax liability in the future could be adversely affected by numerous factors including, but not limited to, income before taxes being lower than anticipated in countries with lower statutory tax rates and higher than anticipated in countries with higher statutory tax rates, changes in the valuation of deferred tax assets and liabilities, and changes in tax laws, regulations, accounting principles or interpretations thereof, which could adversely impact our results of operations and financial condition in future periods. In addition, we are subject to the examination of our income tax returns by the Internal Revenue Service and other tax authorities. We regularly assess the likelihood of adverse outcomes resulting from these examinations to determine the adequacy of our provision for income taxes. There can be no assurance that the outcomes from these continuous examinations will not have an adverse effect on our provision for income taxes and cash tax liability.

Because of conditions impacting our quarterly results of operations, including seasonality, weather conditions and other factors, our quarterly results fluctuate.

As is the case with many retailers, we experience seasonal fluctuations in our net sales and net income. Our net sales and net income are generally weakest during the first two fiscal quarters, and are lower during the second fiscal quarter than during the first fiscal quarter. For example, in Fiscal 2010, 25%, 21%, 27% and 27% of our consolidated net sales occurred in the first, second, third and fourth quarters, respectively. In most fiscal years, we experience operating losses in the second quarter, with the exception of Fiscal 2008, when we experienced minimal income in the second quarter. It is reasonably possible that we will continue to experience second quarter losses in future periods. It is also possible that we could experience losses in other quarters. Our first quarter results are heavily dependent upon sales during the period leading up to the Easter holiday. Our third quarter results are heavily dependent upon back-to-school sales. Our fourth quarter results are heavily dependent upon sales during the holiday season.

Our quarterly results of operations may also fluctuate significantly from quarter to quarter as a result of a variety of other factors, including overall economic conditions, the timing of new store openings and related pre-opening and other start-up costs, net sales contributed by new stores, increases or decreases in Comparable Retail Sales, weather conditions, shifts in the timing of certain holidays and changes in our merchandise mix and pricing strategy. Any failure by us to meet our business plans for, in particular, the third and fourth quarter of any fiscal year, as we experienced in Fiscal 2007, would have a material adverse effect on our financial position, results of operations and cash flows. In addition, because our expense levels are based in part on expectations of future sales levels, a shortfall in expected sales could result in a disproportionate decrease in our net income.

Any disruption in, or changes to, our consumer credit arrangements, including our private label credit card agreement with Citibank, N.A., may adversely affect the ability of our customers to obtain consumer credit.

Credit card operations are subject to numerous federal and state laws that impose disclosure and other requirements upon the origination, servicing and enforcement of credit accounts and limitations on the maximum amount of finance charges that may be charged by a credit provider. The Credit Card Act of 2009 (the "Card Act") went into effect during Fiscal 2010. Provisions of the Card Act include, among other changes, restrictions on interest charges and other fees that credit and debit card providers may charge its consumers. These restrictions may result in decreased revenues for credit card providers, which may cause increases to consumer interest rates, reduce credit availability or cause increases to fees charged to retailers. The Card Act, other new regulations, or changes in existing regulations of credit arrangements could materially limit the availability of credit to our customer base.

Additionally, during periods of increasing consumer credit delinquencies generally, financial institutions may reexamine their lending practices and procedures. There can be no assurance that increased delinquencies being experienced by providers of consumer credit generally would not cause providers of third party credit offered by us to decrease the availability of, or increase the cost of such credit.

Any of the above risks, individually or in aggregation, could have a material adverse effect on the way we conduct business and could negatively impact our financial position, results of operations and cash flows.

We may be unable to protect our trademarks and other intellectual property rights.

We believe that our trademarks and service marks are important to our success and our competitive position due to their name recognition with our customers. We devote substantial resources to the establishment and protection of our trademarks and service marks on a worldwide basis. In order to more effectively protect them from infringement and to defend against claims of infringement, the marks are owned by a separate subsidiary whose purpose is to maintain and manage existing and future marks, thereby increasing their value to us. We are not aware of any material claims of infringement or material challenges to our right to use any of our trademarks and service marks in the United States. Nevertheless, the actions we have taken, including to establish and protect our trademarks and service marks, may not be adequate to prevent imitation of our products by others or to prevent others from seeking to block sales of our products as a violation of the trademarks, service marks and proprietary rights of others. Also, others may assert rights in, or ownership of, trademarks and other proprietary rights of ours and we may not be able to successfully resolve these types of conflicts to our satisfaction. In addition, the laws of certain foreign countries may not protect proprietary rights to the same extent as do the laws of the United States.

Our share price may be volatile.

Our common stock is quoted on the Nasdaq Global Select Market. Stock markets in general have experienced, and are likely to continue to experience, price and volume fluctuations, which could have a material adverse effect on the market price of our common stock without regard to our operating performance. In addition, we believe that factors such as quarterly fluctuations in our financial results, our Comparable Retail Sales results, other risk factors identified here, announcements by other retailers, the overall economy and the geopolitical environment could individually or in aggregation cause the price of our common stock to fluctuate substantially.

Negative changes in the economy, such as the continued deterioration in the global economic environment, and resulting declines in consumer confidence and spending, have had and could continue to have an adverse effect on the apparel industry and on our operating results.

The apparel industry is cyclical in nature and is particularly affected by adverse trends in the general economy. Purchases of apparel and related merchandise are generally discretionary and therefore tend to decline during recessionary periods and also may decline at other times. During 2008 and 2009, the global economic environment deteriorated significantly, and remained weak in 2010 and into 2011. The declining values in real estate, reduced credit lending by banks, solvency concerns of major financial institutions, increases in unemployment levels and significant declines and volatility in the global financial markets have negatively impacted the level of consumer spending for discretionary items. This has adversely affected our business as it is dependent on consumer demand for our products. In North America, we have experienced a significant slowdown in customer traffic and a highly promotional environment. These same conditions exist in many international markets. If the global macroeconomic environment continues to be weak or deteriorates further, there will likely be a negative effect on our revenues, operating margins and earnings.

In addition to the factors contributing to the current economic environment, there are a number of other factors that could contribute to reduced levels of consumer spending, such as increases in interest rates, fluctuating fuel and other energy costs, taxation rates or energy prices. Similarly, political unrest, actual or potential terrorist acts and other conflicts can also create significant instability and uncertainty in the world, causing consumers to defer purchases or preventing our suppliers and service providers from providing required services or materials to us. These or other factors could materially and adversely affect our financial position, results of operations and cash flows.

Acts of terrorism, effects of war, other catastrophes or political unrest could have a material adverse effect on our business.

The threat or actual acts of terrorism continue to be a risk to the global economy. Terrorism and potential military responses, political unrest, natural disasters, pandemics or other health issues could disrupt commerce, undermine consumer confidence or impact our ability to open or operate our stores in affected areas. A disruption of commerce could interfere with the production, shipment or receipt of our merchandise in a timely manner or increase our costs to do so, which could have a material adverse impact on our financial position, results of operations and cash flows. If there is a decline in consumer confidence or if our stores are affected by an act of terrorism or other catastrophe, it could negatively impact consumer spending patterns or customer traffic, which would negatively impact our financial position, results of operations and cash flows.

Since a portion of our available cash is located in foreign jurisdictions, if we need such cash to fund domestic needs we may not be able to do so on favorable terms.

We manage our cash and liquidity within each business according to the country and currency of operations. Because a portion of our cash balances and working capital is located in foreign jurisdictions, we could have a liquidity issue in one country while adequate liquidity exists in other countries. If such a liquidity need were to arise in our domestic operations, there is no guarantee that we would have the ability to make the appropriate intercompany transfer from our foreign subsidiaries on favorable terms and our financial position and results of operations could be materially adversely impacted.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

We lease all of our existing store locations in the United States and Canada, with lease terms expiring through 2023 and 2021, respectively. The average unexpired lease term for our stores is approximately 4.2 years in the United States and approximately 4.8 years in Canada. The leases for most of our existing stores are for initial terms of 10 years and provide for contingent rent based upon a percentage of sales in excess of specific minimums. We anticipate that we will be able to extend those leases on satisfactory terms as they expire, or relocate to desirable locations.

Table of Contents

The following table sets forth information with respect to our non store locations as of January 29, 2011:

Location	Use	Approximate Sq. Footage	Current Lease Term Expiration
South Brunswick Township, NJ(1)	Warehouse Distribution Center	525,000	1/31/2021
Ontario, CA(1)	Warehouse Distribution Center	250,000	3/31/2016
Ontario, Canada(2)	Warehouse Distribution Center	95,000	4/30/2014
Fort Payne, AL(1)	Warehouse Distribution Center	700,000	Owned
500 Plaza Drive, Secaucus, NJ(3)	Corporate Offices, Design	140,000	5/31/2029
Hong Kong, China(3)	Product Support	28,000	4/30/2012
Shanghai, China(3)	Product Support	14,000	7/14/2012
Gurgaon, India(3)	Product Support	7,100	3/12/2012
Tirupur, India(3)	Product Support	3,600	9/15/2012

(1) Supports The Children's Place U.S. stores and/or e-commerce business.

(2) Supports The Children's Place Canada stores.

(3) Supports both The Children's Place U.S. stores and The Children's Place Canada stores.

On occasion, we may operate other leased facilities to support seasonal warehousing needs.

ITEM 3. LEGAL PROCEEDINGS

On June 16, 2009, a putative stockholder derivative action was filed in the Superior Court of New Jersey, Hudson County, Chancery Division, against us and certain of our current and former directors and senior executives. We have been named as a nominal defendant. The complaint alleges, among other things, that certain of our current and former directors and executives breached their fiduciary duties to us and our stockholders by causing us to issue false and misleading public statements and by abdicating their responsibilities to us and our stockholders, in violation of state law. The complaint also alleges that the defendants committed corporate waste in connection with a severance payment to our former Chief Executive Officer. The complaint seeks monetary damages from the individual defendants as well as costs and disbursements of the lawsuit, including expert fees, as well as equitable relief. On November 20, 2009, defendants moved to dismiss the complaint, on the grounds that, among other things, (i) the claims asserted in the action are barred by the prior settlement of the stockholder class action filed in the United States District Court for the Southern District of New York, and (ii) plaintiff failed to make a demand on our Board of Directors to initiate the lawsuit, as required by applicable state law. The court heard oral arguments on the motion to dismiss on March 25, 2010 and on June 3, 2010 the court issued an oral decision denying the defendants' motion to dismiss, while stating that the court took no position on the merits of the case. On July 28, 2010, the defendants filed a motion in the Superior Court of New Jersey, Appellate Division, seeking extraordinary leave to appeal from the interlocutory order denying defendants' motion to dismiss, which motion was denied on August 20, 2010. While we believe there are valid defenses to the claims and we will defend ourselves vigorously, no assurance can be given as to the outcome of this litigation. This claim has been tendered to our insurance carrier and we believe that any settlement would be covered by our insurance and, as such, we do not expect that this litigation will have a material adverse effect on our financial position, results of operations and cash flows.

We are also involved in various legal proceedings arising in the normal course of business. In the opinion of management, any ultimate liability arising out of these proceedings will not have a material effect on our financial condition.

ITEM 4. RESERVED

There is no disclosure required under this Item.

Table of Contents

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock is listed on the Nasdaq Global Select Market, or Nasdaq, under the symbol "PLCE." The following table sets forth the range of high and low sales prices on Nasdaq of our common stock for the fiscal periods indicated.

	High	Low
2010		
First Quarter	$ 50.10	$ 31.41
Second Quarter	49.85	39.81
Third Quarter	57.63	39.84
Fourth Quarter	53.52	42.12
2009		
First Quarter	$ 30.39	$ 17.09
Second Quarter	37.68	24.50
Third Quarter	36.47	26.15
Fourth Quarter	37.00	26.65

On March 23, 2011, the last reported sale price of our common stock was $48.67 per share, the number of holders of record of our common stock was approximately 65 and the number of beneficial holders of our common stock was approximately 18,900.

We do not pay dividends to our stockholders. Our credit facility prohibits the payment of dividends and puts restrictions on the amount of purchases of our common stock. On August 18, 2010, our Board of Directors authorized a share repurchase program in the amount of $100.0 million. On March 3, 2011, the Board authorized an additional share repurchase program in the amount of $100.0 million. Under the programs, we may repurchase shares in the open market at current market prices at the time of purchase or in privately negotiated transactions. As of January 29, 2011, we had repurchased approximately 1.9 million shares at an aggregate cost of approximately $90.0 million, and at an average cost of $46.54 per share. Subsequent to January 29, 2011 and through March 23, 2011, we repurchased an additional 0.2 million shares for approximately $10.5 million, which completed the initial share repurchase program and began the new share repurchase program announced on March 3, 2011. During Fiscal 2009, we purchased approximately 2.5 million shares at a price of $28.88 per share of our common stock from Ezra Dabah, our former Chief Executive Officer, Renee Dabah and certain related trusts. Also, pursuant to restrictions imposed by our equity plan during black-out periods, we withhold and retire shares of vesting stock awards in exchange for payments to satisfy the withholding tax requirements of certain recipients. Our payment of the withholding taxes in exchange for the shares constitutes a purchase of our common stock. During Fiscal 2010 and Fiscal 2009, we retired approximately 14,000 and 18,000 shares, respectively, and made related withholding tax payments of approximately $0.6 million and $0.5 million, respectively. Any determination in the future to pay dividends or purchase additional shares of our common stock will depend upon our earnings, financial condition, cash requirements, future prospects, covenants in our credit facilities and any future debt instruments and such other factors as the Board deems appropriate at such time.

Table of Contents

The following table provides a month-to-month summary of our share repurchase activity during the 13 weeks ended January 29, 2011:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value (in thousands) of Shares that May Yet Be Purchased Under the Plans or Programs
10/31/10 - 11/27/10	209,484	$ 45.90	209,484	$ 10,418
11/28/10 - 1/1/11	12,945	50.57	7,400	10,054
1/2/11 - 1/29/11				10,054
Total	222,429	$ 46.17	216,884	$ 10,054

Equity Plan Compensation Information

The following table provides information as of January 29, 2011, about the shares of our Common Stock that may be issued upon exercise of options granted to employees or members of our Board under all of our existing stock-based compensation plans, including our 1997 Stock Option Plan and 2005 Equity Plan as amended on June 27, 2008 ("2005 Equity Plan").

Plan Category	COLUMN (A) Securities to be issued upon exercise of outstanding options	COLUMN (B) Weighted average exercise price of outstanding options	COLUMN (C) Securities remaining available for future issuances under equity compensation plans (excluding securities reflected in Column (A))
Equity Compensation Plans Approved by Security Holders	350,710(1)	$ 33.93	787,477(2)
Equity Compensation Plans Not Approved by Security Holders	N/A	N/A	N/A
Total	350,710	$ 33.93	787,477

(1) Amount consists of 247,710 shares issuable under our 1997 Stock Option Plan and 103,000 shares issuable under our 2005 Equity Plan.

(2) Effective with the approval of our 2005 Equity Plan by our stockholders, we agreed not to make any further grants under our 1997 Stock Option Plan, thus all securities remaining available for future issuance relate to our 2005 Equity Plan. Excluded from this amount are approximately 356,400 shares issuable upon vesting of deferred stock awards and approximately 151,300 shares issuable upon vesting of performance awards.

Table of Contents

Performance Graph

The following graph compares the cumulative stockholder return on our common stock with the return on the Total Return Index for The NASDAQ Stock Market (US) and The NASDAQ Retail Trade Stocks. The graph and the second table below assume that $100 was invested on January 28, 2006 in each of our common stock, The NASDAQ Stock Market (US) index and The NASDAQ Retail Trade Stock index. The first table below sets forth the closing price of our Common Stock and the closing indices for The NASDAQ Stock Market (US) and The NASDAQ Retail Trade Stocks on the last day of certain of our fiscal years.

Date	The Children's Place "PLCE"	NASDAQ US	NASDAQ RETAIL TRADE STOCKS
1/28/2006	45.090	782.053	498.988
2/3/2007	58.310	842.827	548.239
2/2/2008	19.780	813.974	485.385
1/31/2009	18.810	400.522	312.127
1/30/2010	31.800	579.464	463.164
1/29/2011	43.470	742.933	577.479

Date	The Children's Place "PLCE"	NASDAQ US	NASDAQ RETAIL TRADE STOCKS
1/28/2006	100.000	100.000	100.000
2/3/2007	129.319	107.771	109.870
2/2/2008	43.868	104.082	97.274
1/31/2009	41.717	51.214	62.552
1/30/2010	70.526	74.095	92.821
1/29/2011	96.407	94.998	115.730

ITEM 6. SELECTED FINANCIAL DATA

We are the largest pure-play children's specialty apparel retailer in North America. As of January 29, 2011 we operated 995 The Children's Place stores across North America and an online store at *www.childrensplace.com.* The following table sets forth certain historical financial and operating data for The Children's Place Retail Stores, Inc. and its subsidiaries. The statement of operations data for the three fiscal years ended January 29, 2011, and the balance sheet data as of January 29, 2011 and January 30, 2010 have been derived from, and should be read in conjunction with, the audited financial statements presented elsewhere herein. The balance sheet data as of January 31, 2009, and the balance sheet data and the statement of operations data as of and for the fiscal years ended

Table of Contents

February 2, 2008 and February 3, 2007, have been derived from audited financial statements not included herein. All other data presented herein, have not been audited. The information contained in this table should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations, and the audited consolidated financial statements and notes thereto included elsewhere herein.

	Fiscal Year Ended(1)				
Statement of Operations Data (in thousands, except per share and square footage data):	**January 29, 2011**	**January 30, 2010**	**January 31, 2009**	**February 2, 2008**	**February 3, 2007**
Net sales	$ 1,673,999	$ 1,643,587	$ 1,630,323	$ 1,520,329	$ 1,405,429
Cost of sales	1,010,851	984,086	958,510	924,187	794,985
Gross profit	663,148	659,501	671,813	596,142	610,444
Selling, general and administrative expenses	452,459	455,782	471,302	479,142	435,758
Asset impairment charges(2)	2,713	2,200	6,491	16,565	418
Other costs(3)			213	5,870	
Depreciation and amortization	71,640	71,447	71,410	65,326	57,964
Operating income	136,336	130,072	122,397	29,239	116,304
Interest income (expense), net	(1,530)	(5,731)	(4,939)	(366)	2,707
Income from continuing operations before income taxes	134,806	124,341	117,458	28,873	119,011
Provision for income taxes	51,219	35,500	43,523	18,913	34,740
Income from continuing operations	83,587	88,841	73,935	9,960	84,271
Diluted income per common share from continuing operations	$ 3.05	$ 3.09	$ 2.50	$ 0.34	$ 2.82
Selected Operating Data for Continuing Operations:					
Number of stores open at end of period	995	947	917	904	866
Comparable retail sales increase (decrease)	(2.5)%	(2.1)%	4.7%	2.6%	10.0%
Average net sales per store(4)	$ 1,587	$ 1,634	$ 1,703	$ 1,654	$ 1,643
Average square footage per store(5)	4,943	4,965	4,918	4,846	4,647
Average net sales per square foot(6)	$ 318	$ 332	$ 350	$ 355	$ 361
Balance Sheet Data (in thousands):					
Working capital(7)	$ 347,305	$ 311,366	$ 312,595	$ 200,381	$ 282,049
Total assets	854,331	854,060	939,757	997,537	936,985
Long-term debt			55,000		
Stockholders' equity	607,727	588,970	547,879	472,233	521,787

(1) All periods presented were 52-week years, except the fiscal year ended February 3, 2007, which was a 53-week year.

(2) Asset impairment charges generally relate to the write-off of fixed assets related to underperforming stores. In Fiscal 2007, we also recorded an impairment charge of $14.8 million related to our decision to cease construction on our Emerson Lane administrative office building.

(3) Other costs include $5.9 million in lease exit costs related to our decision not to proceed with the construction of the Emerson Lane administrative office building.

Table of Contents

(4) Average net sales per store represents net sales from stores open throughout the full period divided by the number of such stores.

(5) Average square footage per store represents the square footage of stores operated on the last day of the period divided by the number of such stores.

(6) Average net sales per square foot represent net sales from stores open throughout the full period divided by the square footage of such stores.

(7) Working capital is calculated by subtracting our current liabilities from our current assets.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with our audited financial statements and notes thereto included in Item 15. Exhibits and Financial Statement Schedules. The following discussion contains forward-looking statements that reflect our plans, estimates and beliefs. Our actual results could differ materially from those discussed in the forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed below and elsewhere in this Annual Report on Form 10-K, particularly in Item 1A Risk Factors.

As used in this Annual Report on Form 10-K, references to the "Company", "The Children's Place", "we", "us", "our" and similar terms refer to The Children's Place Retail Stores, Inc. and its subsidiaries. Our fiscal year ends on the Saturday on or nearest to January 31. Other terms that are commonly used in our management's discussion and analysis of financial condition and results of operations are defined as follows:

Fiscal 2010 The fifty-two weeks ended January 29, 2011

Fiscal 2009 The fifty-two weeks ended January 30, 2010

Fiscal 2008 The fifty-two weeks ended January 31, 2009

Fiscal 2011 Our next fiscal year representing the fifty-two weeks ending January 28, 2012

FASB Financial Accounting Standards Board

FASB ASC FASB Accounting Standards Codification, which serves as the source for authoritative U.S. GAAP, except that rules and interpretive releases by the SEC are also sources of authoritative U.S. GAAP for SEC registrants

GAAP Generally Accepted Accounting Principles

SEC Securities and Exchange Commission

Comparable Store Sales Net sales, in constant currency, from stores that have been open at least 14 full months and that have not been substantially remodeled during that time

Comparable Retail Sales Comparable Store Sales plus comparable sales from our e-commerce store

Gross Margin *Gross profit expressed as a percentage of net sales*

SG&A *Selling, general and administrative expenses*

Table of Contents

OVERVIEW

Our Business

We are the largest pure-play children's specialty apparel retailer in North America. We design, contract to manufacture and sell fashionable, high-quality, value-priced merchandise, virtually all of which is under our proprietary "The Children's Place" brand name. As of January 29, 2011, we operated 995 stores across North America and an online store at *www.childrensplace.com.*

Segment Reporting

After the disposal of our Disney Store Business during Fiscal 2008 (see below), management continued its reassessment of our internal reporting structure. Net sales of Canadian operations had grown approximately 56% over the three fiscal years ended January 31, 2009, and after the disposal of the Disney business, its percentage of consolidated net sales had grown from approximately 9% to approximately 12%. Further, the fluctuations of the Canadian dollar relative to the U.S. dollar in recent years have had a significant impact on our Canadian operating results. Beginning in Fiscal 2009, our chief operating decision maker required, and we began reporting, discrete financial information for our Canadian operations.

The "*Segment Reporting*" topic of the FASB ASC establishes standards for reporting information about a company's operating segments. Accordingly, we report segment data based on management responsibility: The Children's Place U.S. and The Children's Place Canada. Included in The Children's Place U.S. segment are our U.S. based stores, including Puerto Rico, and our e-commerce store, *www.childrensplace.com*. We measure our segment profitability based on operating income, defined as earnings before interest and taxes. Net sales and direct costs are recorded by each segment. Certain centrally managed inventory procurement functions such as production and design are allocated to each segment based upon usage. Corporate overhead, including executive management, finance, real estate, human resources, legal, and information technology services are allocated to the segments based primarily on net sales. Included in the allocation of corporate overhead is depreciation and amortization expense; however, the related assets are not allocated. We periodically review these allocations and adjust them based upon changes in business circumstances. Net sales from external customers are derived from merchandise sales and we have no major customers that account for more than 10% of our net sales.

Recent Developments

On August 18, 2010, our Board of Directors authorized a share repurchase program in the amount of $100.0 million. On March 3, 2011, our Board authorized an additional share repurchase program in the amount of $100.0 million. Under the programs, we may repurchase shares in the open market at current market prices at the time of purchase or in privately negotiated transactions. During Fiscal 2010 we repurchased approximately 1.9 million shares for approximately $90.0 million. Subsequent to January 29, 2011 and through March 23, 2011, we repurchased an additional 0.2 million shares for approximately $10.5 million, which completed the initial share repurchase program and began the new share repurchase program announced on March 3, 2011. All of these shares have been retired. The timing and number of shares repurchased under the remaining program will depend on a variety of factors including price, corporate and regulatory requirements, and other business and market conditions, and may be suspended or discontinued, or reinstituted without prior announcement, at any time. In connection with the share repurchase programs the 2008 Credit Agreement was amended each time to increase the allowable amount, subject to certain conditions, that we may spend on share repurchases.

On February 11, 2011, we announced the resignation of Susan J. Riley, Executive Vice President, Finance and Administration. For transitional purposes, Ms. Riley remained in our employment until

March 4, 2011. Under Ms. Riley's employment agreement, she remains entitled to a $1.0 million payment. The expense associated with this payment was being amortized over the life of the employment agreement and as of January 29, 2011, approximately $0.9 million had been accrued.

The Company also announced that, as of February 11, 2011, John Taylor, the Company's Vice President, Finance since 2007, will assume the position of Interim Principal Financial Officer and Bernard McCracken, the Company's Controller since 2009 and Vice President, Controller since 2010, will assume the position of Interim Principal Accounting Officer.

The Disney Store Business

From November 2004 through April 2008, through four wholly owned subsidiaries, the Company operated the Disney Store retail chain in North America (the "Disney Store Business") under a license agreement with the Walt Disney Company. After a thorough review of the Disney Store Business, its potential earnings growth, its capital needs and its ability to fund such needs from its own resources, the Company announced on March 20, 2008 that it had decided to exit the Disney Store Business. Our subsidiaries that operated the Disney Store Business are referred to herein interchangeably and collectively as "Hoop".

After assessing the above factors and considering Hoop's liquidity, Hoop's Board of Directors determined that the best way to complete an orderly wind-down of Hoop's affairs was for Hoop to seek relief under Chapter 11 of the United States Bankruptcy Code (the "Bankruptcy Code"). On March 26, 2008, Hoop Holdings, LLC, Hoop Retail Stores, LLC and Hoop Canada Holdings, Inc. each filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code in the United States Bankruptcy Court for the District of Delaware (the "U.S. Bankruptcy Court") (Case Nos. 08-10544, 08-10545, and 08-10546, respectively, the "Cases"). On March 27, 2008, Hoop Canada, Inc. filed for protection pursuant to the Companies' Creditors Arrangement Act (the "CCAA") in the Ontario Superior Court of Justice (Commercial List) ("Canadian Bankruptcy Court") (Court File No. 08-CL-7453, and together with the Cases, the "Filings"). Each of the foregoing Hoop entities are referred to collectively herein as the "Hoop Entities."

After receiving the approval of the U.S. Bankruptcy Court and the Canadian Bankruptcy Court, on April 30, 2008, Hoop transferred the Disney Store business in the U.S. and Canada and a substantial portion of the Disney Store assets to affiliates of Disney in an asset sale (the "Sale"), pursuant to an asset purchase agreement dated as of April 3, 2008 among the Hoop Entities and affiliates of Disney (the "Sale Agreement") and Section 363 of the Bankruptcy Code (and a similar provision under the CCAA). Upon closing, affiliates of Disney paid approximately $61.6 million, including certain post-closing adjustments, for the acquired assets of the Disney Store business. The proceeds received from the Sale are included in the assets of the Hoop Entities' for distribution to their creditors pursuant to the plan of reorganization that was approved by the U.S. Bankruptcy Court on December 15, 2008 (the "Plan"). A similar plan was approved by the Canadian Bankruptcy Court.

According to the terms of the Sale, Hoop transferred 217 Disney Stores to affiliates of Disney and granted such affiliates the right to operate and wind-down the affairs of the remaining stores. The lease obligations associated with the stores that were not sold were rejected and resulting damage claims were administered pursuant to the Plan.

In April 2008, the Company entered into a settlement and release of claims agreement with Hoop and the official committee of unsecured creditors in the Cases (the "Settlement Agreement"), which was approved by the U.S. Bankruptcy Court on April 29, 2008. Under the Settlement Agreement, the Company agreed to provide transitional services and to forgive all pre- and post-bankruptcy petition claims against the Hoop Entities. Such claims included intercompany charges for shared services of approximately $24.9 million, a capital contribution made on March 18, 2008 of approximately $8.3 million, payment of severance and other employee costs for the Company's employees servicing

Hoop of approximately $7.7 million, and $6.8 million of professional fees and other costs the Company has incurred during the Cases, as well as claims that might be asserted against the Company in the Cases. At January 30, 2010, the Company had paid approximately $46.1 million related to the Settlement Agreement, and had remaining accruals of $1.6 million, primarily for legal claims and related costs. As of January 29, 2011, the Company had paid approximately $47.2 million related to the Settlement Agreement, and had remaining accruals of $0.5 million, primarily for legal claims and related costs.

On December 15, 2008, the U.S. Bankruptcy Court approved the Plan, pursuant to which the Hoop Entities that were U.S. debtors were dissolved and all assets and liabilities were transferred to a trust (the "Trust"), which is overseen by a trustee appointed by the U.S. Bankruptcy Court under the Plan and a trust oversight committee. Hoop Canada, Inc., which currently remains under the jurisdiction of the Canadian Bankruptcy Court, has not yet been legally dissolved but is a wholly owned subsidiary of the Trust and is effectively part of the Trust's assets.

Upon effectiveness of the Plan in December 2008, the Company deconsolidated all Hoop Entities. As a result, all intercompany balances, including investments in subsidiaries, were eliminated, and the net liabilities in excess of assets transferred were written off, which resulted in a $25.5 million gain on the relief of indebtedness of the Hoop Entities in the fourth quarter of Fiscal 2008.

During Fiscal 2010, the Company reported a $0.5 million loss from discontinued operations, net of income taxes, which is comprised of approximately $0.6 million of reserve adjustments, primarily related to legal claims and approximately $0.2 million of professional fees associated with the wind-down of the Hoop Entities. These costs are offset by a tax benefit of approximately $0.3 million.

During Fiscal 2009, the Company reported a $0.5 million loss from discontinued operations, net of income taxes, which is comprised of approximately $0.6 million of professional fees associated with the wind-down of the Hoop Entities and approximately $0.2 million of reserve adjustments, primarily related to legal claims. These costs are offset by a tax benefit of approximately $0.3 million.

In accordance with U.S. GAAP, the Disney Store business has been segregated from continuing operations and included in "Income (loss) from discontinued operations, net of income taxes" in the consolidated statements of operations.

Operating Highlights

Net sales in Fiscal 2010 increased approximately $30.4 million, or 1.8%, to $1,674.0 million, compared to $1,643.6 million reported in Fiscal 2009. During Fiscal 2010, our Comparable Retail Sales decreased 2.5% compared to a decrease of 2.1% in Fiscal 2009. In Fiscal 2010, we opened 67 stores, remodeled 35 stores and closed 19 stores.

Based on information from NPD Group, a consumer and retail market research firm, we believe our market share of children's apparel for The Children's Place brand increased to 4.4% in Fiscal 2010 from 4.1% in Fiscal 2009.

During Fiscal 2010, we reported income from continuing operations of $83.6 million, or $3.05 per diluted share, compared to $88.8 million, or $3.09 per diluted share, in Fiscal 2009. During Fiscal 2010, our business was significantly impacted by the continued weakness in the U.S. and Canadian economic environments.

Table of Contents

Additionally, income from continuing operations included the following items, which affect comparability between the years:

Fiscal 2010

- A gain of approximately $0.7 million from the settlement of an employment tax audit related to stock options, of which approximately $0.1 million was a reversal of accrued interest.

Fiscal 2009

- Approximately $14.8 million of tax benefits, of which $10.3 million relates to foreign tax credits associated with the repatriation of foreign cash and $4.5 million relates to the release of certain accruals upon settlement of an IRS audit;
- A gain of approximately $5.0 million from the settlement of an IRS employment tax audit related to stock options, of which approximately $1.5 million was a reversal of accrued interest;
- Restructuring costs of approximately $2.8 million related to our strategic initiatives, primarily the relocation of our e-commerce fulfillment center from Secaucus, New Jersey to our distribution center in Fort Payne, Alabama;
- Approximately $2.4 million of interest and deferred financing expenses related to repayments of our term loan;
- Approximately $2.1 million of professional fees related to our proxy contest; and
- An asset impairment charge of approximately $0.8 million for an underperforming store that had been open for less than two years.

We have subsidiaries in Canada, Hong Kong and Shanghai whose operating results are based in foreign currencies and are thus subject to the fluctuations of the corresponding translation rates into U.S. dollars. The below table summarizes the average translation rates impacting our operating results:

	Fiscal 2010	Fiscal 2009	Fiscal 2008
***Average Translation Rates*(1)**			
Canadian Dollar	0.9743	0.8913	0.9301
Hong Kong Dollar	0.1287	0.1290	0.1285
China Yuan Renminbi	0.1481	0.1464	0.1446

(1) The average translation rates are the average of the 12 monthly translation rates used during each fiscal year to translate the respective income statements. The rates represent the U.S. dollar equivalent of each foreign currency.

For Fiscal 2010, the effects of these translation rate changes on net sales, gross profit and income from continuing operations before income taxes were increases of $18.2 million, $8.7 million and $4.5 million, respectively. Net sales are affected only by the Canadian dollar translation rates. In addition to the translation rate changes, the gross profit of our Canadian subsidiary is also impacted by its inventory purchases which are priced in U.S. dollars. The effect of the exchange rate on these purchases was an increase to our gross profit of approximately $5.6 million in Fiscal 2010.

CRITICAL ACCOUNTING POLICIES

The preparation of consolidated financial statements in conformity with U.S. GAAP requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements, as well as the reported revenues and expenses during the reported period. In many cases, there are alternative policies or estimation techniques that could be used. We continuously review the application of our accounting policies and evaluate the appropriateness of the estimates used in preparing our financial statements; however, estimates routinely require adjustment based on changing circumstances and the receipt of new or better information. Consequently, actual results could differ from our estimates.

The accounting policies and estimates discussed below include those that we believe are the most critical to aid in fully understanding and evaluating our financial results. Senior management has discussed the development and selection of our critical accounting policies and estimates with the Audit Committee of our Board of Directors, which has reviewed our related disclosures herein.

Inventory Valuation Merchandise inventories are stated at the lower of average cost or market, using the retail inventory method. Under the retail inventory method, the valuation of inventories at cost and the resulting gross margins are calculated by applying a cost-to-retail ratio, for each merchandise department, to the retail value of inventories. An initial mark-up is applied to inventory at cost to establish a cost-to-retail ratio. Permanent markdowns, when taken, reduce both the retail and cost components of inventory on hand so as to maintain the already established cost-to-retail relationship. At any one time, inventories include items that have been marked down to our best estimate of the lower of their cost or fair market value and an estimate of our inventory shrinkage.

We base our decision to mark down merchandise upon its current rate of sale, the season, and the age and sell-through of the item. We estimate sell-through rates based upon historical and forecasted information. Markdown reserves are assessed and adjusted each quarter based on current sales trends and their resulting impact on forecasts. Our success is largely dependent upon our ability to gauge the fashion taste of our customers, and to provide a well-balanced merchandise assortment that satisfies customer demand. Throughout the year, we review our inventory in order to identify slow moving items and generally use markdowns to clear them. Any inability to provide the proper quantity of appropriate merchandise in a timely manner, or to correctly estimate the sell-through rate, could have a material impact on our consolidated financial statements. Our historical estimates have not differed materially from actual results and a 10% difference in our markdown reserve as of January 29, 2011 would have impacted net income by approximately $0.7 million. Our markdown reserve balance at January 29, 2011 and January 30, 2010 was approximately $11.2 million and approximately $12.9 million, respectively.

Additionally, we adjust our inventory based upon an annual physical inventory, which is taken during the last quarter of the fiscal year. Based on the results of our historical physical inventories, an estimated shrink rate is used for each successive quarter until the next annual physical inventory, or sooner if facts or circumstances should indicate differently. A 1% difference in our shrinkage rate at retail could impact each quarter's net income by approximately $0.6 million.

Stock-Based Compensation We account for stock-based compensation according to the provisions of the "*Compensation Stock Compensation*" topic of the FASB ASC.

Restricted Stock, Deferred Stock and Performance Awards

We grant restricted shares and deferred stock awards to our employees and non-employee directors and performance awards to certain key members of management. The fair value of these awards is based on the average of the high and low selling price of our common stock on the grant date. Compensation expense is recognized ratably over the related service period reduced for estimated forfeitures of those awards not expected to vest due to employee turnover. While actual forfeitures could vary significantly from those estimated, a 10% change in our forfeiture rate would impact our net income by approximately $0.2 million. In addition, the number of performance shares earned is dependent upon our operating results over a specified time period. The expense for performance shares is based on the number of shares we estimate will vest as a result of our earnings-to-date plus our estimate of future earnings for the performance period. For all outstanding performance awards as

Table of Contents

of January 29, 2011, the performance periods have concluded and therefore are not subject to estimates of future operating performance.

Stock Options

During fiscal 2008, we ceased issuing stock options in favor of deferred stock awards. The fair value of all outstanding stock options was estimated using the Black-Scholes option pricing model based on a Monte Carlo simulation, which requires extensive use of accounting judgment and financial estimates, including estimates of how long employees will hold their vested stock options before exercise, the estimated volatility of our common stock over the expected term, and the number of options that will be forfeited prior to the completion of vesting requirements. All exercise prices were based on the average of the high and low of the selling price of our common stock on the grant date. Total unamortized stock compensation at January 29, 2011 was not material and use of different assumptions regarding pricing and forfeitures would not have a material impact on our financial position or results of operations.

Insurance and Self-Insurance Liabilities Based on our assessment of risk and cost efficiency, we self-insure as well as purchase insurance policies to provide for workers' compensation, general liability, and property losses, as well as directors' and officers' liability, vehicle liability and employee medical benefits. We estimate risks and record a liability based upon historical claim experience, insurance deductibles, severity factors and other actuarial assumptions. These estimates include inherent uncertainties due to the variability of the factors involved, including type of injury or claim, required services by the providers, healing time, age of claimant, case management costs, location of the claimant, and governmental regulations. While we believe that our risk assessments are appropriate, these uncertainties or a deviation in future claims trends from recent historical patterns could result in our recording additional or reduced expenses, which may be material to our results of operations. Our historical estimates have not differed materially from actual results and a 10% difference in our insurance reserves as of January 29, 2011 would have impacted net income by approximately $0.6 million.

Impairment of Long-Lived Assets We periodically review our long-lived assets when events indicate that their carrying value may not be recoverable. Such events include a history trend or projected trend of cash flow losses or a future expectation that we will sell or dispose of an asset significantly before the end of its previously estimated useful life. In reviewing for impairment, we group our long-lived assets at the lowest possible level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities. In that regard, we group our assets into two categories: corporate-related and store-related. Corporate-related assets consist of those associated with our corporate offices, distribution centers and our information technology systems. Store-related assets consist of leasehold improvements, furniture and fixtures, certain computer equipment and lease related assets associated with individual stores.

For store-related assets, we review all stores that have been open for at least two years, or sooner if circumstances should dictate, on at least an annual basis. For each store that shows indications of operating losses, we project future cash flows over the remaining life of the lease and compare the total undiscounted cash flows to the net book value of the related long-lived assets. If the undiscounted cash flows are less than the related net book value of the long-lived assets, they are written down to their fair market value. We primarily determine fair market value to be the discounted future cash flows associated with those assets. In evaluating future cash flows, we consider external and internal factors. External factors comprise the local environment in which the store resides, including mall traffic, competition, and their effect on sales trends. Internal factors include our ability to gauge the fashion taste of our customers, control variable costs such as cost of sales and payroll, and in certain cases, our ability to renegotiate lease costs. Historically, less than 2% of our stores required impairment charges in any one year. If external factors should change unfavorably, if actual sales should differ from our projections, or if our ability to control costs is insufficient to sustain the necessary cash flows, future impairment charges could be material. At January 29, 2011, the average net book value per store was approximately $0.2 million.

Table of Contents

Income Taxes We utilize the liability method of accounting for income taxes as set forth in the "*Income Taxes"* topic of the FASB ASC. Under the liability method, deferred taxes are determined based on the temporary differences between the financial statement and tax basis of assets and liabilities using tax rates expected to be in effect during the years in which the basis differences reverse. A valuation allowance is recorded when it is more likely than not that some of the deferred tax assets will not be realized. In determining the need for valuation allowances we consider projected future taxable income and the availability of tax planning strategies. If, in the future we determine that we would not be able to realize our recorded deferred tax assets, an increase in the valuation allowance would decrease earnings in the period in which such determination is made.

We assess our income tax positions and record tax benefits for all years subject to examination based upon our evaluation of the facts, circumstances and information available at the reporting date. For those tax positions where it is more likely than not that a tax benefit will be sustained, we have recorded the largest amount of tax benefit with a greater than 50% likelihood of being realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information. For those income tax positions where it is not more likely than not that a tax benefit will be sustained, no tax benefit has been recognized in the financial statements.

Fair Value Measurement and Financial Instruments The "*Fair Value Measurements and Disclosure*" topic of the FASB ASC provides a single definition of fair value, together with a framework for measuring it, and requires additional disclosure about the use of fair value to measure assets and liabilities.

This topic defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date and establishes a three-level hierarchy, which encourages an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The three levels of the hierarchy are defined as follows:

Level 1 inputs to the valuation techniques that are quoted prices in active markets for identical assets or liabilities

Level 2 inputs to the valuation techniques that are other than quoted prices but are observable for the assets or liabilities, either directly or indirectly

Level 3 inputs to the valuation techniques that are unobservable for the assets or liabilities

The Company's cash and cash equivalents, accounts receivable, accounts payable, credit facilities and certain other short-term financial instruments are all short-term in nature. As such, their carrying amounts approximate fair value.

Recently Adopted Accounting Standards

We have reviewed recent accounting standards issued under FASB ASC and have determined that they will have no material financial impact on our condensed consolidated financial statements.

RESULTS OF OPERATIONS

We primarily evaluate the results of our operations as a percentage of net sales rather than in terms of absolute dollar increases or decreases by analyzing the year over year change in our business expressed as a percentage of net sales (i.e., "basis points"). For example, our selling, general and administrative expenses decreased approximately 70 basis points to 27.0% of net sales during Fiscal 2010 from 27.7% during Fiscal 2009. Accordingly, to the extent that our sales have increased at a faster rate than our costs (i.e., "leveraging"), the more efficiently we have utilized the investments we have made in our business. Conversely, if our costs grow at a faster pace than our sales

Table of Contents

(i.e., "de-leveraging"), we have less efficiently utilized the investments we have made in our business. The following table sets forth, for the periods indicated, selected income statement data expressed as a percentage of net sales.

	Fiscal Year Ended		
	January 29, 2011	January 30, 2010	January 31, 2009
Net sales	100.0%	100.0%	100.0%
Cost of sales	60.4	59.9	58.8
Gross profit	39.6	40.1	41.2
Selling, general and administrative expenses	27.0	27.7	28.9
Asset impairment charge	0.2	0.1	0.4
Other costs			
Depreciation and amortization	4.3	4.3	4.4
Operating income	8.1	7.9	7.5
Interest income (expense), net	(0.1)	(0.3)	(0.3)
Income from continuing operations before income taxes	8.1	7.6	7.2
Provision for income taxes	3.1	2.2	2.7
Income from continuing operations	5.0	5.4	4.5
Income (loss) from discontinued operations, net of income taxes			0.5
Net income (loss)	5.0%	5.4%	5.1%
Number of stores in continuing operations, end of period	995	947	917

Note:

Table may not add due to rounding.

The following tables sets forth by segment, for the periods indicated, net sales, gross profit and Gross Margin (in thousands).

	Fiscal Year Ended		
	January 29, 2011	January 30, 2010	January 31, 2009
Net sales:			
The Children's Place U.S.	$ 1,450,116	$ 1,441,562	$ 1,428,073
The Children's Place Canada	223,883	202,025	202,250
Total net sales	$ 1,673,999	$ 1,643,587	$ 1,630,323
Gross profit:			
The Children's Place U.S.	$ 555,888	$ 559,865	$ 568,059
The Children's Place Canada	107,260	99,636	103,754
Total gross profit	$ 663,148	$ 659,501	$ 671,813
Gross Margin:			
The Children's Place U.S.	38.3%	38.8%	39.8%
	47.9%	49.3%	51.3%

The Children's Place Canada			
Total Gross Margin	39.6%	40.1%	41.2%

Fiscal 2010 Compared to Fiscal 2009

Net sales increased $30.4 million, or 1.8%, to $1,674.0 million during Fiscal 2010 from $1,643.6 million during Fiscal 2009. Our net sales increase resulted from a $51.1 million increase in sales from new stores, as well as other stores that did not qualify as comparable stores, and an $18.2 million increase from favorable changes in the Canadian foreign exchange rate, partially offset by a Comparable Retail Sales decrease of 2.5%, or $38.9 million. Our 2.5% decrease in Comparable Retail Sales was primarily the result of a 4% decline in the average dollar transaction size partially offset by a 2% increase in the number of transactions. By department, Comparable Retail Sales were strongest for Accessories and Boys, and negative for Newborn and Girls. Regionally, U.S. Comparable Store Sales were down in all regions except the Southeast, which was flat.

On a segment basis, The Children's Place U.S. net sales increased $8.5 million, or 0.6%, to $1,450.1 million in Fiscal 2010 compared to $1,441.6 million in Fiscal 2009. This increase resulted from a $31.7 million increase in e-commerce sales and a $37.3 million increase in sales from new stores and other stores that did not qualify as comparable stores, mostly offset by a Comparable Store Sales decrease of 4.7%, or $60.5 million. The decrease in Comparable Store Sales resulted primarily from a 6% decline in the average dollar transaction size partially offset by a 1% increase in the number of transactions. E-commerce sales, as a percentage of net sales, increased to 9.0% in Fiscal 2010 from 7.3% in Fiscal 2009. The Children's Place Canada net sales increased $21.9 million, or 10.8%, to $223.9 million in Fiscal 2010 compared to $202.0 million in Fiscal 2009. This increase resulted primarily from an $18.2 million increase resulting from favorable changes in the Canadian exchange rates and a $13.8 million increase in sales from new stores and other stores that did not qualify as comparable stores partially offset by a decline in Comparable Store Sales of 4.9%, or $10.1 million. The decrease in Comparable Store Sales was primarily the result of a 6% decline in the average dollar transaction size partially offset by a 1% increase in the number of transactions.

During Fiscal 2010, we opened 67 stores, which included 58 in the United States and nine in Canada. We closed 19 stores in Fiscal 2010, all in the United States.

Gross profit increased by $3.6 million to $663.1 million during Fiscal 2010 from $659.5 million in Fiscal 2009. Gross Margin decreased 50 basis points to 39.6% during Fiscal 2010 from 40.1% during Fiscal 2009. This decrease resulted primarily from higher markdowns of approximately 90 basis points and higher buying and occupancy costs of approximately 20 basis points partially offset by a higher initial mark-up of approximately 50 basis points and lower production, design and other costs of approximately 10 basis points. Increased markdowns resulted from a lack of demand for the product assortment. Gross Margin at The Children's Place U.S. decreased approximately 50 basis points to 38.3% in Fiscal 2010 from 38.8% in Fiscal 2009. This decrease resulted primarily from higher markdowns of approximately 60 basis points and higher buying costs of approximately 10 basis points partially offset by lower production, design and other costs of approximately 20 basis points. Gross Margin at The Children's Place Canada decreased approximately 140 basis points to 47.9% in Fiscal 2010 from 49.3% in Fiscal 2009. This decrease resulted primarily from higher markdowns of approximately 230 basis points and higher occupancy costs of approximately 60 basis points partially offset by a higher initial mark-up of approximately 150 basis points. The higher initial mark-up was favorably impacted by changes in foreign exchange rates.

Selling, general and administrative expenses decreased $3.3 million to $452.5 million during Fiscal 2010 from $455.8 million during Fiscal 2009. As a percentage of net sales, SG&A decreased approximately 70 basis points to 27.0% during Fiscal 2010 from 27.7% during Fiscal 2009. The comparability of our SG&A was affected by the following items:

Fiscal 2010

- approximately $0.6 million, or 10 basis points, of accrual reversals related to the settlement of an employment tax audit related to stock options.

Fiscal 2009

- approximately $3.5 million, or 20 basis points, of accrual reversals related to the settlement of an IRS employment tax audit related to stock options;
- approximately $2.8 million, or 20 basis points, of severance charges from the relocation of our e-commerce fulfillment facility and buyout costs related to the elimination of our auto-lease program; and
- approximately $2.1 million, or 10 basis points, of professional fees associated with a proxy contest.

Excluding the effect of the above, SG&A decreased approximately $1.4 million, or 60 basis points, primarily as a result of the following:

- marketing expenses decreased approximately $9.1 million, or 60 basis points, due primarily to reductions in our direct mail and advertising programs;
- stock-based compensation expense decreased approximately $0.6 million, or 10 basis points, primarily related to a reduction in the expected number of performance shares that will vest.
- store expenses increased approximately $6.7 million, or 10 basis points. The increase in dollars is due to an average of 39 more stores in Fiscal 2010 and the de-leveraging is due primarily to a 2.5% decrease in Comparable Retail Sales partially offset by cost savings in supplies and repairs and maintenance; and
- pre-opening expenses increased approximately $1.0 million, or 10 basis points, resulting from opening 29 more stores in Fiscal 2010.

Asset impairment charges were $2.7 million during Fiscal 2010 compared to $2.2 million during Fiscal 2009. Asset impairment charges in Fiscal 2010 relate primarily to eight underperforming stores compared to 14 underperforming stores in Fiscal 2009. All underperforming stores were in The Children's Place U.S.

Depreciation and amortization was $71.6 million during Fiscal 2010 compared to $71.4 million in Fiscal 2009. As a percentage of sales, depreciation expense was 4.3% in each of Fiscal 2010 and Fiscal 2009.

Interest expense, net, was $1.5 million in Fiscal 2010, compared to $5.7 million in Fiscal 2009. Fiscal 2009 includes $3.9 million of interest expense related to an $85 million term loan that was fully repaid during the third quarter of Fiscal 2009. Also included in the interest expense during Fiscal 2009 is a $1.5 million accrued interest reduction resulting from the settlement of an IRS employment tax audit related to stock options and a $2.5 million charge related to the pre-payment of the remaining balance on our term loan.

Provision for income taxes was approximately $51.2 million during Fiscal 2010, compared to $35.5 million during Fiscal 2009. The increase of $15.7 million is due to a $10.5 million increase in income from continuing operations before income taxes and an increase in our effective tax rate to 38.0% in Fiscal 2010 from 28.6% in Fiscal 2009. The increase in our effective tax rate is due to discrete items during Fiscal 2009, including $10.3 million of foreign tax credits related to cash repatriations from our Canadian subsidiaries and a $4.5 million accrual reduction related to the settlement of an IRS audit.

Income (loss) from discontinued operations, net of income taxes was a loss of $0.5 million during each of Fiscal 2010 and Fiscal 2009. These losses relate to professional fees and accrual adjustments related to the wind-down of the Company's former subsidiaries that operated the Disney Store Business.

Net income was $83.1 million in Fiscal 2010, compared to $88.4 million in Fiscal 2009 due to the factors discussed above. Earnings per diluted share was $3.03 during Fiscal 2010 compared to $3.08 during Fiscal 2009. This decrease in earnings per diluted share is due to the decrease in net income partially offset by a lower weighted average common shares outstanding of approximately 1.3 million. During Fiscal 2010, we repurchased and retired approximately 1.9 million common shares under our share repurchase program and during Fiscal 2009, we repurchased and retired approximately 2.5 million common shares pursuant to a share repurchase agreement.

Fiscal 2009 Compared to Fiscal 2008

Net sales increased $13.3 million, or 0.8%, to $1,643.6 million during Fiscal 2009 from $1,630.3 million during Fiscal 2008. Our net sales increase resulted from $48.3 million of sales from new stores as well as stores that did not qualify as comparable stores, mostly offset by a Comparable Retail Sales decrease of 2.1%, or $29.8 million, and a $5.2 million decrease from unfavorable changes in the Canadian foreign exchange rate. The Comparable Retail Sales decrease is comprised of a Comparable Store Sales decrease of 3.8%, or $60.4 million, partially offset by an increase in e-commerce sales of 34.4%, or $30.6 million. Our 3.8% Comparable Store Sales decrease reflects a 1% decrease in the number of transactions and a 3% decrease in our average dollar transaction size.

On a segment basis, The Children's Place U.S. net sales increased $13.5 million, or 1.0%, to $1,441.6 million in Fiscal 2009 compared to $1,428.1 million in Fiscal 2008. This increase resulted from a $30.6 million increase in e-commerce sales and a $31.4 million increase in sales from new stores and other stores that did not qualify as comparable stores, partially offset by a Comparable Store Sales decrease of 3.8%, or $48.5 million. E-commerce sales, as a percentage of net sales, increased to 7.3% in Fiscal 2009 from 5.5% in Fiscal 2008. The decrease in Comparable Store Sales resulted primarily from a 3% decline in the average dollar transaction size while the number of transactions were flat. Comparable Store Sales were down in all regions and all departments except for accessories, which was flat. The Children's Place Canada net sales decreased $0.2 million, or 0.1%, to $202.0 million in Fiscal 2009 compared to $202.2 million in Fiscal 2008. This decrease resulted from a Comparable Store Sales decrease of 6.0%, or $11.9 million and a $5.2 million decrease resulting from changes in the Canadian exchange rates mostly offset by a $16.9 million increase in sales from new stores and other stores that did not qualify as comparable stores. The decrease in Comparable Store Sales was primarily attributable to a 3% decline in the number of transactions and a 3% decrease in the average dollar transaction size. Comparable Store Sales were down in all departments except for accessories.

During Fiscal 2009, we opened 38 stores, which included 30 in the United States and eight in Canada. We closed eight stores in Fiscal 2009, all in the United States.

Gross profit decreased by $12.3 million to $659.5 million during Fiscal 2009 from $671.8 million in Fiscal 2008. Gross Margin decreased 110 basis points to 40.1% during Fiscal 2009 from 41.2% during Fiscal 2008. This decrease resulted primarily from higher markdowns of approximately 120 basis points and higher occupancy of approximately 30 basis points partially offset by lower production, design and other costs of approximately 20 basis points, a higher initial mark-up of approximately 10 basis points and lower buying costs of approximately 10 basis points. Increased markdowns resulted from higher inventory levels due to lower Comparable Store Sales as noted above. Gross Margin at The Children's

Place U.S. decreased approximately 100 basis points to 38.8% in Fiscal 2009 from 39.8% in Fiscal 2008. This decrease resulted primarily from higher markdowns of approximately 120 basis points and higher occupancy of approximately 20 basis points partially offset by a higher initial mark-up of approximately 20 basis points and lower production, design and other costs of approximately 20 basis points. Gross Margin at The Children's Place Canada decreased approximately 200 basis points to 49.3% in Fiscal 2009 from 51.3% in Fiscal 2008. This decrease resulted primarily from higher occupancy of approximately 110 basis points, a lower initial mark-up of approximately 70 basis points and higher markdowns of approximately 50 basis points partially offset by lower production, design and other costs of approximately 30 basis points. Gross profit at The Children's Place Canada was also negatively impacted by changes in foreign exchange rates.

Selling, general and administrative expenses decreased $15.5 million to $455.8 million during Fiscal 2009 from $471.3 million during Fiscal 2008. As a percentage of net sales, SG&A decreased approximately 120 basis points to 27.7% during Fiscal 2009 from 28.9% during Fiscal 2008. The comparability of our SG&A was affected by the following items:

Fiscal 2009

- approximately $3.5 million, or 20 basis points of accrual reversals related to the settlement of an IRS employment tax audit related to stock options;
- approximately $2.8 million, or 20 basis points, of severance charges from the relocation of our e-commerce fulfillment facility and buyout costs related to the elimination of our auto-lease program; and
- approximately $2.1 million, or 10 basis points, of professional fees associated with a proxy contest.

Fiscal 2008

- approximately $11.6 million or 70 basis points of transition service income, net of variable expenses, related to administrative and distribution services provided to affiliates of Disney as part of the Sale;
- approximately $2.3 million or 10 basis points of gain related to the sale of a store lease; and
- professional fees, net of recoveries, of approximately $3.1 million, or 20 basis points, primarily legal costs related to the stock option investigation and strategic review.

Excluding the effect of the above, SG&A decreased approximately $27.7 million, or 190 basis points. We were able to reduce these expenses primarily as a result of the following:

Favorable variances

- store operating expenses, excluding payroll, decreased approximately $7.8 million, or 50 basis points. This decrease is due primarily to cost containment measures in supplies, repairs and maintenance and information technology;
- incentive bonus decreased approximately $5.6 million, or 40 basis points, resulting from a lower payout in Fiscal 2009 due to operating results lower than planned;
- marketing expenses decreased approximately $3.9 million, or 30 basis points, which was primarily attributable to a reduction in our direct mailing programs;

professional fees decreased approximately $5.1 million, or 30 basis points, resulting from reductions in consulting, legal and accounting fees;

Table of Contents

- administrative payroll decreased approximately $3.0 million, or 20 basis points, resulting from a decrease in headcount;

- foreign currency transaction gains of $0.5 million in Fiscal 2009 compared to losses of $2.7 million in Fiscal 2008 resulted in leveraging of approximately 20 basis points. This was due to favorable changes in foreign currency rates, primarily the Canadian Dollar;

- corporate facility expense decreased approximately $1.0 million, or 10 basis points, due to lower utilities and cost containment measures on supplies; and

- employee service costs decreased approximately $1.4 million, or 10 basis points, due to the elimination of our auto lease program and no significant employee relocation costs in Fiscal 2009.

Unfavorable variance

- store payroll and benefit costs increased approximately $6.3 million, or 30 basis points. This de-leveraging was the result of the 4% decrease in Comparable Store Sales while the number of transactions decreased only 1%.

Asset impairment charges were $2.2 million during Fiscal 2009 compared to $6.5 million during Fiscal 2008. Asset impairment charges in Fiscal 2009 relate primarily to 14 underperforming stores compared to 18 underperforming stores in Fiscal 2008.

Other costs of $0.2 million during Fiscal 2008 related to interest accretion from our decision to exit the Emerson Lane administrative office lease. There were no other costs in Fiscal 2009.

Depreciation and amortization was $71.4 million during each of Fiscal 2009 and Fiscal 2008. As a percentage of sales, depreciation expense was 4.3% in Fiscal 2009 compared to 4.4% in Fiscal 2008.

Interest (expense) income, net, was expense of $5.7 million in Fiscal 2009, compared to expense of $4.9 million in Fiscal 2008. The increase in net interest expense is due primarily to lower interest income of $2.5 million and increased unused line fees on our credit facility of $0.5 million mostly offset by lower interest expense associated with our term loan and credit facilities of $2.6 million. The lower interest expense resulted from a lower average outstanding debt balance during Fiscal 2009 compared to Fiscal 2008. Also included in the interest expense during Fiscal 2009 is a $1.5 million accrued interest reduction resulting from the settlement of an IRS employment tax audit related to stock options and a $2.5 million charge related to the pre-payment of the remaining balance on our term loan.

Provision for income taxes was approximately $35.5 million during Fiscal 2009, compared to $43.5 million during Fiscal 2008, and our effective tax rate was 28.6% in Fiscal 2009, compared to 37.1% in Fiscal 2008. The decrease in the effective tax rate resulted primarily from discrete items during Fiscal 2009, including $10.3 million of foreign tax credits related to cash repatriations from our Canadian subsidiaries and a $4.5 million accrual reduction related to the settlement of an IRS audit.

Income (loss) from discontinued operations, net of income taxes was a loss of $0.5 million during Fiscal 2009, compared to income of approximately $8.4 million during Fiscal 2008. The loss in Fiscal 2009 relates to legal fees incurred in winding down the Disney Store Business. The income in Fiscal 2008 is due primarily to a $22.2 million pre-tax gain on the Sale, and a $25.5 million gain on the relief of indebtedness of the Hoop Entities mostly offset by operating losses of $13.1 million and restructuring charges of $18.8 million.

Net income was $88.4 million in Fiscal 2009, compared to $82.4 million in Fiscal 2008 due to the factors discussed above.

Table of Contents

LIQUIDITY AND CAPITAL RESOURCES

Debt Service/Liquidity

Our working capital needs follow a seasonal pattern, peaking during the third quarter when inventory is purchased for the back-to-school and winter selling seasons. Our primary uses of cash are the financing of new store openings, other capital projects, working capital requirements, principally inventory purchases, and the repurchase of our common stock.

Our working capital increased $35.9 million to $347.3 million at January 29, 2011 compared to $311.4 million at January 30, 2010. This increase is primarily due to cash generated from operations mostly offset by cash paid for share repurchases. During Fiscal 2010, under our $100 million share repurchase program, we repurchased approximately 1.9 million shares for approximately $90.0 million. Subsequent to January 29, 2011 and through March 23, 2011, we repurchased an additional 0.2 million shares for approximately $10.5 million, which completed the initial share repurchase program and began the new share repurchase program announced on March 3, 2011. As of January 29, 2011, we had no borrowings under our credit facility. Our credit facility provides for borrowings up to the lesser of $200 million or our borrowing base, as defined by the credit facility agreement (see "Credit Facilities" below). At January 29, 2011, our borrowing base was $168.4 million.

On June 11, 2009, we received a notice of assessment in the amount of approximately 2.3 million Canadian dollars from Revenue Quebec regarding our sales tax filings. We have objected to the assessment and believe that upon review it will be reversed. During the third quarter of fiscal 2009, Revenue Quebec required us to guarantee the assessed amount in the form of a deposit into a restricted cash account. Until such time that the pending assessment is resolved, the balance of the account remains the property of the Company. This amount is shown on the accompanying consolidated balance sheet as restricted cash. At January 29, 2011 and January 30, 2010, the U.S. dollar value of this deposit was $2.3 million and $2.1 million, respectively.

On August 3, 2009, pursuant to a securities purchase agreement, we purchased approximately 2.5 million shares of our common stock at a price of $28.88 per share. Total cost of this share repurchase was $73.5 million, which included transaction costs of approximately $2.7 million.

During Fiscal 2009, we re-paid in full our $85.0 million term loan (see "Term Loan" below).

During the latter part of Fiscal 2010, we have observed material increases in the price of cotton and anticipate such prices will escalate through Fiscal 2011. We expect to mitigate these higher prices through product cost engineering, mix changes and retail price increases.

We expect to be able to meet our capital requirements principally by using our cash on hand, cash flows from operations and availability under our credit facility.

Credit Facilities

On July 31, 2008, we and certain of our domestic subsidiaries entered into a five year credit agreement (the "2008 Credit Agreement") with Wells Fargo Retail Finance, LLC ("Wells Fargo"), Bank of America, N.A., HSBC Business Credit (USA) Inc., and JPMorgan Chase Bank, N.A. as lenders and Wells Fargo, as Administrative Agent, Collateral Agent and Swing Line Lender.

The 2008 Credit Agreement consists of a $200 million asset based revolving credit facility, with a $175 million sublimit for standby and documentary letters of credit. Revolving credit loans outstanding under the 2008 Credit Agreement bear interest, at our option, at:

(i) the prime rate plus a margin of 0.0% to 0.5% based on the amount of our average excess availability under the facility; or

Table of Contents

(ii) the London InterBank Offered Rate, or "LIBOR", for an interest period of one, two, three or six months, as selected by us, plus a margin of 2.00% to 2.50% based on the amount of our average excess availability under the facility.

An unused line fee of 0.50% or 0.75%, based on total facility usage, will accrue on the unused portion of the commitments under the facility. Letter of credit fees range from 1.25% to 1.75% for commercial letters of credit and range from 2.00% to 2.50% for standby letters of credit. Letter of credit fees are determined based on the daily average undrawn stated amount of such outstanding letters of credit. The 2008 Credit Agreement expires on July 31, 2013. The amount available for loans and letters of credit under the 2008 Credit Agreement is determined by a borrowing base consisting of certain credit card receivables, certain inventory and the fair market value of certain real estate, subject to certain reserves.

The outstanding obligations under the 2008 Credit Agreement may be accelerated upon the occurrence of certain events, including, among others, non-payment, breach of covenants, the institution of insolvency proceedings, defaults under other material indebtedness and a change of control, subject, in the case of certain defaults, to the expiration of applicable grace periods. Since August 1, 2010, we are no longer subject to any early termination fees.

The 2008 Credit Agreement contains covenants, which include limitations on annual capital expenditures, share repurchase programs and the payment of dividends or similar payments. Credit extended under the 2008 Credit Agreement is secured by a first or second priority security interest in substantially all of our assets.

On August 18, 2010 and also on March 7, 2011, in connection with the approval of our share repurchase programs, the 2008 Credit Agreement was amended to increase the allowable amount, subject to certain conditions, that we may spend on share repurchases.

We capitalized an aggregate of approximately $2.6 million in deferred financing costs related to the 2008 Credit Agreement, which is being amortized on a straight-line basis over its term.

The following table presents the components (dollars in millions) of the Company's credit facilities:

	January 29, 2011	**January 30, 2010**
Credit facility maximum	$ 200.0	$ 200.0
Borrowing Base	168.4	164.1
Outstanding borrowings		
Letters of credit outstanding merchandise	41.3	32.4
Letters of credit outstanding standby	11.0	15.2
Utilization of credit facility at end of period	52.3	47.6
Availability	$ 116.1	$ 116.5
Interest rate at end of period	3.3%	3.3%

	Fiscal 2010	**Fiscal 2009**
Average end of day loan balance during the period		0.1
Highest end of day loan balance during the period	0.1	3.3
Average interest rate	3.3%	3.3%

Term Loan

On July 31, 2008, concurrently with the execution of the 2008 Credit Agreement, we and certain of our domestic subsidiaries and Sankaty Credit Opportunities III, L.P., Sankaty Credit Opportunities IV, L.P., RGIP, LLC, Crystal Capital Fund, L.P., Crystal Capital Onshore Warehouse LLC, 1903 Onshore Funding, LLC, and Bank of America, N.A., all as note purchasers, together with Sankaty Advisors, LLC, as Collateral Agent, and Crystal Capital Fund Management, L.P., as Syndication Agent, entered into a note purchase agreement ("Note Purchase Agreement").

Under the Note Purchase Agreement, we issued $85.0 million of non-amortizing secured notes (the "Notes") which were due and payable on July 31, 2013. Amounts outstanding under the Note Purchase Agreement bore interest at the greater of (i) LIBOR, for an interest period of one, two, three or six months, as selected by the Company, or (ii) 3.00%, plus, in each case, a margin of between 8.50% and 9.75% depending on our leverage ratio.

On April 13, 2009, we prepaid $47.0 million of the Notes, which included a $32.0 million mandatory payment plus a penalty free optional payment of $15.0 million. On August 3, 2009, the remaining principal amount of $38.0 million was prepaid (the "Final Payment"). In accordance with the terms of the Note Purchase Agreement, we were required to pay a prepayment premium of 1.5%, or approximately $0.6 million, on the Final Payment. Also, in connection with the Final Payment, the Note Purchase Agreement and our obligations under the Note Purchase Agreement were terminated.

Cash Flows/ Capital Expenditures

Cash flows provided by operating activities were $174.5 million and $155.2 million during Fiscal 2010 and Fiscal 2009, respectively. The net increase of $19.3 million resulted primarily from the following:

- the timing of payments on accounts payable and other current liabilities, primarily in-transit inventory, payroll and occupancy costs, which resulted in lower cash outflows of approximately $21.5 million;

- lower cash outflows from deferred rent and other liabilities of approximately $5.9 million, primarily from lower lease costs related to our store expansion program;

- net income, exclusive of non-cash charges, increased by approximately $3.4 million due primarily to higher net sales and the lower SG&A expenses; and

- an increase in inventory during Fiscal 2010 compared to a decrease during Fiscal 2009 resulted in approximately $10.9 million of net cash outflows.

Cash flows used in investing activities were $84.3 million and $64.3 million during Fiscal 2010 and Fiscal 2009, respectively. Cash paid for capital expenditures was $83.9 million in Fiscal 2010 compared to $62.2 million in Fiscal 2009. This increase of $21.7 million resulted primarily from Fiscal 2010 having 29 more store openings. Fiscal 2009 also included a $2.1 million restriction of cash.

Cash flows used in financing activities were $78.0 million and $154.0 million in Fiscal 2010 and Fiscal 2009, respectively. Fiscal 2010 includes payments of $90.6 million for purchases of our common stock, primarily related to our share repurchase program, partially offset by $12.6 million of proceeds from the exercise of stock options and related tax benefits. Fiscal 2009 includes the full repayment of our $85.0 million term loan, stock repurchases of $74.0 million and $1.0 million paid for deferred financing costs partially offset by $6.0 million of proceeds from the exercise of stock options.

We estimate that total capital expenditures will be in the range of $85 to $90 million in Fiscal 2011. Our increased planned capital expenditures for Fiscal 2011 reflects the anticipation of opening 85 stores and remodeling 90 stores compared to 67 store openings and 35 remodels in Fiscal 2010.

Table of Contents

Approximately $60 million of our planned capital expenditures is expected to provide for new store openings and remodels, and we anticipate receiving approximately $11.5 million in related lease incentives during Fiscal 2011. The remainder of our Fiscal 2011 capital expenditure budget will be utilized for information technology, including merchandising and e-commerce systems, and other initiatives.

Our ability to meet our capital requirements in Fiscal 2011 depends on our ability to generate cash flows from operations and our available borrowings under our credit facility. Cash flow generated from operations depends on our ability to achieve our financial plans. We believe that cash on hand, cash generated from operations and funds available to us through our credit facility will be sufficient to fund our capital and other cash flow requirements over the next 12 months. Further, we do not expect the current economy to preclude us from meeting our cash requirements.

Historically, we have funded our capital expenditures primarily from operations, with occasional seasonal advances on our debt facilities. In Fiscal 2010, Fiscal 2009 and Fiscal 2008, our cash generated from operations along with existing cash on hand provided sufficient funds for our capital requirements.

CONTRACTUAL OBLIGATIONS AND COMMERCIAL COMMITMENTS

The following tables summarize our contractual and commercial obligations for continuing operations as of January 29, 2011:

Contractual Obligations (dollars in thousands)	Payment Due By Period Total	1 year or less	1-3 years	3-5 years	More than 5 years
Operating leases(1)	$ 880,589	$ 154,332	$ 250,606	$ 185,959	$ 289,692
Employment contracts(2)	16,900	16,900			
New store and remodel capital expenditure commitments (3)	21,600	21,600			
Total Contractual Obligations	$ 919,089	$ 192,832	$ 250,606	$ 185,959	$ 289,692

Other Commercial Commitments (dollars in thousands)	Amounts of Commitment Expiration Per Period Total	1 year or less	1-3 years	3-5 years	More than 5 years
Credit facilities	$	$	$	$	$
Purchase commitments(4)	287,786	287,786			
Merchandise letters of credit	41,300	41,300			
Standby letters of credit(5)	11,000	11,000			
Total Other Commercial Commitments	340,086	340,086			
Total Contractual Obligations and Other Commercial Commitments	$ 1,259,175	$ 532,918	$ 250,606	$ 185,959	$ 289,692

(1) Certain of our operating leases include common area maintenance and other charges in our monthly rental expense. For other leases which do not include these charges in the minimum lease payments, we incur monthly charges, which are billed and recorded separately. These additional charges approximated 58% of our minimum lease payments over the last three fiscal years. Additionally, our minimum lease obligation does not include contingent rent based upon sales volume, which represented approximately 1.4% of our minimum lease payments over the last three fiscal years.

(2)
We have an employment agreement with our Chief Executive Officer, which provides for severance of two times the sum of base salary plus bonus, and certain benefits following any termination without cause or for "good reason". As of January 29, 2011, these severance benefits approximated $4.0 million. In the event of a change in control of the Company, certain executives will receive, in the aggregate, approximately $16.9 million of severance benefits should they either be terminated or suffer a degradation of duties as defined in their agreement. On February 11, 2011, we announced the resignation of Susan J. Riley, our Executive Vice President of Finance and Administration, and agreed to end her employment with us effective March 4, 2011. Ms. Riley's change in control benefits of $1.8 million, which is included in the aggregate amount above, ended with the announcement of her resignation on February 11, 2011.

(3)
As of January 29, 2011, we had executed 49 leases for new stores and 15 remodels. This amount represents our estimate of the capital expenditures required to open and begin operating the new and remodeled stores.

(4)
Represents purchase orders for merchandise for re-sale of approximately $286.6 million and equipment, construction and other non-merchandise commitments of approximately $1.2 million.

(5)
Represents letters of credit issued to landlords, banks and insurance companies.

We self-insure and purchase insurance policies to provide for workers' compensation, general liability, and property losses, as well as directors' and officers' liability, vehicle liability and employee medical benefits, as described in Note 1 of the Notes to our Consolidated Financial Statements. Insurance reserves of approximately $5.8 million are included in other long term liabilities as of January 29, 2011. The long-term portion represents the total amount estimated to be paid beyond one year. We are not able to further estimate in which periods the long-term portion will be paid.

As discussed more fully in Note 12 of the Notes to our Consolidated Financial Statements, our long-term liabilities include unrecognized tax benefits of approximately $15.2 million at January 29, 2011. We cannot make a reasonable estimate of the amount and period of related future payments for any of this amount.

Off-Balance Sheet Arrangements

None.

QUARTERLY RESULTS AND SEASONALITY

Our quarterly results of operations have fluctuated and are expected to continue to fluctuate materially depending on a variety of factors, including overall economic conditions, the timing of new store openings and related pre-opening and other startup costs, net sales contributed by new stores, increases or decreases in Comparable Store Sales, weather conditions, shifts in timing of certain holidays, changes in our merchandise mix and pricing strategy. The combination and severity of one or more of these factors could result in material fluctuations.

Table of Contents

The following table sets forth certain statement of operations data and selected operating data for each of our last four fiscal quarters. Quarterly information for Fiscal 2009 is included in Note 15 of the Notes to our Consolidated Financial Statements. The quarterly statement of operations data and selected operating data set forth below were derived from our unaudited consolidated financial statements and reflect, in our opinion, all adjustments (consisting only of normal recurring adjustments) necessary to fairly present the results of operations for these fiscal quarters (in thousands, except per share data) (unaudited):

	Fiscal Year Ended January 29, 2011			
	First Quarter	**Second Quarter**	**Third Quarter**	**Fourth Quarter(1)**
Net sales	$ 422,133	$ 345,301	$ 453,395	$ 453,170
Gross profit	179,704	113,574	182,343	187,527
Selling, general and administrative expenses	113,455	107,281	114,210	117,513
Asset impairment charges	930	1,222	354	207
Depreciation and amortization	17,625	18,199	17,738	18,078
Operating income (loss)	47,694	(13,128)	50,041	51,729
Income (loss) from continuing operations before income taxes	47,238	(13,509)	49,651	51,426
Provision (benefit) for income taxes	19,231	(5,241)	18,493	18,736
Income (loss) from continuing operations	28,007	(8,268)	31,158	32,690
Income (loss) from discontinued operations, net of income taxes	(105)	35	151	(544)
Net income (loss)	27,902	(8,233)	31,309	32,146
Basic earnings (loss) per share amounts				
Income (loss) from continuing operations	$ 1.02	$ (0.30)	$ 1.16	$ 1.25
Income (loss) from discontinued operations, net of taxes	(0.00)	0.00	0.01	(0.02)
Net income (loss)	1.01	(0.30)	1.16	1.23
Basic weighted average common share outstanding	27,583	27,755	26,907	26,091
Diluted earnings (loss) per share amounts				
Income (loss) from continuing operations	$ 1.00	$ (0.30)	$ 1.14	$ 1.24
Income (loss) from discontinued operations, net of taxes	(0.00)	0.00	0.01	(0.02)
Net income (loss)	1.00	(0.30)	1.15	1.22
Diluted weighted average common share outstanding	27,930	27,755	27,238	26,452

* Per share amounts may not add due to rounding.

(1) Significant items impacting the fourth quarter of Fiscal 2010 include a reversal of stock-based compensation expense of approximately $1.6 million related to a reduction in the expected number of performance shares that will vest.

ITEM 7A QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

In the normal course of business, our financial position and results of operations are routinely subject to market risk associated with interest rate movements on borrowings and investments and currency rate movements on non-U.S. dollar denominated assets, liabilities and income. We utilize cash from operations and, if necessary, short-term borrowings to fund our working capital and investment needs.

Table of Contents

Cash and Cash Equivalents

Cash and cash equivalents are normally invested in short-term financial instruments that will be used in operations within 90 days of the balance sheet date. Because of the short-term nature of these instruments, changes in interest rates would not materially affect their fair value.

Interest Rates

Our credit facility bears interest at a floating rate equal to the prime rate or LIBOR, plus a calculated spread based on our average excess availability. As of January 29, 2011, we had no borrowings under the credit facility. During Fiscal 2010, end of day borrowings were not material and any change in interest rates would not have a material impact on our interest expense.

Foreign Assets and Liabilities

Assets and liabilities outside the United States are primarily located in Canada and Hong Kong. Our investments in our Canadian subsidiaries are considered long-term; however, we are not deemed to be permanently reinvested in our Hong Kong subsidiary. We do not hedge these net investments nor are we party to any derivative financial instruments. As of January 29, 2011, net assets in Canada and Hong Kong were approximately $114.6 million and $6.8 million, respectively. A 10% increase or decrease in the Canadian and Hong Kong exchange rates would increase or decrease the corresponding net investment by approximately $11.5 million and $0.7 million, respectively. All changes in the net investment of our foreign subsidiaries are recorded in other comprehensive income as unrealized gains or losses.

As of January 29, 2011, we had approximately $77.9 million of our cash and investment balances held in foreign countries, of which approximately $69.8 million was in Canada, $5.6 million was in Hong Kong and $2.5 million was in China.

Foreign Operations

Approximately 13% of our consolidated net sales and total costs and expenses are transacted in foreign currencies. As a result, fluctuations in exchange rates impact the amount of our reported sales and expenses. Assuming a 10% change in foreign exchange rates, Fiscal 2010 net sales and operating expenses could have decreased or increased by approximately $22.4 million and $21.5 million, respectively. Additionally, we have foreign currency denominated receivables and payables that when settled, result in transaction gains or losses. At January 29, 2011, we had foreign currency denominated receivables and payables, including intercompany balances, of approximately $3.0 million and $6.1 million, respectively. We have not used derivatives to manage foreign currency exchange risk, and no foreign currency exchange derivatives were outstanding at January 29, 2011.

While we do not have substantial financial assets in China, we import a large percentage of our merchandise from that country. Consequently, any significant or sudden change in China's political, foreign trade, financial, banking or currency policies and practices could have a material adverse impact on our financial position, results of operations or cash flows.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The information required by this Item is incorporated herein by reference to the consolidated financial statements and supplementary data set forth in "Item 15 Exhibits and Financial Statement Schedules" of Part III of this Annual Report on Form 10-K.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

Not applicable.

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Management, including our Chief Executive Officer, our Interim Principal Accounting Officer, and our Interim Principal Financial Officer evaluated the effectiveness of our disclosure controls and procedures as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), as of January 29, 2011. Based on that evaluation, our Chief Executive Officer, Interim Principal Accounting Officer and our Interim Principal Financial Officer concluded that our disclosure controls and procedures were effective as of January 29, 2011 to ensure that all information required to be disclosed in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms and is accumulated and communicated to our management, including our principal executive and principal financial officer, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

Management's Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as defined in Securities Exchange Act Rule 13a-15(f). Internal control over financial reporting is a process to provide reasonable assurance regarding the reliability of our financial reporting for external purposes in accordance with accounting principles generally accepted in the United States of America. Because of its inherent limitations, internal control over financial reporting is not intended to provide absolute assurance that a misstatement of our financial statements would be prevented or detected.

Under the supervision and with the participation of our management, including our principal executive officers, we conducted an evaluation of the design and effectiveness of our internal control over financial reporting based on the criteria set forth in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"). Based on our evaluation under the framework in *Internal Control Integrated Framework*, our management concluded that our internal control over financial reporting was effective as of January 29, 2011. Our independent registered public accounting firm that audited the consolidated financial statements included in this annual report has issued an attestation report on our internal control over financial reporting, which is included herein.

Changes in Internal Control Over Financial Reporting

There has been no change in our internal control over financial reporting that occurred during our last fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

Report of Independent Registered Public Accounting Firm

To the Stockholders and Board of Directors of
The Children's Place Retail Stores, Inc.
Secaucus, New Jersey:

We have audited The Children's Place Retail Stores, Inc. and subsidiaries' (the "Company") internal control over financial reporting as of January 29, 2011, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying "Item 9A, Management's Report on Internal Control Over Financial Reporting". Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of January 29, 2011, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of the Company as of January 29, 2011 and January 30, 2010, and the related consolidated statements of operations, changes in stockholders' equity, and cash flows for each of the three fiscal years in the period ended January 29, 2011 and our report dated March 28, 2011 expressed an unqualified opinion thereon.

/s/ BDO USA, LLP

New York, NY
March 28, 2011

Table of Contents

ITEM 9B. OTHER INFORMATION

None.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required to be included by Item 10 of Form 10-K will be set forth in the Company's proxy statement for its 2011 annual meeting of stockholders to be filed within 120 days after January 29, 2011 (the "Proxy Statement") and is incorporated by reference herein.

ITEM 11. EXECUTIVE COMPENSATION

The information required to be included by Item 11 of Form 10-K will be set forth in the Proxy Statement and is incorporated by reference herein.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required to be included by Item 12 of Form 10-K will be set forth in the Proxy Statement and is incorporated by reference herein.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required to be included by Item 13 of Form 10-K will be set forth in the Proxy Statement and is incorporated by reference herein.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required to be included by Item 14 of Form 10-K will be set forth in the Proxy Statement and is incorporated by reference herein.

Table of Contents

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a)(1) Financial Statements

The following documents are filed as part of this report:

Table of Contents

Report of Independent Registered Public Accounting Firm

To the Stockholders and Board of Directors of
The Children's Place Retail Stores, Inc.
Secaucus, New Jersey:

We have audited the accompanying consolidated balance sheets of The Children's Place Retail Stores, Inc. and subsidiaries (the "Company") as of January 29, 2011 and January 30, 2010 and the related consolidated statements of operations, changes in stockholders' equity, and cash flows for each of the three fiscal years in the period ended January 29, 2011. In connection with our audits of the financial statements, we have also audited the financial statement schedule listed in the accompanying index. These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements and schedule. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of The Children's Place Retail Stores, Inc. and subsidiaries as of January 29, 2011 and January 30, 2010, and the results of its operations and its cash flows for each of the three fiscal years in the period ended January 29, 2011, in conformity with accounting principles generally accepted in the United States.

Also, in our opinion, the financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), The Children's Place Retail Stores, Inc. and subsidiaries' internal control over financial reporting as of January 29, 2011, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated March 28, 2011 expressed an unqualified opinion thereon.

/s/ BDO USA, LLP

New York, NY
March 28, 2011

Table of Contents

THE CHILDREN'S PLACE RETAIL STORES, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(In thousands, except share information)

	January 29, 2011	January 30, 2010
ASSETS		
Current assets:		
Cash and cash equivalents	$ 183,657	$ 168,380
Restricted cash	2,258	2,112
Accounts receivable	16,121	16,910
Inventories	210,523	206,227
Prepaid expenses and other current assets	46,860	45,713
Deferred income taxes	18,282	17,540
Total current assets	477,701	456,882
Long-term assets:		
Property and equipment, net	320,601	312,801
Deferred income taxes	51,931	79,934
Other assets	4,098	4,443
Total assets	$ 854,331	$ 854,060
LIABILITIES AND STOCKHOLDERS' EQUITY		
LIABILITIES:		
Current liabilities:		
Accounts payable	$ 50,730	$ 55,547
Income taxes payable	1,143	1,212
Accrued expenses and other current liabilities	78,523	88,757
Total current liabilities	130,396	145,516
Long-term liabilities:		
Deferred rent liabilities	94,394	98,705
Other tax liabilities	15,184	15,396
Other long-term liabilities	6,630	5,473
Total liabilities	246,604	265,090
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS' EQUITY:		
Preferred stock, $1.00 par value, 1,000,000 shares authorized, 0 shares issued and outstanding at January 29, 2011		
Common stock, $0.10 par value, 100,000,000 shares	2,613	2,747

authorized, 26,136,084 and 27,474,774 issued and outstanding at January 29, 2011 and January 30, 2010, respectively				
Additional paid-in capital	209,960	204,646		
Accumulated other comprehensive income	13,157	7,561		
Retained earnings	381,997	374,016	$ 2,947,985	100%

As of September 30, 2007, the Company had three customers that accounted for 18%, 19% and 34% of net receivables, respectively. As of September 30, 2006, the Company had three customers that accounted for 11%, 29% and 50% of net receivables, respectively.

9. 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, 2006 for a description of material legal proceedings, including the proceedings discussed below.

Securities and Exchange Commission Litigation. As previously disclosed in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2006, the SEC temporarily suspended the trading of the Company's securities on January 17, 2006 and advised the Company that it was conducting a non-public investigation. On September 11, 2007, the Company was informed that Dennis Michael Nouri, its then serving President, Chief Executive Officer, and a director, had been charged in a criminal complaint that alleges federal securities fraud and conspiracy to commit fraud. The Company is not named in the criminal complaint. The U.S. government filed the complaint under seal on August 1, 2007 in the U.S. District Court for the Southern District of New York. Also named as defendants in the criminal complaint are Reeza Eric Nouri, a former manager of the Company, and Ruben Serrano, Anthony Martin, James Doolan, and Alain Lustig, brokers alleged to have participated with the Nouris in the alleged fraud. The criminal complaint alleges that the defendants, directly and indirectly, used manipulative and deceptive devices in violation of Sections 2 and 371 of Title 18 of the U.S. Code, Sections 10(b) and 32 of the Securities Exchange Act of 1934, as amended ("the Exchange Act"), and Rule 10b-5 promulgated under the Exchange Act ("Rule 10b-5"). On November 8, 2007, as part of this on-going action, the U.S. government filed a grand jury indictment against Dennis Michael Nouri, Reeza Nouri, Reuben Serrano and Alain Lustig in the U.S. District Court for the Southern District of New York. The grand jury indictment charges these defendants with conspiracy to commit securities fraud in violation of Sections 78j(b) and 78 ff of Title 17 of the U.S. Code and Rule 10b-5, wire fraud in violation of Sections 1343 and 1346 of Title 18 of the U.S. Code and commercial bribery in violation of Section 1952(a)(3) of Title 18 of the U.S. Code and Sections 180.00 and 180.03 of the New York State Penal Law. Under the grand jury indictment, the U.S. government is seeking forfeiture from these defendants of all property, real and personal, that constitutes or is derived from proceeds traceable to the commission of the alleged securities fraud offenses.

On September 11, 2007, the SEC filed a civil action against the Company and the defendants named in the criminal complaint in the U.S. District Court for the Southern District of New York. The SEC complaint alleged that the defendants in this civil action, either directly or indirectly, engaged in transactions, acts, practices, and courses of business which constitute violations of Section 17(a) of the Securities Act of 1933, as amended ("the Securities Act"), Section 10(b) of the Exchange Act, and Rule 10b-5. The SEC complaint sought to permanently enjoin each of the civil defendants from committing future violations of the foregoing federal securities laws. The SEC complaint also requested that each of the defendants, excluding the Company, be required to disgorge his ill-gotten gains and pay civil penalties. The SEC complaint further sought an order permanently barring Michael Nouri from serving as an officer or director of a public company. The SEC complaint did not seek any fines or other monetary penalties against the Company. On September 28, 2007, the Company agreed, without admission of any liability, to the entry of a consent judgment against it which permanently enjoins it from further violations of the antifraud provisions of the federal securities laws, specifically Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5. No fines or other monetary sanctions were levied against the Company. The consent judgment settles the SEC complaint against the Company and was entered by the court on October 2, 2007. The litigation is continuing against the other defendants.

<u>Gooden v. Smart Online, Inc.</u> 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 Exchange Act and Rule 10b-5. The complaint is based on the matters alleged in the SEC complaint described above and asserts that the defendants participated 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.

<u>Nouri v. Smart Online, Inc.</u> On October 17, 2007, Henry Nouri, the Company's former Executive Vice President, filed a civil action against the Company in the General Court of Justice, Superior Court Division, in Orange County, North Carolina. The complaint alleges that the Company had no "cause" to terminate Mr. Nouri's employment and that it breached Mr. Nouri's employment agreement by notifying him that his employment was terminated for cause, by failing to itemize the cause for the termination, and by failing to pay him benefits to which he would have been entitled had his employment been terminated without "cause." The complaint seeks unspecified compensatory damages, including interest, a declaratory judgment that no cause existed for the termination of Mr. Nouri's employment and that Mr. Nouri is entitled to the benefits provided under his employment agreement for a termination without "cause," and costs and expenses.

At this time, the Company is not able to determine the likely outcome of the legal matters described above, nor can it estimate its potential financial exposure. The Company's management has made an initial estimate based upon its knowledge, experience and input from legal counsel, and the Company has accrued approximately $300,000 of additional legal reserves. Such reserves will be adjusted in future periods as more information becomes available.

10. SUBSEQUENT EVENTS

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. In addition, the noteholders have committed to purchase on a pro rata basis up to $5.2 million aggregate principal of secured subordinated notes upon approval and call by the Company's Board of Directors in future closings. The Company is obligated to pay interest on the notes at an annualized rate of 8% payable in quarterly installments commencing on February 14, 2008. The Company does not have the ability to prepay the notes without approval 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, acquisition, sale of all or substantially all of the Company's assets or capital stock or similar transaction, each noteholder in its sole discretion shall have the option to:

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

If a noteholder elects to convert its note under these circumstances, the conversion price for notes:

- issued in the initial closing on November 14, 2007 shall be a 20% premium above 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 averaged over five trading days prior to November 14, 2007; and
- issued in any additional closings shall be the lesser of a 20% premium above 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 StockMarket 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 respective additional closing date.

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

The notes and the common stock into which they may be converted have not been registered under the Securities Act or the securities laws of any other jurisdiction. As a result, offers and sales of the notes were made pursuant to Regulation D of the Securities Act and only made to accredited investors that were the Company's existing stockholders. The investors include, among others, (i) The Blueline Fund, who originally recommended Philippe Pouponnot, one of the Company's directors, for appointment to the Company's Board of Directors, (ii) Atlas Capital, S.A., who originally recommended Shlomo Elia, another one of the Company's directors, for appointment to the Board of Directors, and (iii) William Furr, who is the father of Thomas Furr, one of the Company's directors and executive officers.

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.

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 foreign currency exchange rate and 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 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 below, under "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 Internet-delivered Software-as-a-Service, or SaaS, software applications and data resources for small businesses. We reach small businesses through (1) syndication arrangements with other companies that private label our software applications through their corporate web sites and (2) our own website at www.onebiz.com. Our syndication relationships provide a cost and time effective way to market our products and services to the small business sector. We also provide solutions to companies developing customized IT applications through the licensing of one of our platforms.

We currently operate our company in two segments. Those segments are 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 generates revenues from the development and distribution of Internet-delivered SaaS small business applications through a variety of subscription, licensing, integration and syndication channels. The Smart Commerce segment generally generates revenue from subscription fees, professional services fees, and licensing fees related to domain name subscriptions, e-commerce or networking consulting or networking maintenance agreements. 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.

Sources of Revenue

We derive revenues from the following sources:

- Subscription fees - monthly fees charged to end-users for access to our SaaS applications.
- License fees – fees charged for licensing of platforms or applications. Licenses may be perpetual or for a specific term.
- Integration fees - fees charged to partners to integrate their products into our syndication platform.
- Syndication fees
  - fees charged to syndication partners to create a customized private-label site.
  - barter revenue derived from syndication agreements with media companies.
- Professional services fees - fees related to consulting services which complement our other products and applications.
- Other revenues - revenues generated from non-core activities such as sales of shrink-wrapped products, original equipment manufacturer, or OEM, contracts and miscellaneous other revenues.

Our current primary focus is to target established companies that have both a substantial base of small business customers as well as a recognizable and trusted brand name. We are also seeking to establish partnerships with smaller companies with a specific vertical expertise catering to the small business customer base that we view as more ready to adopt new technologies. Our goal is to enter into partnerships with these companies whereby they private label our products and offer them to their base of 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. In addition, we are targeting larger or developing enterprises that are developing a customized application delivery system or IT solution that might utilize our platforms as a solution. Such enterprises might wish to use our platform(s) as the framework into which they will integrate their own or other third-party applications, or they might wish to use all or some of our existing applications. Such solutions generally would generate licensing revenue and potentially subscription revenue for us if the customer desires that our applications be made a part of their solution.

Subscription revenues consist of sales of subscriptions directly to end-users, or to others for distribution to end-users, hosting and maintenance fees, and e-commerce website design fees. Subscription sales are made either on a subscription or on a “for fee” basis. Subscriptions, which include access to most of our offerings, are payable in advance on a monthly basis and are typically paid via credit card of the individual end-user or the aggregating entity. We offer new subscribers a limited free use period and notify such free users that we will terminate access it they fail to become paid subscribers within a certain period of time. We expect lower net subscription fees from subscribers at the private label syndication websites of our partners than from our main portal since our syndication agreements require us to share revenue generated from syndication sites with each respective partner. In the first nine months of 2007, 98% of our subscription revenue was generated by our Smart Commerce segment, and the remaining 2% by our Smart Online segment. As of September 30, 2007, we had an aggregate of approximately 13,500 subscribers: approximately 13,100 through our Smart Commerce segment and 400 through our Smart Online segment.

Licensing revenue consists of perpetual or term license agreements for the use of the Smart Online platform, the Smart Commerce platform or any of our applications. Perpetual license revenue is typically recorded in the period the license is sold and meets the requirements of American Institute of Certified Public Accountants Statement of Position 97-2, *Software Revenue Recognition*, or SOP 97-2; specifically, that there is evidence of an arrangement, the product has been delivered, the fee is fixed and determinable, and collection is reasonably assured. The revenue associated with term licenses is typically recorded over the period of the license. In the first nine months of 2007, 58% of our licensing revenue was generated by our Smart Online segment and 42% by our Smart Commerce segment.

When appropriate, we charge our partners a fee for private-labeling our website in their own customized interface (i.e., in the “look and feel” of our partners' sites). This fee is based on the extent of the modifications required as well as the revenue sharing ratio that has been negotiated between us and our partner. If a fee is charged for the production of the website and the modifications, it is recorded as syndication revenue.

In certain instances, we have integrated products offered by other companies into our products or websites. This integration approach is a means for the integration partner to generate additional traffic to its own website or revenue for its own product while expanding the range of our products and services. Such revenue is recorded as integration revenue. Our integration contracts also provide for us to receive a percentage of revenue generated by our partner. Such revenues have been immaterial during the nine months ended September 30, 2007.

Both syndication and integration fees are recognized on a monthly basis over the life of the contract, although a significant portion of integration fees is received upfront. Our contracts and support contracts are generally non-cancelable, though customers typically have the right to terminate their contracts for cause if we fail to perform. We generally invoice our paying syndication or integration partners in annual or monthly installments, and typical payment terms provide that they pay us within 30 days of invoice. Invoiced amounts are recorded as accounts receivable and in deferred revenue or revenue depending on whether the appropriate revenue recognition criteria have been met. In general, we collect our billings in advance of the service period. As we shift our focus to increasing subscription revenue, which we deem to have the greatest potential for future revenue growth, we have seen a decrease in syndication and integration revenue through the first nine months of 2007, and we expect this decrease to continue through the remainder of the fiscal year. In the first nine months of 2007, 100% of our syndication and integration revenue was generated by our Smart Online segment.

Professional services fees are fees generated from 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. Such fees are typically billed on a time and material basis and are recognized as revenue when these services are performed and the customer is invoiced. In the nine months of 2007, 100% of our professional services revenue was generated by our Smart Commerce segment.

Other revenues consist primarily of non-core revenue sources such as traditional shrink-wrap software sales and miscellaneous web services. It also includes OEM revenue generated through sales of our applications bundled with products offered by manufacturers such as Dell, Gateway and CompUSA. Revenues from OEM arrangements are reported and paid to us on a quarterly basis. In the first nine months of 2007, 33% of our other revenues were generated by our Smart Online segment and the remaining 67% were generated by our Smart Commerce segment.

Cost of Revenues

Cost of revenues is primarily composed of salaries associated with maintaining and supporting integration and syndication partners and the cost of external hosting facilities associated with maintaining and supporting integration and syndication partners. Historically, we have not capitalized any costs associated with the development of our products and platforms. Statement of Financial Accounting Standards, or 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. Based on our product development process, technological feasibility is established upon completion of a working model. Costs related to software development incurred between completion of the working model and the point at which the product is ready for general release have been insignificant.

Operating Expenses

In previous years, our efforts primarily focused on basic product development and integration. In the fourth quarter of 2006, we shifted our focus to increasing subscription revenue while concentrating our development efforts on enhancements and customization of our proprietary platforms and applications. In the early part of 2007, we also began to focus on licensing our platform products and applications. As of September 30, 2007, we had 56 employees. Most employees perform multiple functions.

Research and Development. Historically, we have not capitalized any costs associated with the development of our products and platforms. SFAS No. 86 requires capitalization of certain software development costs subsequent to the establishment of technological feasibility. Because any such costs that would be capitalized following the establishment of technological feasibility would immediately be written off due to uncertain realizability, all such costs have been recorded as research and development costs and expensed as incurred. Because of our proprietary, 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 have relatively low research and development expenses as compared to traditional enterprise software business models. We expect that in the future, research and development expenses will increase substantially in absolute dollars, but decrease as a percentage of total revenue, as we hire additional personnel in both segments to enhance and customize our platforms and applications.

Sales and Marketing. Historically, we spent limited funds on marketing, advertising, and public relations. Our business model of partnering with established companies with extensive small business customer bases allows us to leverage the marketing dollars spent by our partners rather than requiring us to incur such costs. We do not conduct any significant direct marketing or advertising programs. Our sales and marketing costs have increased significantly in 2007 due to the addition of several sales personnel. As we begin to grow the number of subscribers to our products, we expect sales and marketing expense to increase due to the percentages of revenue we may be required to pay to partners as marketing fees.

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, and other corporate expenses, including facilities costs. We anticipate general and administrative expenses will increase as we add personnel and incur additional professional fees and insurance costs related to the growth of our business and to our operations as a public company. Non-recurring general and administrative expenses increased significantly in 2006 as a result of the suspension of trading of our securities by the Securities and Exchange Commission, or the SEC, the related SEC investigation, and the internal investigation of matters relating to that suspension. Our expenses related to these matters decreased to an immaterial amount in the fourth quarter of 2006 and first half of 2007. Due to legal matters in which we are involved, as more fully described in Part II, Item 1, "Legal Proceedings" of this report, legal fees increased significantly in the third quarter of 2007, and we expect those increased costs to continue through the first half of 2008. We also expect to incur additional material costs in 2007 and 2008 as we take the necessary steps to comply with Section 404 of the Sarbanes-Oxley Act of 2002.

Stock-Based Expenses. Our operating expenses include stock-based expenses related to stock awards, options 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*, or SFAS No. 123R, 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 addition, 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 and do not anticipate any further stock option awards to be granted under the 2004 Plan.

Critical Accounting Policies and Estimates

Our discussion and analysis of financial condition and results of operations is 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 re-evaluate 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, 2006.

Effective January 1, 2007, a major customer executed a letter of clarification which more clearly defined the roles and responsibilities of each party. Individual Business Owners, or IBOs, associated with this customer are provided e-commerce, domain name and email services. In exchange for marketing these services to its IBOs, the customer is paid a marketing fee. At the inception of the business relationship, it was agreed that the customer would collect the gross service fee from the IBOs, and the customer would retain its marketing fee and remit the net remaining cash to us. Because the roles and responsibilities of each party were vaguely defined in the past, revenue was recorded only on the net cash received. Following the execution of the letter of clarification and in accordance with Emerging Issues Task Force, or EITF, 99-19, *Reporting Revenue Gross as a Principal versus Net as an Agent*, this revenue is now recorded as the gross amount paid by the IBO and a sales and marketing expense for the marketing services rendered by the customer. Ultimately, the effect on net income is nil; however, subscription revenue and sales and marketing expense are effectively and appropriately recognized on a gross basis. Because the new accounting method was triggered by a clarification to the existing agreement and not by a change from one accepted accounting method to another, the 2006 subscription revenue was not retroactively adjusted as would be required by SFAS No. 154, *Accounting Changes and Error Corrections - a replacement of APB Opinion No. 20 and FASB Statement No. 3*, or SFAS No. 154. For the three months and nine months ended September 30, 2007, this accounting method resulted in approximately $203,000 and $691,000, respectively, of additional subscription revenue and a corresponding charge to sales and marketing expense.

We derive revenue from the licensing of software platforms along with the sale of associated maintenance, consulting, and application development services. The arrangement may include delivery in multiple-element arrangements if the customer purchases a combination of products and/or services. We use the residual method pursuant to SOP 97-2. 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 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 us 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.

The amount of revenue to be recognized from development and consulting services is typically based on estimates involving total costs to complete, the stage of completion and the amount of work performed in a given period. The assumptions and estimates made to determine total costs and stage of completion may affect the timing of revenue recognition. Changes in estimates of progress to completion and costs to complete are accounted for as cumulative catch-up adjustments.

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. collectability is probable

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

We are currently facing legal actions from stockholders as well as a former employee, some of which 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 these 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 $300,000 of additional 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, 2007 and September 30, 2006

	Three Months Ended September 30, 2007	**Three Months Ended September 30, 2006**
REVENUES:		
Integration Fees	$ -	$ 6,250
Syndication Fees	15,000	57,352
Subscription Fees	830,660	429,426
Professional Services Fees	378,068	242,177
License Fees	200,000	-
Other Revenues	5,467	14,001
Total Revenues	1,429,195	749,206
COST OF REVENUES	168,035	31,311
GROSS PROFIT	1,261,160	717,895
OPERATING EXPENSES:		
General and Administrative	1,398,170	1,208,044
Sales and Marketing	635,201	135,027
Research and Development	636,780	455,997
Total Operating Expenses	2,670,151	1,799,068
LOSS FROM CONTINUING OPERATIONS	(1,408,991)	(1,081,173)
OTHER INCOME (EXPENSE):		
Interest Expense, Net	(139,124)	(51,746)

Takeback of Investor Relations Shares		-		1,562,500
Legal Reserve and Debt Forgiveness, Net		(39,477)		-
Other Income		24,866		-
Total Other Income (Expense)		(153,735)		1,510,754
NET INCOME (LOSS) FROM CONTINUING OPERATIONS		(1,562,726)		429,581
DISCONTINUED OPERATIONS				
Loss of Operations of Smart CRM, net of tax		-		(2,329,429)
NET LOSS				
Net loss attributed to common stockholders	$	(1,562,726)	$	(1,899,848)
NET LOSS PER SHARE:				
Continuing Operations				
Basic and Fully Diluted	$	(0.09)		0.03
Discontinued Operations				
Basic and Fully Diluted	$	-		(0.15)
Net Loss Attributed to Common Stockholders				
Basic	$	(0.09)		(0.13)
Fully Diluted		(0.09)		(0.12)
SHARES USED IN COMPUTING NET LOSS PER SHARE				
Basic		17,292,639		15,127,510
Fully Diluted		17,292,639		15,387,110

The following table shows our consolidated statements of operations data expressed as a percentage of revenue for the periods indicated:

	Three Months Ended September 30, 2007	Three Months Ended September 30, 2006
REVENUES:		
Integration Fees	0%	1%
Syndication Fees	1%	8%
Subscription Fees	58%	57%
Professional Services Fees	26%	32%
License Fees	14%	0%
Other Revenues	1%	2%
Total revenues	100%	100%
COST OF REVENUES	12%	4%
GROSS PROFIT	88%	96%
OPERATING EXPENSES:		
General and Administrative	98%	161%
Sales and Marketing	44%	18%
Research and Development	45%	61%
Total Operating Expenses	187%	240%
LOSS FROM OPERATIONS	(99)%	(144)%
OTHER INCOME (EXPENSE):		
Interest Income (Expense), net	(10)%	(7)%
Other Income	2%	0%
Takeback of Investor Relations Shares	0%	209%
Legal Reserve and Debt Forgiveness, Net	(3)%	0%
DISCONTINUED OPERATIONS		
Loss of Operations of Smart CRM, net of tax	0%	(311)%
NET INCOME(LOSS)	(109)%	(254)%

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

Total revenues were $1,429,000 for the third quarter of 2007 compared to $749,000 for the third quarter of 2006, representing an increase of $680,000, or 91%. Gross profit increased $543,000, or 76%, to $1,261,000 from $718,000. Operating expenses increased $871,000, or 48%, to $2,670,000 from $1,799,000. Loss from continuing operations grew to $1,409,000 from $1,081,000, an increase of $328,000, or 30%, while net loss from continuing operations grew to $1,563,000 from a gain of $430,000, an increase in loss of $1,993,000. Net loss attributed to common stockholders for the three months ended September 30, 2007 decreased $337,000, or 18%, to $1,563,000 from $1,900,000. The net loss for the third quarter of 2006 included other non-cash income of $1,562,500 related to the takeback of certain investor relations shares. Net loss attributed to common stockholders for the third quarter of 2007 decreased $337,000, or 18%, to $1,563,000 from $1,900,000.

Comparison of the Results of Operations for the Three Months Ended September 30, 2007 and September 30, 2006

Revenues

Total revenues were $1,429,000 for the third quarter of 2007 compared to $749,000 for the third quarter of 2006 representing an increase of $680,000, or 91%. This increase is primarily attributable to increases in revenue from license fees of $200,000, subscription fees of $402,000 and professional services fees of $136,000, which were offset by decreases in integration revenue of $6,000, syndication fees of $42,000 and other revenues of $9,000.

Revenues from license fees increased to $200,000 for the third quarter of 2007 from $0 for the third quarter of 2006 and represented 14% of our consolidated revenue for the third quarter of 2007. This increase is attributable to a $400,000 platform license sale in our Smart Commerce segment in the second quarter of 2007. Such revenue was deferred based on collectability issues. In the third quarter of 2007, we received a payment of $200,000 related to that platform license and the cash received was recognized as revenue in the third quarter of 2007 in accordance with SOP 97-2.

Subscription revenues increased $402,000, or 94%, to $831,000 for the third quarter of 2007 from $429,000 for the third quarter of 2006. This increase was due to approximately $203,000 of additional revenue recorded in the third quarter of 2007 due to our adoption of gross revenue reporting. As discussed above, certain subscription revenues that were recorded net for the third quarter of 2006 were recorded as gross for the third quarter of 2007. Because the new accounting method was triggered by a clarification to an existing agreement and not by a change from one accepted accounting method to another, the 2006 subscription revenues were not retroactively adjusted as would be required by SFAS No. 154. Therefore, subscription revenues for the third quarter of 2007 are not recorded in the same manner as subscription revenues for the third quarter of 2006. If revenue from this customer had been recognized on a net basis (making it comparable to the third quarter of 2006), subscription revenues for the third quarter of 2007 would have been approximately $628,000, as compared to approximately $429,000 in the same period of 2006, an increase of approximately $199,000, or 46%. The remaining increase was the result of two new customers in our Smart Commerce segment, one of which launched in June 2007 and the other in July 2007.

Revenues from professional services fees, all of which are derived from our Smart Commerce segment, increased $136,000, or 56%, to $378,000 for the third quarter of 2007 from $242,000 for the third quarter of 2006. This increase was attributable to the addition of one new customer as well as additional services being provided to one existing customer.

Integration revenues decreased $6,250, or 100%, to $0 for the third quarter of 2007 as compared to $6,250 for the same period in 2006. The third quarters of 2007 and 2006 also included $0 and $5,000, respectively, of revenue derived from barter transactions. Almost all integration contract revenue was recognized by the end of 2006 and we have entered into no new integration agreements. As we shift our focus to growing subscription and license revenue, we have not sought any new or additional integration partners.

Syndication revenues decreased $42,000, or 74%, to $15,000 for the third quarter of 2007 from $57,000 for the third quarter of 2006. This decrease primarily is due to a change in our strategy regarding syndication fees. In the past, we sought and received syndication fees as part of our contracts with partners to set up private label websites. Currently, as part of our efforts to increase the number of subscribers to our services through these partnerships, we are no longer seeking contracts which include such syndication fees and are focusing on increasing subscription revenues from end subscribers. The $15,000 of recognized syndication revenues in the third quarter of 2007 relates to a monthly hosting fee in the amount of $5,000 from one syndication partner.

Other revenues decreased $9,000, or 64%, to $5,000 for the third quarter of 2007 as compared to $14,000 for the same period in 2006. This revenue is generated from non-core activities such as sales of shrink-wrapped products, OEM contracts and miscellaneous other revenues.

Cost of Revenues

Cost of revenues increased $137,000, or 442%, to $168,000 in the third quarter of 2007 from $31,000 in the third quarter of 2006, primarily as a result of increased hosting costs at our Smart Commerce segment related to hosting for additional customers, which resulted in an increase in cost of revenues of approximately $70,000. There was approximately $65,000 of additional expense incurred in the third quarter of 2007 at the Smart Online segment as compared to the third quarter of 2006 related to the addition of several employees in our call center providing customer service which are categorized as cost of revenues.

Operating Expenses

Operating expenses increased $871,000, or 48%, to $2,670,000 for the third quarter of 2007 from $1,799,000 during the third quarter of 2006. This increase is primarily due to an increase in general and administrative expenses of approximately $190,000, an increase in research and development expenses of approximately $181,000, and an increase in sales and marketing expense of approximately $500,000.

General and Administrative - General and administrative expenses increased by $190,000, or 16%, to $1,398,000 for the third quarter of 2007 from $1,208,000 for the third quarter of 2006. This increase was primarily due to certain increases in expenses at the Smart Online segment. There was an increase in wages and associated taxes of approximately $73,000 related to the hiring of a new Chief Operating Officer as well as the appointment of an interim Chief Executive Officer. Compensation expense required by SFAS No. 123R increased by $21,000 from the prior period as there have been several grants of restricted stock which had portions vest in the third quarter of 2007. Legal and professional fees increased by approximately $150,000 over the corresponding period in 2006 due to the legal fees incurred in connection with the legal proceedings brought during the third quarter of 2007 against us, our former executive officer and a former employee. Rent for the period increased approximately $16,000 over the preceding period as a result of a rent increase at the North Carolina corporate office and the addition of a sales office in Iowa, which was subsequently closed in September 2007. Board compensation increased by approximately $14,000 due to the addition of independent directors between September 30, 2006 and 2007. Investor relations expense increased approximately $15,000 as we retained consultants to assist with our analysis of returning to a national market and address blue sky issues related to the registration statement we filed in April 2007. These additions were offset by a reduction of approximately $116,000 of registration rights penalties as we successfully filed a registration statement in 2007 terminating such penalties. In the third quarter of 2006, we paid a commission of $55,000 to a related party in connection with the sale of our Smart CRM segment. There was no corresponding charge in 2007. At the Smart Commerce segment, credit card transaction fees increased by approximately $23,000 in the third quarter of 2007 compared to the third quarter of 2006 as we launched several new customer websites which generated revenue along with associated credit card processing fees.

We are currently disputing our insurance carrier's refusal to cover certain legal expenses related to our securities litigation matters. We contend that these legal expenses should be reimbursed by our insurance carrier. Because the outcome of this dispute is unclear, we have expensed all legal costs incurred with respect to the SEC matters and our internal investigation, and we will account for any insurance reimbursement, should there be any, in the period such amounts are reimbursed.

Sales and Marketing - Sales and marketing expense increased to $635,000 in the third quarter of 2007 from $135,000 in the third quarter of 2006, an increase of $500,000, or 370%. As detailed in the Revenues section above, in the Smart Commerce segment, there was approximately $203,000 of additional revenue recorded in the third quarter of 2007 due to our adoption of gross revenue reporting. A corresponding increase in sales and marketing expense of $203,000 was recorded in association with the new gross accounting method. In addition, the two new customers created revenue share expense in the amount of approximately $215,000 for the third quarter of 2007, for which there was no corresponding expense in the third quarter of 2006. At the Smart Online segment, there was an increase in sales and marketing wages of approximately $38,000 as we had expanded our sales force in both our North Carolina and Iowa offices earlier in 2007. The Iowa office was subsequently closed in September of 2007 as part of our internal restructuring. During the second quarter of 2007, a former employee became a sales consultant, which generated consulting expense of approximately $23,000 in the third quarter of 2007 for which there was no corresponding expense in the third quarter of 2006. That consulting contract was terminated in November of 2007.

Research and Development - Research and development expense increased to $637,000 in the third quarter of 2007 from $456,000 in the third quarter of 2006, an increase of approximately $181,000, or 40%. This increase is due primarily to increased wages, payroll taxes and commission expenses from the Smart Online segment of approximately $178,000 as we added research and development personnel. We expect research and development expenses to increase during the last quarter of 2007 as a result of anticipated hiring of additional research and development personnel for both the Smart Online and Smart Commerce segments to enhance and customize our platforms and applications and launch additional private label sites.

Other Income (Expense)

We incurred net interest expense of $139,000 during the third quarter of 2007 compared to $52,000 during the third quarter of 2006, an increase of approximately $87,000, or 169%. Interest expense increased as a direct result of the notes payable to Fifth Third Bank related to the refinance of the debt to the sellers of iMart Incorporated, or iMart. The Fifth Third Bank note was originated in the fourth quarter of 2006, so there was no corresponding interest expense in the third quarter of 2006. The monthly interest on that note has been approximately $11,000 per month but decreases each month as our outstanding principal balance is reduced. Additionally, interest expense of approximately $33,000 was incurred during the third quarter of 2007 on our revolving line of credit with Wachovia Bank, NA, or Wachovia. We earned interest income of $35,000 during the third quarter of 2007 on money market account deposits compared to $3,000 earned for the same period in 2006. The third quarter 2007 interest income increase was attributable to the interest earned on the cash proceeds of the February 2007 private placement described in Note 7, “Stockholders’ Equity,” to the consolidated financial statements in this report.

We realized a gain of $211,000 during the third quarter of 2007 from negotiated and contractual releases of outstanding liabilities compared to $0 gain from debt forgiveness in the third quarter of 2006. During the third quarter of 2007, we recorded reserves of approximately $300,000 for legal expenses and losses we might incur as a result of the litigation we are facing.

Overview of Results of Operation for the Nine Months Ended September 30, 2007 and 2006

	Nine Months Ended September 30, 2007	Nine Months Ended September 30, 2006
REVENUES:		
Integration Fees	$ 5,000	$ 182,660
Syndication Fees	45,000	183,619
Subscription Fees	2,040,243	1,476,194
Professional Services Fees	984,548	601,200
License Fees	480,000	450,000
Other Revenues	20,720	54,312
Total Revenues	3,575,511	2,947,985
COST OF REVENUES	355,942	212,515
GROSS PROFIT	3,219,569	2,735,470
OPERATING EXPENSES:		
General and Administrative	3,567,385	4,844,464
Sales and Marketing	1,563,653	666,940
Research and Development	1,908,644	1,279,198
Total Operating Expenses	7,039,682	6,790,602
LOSS FROM CONTINUING OPERATIONS	(3,820,113)	(4,055,132)
OTHER INCOME (EXPENSE):		
Interest Expense, Net	(400,910)	(190,802)
Gain on Debt Forgiveness	-	144,351
Takeback of Investor Relations Shares	-	3,125,000
Gain (Loss) from Legal Settlements	(34,877)	-
Writeoff of Investment	-	(25,000)
Other Income	168,672	-
Total Other Income (Expense)	(267,115)	3,053,549
NET LOSS FROM CONTINUING OPERATIONS	(4,087,228)	(1,001,583)
DISCONTINUED OPERATIONS		
Loss of Operations of Smart CRM, net of tax	-	(2,525,563)
NET LOSS		
Net loss attributed to common stockholders	$ (4,087,228)	$ (3,527,146)
NET LOSS PER SHARE:		
Continuing Operations		
Basic and Fully Diluted	$ (0.24)	(0.07)
Discontinued Operations		

Basic and Fully Diluted	$	-	(0.17)
Net Loss Attributed to Common Stockholders			
Basic	$	(0.24)	(0.23)
Fully Diluted		(0.24)	(0.23)
SHARES USED IN COMPUTING NET LOSS PER SHARE			
Basic and Fully Diluted		17,002,827	15,077,583

The following table shows our consolidated statements of operations data expressed as a percentage of revenue for the periods indicated:

	Nine Months Ended September 30, 2007	**Nine Months Ended September 30, 2006**
REVENUES:		
Integration fees	0%	6%
Syndication fees	1%	6%
Subscription fees	57%	50%
Professional services fees	28%	21%
License fees	1%	15%
Other revenues	13%	2%
Total revenues	100%	100%
COST OF REVENUES	10%	7%
GROSS PROFIT	90%	93%
OPERATING EXPENSES:		
General and administrative	100%	164%
Sales and marketing	44%	23%
Research and development	53%	43%
Total operating expenses	197%	230%
LOSS FROM OPERATIONS	(107)%	(137)%
OTHER INCOME (EXPENSE):		
Interest expense, net	(11)%	(7)%
Other income	5%	0%
Writeoff of investment	0%	(1)%
Takeback of investor relations shares	0%	106%
Loss on legal settlements	(1)%	0%
Gain on debt forgiveness	0%	5%
Total Other Income (Expense)	(7)%	103%
DISCONTINUED OPERATIONS		
Loss of Operations of Smart CRM, net of tax	0%	(86)%
NET INCOME (LOSS)	(114)%	(120)%

Overview of Results of Operations for the Nine Months Ended September 30, 2007

Total revenues were $3,576,000 for the nine months ended September 30, 2007 compared to $2,948,000 for the nine months ended September 30, 2006, representing an increase of $628,000, or 21%. Gross profit increased $485,000, or 18%, to $3,220,000 from $2,735,000. Operating expenses increased $249,000, or 4%, to $7,040,000 from $6,791,000. Loss from continuing operations decreased by $235,000, or 6%, to $3,820,000 from $4,055,000, while net loss from continuing operations grew by $3,085,000, or 303%, to $4,087,000 from $1,002,000. The net loss for the nine months ended September 30, 2006 included other non-cash income of $3,125,000 related to the takeback of certain investor relations shares. Net loss attributable to common stockholders for the nine months ended September 30, 2007 increased $560,000, or 16%, to $4,087,000 from $3,527,000.

Comparison of the Results of Operations for the Nine Months Ended September 30, 2007 and September 30, 2006

Revenues.

Total revenues were $3,576,000 for the nine months ended September 30, 2007 compared to $2,948,000 for the same period of 2006, representing an increase of $628,000, or 21%. This increase is primarily attributable to increases in subscription fees of $564,000, professional services fees of $384,000 and license fees of approximately $30,000, offset by decreases in integration and syndication fees of approximately $316,000 and other revenues of approximately $34,000.

Revenues from license fees increased by $30,000, or 7%, to $480,000 for the nine months ended September 30, 2007 from $450,000 for the same period of 2006, representing 13% of our consolidated revenue for the first three quarters of 2007. This increase is attributable to there being one $280,000 platform license sale from the Smart Online segment in the first nine months of 2007 and one $200,000 sale in the Smart Commerce segment, as compared to one $450,000 license sale in the Smart Commerce segment for the same period in 2006.

Subscription revenues increased approximately $564,000, or 16%, to $2,040,000 for the nine months ended September 30, 2007 from $1,476,000 for the nine months ended September 30, 2006. This increase was due to approximately $691,000 of additional revenue recorded in the nine months ended September 30, 2007 due to our adoption of gross revenue reporting. As discussed above, certain subscription revenues recorded on a net basis for the nine months ended September 30, 2006 were recorded on a gross basis for the nine months ended September 30, 2007. Because the new accounting method was triggered by a clarification to an existing agreement and not by a change from one accepted accounting method to another, the 2006 subscription revenues were not retroactively adjusted as would be required by SFAS No. 154. Therefore, subscription revenues for the nine months ended September 30, 2007 are not recorded in the same manner as subscription revenues for the nine months ended September 30, 2006. If revenue from this customer had been recognized on a net basis (making it comparable to the nine months ended September 30, 2006), subscription revenues for the nine months ended September 30, 2007 would have been approximately $1,350,000 as compared to approximately $1,476,000 in the same period of 2006. This net decrease of approximately $126,000 primarily resulted from a decrease in the number of subscribers resulting from the 2006 restructuring of a major customer of the Smart Commerce segment, which lowered gross revenue by approximately $493,000. This decrease was partially offset by the addition of two new customers in the Smart Commerce segment that generated an additional $367,000 of gross revenue.

Revenues from professional services fees, all of which are derived from our Smart Commerce segment, increased to $985,000 for the nine months ended September 30, 2007 from $601,000 for the nine months ended September 30, 2006. This increase of $384,000, or 64%, was attributable to the addition of one new customer as well as additional services being provided to one existing customer.

Integration revenues decreased $178,000, or 97%, to $5,000 for the nine months ended September 30, 2007 as compared to $183,000 for the same period in 2006. The 2007 and 2006 periods also included $0 and $5,000 of revenue derived from barter transactions, respectively. Almost all integration contract revenue was recognized by the end of 2006 and we have entered into no new integration agreements. As we shift our focus to growing subscription revenue, we have not sought any new or additional integration partners.

Syndication revenues decreased $139,000, or 76%, to $45,000 for the nine months ended September 30, 2007 as compared to $184,000 for the same period in 2006. This decrease primarily is due to a change in our strategy regarding syndication fees. In the past, we sought and received syndication fees as part of our contracts with partners to set up private label websites. Currently, as part of our efforts to increase the number of subscribers to our services through these partnerships, we are no longer seeking contracts which include such revenues and are focusing on increasing subscription revenues. The $45,000 of recognized syndication revenues in the nine months ended September 30, 2007 relates to a monthly hosting fee in the amount of $5,000 from one syndication partner.

Other revenues totaled approximately $21,000 for the nine months ended September 30, 2007 as compared to $54,000 for the comparable period in 2006. Other revenues relate primarily to smaller OEM contracts and other miscellaneous revenues. These are non-core and non-recurring sources of revenue. The decrease is primarily related to decreased sales of remnant shrink wrap products.

Cost of Revenues

Cost of revenues increased $143,000, or 67%, to $356,000 in the nine months ended September 30, 2007, from $213,000 in the comparable period in 2006, primarily as a result of increased hosting costs at our Smart Commerce segment related to hosting for additional customers, which resulted in an increase in cost of revenues of approximately $75,000. There was approximately $66,000 of additional expense incurred in the nine months ended September 30, 2007 at the Smart Online segment as compared to the same period of 2006 related to the addition of several employees in our call center providing customer service which are categorized as cost of revenues.

Operating Expenses

Operating expenses increased $249,000, or 4%, to $7,040,000 for the nine months ended September 30, 2007 from $6,791,000 for the nine months ended September 30, 2006. This increase is primarily due to an increase in sales and marketing expenses of approximately $897,000 and an increase in research and development expenses of approximately $630,000, offset by a decrease in general and administrative expenses of approximately $1,277,000.

General and Administrative - General and administrative expenses decreased by $1,277,000, or 26%, to $3,567,000 for the nine months ended September 30, 2007 from $4,844,000 in the same period of 2006. This decrease is primarily due to a reduction of $719,000 in legal fees as the nine months ended September 30, 2006 included legal expense related to the SEC’s suspension of trading of our securities and our own internal investigation. Those 2006 legal fees of approximately $900,000 were partially offset by an increase in legal fees of approximately $200,000 incurred in the third quarter of 2007 related to legal actions against us and a former executive officer and a former employee. Compensation expense required by SFAS No. 123R decreased $48,000 from the prior period. This decrease was primarily due to minimal option grants from the nine months ended September 30, 2006 through the end of the nine months ended September 30, 2007, and because the number of expirations exceeded the grants. This decrease was offset by an increase in such expense as a result of the lapse of a portion of the restrictions for several grants of restricted shares in 2007. Registration rights penalties decreased $323,000 as certain stockholders settled claims for registration penalties in the nine months ended September 30, 2007, and no additional penalties were accrued for those individuals. In addition, our filing of a resale registration statement enabled us to avoid similar registration rights penalties in 2007 as compared to those incurred during prior years. Accounting expense was reduced by approximately $151,000 in the first nine months of 2007 as compared to the same period in 2006 primarily through the hiring of a full-time Chief Financial Officer and the elimination of using outside firms to provide those services. In addition, the 2006 period contains additional audit fees incurred as we engaged new independent accountants following the resignation of our previous independent accountants.

We are currently disputing our insurance carrier's refusal to cover certain legal expenses related to our securities litigation matters. We contend that these legal expenses should be reimbursed by our insurance carrier. Because the outcome of this dispute is unclear, we have expensed all legal costs incurred with respect to the SEC matters and our own internal investigation, and we will account for any insurance reimbursement, should there be any, in the period such amounts are reimbursed.

Sales and Marketing - Sales and marketing expense was $1,564,000 for the nine months ended September 30, 2007, up from $667,000 in the nine months ended September 30, 2006, an increase of $897,000, or 134%. As detailed in the Revenues section above, due to our adoption of gross revenue reporting for the nine months ended September 30, 2007, we recorded approximately $691,000 of additional revenue and an equivalent increase in sales and marketing expense. In addition, two new customers at the Smart Commerce segment resulted in revenue share expense of approximately $227,000, for which there was no corresponding charge for the nine months ended September 2006. The expansion of the Smart Online segment’s sales and marketing offices in North Carolina and Iowa resulted in additional wages for the nine months ended September 30, 2007 of approximately $89,000 as compared to the corresponding period of 2006. Our Iowa office was closed in September 2007 as part of our internal restructuring.

These increases were offset by several decreases in sales and marketing expense in the Smart Online segment, including a $38,000 reduction in barter advertising expense and a $75,000 decrease in revenue share expense, as we paid our partners a fee in the nine months ended September 30, 2006 for a syndication contract and had no similar expense in the nine months ended September 30, 2007.

Generally, we expect we will need to increase sales and marketing expenses before we can substantially increase our revenue from sales of subscriptions. We increased investment in sales and marketing by increasing the number of direct sales personnel and increasing penetration within our existing customer base, expanding our domestic selling and marketing activities, attempting to build brand awareness and participating in additional marketing programs, and we are planning to continue to increase these investments.

Research and Development - Research and development expense increased to $1,909,000 in the nine months ended September 30, 2007 from $1,279,000 in the nine months ended September 30, 2006, an increase of approximately $630,000, or 49%. This increase is due to several factors in the Smart Online segment, including increases of $227,000 in consulting expense for our accounting application and an increase of $275,000 for wages for additional staffing. In addition, at our Smart Commerce segment, our research and development wages increased by approximately $80,000 and our consulting expense increased by approximately $47,000 related to additional staff and support required to accommodate our new customers.

Other Income (Expense)

We incurred net interest expense of $401,000 during the nine months ended September 30, 2007 compared to $191,000 during the nine months ended September 30, 2006. Interest expense increased as a direct result of approximately $320,000 of interest expense related to the amortization of deferred financing costs of the warrants issued to Atlas Capital, S.A., or Atlas. Additionally, interest expense of approximately $92,000 was incurred on our revolving line of credit with Wachovia and $150,000 of interest expense was incurred related to the Smart Commerce loan with Fifth Third Bank during the nine months ended September 30, 2007. Interest income for our Smart Online segment totaling $115,000 was earned on money market account deposits compared to $5,000 earned for the same period in 2006. The first nine months of 2007 interest income increase was attributable to the interest earned on the cash proceeds of the February 2007 private placement described in Note 7, “Stockholders’ Equity,” to the consolidated financial statements in this report.

We realized a gain of $215,000 during the nine months ended September 30, 2007 from negotiated and contractual releases of outstanding liabilities as compared to $144,000 in the nine months ended September 30, 2006. During 2007, we recorded reserves of approximately $300,000 for legal expenses and losses we might incur as a result of litigation we are facing.

One of the assets purchased as part of our acquisition of iMart was a $25,000 investment in a privately held company that was a customer of iMart's. Management determined that it is likely that such investment is currently worthless, so the entire $25,000 investment along with approximately $65,000 of the accounts receivable due from that customer was written off in the nine months ended September 30, 2006. We did not have similar expenses in the nine months ended September 30, 2007. This accounts for $90,000 decrease in other expenses.

Provision for Income Taxes

We have not recorded a provision for income tax expense because we have been generating net losses. Furthermore, we have not recorded an income tax benefit for the third quarter of 2007 primarily due to continued substantial uncertainty regarding our ability to realize our deferred tax assets. Based upon available objective evidence, there has been sufficient uncertainty regarding the ability to realize our deferred tax assets, which warrants a full valuation allowance in our financial statements. We have approximately $35,000,000 in net operating loss carryforwards, which may be utilized to offset future taxable income.

Liquidity and Capital Resources

At September 30, 2007, our principal sources of liquidity were unrestricted cash and cash equivalents totaling $2,228,000 and accounts receivable of $964,000. As of November 12, 2007, our principal sources of liquidity were cash and cash equivalents totaling approximately $1,300,000 and accounts receivable of approximately $821,000. However, $250,000 of our cash is restricted under the loan agreement with Fifth Third Bank as described below. As of September 30, 2007, we have drawn approximately $2.1 million of our $2.5 million line of credit with Wachovia, leaving approximately $400,000 available for our operations.

At September 30, 2007, we had a working capital deficit of approximately $1.0 million, however the proceeds raised through the secured subordinated convertible notes sold on November 14, 2007 results in approximately $1.7 million of working capital as of November 12, 2007. In addition, we may call up to approximately $5.2 million of additional funding from our convertible noteholders as well as an additional $0.4 million under our Line of Credit with Wachovia.

Cash Flow from Operations. Cash flows used in operations for the nine months ended September 30, 2007 totaled $3,039,000, up from $2,049,000 for the nine months ended September 30, 2006. This increase is primarily due to increased accounts receivable as well as the loss of cash flow from discontinued operations.

Cash Flow from Financing Activity. For the nine months ended September 30, 2007, we generated a total of $5,029,000 net cash from our financing activities, up from $871,000 for the nine months ended September 30, 2006. This net cash was generated through both equity and debt financing, as described below.

Equity Financing. In a transaction that closed on February 21, 2007, we sold an aggregate of 2,352,941 shares of our common stock to two new investors, or the Investors. The private placement shares were sold at $2.55 per share pursuant to a Securities Purchase Agreement, or the SPA, between us and each of the Investors. The aggregate gross proceeds to us were $6 million, and we incurred issuance costs of approximately $637,000 as of September 30, 2007. These costs were higher than the $585,000 originally anticipated due to state securities law filing requirements along with the associated legal fees. Under the SPA, the Investors were issued warrants for the purchase of an aggregate of 1,176,471 shares of common stock at an exercise price of $3.00 per share. These warrants contain a provision for cashless exercise and must be exercised, if at all, by February 21, 2010.

Debt Financing. On November 9, 2006, Smart Commerce entered into a loan agreement with Fifth Third Bank. Under the terms of this agreement, Smart Commerce borrowed $1.8 million to be repaid in 24 monthly installments of $75,000 plus interest beginning in December 2006. The interest rate is prime plus 1.5% as periodically determined by Fifth Third Bank. The loan is secured by all of the assets of Smart Commerce, including a cash security account of $250,000 and all of Smart Commerce's intellectual property. Such restricted cash is scheduled to be released from the restrictions in three equal installments of approximately $83,000, on June 30, 2007, December 31, 2007 and June 30, 2008, if certain debt covenants regarding operating metrics for Smart Commerce are met. Those operating metrics relate to Smart Commerce’s actual results of operations as compared to certain projections provided to Fifth Third Bank at the inception of the loan. Failure to meet these metrics could, after receipt of notice of an event of default from Fifth Third Bank and the expiration of a ten-day cure period, result in an acceleration of the debt. The metrics for the June 30, 2007 release were not met, and therefore, no cash has yet been released. Fifth Third Bank has not notified us that any default exists. As of November 12, 2007, our outstanding principal balance on this debt was approximately $900,000.

On November 14, 2006, we entered into a revolving credit arrangement with Wachovia, or the Line of Credit, for $1.3 million which can be used for general working capital. Any advances made on the Line of Credit were to be paid off no later than August 1, 2007, with monthly payments of accrued interest on any outstanding balance commencing on December 1, 2006. Interest accrues on the unpaid principal balance at the LIBOR Market Index Rate plus 0.9%. On January 24, 2007, we entered into an amendment to the Line of Credit. The amendment resulted in an increase in the line of credit from $1.3 million to $2.5 million. The pay-off date was also extended from August 1, 2007 to August 1, 2008. The Line of Credit is secured by our deposit account at Wachovia and an irrevocable standby letter of credit in the amount of $2,500,000 issued by HSBC Private Bank (Suisse) S.A. with Atlas as account party. We have separately agreed with Atlas that in the event of a default by us in the repayment of the Line of Credit that results in the letter of credit being drawn, we shall reimburse Atlas any sums that Atlas is required to pay. At our sole discretion, these payments may be made in cash or by issuing shares of our common stock at a set per share price of $2.50. As of November 12, 2007, we have drawn down approximately $2.1 million on the Line of Credit.

We have not yet achieved positive cash flows from operations, and our main sources of funds for our operations are the sale of securities in private placements, the sale of additional convertible notes and the Wachovia Line of Credit. We must continue to rely on these sources until we are able to generate sufficient revenue to fund our operations. We believe that anticipated cash flows from operations, funds available from our existing Line of Credit and additional issuances of notes (as described below), together with cash on hand, will provide sufficient funds to finance our operations at least for the next 22 to 28 months, depending on the annual operating budget approved by the Board of Directors. Changes in our operating plans, lower than anticipated sales, increased expenses, or other events may cause us to seek additional equity or debt financing in future periods. There can be no guarantee that financing will be available on acceptable terms or at all. Additional equity financing could be dilutive to the holders of our common stock, and additional debt financing, if available, could impose greater cash payment obligations and more covenants and operating restrictions.

Recent Developments

As more fully described elsewhere in this report, a stockholder class action lawsuit was filed against us and other defendants on October 18, 2007. This lawsuit may require the re-allocation of significant financial resources from working capital to the payment of legal fees and expenses related to the lawsuit. In addition, certain of the other named defendants may be entitled to indemnification and advancement of legal fees and expenses under our Bylaws. We have referred the complaint to our insurance carrier. Although our carrier has accepted our tender of coverage, it has reserved its right to seek reimbursement of the amounts it pays, and may not pay us all of the expenses we incur, either of which may have a material adverse effect on our results of operations and financial condition.

As more fully described elsewhere in this report, on November 14, 2007 in an initial closing, we sold $3.3 million aggregate principal amount of secured subordinated convertible notes due November 14, 2010. In addition, the noteholders have committed to purchase on a pro rata basis up to $5.2 million aggregate principal of secured subordinated notes upon approval and call by our Board of Directors in future closings. We are obligated to pay interest on the notes at an annualized rate of 8% payable in quarterly installments commencing on February 14, 2008. We do not have the ability to prepay the notes without approval of at least a majority of the principal amount of the notes then outstanding.

3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest rate sensitivity

We had unrestricted cash and cash equivalents totaling $327,000, $1,435,000, and $173,000 at December 31, 2006, 2005, and 2004, respectively. At September 30, 2007, our unrestricted cash was $2,228,000. These amounts were invested primarily in demand deposit accounts and money market funds. The cash and cash equivalents are held for working capital purposes. We do not enter into investments for trading or speculative purposes. Due to the short-term nature of these investments, we believe that we do not have any material exposure to changes in the fair value of our investment portfolio as a result of changes in interest rates. Declines in interest rates, however, will reduce future investment income.

Two debt instruments have variable interest rates: one is prime + 1.5% and the other is LIBOR + .9% (See Note 6, “Notes Payable,” to the consolidated financial statements). As of September 30, 2007, the outstanding principal balance on these loans was $1,050,000 and $2,052,000, respectively. Due to the relatively short term of these debt instruments combined with the relative stability of interest rates, we do not expect interest rate or market volatility will have a material effect on our cash flows.

4. CONTROLS AND PROCEDURES

Not applicable.

4T. CONTROLS AND PROCEDURES

As required by paragraph (b) of Rule 13a-15 under the Exchange Act, an evaluation was carried out under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) under the Exchange Act) as of the end of the period covered by this Quarterly Report. As defined in Rule 13a-15(e) and 15d-15(e) under the Exchange Act, the term disclosure controls and procedures means controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Exchange Act is accumulated and communicated to the issuer's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

Based on their evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this Quarterly Report, our disclosure controls and procedures were not effective because we have not completed the testing of certain changes in our internal control over financial reporting that were implemented in July 2006. Management first reported on these changes to our internal controls under Item 9A of Part II of our Annual Report on Form 10-K for the fiscal year ended December 31, 2005, or the 2005 Annual Report, and most recently provided an update regarding the implementation of the internal controls in our Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2007. See “Changes to Internal Control Over Financial Reporting” below for a more detailed description of the status of these internal control changes.

Changes to Internal Control Over Financial Reporting

There have been no changes in our internal control over financial reporting that occurred during the third quarter of fiscal 2007 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

As described in our 2005 Annual Report, and as updated in our Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2007, we have continued to test certain internal controls added in response to the final findings of our Audit Committee’s investigation related to the SEC’s suspension of trading of our common stock in January 2006. The internal controls that are still being tested for effectiveness as of the end of the period covered by this Quarterly Report include the following:

1. Our outside counsel has provided periodic educational training for management and directors by outside legal counsel and other appropriate professional advisors.
2. We have adopted a revised Securities Trading Policy.
3. We have instituted a program requiring written confirmation of compliance with our Code of Ethics and Conflicts of Interest Policy on a quarterly basis from all members of management and the Board of Directors.

We cannot assure you that we will not in the future identify deficiencies in our controls. However, we plan to continue to review and make any necessary changes to the overall design of our control environment in order to enhance our corporate governance and reporting practices.

II. OTHER INFORMATION
1. LEGAL PROCEEDINGS

Please refer to Part I, Item 3 of our Annual Report on Form 10-K for the fiscal year ended December 31, 2006 for a description of material legal proceedings, including the proceedings discussed below.

Securities and Exchange Commission Litigation. As previously disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2006, the SEC temporarily suspended the trading of our securities on January 17, 2006 and advised us that it was conducting a non-public investigation. On September 11, 2007, we were informed that Dennis Michael Nouri, our then serving President, Chief Executive Officer, and a director, had been charged in a criminal complaint that alleges federal securities fraud and conspiracy to commit fraud. We are not named in the criminal complaint. The U.S. government filed the complaint under seal on August 1, 2007 in the U.S. District Court for the Southern District of New York. Also named as defendants in the criminal complaint are Reeza Eric Nouri, a former manager of our company, and Ruben Serrano, Anthony Martin, James Doolan, and Alain Lustig, brokers alleged to have participated with the Nouris in the alleged fraud. The criminal complaint alleges that the defendants, directly and indirectly, used manipulative and deceptive devices in violation of Sections 2 and 371 of Title 18 of the U.S. Code, Sections 10(b) and 32 of the Exchange Act, and Rule 10b-5 promulgated under the Exchange Act, or Rule 10b-5. On November 8, 2007, as part of this on-going action, the U.S. government filed a grand jury indictment against Dennis Michael Nouri, Reeza Nouri, Reuben Serrano and Alain Lustig in the U.S. District Court for the Southern District of New York. The grand jury indictment charges these defendants with conspiracy to commit securities fraud in violation of Sections 78j(b) and 78 ff of Title 17 of the U.S. Code and Rule 10b-5, wire fraud in violation of Sections 1343 and 1346 of Title 18 of the U.S. Code and commercial bribery in violation of Section 1952(a)(3) of Title 18 of the U.S. Code and Sections 180.00 and 180.03 of the New York State Penal Law. Under the grand jury indictment, the U.S. government is seeking forfeiture from these defendants of all property, real and personal, that constitutes or is derived from proceeds traceable to the commission of the alleged securities fraud offenses.

On September 11, 2007, the SEC filed a civil action against us and the defendants named in the criminal complaint in the U.S. District Court for the Southern District of New York. The SEC complaint alleged that the defendants in this civil action, either directly or indirectly, have engaged in transactions, acts, practices, and courses of business which constitute violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5. The SEC complaint sought to permanently enjoin each of the civil defendants from committing future violations of the foregoing federal securities laws. The SEC complaint also requested that each of the defendants, excluding us, be required to disgorge his ill-gotten gains and pay civil penalties. The SEC complaint further sought an order permanently barring Michael Nouri from serving as an officer or director of a public company. The SEC complaint did not seek any fines or other monetary penalties against us. On September 28, 2007, we agreed, without admission of any liability, to the entry of a consent judgment against us which permanently enjoins us from further violations of the antifraud provisions of the federal securities laws, specifically Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5. No fines or other monetary sanctions were levied against us. The consent judgment settles the SEC complaint against us and was entered by the court on October 2, 2007. The litigation is continuing against the other defendants.

Gooden v. Smart Online, Inc. On October 18, 2007, Robyn L. Gooden filed a purported class action lawsuit in the United States District Court for the Middle District of North Carolina naming us, certain of our current and former officers and directors, Maxim Group, LLC, and Jesup & Lamont Securities Corp. as defendants. The lawsuit was filed on behalf of all persons other than the defendants who purchased our securities from May 2, 2005 through September 28, 2007 and were damaged. The complaint asserts violations of federal securities laws, including violations of Section 10(b) of the Exchange Act and Rule 10b-5. The complaint is based on the matters alleged in the SEC complaint described above and asserts that the defendants participated in a fraudulent scheme to manipulate trading in our stock, allegedly causing plaintiffs to purchase the stock at an inflated price. The complaint requests certification of the plaintiff as class representative and seeks, among other relief, unspecified compensatory damages, including interest, plus reasonable costs and expenses, including counsel fees and expert fees.

Nouri v. Smart Online, Inc. On October 17, 2007, Henry Nouri, our former Executive Vice President, filed a civil action against us in the General Court of Justice, Superior Court Division, in Orange County, North Carolina. The complaint alleges that we had no "cause" to terminate Mr. Nouri's employment and that we breached Mr. Nouri's employment agreement by notifying him that his employment was terminated for cause, by failing to itemize the cause for the termination, and by failing to pay him benefits to which he would have been entitled had his employment been terminated without "cause." The complaint seeks unspecified compensatory damages, including interest, a declaratory judgment that no cause existed for the termination of Mr. Nouri's employment and that Mr. Nouri is entitled to the benefits provided under his employment agreement for a termination without "cause," and costs and expenses.

At this time, we are not able to determine the likely outcome of the legal matters described above, nor can we estimate our potential financial exposure. Our management has made an initial estimate based upon its knowledge, experience and input from legal counsel, and we have accrued approximately $300,000 of additional 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, our business, results of operations and financial condition could be materially adversely affected.

1A. RISK FACTORS

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, which we currently deem immaterial, or that are similar to those faced by other companies in our industry or business in general may also affect our business. If any of the risks described below actually occurs, our business, financial condition, or results of operations could be materially and adversely affected.

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 and Litigation Risks
- Market for Our Securities

Risks Associated with Our Financial Condition

(1) We have had recurring losses from operations since inception and continue to have negative cash flows. If we do not rectify these deficiencies through additional financing or growth, we may have to cease operations and liquidate our business.

Through September 30, 2007, we have lost an aggregate of approximately $61.4 million since inception on August 10, 1993. During the quarters ended September 30, 2007 and 2006, we incurred a net loss of approximately $1,600,000 and $1,900,000, respectively. At September 30, 2007, we had a working capital deficit of approximately $1.0 million. Due to the secured subordinated convertible note financing that closed on November 14, 2007, we now have approximately $1.7 million of working capital not including additional amounts available to us from future capital calls on the convertible noteholders. Our working capital, including our line of credit, February 2007 financing transaction and convertible note financing, should fund our operations for the next 22-28 months, depending on the annual operating budget approved by our Board of Directors. Factors such as the commercial success of our existing services and products, the timing and success of any new services and products, the progress of our research and development efforts, our results of operations, the status of competitive services and products, the timing and success of potential strategic alliances or potential opportunities to acquire technologies or assets, the charges filed against a former officer and a former employee filed by the SEC and the United States Attorney General and the resulting drop in share price, the shareholder class action lawsuit, trading volume and liquidity, 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.

(2) Any issuance of shares of our common stock in the future could have a dilutive effect on your investment.

We may issue shares of our common stock in the future for a variety of reasons. For example, under the terms of the stock purchase warrant and agreement we entered into with Atlas in January 2007, it may elect to purchase up to 444,444 shares of our common stock at $2.70 per share upon termination of, or if we are in breach under the terms of, our line of credit with Wachovia. In connection with our private financing in February 2007, we issued warrants to the investors to purchase an additional 1,176,471 shares of our common stock at $3.00 per share and a warrant to our placement agent in that transaction to purchase 35,000 shares of our common stock at $2.55 per share. Upon maturity of their convertible notes, our noteholders may elect to convert all, a part or none of their notes into shares of our common stock at variable conversion prices. In addition, we may raise funds in the future by issuing additional shares of common stock or other securities.

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

(3) In the future, we may enter into certain debt financing transactions with third parties that could adversely affect our financial health.

We currently have a secured loan arrangement from Fifth Third Bank. Under the terms of this agreement, Smart Commerce borrowed $1.8 million to be repaid in 24 monthly installments of $75,000 plus interest beginning in December 2006. The interest rate is prime plus 1.5% as periodically determined by Fifth Third Bank. The loan is secured by all of the assets of Smart Commerce and all of Smart Commerce's intellectual property. The loan is guaranteed by us and such guaranty is secured by all the common stock of Smart Commerce.

We also have a revolving line of credit from Wachovia. This line of credit is $2.5 million, and as of November 12, 2007, we have drawn down approximately $2.1 million. Any advances made on the line of credit must be repaid no later than August 1, 2008, with monthly payments of accrued interest only commencing on December 1, 2006 on any outstanding balance. The interest shall accrue on the unpaid principal balance at the LIBOR Market Index Rate plus 0.9%. The line of credit is secured by our deposit account at Wachovia and an irrevocable standby letter of credit in the amount of $2.5 million issued by HSBC Private Bank (Suisse) S.A. with Atlas as account party.

On November 14, 2007, in an initial closing, we sold $3.3 million aggregate principal amount of secured subordinated convertible notes due November 14, 2010. In addition, the noteholders have committed to purchase on a pro rata basis up to $5.2 million aggregate principal of secured subordinated notes upon approval and call by our Board of Directors in future closings. We are obligated to pay interest on the notes at an annualized rate of 8% payable in quarterly installments commencing on February 14, 2008.

In the future, we may need to evaluate additional equity and debt financing options and may incur indebtedness that could adversely affect our financial health. For example, indebtedness could:

- increase our vulnerability to general adverse economic and industry conditions;
- require us to dedicate a substantial portion of our cash flow from operations to payments on our debt, thereby reducing the availability of our cash flow to fund working capital, capital expenditures and other general corporate purposes;
- limit our flexibility in planning for, or reacting to, changes in our business and the industry in which we operate;
- result in the loss of a significant amount of our assets or the assets of our subsidiary if we are unable to meet the obligations of these arrangements;
- place us at a competitive disadvantage compared to our competitors that have less indebtedness or better access to capital by, for example, limiting our ability to enter into new markets; and
- limit our ability to borrow additional funds in the future.

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

Our loan from Fifth Third Bank is secured by all of the assets of Smart Commerce, including a security account of $250,000 and all of Smart Commerce's intellectual property. The loan is guaranteed by us, and such guaranty is secured by all the common stock of Smart Commerce. Our revolving line of credit from Wachovia is secured by our deposit account at Wachovia and an irrevocable standby line of credit issued by HSBC Private Bank (Suisse) S.A. with Atlas as account party. Our secured subordinated convertible notes are secured by a first-priority lien on all of our unencumbered assets, and a primary subordinated security interest in our encumbered assets, as permitted by our agreements with Wachovia and Fifth Third Bank.

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

Risks Associated with Our Products and Operations

(5) Our business is dependent upon the development and market acceptance of our applications, including the acceptance of using some of our applications to conduct business. Our business models and operating plans have changed as a result of forces beyond our control. Consequently, we have not yet demonstrated that we have a successful business model or operating plan.

We continually revise our business models and operating plans as a result of changes in our market, the expectations of customers and the behavior of competitors. Today, we anticipate that our future financial performance and revenue growth will depend, in large part, upon our Internet-based SaaS business model and the results of our sales efforts to reach agreements with syndication partners with small business customer bases, but this business model may become ineffective due to forces beyond our control that we do not currently anticipate. In 2007, we have entered into agreements with ten new partners and customers. However, we have not yet demonstrated that we have a successful business model or operating plan. Our evolving business model makes our business operations and prospects difficult to evaluate. There can be no assurance that our revised business model will allow us to capture significant future market potential. Investors in our securities should consider all the risks and uncertainties that are commonly encountered by companies in this stage of operations under our current business model, particularly companies, such as ours, that are in emerging and rapidly evolving markets.

Our future financial performance and revenue growth will depend, in part, upon the successful development, integration, introduction, and customer acceptance of our software applications. Thereafter, other new products, either developed or acquired, and enhanced versions of our existing applications will be critically important to our business. Our business could be harmed if we fail to deliver timely enhancements to our current and future solutions that our customers desire. We also must continually modify and enhance our services and products to keep pace with market demands regarding hardware and software platforms, database technology, information security, and electronic commerce technical standards. There can be no assurance that we will be able to successfully develop new services or products, or to introduce in a timely manner and gain acceptance of our new services or products in the marketplace.

Our business could be harmed if we fail to achieve the improved performance that customers want with respect to our current and future product offerings. There can be no assurance that our products will achieve widespread market penetration or that we will derive significant revenues from the sale or licensing of our platforms or applications.

Certain of our services involve the storage and transmission of customers' personal and proprietary information (such as credit card, employee, purchasing, supplier, and other financial and accounting data). If customers determine that our services do not provide adequate security for the dissemination of information over the Internet or corporate extranets, or are otherwise inadequate for Internet or extranet use, or if, for any other reason, customers fail to accept our products for use, our business will be harmed. Our failure to prevent security breaches, or well-publicized security breaches affecting the Internet in general, could significantly harm our business, operating results, and financial condition.

(6) We may consider strategic divestiture, acquisition or investment opportunities in the future. We face risks associated with any such opportunity.

From time to time we evaluate strategic opportunities available to us for product, technology or business acquisitions, investments and divestitures. In the future, we may divest ourselves of products or technologies that are not within our continually evolving business strategy or acquire other products or technologies. We may not realize the anticipated benefits of any such current or future opportunity to the extent that we anticipate, or at all. We may have to issue debt or equity securities to pay for future acquisitions or investments, the issuance of which could be dilutive to our existing stockholders. If any opportunity is not perceived as improving our earnings per share, our stock price may decline. In addition, we may incur non-cash amortization charges from acquisitions, which could harm our operating results. Any completed acquisitions or divestitures would also require significant integration or separation efforts, diverting our attention from our business operations and strategy. We have limited acquisition experience, and therefore our ability as an organization to integrate any acquired companies into our business is unproven. Acquisitions and investments involve numerous risks, including:

- difficulties in integrating operations, technologies, services and personnel
- diversion of financial and managerial resources from existing operations
- reduction of available cash
- risk of entering new markets
- potential write-offs of acquired assets
- potential loss of key employees
- inability to generate sufficient revenue to offset acquisition or investment costs

· delays in customer purchases due to uncertainty

If we fail to properly evaluate and execute acquisitions, divestitures or investments, our business and prospects may be seriously harmed.

(7) We rely on third-party software that may be difficult to repair should errors or failures occur. Such an error or failure, or the process undertaken by us to correct such an error or failure, could disrupt our services and harm our business.

We rely on software licensed from third parties in order to offer our services. We use key systems software from commercial vendors. The software we use may not continue to be available on commercially reasonable terms, or at all, or upgrades may not be available when we need them. We currently do not have support contracts or upgrade subscriptions with some of our key vendors. We are not currently aware of any immediate issues, but any loss of the right to use any of this software could result in delays in providing our services until equivalent technology is either developed by us, or, if available, is identified, obtained and integrated, which could harm our business. Any errors or defects in, or unavailability of, third-party software could result in errors or a failure of our services, which could harm our business.

We also use key systems software from leading open source communities that are free and available in the public domain. Our products will use additional public domain software, if needed for successful implementation and deployment. We currently do not have support contracts for the open source software that we use. We rely on our own research and development personnel and the open source community to discover and fix any errors and bugs that may exist in the software we use. As a result, if there are errors in such software of which we are unaware or are unable to repair in a timely manner, there could be a disruption in our services if certain critical defects are discovered in the software at a future date.

Risks Associated with Our Markets, Customers and Partners

(8) The structure of our subscription model makes it difficult to predict the rate of customer subscription renewals or the impact non-renewals will have on our revenue or operating results.

Our small business customers do not sign long-term contracts. Our customers have no obligation to renew their subscriptions for our services after the expiration of their initial subscription period and, in fact, customers have often elected not to do so. In addition, our customers may renew for a lower-priced edition of our services or for fewer users. Many of our customers utilize our services without charge. These factors make it difficult to accurately predict customer renewal rates. Our customers' renewal rates may decline or fluctuate as a result of a number of factors, including when we begin charging for our services, their dissatisfaction with our services and their capability to continue their operations and spending levels. Most of our subscribers are in our Smart Commerce segment. Since the first quarter of 2006, the number of subscribers to our software products in our Smart Online segment has declined. We are not certain what caused this decline. Some customers indicated that they had difficulty accessing our software applications on our website. Consequently, we redesigned our website and product bundling to address this problem. As of November 2007, the decline in the number of subscribers has continued, but has been offset by an increase in the number of subscribers to our Smart Commerce segment. However, if our customers do not renew their subscriptions for our services or we are not able to increase the number of subscribers, our revenue may decline and our business will suffer.

(9) We depend on corporate partners to market our products through their web sites under relatively short-term agreements in order to increase subscription fees and grow revenue. Failure of our partners' marketing efforts or termination of these agreements could harm our business.

Subscription fees represented approximately 58% of total revenues in the third quarter of 2007 compared to 57% of total revenues in the third quarter of 2006. With the launch of our new applications and the acquisition of iMart, subscription fees represent a significant percentage of our total revenues and our future financial performance and revenue growth depends, in large part, upon the growth in customer demand for our outsourced services delivery models. We depend on our syndication partners and referral relationships to offer our products and services to a larger customer base than we can reach through direct sales or other marketing efforts. Although we entered into agreements with ten new partners and customers during 2007, and a marketing referral agreement, our success depends in part on the ultimate success of our syndication partners and referral partners and their ability to market our products and services successfully. Our partners are not obligated to provide potential customers to us. In addition, some of these third parties have entered, and may continue to enter, into strategic relationships with our competitors. Further, many of our strategic partners have multiple strategic relationships, and they may not regard us as significant for their businesses. Our strategic partners may terminate their respective relationships with us, pursue other partnerships or relationships, or attempt to develop or acquire products or services that compete with our products or services. Our strategic partners also may interfere with our ability to enter into other desirable strategic relationships. If we are unable to maintain our existing strategic relationships or enter into additional strategic relationships, we will have to devote substantially more resources to the distribution, sales, and marketing of our products and services.

(10) Our future growth is substantially dependent on customer demand for our subscription services delivery models. Failure to increase this revenue could harm our business.

We have invested significantly in infrastructure, operations, and strategic relationships to support our SaaS delivery model, which represents a significant departure from the delivery strategies that other software vendors and we have traditionally employed. To maintain positive margins for our small business services, our revenues will need to continue to grow more rapidly than the cost of such revenues. There can be no assurance that we will be able to maintain positive gross margins in our subscription services delivery models in future periods. If our subscription services business does not grow sufficiently, we could fail to meet expectations for our results of operations, which could harm our business.

Any delays in implementation may prevent us from recognizing revenue for periods of time, even when we have already incurred costs relating to the implementation of our subscription services. Additionally, subscribers can cancel their subscriptions to our services at any time and, as a result, we may recognize substantially less revenue than we expect. If large numbers of customers cancel or otherwise seek to terminate subscription agreements more quickly than we expect, our operating results could be substantially harmed. To become successful, we must cause subscribers who do not pay fees to begin paying fees, increase the length of time subscribers pay subscription fees and continue to increase the number of subscribers.

(11) There are risks associated with international operations, which may become a bigger part of our business in the future.

We currently do not generate revenue from international operations. Although we signed an agreement with a company in January 2007 to market our products and services in a foreign country, this agreement has not yet generated any revenue for us. We are currently evaluating whether and how to expand into additional international markets. If we continue to develop our international operations, these operations will be subject to risks associated with selling abroad. These international operations are subject to a number of difficulties and special costs, including:

- costs of customization and localization of products for foreign countries
- laws and business practices favoring local competitors
- uncertain regulation of electronic commerce
- compliance with multiple, conflicting, and changing governmental laws and regulations
- longer sales cycles; greater difficulty in collecting accounts receivable
- import and export restrictions and tariffs
- potentially weaker protection for our intellectual property than in the United States, and practical difficulties in enforcing such rights abroad
- difficulties staffing and managing foreign operations
- political and economic instability

Our international operations may also face foreign currency-related risks. To date, all of our revenues have been denominated in United States Dollars, but an increasing portion of our revenues may be denominated in foreign currencies. We do not engage in foreign exchange hedging activities, and therefore our international revenues and expenses may be subject to the risks of foreign currency fluctuations.

We must also customize our services and products for international markets. This process is much more complex than merely translating languages. For example, our ability to expand into international markets will depend on our ability to develop and support services and products that incorporate the tax laws, accounting practices, and currencies of particular countries. Since a large part of our value proposition to customers is tied to developing products with the peculiar needs of small businesses in mind, any variation in business practice from one country to another may substantially decrease the value of our products in that country unless we identify the important differences and customize our product to address the differences.

Our international operations may also increase our exposure to international laws and regulations. If we cannot comply with domestic or foreign laws and regulations, which are often complex and subject to variation and unexpected changes, we could incur unexpected costs and potential litigation. For example, the governments of foreign countries might attempt to regulate our services and products or levy sales or other taxes relating to our activities. In addition, foreign countries may impose tariffs, duties, price controls or other restrictions on foreign currencies or trade barriers, any of which could make it more difficult for us to conduct our business in international markets.

Risks Associated with Our Officers, Directors, Employees and Stockholders

(12) Our executive management team is critical to the execution of our business plan and the loss of their services could severely impact negatively on our business.

Our executive management team recently has undergone significant changes. On August 15, 2007, we hired a new chief operating officer. On September 11, 2007, our President and Chief Executive Officer resigned from those positions and also resigned as a member of our Board of Directors. We terminated the employment of our Executive Vice President in September 2007, and we did not renew the employment contract of the chief operating officer and vice president of our Smart Commerce segment, which expired on October 17, 2007. We were able to appoint a person serving on our Board of Directors as an independent director to serve as Interim President and Chief Executive Officer and are currently in the process of determining who will serve as a permanent replacement. Although we have resolved the SEC charges filed against us, we may not be able to attract highly qualified candidates to serve as our President and Chief Executive Officer. If we cannot attract and retain a qualified replacement and to integrate new members of our executive management team effectively into our business, then our business and financial results may suffer.

Our success depends significantly on the continued services of our remaining executive management personnel. Losing any of our remaining officers could seriously harm our business. Competition for executives is intense. If we had to replace any of our other officers, we would not be able to replace the significant amount of knowledge that they may have about our operations. All of our executive team work at the same location, which could make us vulnerable to loss of our entire management team in the event of a natural or other disaster. We do not maintain key man insurance policies on any of our employees.

(13) Officers, directors and principal stockholders control us. This might lead them to make decisions that do not benefit the interests of minority stockholders.

Our officers, directors and principal stockholders beneficially own or control approximately 50% of our outstanding common stock. Certain of these principal stockholders hold warrants and convertible notes, which may be exercised or converted into additional shares of our common stock under certain conditions. The convertible noteholders have designated a bond representative to act as their agent. We have agreed that the bond representative shall be granted access to our facilities and personal during normal business hours, shall have the right to attend all meetings of our Board of Directors and its committees and to receive all materials provided to our Board of Directors or any committee of our Board. In addition, so long as the notes are outstanding, we have agreed that we will not take certain material corporate actions without approval of the bond representative.

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

Regulatory and Litigation Risks

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

As a public company, we have incurred and will incur significant legal, accounting and other expenses that we did not incur as a private company. We will incur costs associated with our public company reporting requirements. We also anticipate that we will incur costs associated with corporate governance and disclosure requirements, including requirements under the Sarbanes-Oxley Act of 2002, or Sarbanes-Oxley, as well as new rules implemented by the SEC and the NASD. We expect these rules and regulations to increase our legal and financial compliance costs and to make some activities more time consuming and costly. Any unanticipated difficulties in preparing for and implementing these reforms could result in material delays in complying with these laws and regulations or significantly increase our costs. Our ability to fully comply with these laws and regulations is also uncertain. Our failure to prepare timely for and implement the reforms required by these laws and regulations could significantly harm our business, operating results, and financial condition. We also expect that these rules and regulations may make it more difficult and more expensive for us to obtain director and officer liability insurance, and we may be required to accept reduced policy limits and coverage or incur substantially higher costs to obtain the same or similar coverage.

(15) Remediation of deficiencies in our internal control over financial reporting is uncertain and may be expensive.

By the end of fiscal 2007, we are required to comply with Sarbanes-Oxley requirements involving management's assessment of our internal control over financial reporting, and our independent accountant's audit of our internal control over financial reporting is required for fiscal 2008. In March 2006, we retained a new Chief Financial Officer, whose review of our internal control over financial reporting to date and the final findings of our 2006 Audit Committee investigation have identified several deficiencies in our internal control over financial reporting. In July 2006, the Audit Committee concluded that: (i) our then Chief Executive Officer should have disclosed and sought approval from the Board of Directors before entering into certain transactions and arrangements, including personal loans; (ii) there was inadequate diligence by management and the Board of Directors regarding third parties with which we contracted, including outside investor relations vendors, some of which were registered brokers; (iii) management and our directors lacked sufficient knowledge regarding rules and regulations with respect to dealings between registered brokers and public companies, (iv) we lack clear policies regarding the limits on the Chief Executive Officer's authority to enter into business transactions and agreements without Board approval; (v) there has been inadequate legal and accounting review of material contracts; (vi) there has been inadequate training and understanding of SEC disclosure requirements; (vii) there was an unintentional violation of our Securities Trading Policy by one of our directors as previously reported in our public filings; (viii) we have inadequate processes for determination of independence of Board members; and (ix) there has been a failure to communicate and stress the importance of controls and procedures throughout our organization. The Audit Committee investigation concluded that these deficiencies primarily resulted from our transition from a private company to a publicly reporting company and insufficient preparation for, focus on, and experience with compliance requirements for a publicly reporting company. We reported the changes to our internal controls related to the Audit Committee's findings in our Annual Report on Form 10-K for the fiscal year ended December 31, 2005, filed with the SEC on July 11, 2006, as updated in our Annual Report on Form 10-K for the fiscal year ended December 31, 2006, filed with the SEC on March 30, 2007.

While we have made some progress on this remediation effort, we continue to work on addressing all the issues raised in these findings. We have identified some deficiencies and may identify others that we may not be able to remediate and test by the end of fiscal 2007.

If we cannot assess our internal controls over financial reporting as effective, it may affect our management's assessment of our internal control environment as it will be disclosed in our Annual Report on Form 10-K for fiscal 2007 and our stock price could decline.

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

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

Legal and other fees related to these actions have also reduced our cash flow. We completed a private placement financing for $6 million in February 2007 and a convertible note financing for an initial $3.3 million in November 2007; however, we make no assurance that we will not continue to experience additional harm as a result of these matters. The time spent by our management team and directors dealing with issues related to these actions detracts from the time they spend on our operations, including strategy development and implementation. These actions also have harmed our reputation in the business community and jeopardized our relationships with vendors and customers, especially given the media coverage of these events. An important part of our business plan is to enter into private label syndication agreements with large companies. These actions and related matters have caused us to be a less attractive partner for large companies and to lose important opportunities. These actions and related matters may cause other problems in our operations.

(17) We face uncertainty regarding amounts that we may have to pay as indemnification to certain current and former officers, directors and employees under our Bylaws and Delaware law. We may not recover all of these amounts from our directors and officers liability insurance policy carrier. These expenses may substantially harm our business and operations.

Our Bylaws and Delaware law generally require us to indemnify, and in certain circumstances advance legal expenses to, current and former officers, directors, employees and agents against claims arising out of such person’s status or activities as our officer, director, employee or agent, unless such person (i) did not act in good faith and in a manner the person reasonably believed to be in or not opposed to our best interests or (ii) had reasonable cause to believe his conduct was unlawful. As of November 12, 2007, there are SEC and criminal actions pending against a former executive officer and a former employee who have requested that we indemnify them and advance expenses incurred by them in the defense of those actions. Also, a stockholder class action lawsuit has been filed against us and certain of our current and former officers, directors and employees. The SEC, criminal, and stockholder actions are more fully described in Part II, Item 1, “Legal Proceedings” in this report.

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

Although we have purchased insurance that may cover these obligations, we can offer no assurances that all of the amounts that may be expended by us will be recovered under our insurance policy. It is possible that we may have an obligation to indemnify our current and former officers, directors and employees under the terms of our Bylaws and Delaware law, but that there may be insufficient coverage for these payments under the terms of our insurance policy. The available coverage under our directors and officers liability insurance policy for the SEC, criminal and stockholder actions is limited to $3 million. Approximately $1 million of this coverage, including a $150,000 retention, already has been paid in connection with the SEC investigation that commenced in January 2006, leaving approximately $2 million in available coverage for the current actions. Therefore, we face the risk of making substantial payments related to the defense of these actions, which could significantly reduce amounts available to fund working capital, capital expenditures and other general corporate objectives.

In addition, our insurance policy provides that, under certain conditions, our insurer may have the right to seek recovery of any amounts it paid to the individual insureds or us. As of November 12, 2007, we do not know and can offer no assurances about whether these conditions will apply or whether the insurance carrier will change its position regarding coverage related to the current actions. Therefore, we can offer no assurances that our insurer will not seek to recover any amounts paid under its policy from the individual insureds or us. If such recovery is sought, then we may have to expend considerable financial resources in defending and potentially settling or otherwise resolving such a claim, which could substantially reduce the amount of capital available to fund our operations.

Finally, if our directors and officers liability insurance premiums increase as a result of the current actions, our financial results may be materially harmed in future periods. If we are unable to obtain coverage due to prohibitively expensive premiums, we would have more difficulty in retaining and attracting officers and directors and would be required to self-fund any potential future liabilities ordinarily mitigated by directors and officers liability insurance.

Risks Associated with the Market for Our Securities

(18) If securities analysts do not publish research or reports about our business or if they downgrade our stock, the price of our stock could decline.

The trading market for our common stock relies in part on the research and reports that industry or financial analysts publish about us or our business. Because our stock is currently quoted on the Over-the-Counter Bulletin Board rather than traded on a national exchange, analysts may not be interested in conducting research or publishing reports on us. If we do not succeed in attracting analysts to report about our company, most investors will not know about us even if we are successful in implementing our business plan. We do not control these analysts. There are many large, well established publicly traded companies active in our industry and market, which may mean it will be less likely that we receive widespread analyst coverage. Furthermore, if one or more of the analysts who do cover us downgrade our stock, our stock price would likely decline rapidly. If one or more of these analysts cease coverage of our company, we could lose visibility in the market, which in turn could cause our stock price to decline.

(19) Our revenues and operating results may fluctuate in future periods and we may fail to meet expectations of investors and public market analysts, which could cause the price of our common stock to decline.

Our revenues and operating results may fluctuate significantly from quarter to quarter. If quarterly revenues or operating results fall below the expectations of investors or public market analysts, the price of our common stock could decline substantially. Factors that might cause quarterly fluctuations in our operating results include:

- the evolving demand for our services and software
- spending decisions by our customers and prospective customers
- our ability to manage expenses
- the timing of product releases
- changes in our pricing policies or those of our competitors
- the timing of execution of contracts
- changes in the mix of our services and software offerings
- the mix of sales channels through which our services and software are sold

- costs of developing product enhancements
- global economic and political conditions
- our ability to retain and increase sales to existing customers, attract new customers and satisfy our customers' requirements
- subscription renewal rates for our service
- the rate of expansion and effectiveness of our sales force

- the length of the sales cycle for our service
- new product and service introductions by our competitors
- technical difficulties or interruptions in our service
- regulatory compliance costs
- integration of acquisitions
- extraordinary expenses such as litigation or other dispute-related settlement payments

In addition, due to a slowdown in the general economy and general uncertainty of the current geopolitical environment, an existing or potential customer may reassess or reduce its planned technology and Internet-related investments and defer purchasing decisions. Further delays or reductions in business spending for technology could have a material adverse effect on our revenues and operating results.

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

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

- variations in our actual and anticipated operating results
- the volatility inherent in stock prices within the emerging sector in which we conduct business
- announcements of technological innovations, new services or service enhancements, strategic alliances or significant agreements by us or by our competitors
- recruitment or departure of key personnel
- changes in the estimates of our operating results or changes in recommendations by any securities analysts that elect to follow our common stock
- market conditions in our industry, the industries of our customers and the economy as a whole
- the volume of trading in our common stock, including sales of substantial amounts of common stock issued upon the exercise of outstanding options and warrants

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

Further, securities class action litigation has often been brought against companies that experience periods of volatility in the market prices of their securities. Such an action was filed against us in October 2007 as more fully described elsewhere in this report. This securities class action litigation could result in substantial costs and a diversion of our management's attention and resources. We may determine, like many defendants in such lawsuits, that it is in our best interests to settle the lawsuit, even if we believe that the plaintiffs' claims have no merit, to avoid the cost and distraction of continued litigation. Any liability we incur in connection with this or any other potential lawsuit could materially harm our business and financial position and, even if we defend ourselves successfully, there is a risk that management's distraction in dealing with this type of lawsuit could harm our results.

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

Certain holders of shares of our common stock signed agreements that prohibit resales of our common stock. If substantial numbers of shares are resold as lock-up periods expire, the market price of our common stock is likely to decrease substantially.

At November 12, 2007, 18,009,564 shares of our common stock were issued and outstanding and 3,855,215 shares may be issued pursuant to the exercise of warrants and options. In addition, on November 14, 2007, we sold $3.3 million aggregate principal amount of secured subordinate convertible notes due November 14, 2010, which principal amount may be converted into the number of shares of our common stock calculated by using a conversion price equal to a 20% premium above the average of the closing bid and asked prices of shares of our common stock quoted in the Over-the-Counter Market Summary averaged over five trading days prior to November 14, 2007. During May 2005, we registered on Form S-8 5,000,000 shares of our common stock for issuance to our officers, directors and consultants under the 2004 Plan, of which at November 12, 2007, 156,000 unrestricted shares were outstanding, 174,500 restricted shares were outstanding and 1,373,700 shares are subject to outstanding stock options of the 5,000,000 shares reserved for issuance under the 2004 Plan. In June 2007, we limited the issuance of shares of our common stock reserved under the 2004 Plan to awards of shares of restricted and unrestricted common stock. Also in June 2007, our Board of Directors approved an offer for certain holders of outstanding options with an exercise price of $2.50 per share or greater to exchange the outstanding options for a certain number of shares of restricted stock. We target that the restriction on these shares of stock would lapse in four equal, quarterly increments over the year following the acceptance of the exchange offer. The exchange offer has not commenced and will not commence until certain actions are taken by us, including a filing of a tender offer statement and offer to exchange on Scheduled TO with the SEC. This Quarterly Report on Form 10-Q is not an offer or solicitation of an offer to sell or exchange any outstanding options.

We entered into agreements that limit the number of shares that may be sold during specific time periods, or Dribble Out Agreements, with all of the investors who purchased shares of our stock from us in private placements during 2005 and 2006, a total of approximately 2,497,000 shares. Under these Dribble Out Agreements, sales of shares are limited to 25% during a rolling 30-day period. Such limitations terminate six months after the effective date of the registration statement registering these shares. Almost all of these shares are registered on our Registration Statement on Form S-1 (Registration No. 333-141853), or the Registration Statement, which was declared effective by the SEC as of July 31, 2007.

Certain of our affiliates have also entered into other Lock-Up Agreements covering a portion of their shares. These agreements restrict the sale of 1,296,623 shares of our common stock. Under the terms of these Lock-Up Agreements, these affiliates cannot sell, pledge, grant or otherwise transfer the shares subject to the agreement for one year following July 31, 2007. After one year, 2.5% of these shares per quarter are released from these restrictions on a pro rata basis among these affiliates. All remaining shares will be released from the Lock-Up Agreements on July 31, 2009. These Lock-Up Agreements will otherwise terminate at the following times: (A) if the Registration Statement is terminated, the earlier of (i) the date of termination if no shares were sold, or (ii) the date any proceeds received from public investors are placed in the mail for return; (B) the date our common stock is listed on a national securities exchange, or (C) 30 days following the date the persons signing these Lock-Up Agreements are no longer affiliates.

Our stock is very thinly traded. The average daily trading volume for our common stock between January 2007 and November 2007 was approximately 16,200 shares per day. The number of shares that could be sold during this period was restrained by Dribble Out Agreements, Lock-Up Agreements, and other contractual limitations imposed on some of our shares, while there was no similar contractual restraint on the number of buyers of our common stock. This means that market supply may increase more than market demand for our shares when lock-up and dribble-out periods expire. Many companies experience a decrease in the market price of their shares when such events occur.

We cannot predict if future sales of our common stock, or the availability of our common stock held for sale, will materially and adversely affect the market price for our common stock or our ability to raise capital by offering equity or other securities. Our stock price may decline if the resale of shares under Rule 144, in addition to the resale of registered shares, at any time in the future exceeds the market demand for our stock.

Future sales of substantial amounts of our shares in the public market could adversely affect market prices prevailing from time to time and could impair our ability to raise capital through the sale of our securities.

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

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

The penny stock rules require a broker-dealer, prior to a transaction in a penny stock not otherwise exempt from those rules, to deliver a standardized risk disclosure document prescribed by the SEC, which:

- contains a description of the nature and level of risk in the market for penny stocks in both public offerings and secondary trading

- contains a description of the broker's or dealer's duties to the customer and of the rights and remedies available to the customer with respect to a violation of such duties or other requirements

- contains a brief, clear, narrative description of a dealer market, including "bid" and "ask" prices for penny stocks and the significance of the spread between the bid and ask price

- contains a toll-free telephone number for inquiries on disciplinary actions

- defines significant terms in the disclosure document or in the conduct of trading penny stocks

- contains such other information and is in such form (including language, type, size, and format) as the SEC requires

The broker-dealer also must provide the customer, prior to effecting any transaction in a penny stock, with:

- bid and ask quotations for the penny stock

- the compensation of the broker-dealer and its salesperson in the transaction

- the number of shares to which such bid and ask prices apply, or other comparable information relating to the depth and liquidity of the market for such stock

- monthly account statements showing the market value of each penny stock held in the customer's account

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

5. OTHER INFORMATION

Effective October 16, 2007, we amended our Third Amended and Restated Bylaws. The amendment permits us to issue shares of our stock in book entry form in addition to preparing stock certificates.

Effective October 17, 2007, the employment contract between Smart Commerce and Gary Mahieu expired according to the terms of that agreement, and as of that date Mr. Mahieu no longer serves as an employee of ours or Smart Commerce. Mr. Mahieu had served as the Chief Operating Officer and Vice President at Smart Commerce.

On November 14, 2007, in an initial closing, we sold $3.3 million aggregate principal amount of secured subordinated convertible notes due November 14, 2010. In addition, the noteholders have committed to purchase on a pro rata basis up to $5.2 million aggregate principal of secured subordinated notes upon approval and call by our Board of Directors in future closings. We are obligated to pay interest on the notes at an annualized rate of 8% payable in quarterly installments commencing on February 14, 2008. We do not have the ability to prepay the notes without approval 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, acquisition, sale of all or substantially all of our assets or capital stock or similar transaction, each noteholder in its sole discretion shall have the option to:

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

If a noteholder elects to convert its note under these circumstances, the conversion price for notes:

- issued in the initial closing on November 14, 2007 shall be a 20% premium above the average of the closing bid and asked prices of shares of our common stock quoted in the Over-The-Counter Market Summary averaged over five trading days prior to November 14, 2007; and
- issued in any additional closings shall be the lesser of a 20% premium above the average of the closing bid and asked prices of shares of our common stock quoted in the Over-The-Counter Market Summary (or, if our shares are traded on the Nasdaq Stock Market or another exchange, the closing price of shares of our common stock quoted on such exchange) averaged over five trading days prior to :

- o November 14, 2007; or
- o the respective additional closing date.

Upon the following events of default and at any time during the continuance of such an event of default, the noteholders have the right, with the consent of the agent appointed for such noteholders, to accelerate payment on their notes:

- · failure to pay any amounts when due;
- · non-performance of any material covenant that remains uncured for 15 days;
- · any of our representations and warranties prove to have been false or misleading in any material respect when made;
- · one or more judgments, decrees, or orders (excluding settlement orders) for the payment of money in the aggregate of $1,000,000 or more is entered against us or a subsidiary and is not discharged or stayed for a period of 60 days; or
- · default by us or a subsidiary under any agreement related to indebtedness resulting in the acceleration of more than $500,000 of indebtedness.

In addition, payment of the notes will be automatically accelerated if we enter voluntary or involuntary bankruptcy or insolvency proceedings.

The notes are secured by a first-priority lien on all our unencumbered assets, and a primary subordinated security interest in our encumbered assets, as permitted by our agreements with Wachovia and Fifth Third Bank.

The notes and the common stock into which they may be converted have not been registered under the Securities Act of 1933, as amended, or the Securities Act, or the securities laws of any other jurisdiction. As a result, offers and sales of the notes were made pursuant to Regulation D of the Securities Act and only made to accredited investors that were our existing stockholders. The investors include, among others, (i) The Blueline Fund, who originally recommended Philippe Pouponnot, one of the Company's directors, for appointment to the Company's Board of Directors, (ii) Atlas Capital, S.A., who originally recommended Shlomo Elia, another one of the Company's directors, for appointment to the Board of Directors, and (iii) William Furr, who is the father of Thomas Furr, one of the Company's directors and executive officers. Unless and until they are registered, the notes and the common stock into which they may be converted may not be offered or sold except pursuant to an exemption from, or in a transaction not subject to, the registration requirements of the Securities Act or applicable securities laws of other jurisdictions.

If notes are converted into our common stock and a demand for registration of the shares of common stock is made by a holder of a majority of the converted common stock, we have agreed, subject to certain limitations, to use our best efforts to file a registration statement with the SEC:

- · within 180 days of such demand if:
- o we are eligible to use Form S-1, and
- o the demand is made with respect to at least 40% of the converted common stock then outstanding (or a lesser percentage if the anticipated aggregate offering price, net of selling expenses, would exceed $5 million); and
- · within 90 days of such demand if:
- o we are eligible to use Form S-3, and
- o the demand is made with respect to at least 30% of the converted common stock then outstanding (or a lesser percentage if the anticipated aggregate offering price, net of selling expenses, would exceed $2 million).

In addition, if we propose to file a registration statement to register any of our common stock under the Securities Act in connection with the public offering of such securities solely for cash, subject to certain limitations, we 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. We have agreed to bear the expenses for any of these registrations, exclusive of any stock transfer taxes, underwriting discounts and commissions.

The noteholders have designated a bond representative to act as their agent. We have agreed that the bond representative shall be granted access to our facilities and personal during normal business hours, shall have the right to attend all meetings of our Board of Directors and its committees and to receive all materials provided to our Board of Directors or any committee of our Board. We have agreed to pay all reasonable travel and lodging expenses of the bond representative related to his access to our facilities. In addition, so long as the notes are outstanding, we have agreed that we will not take any of the following actions without approval of the bond representative:

- make any loan or advance to, or own any stock or other securities of, any subsidiary or other corporation, partnership, or other entity unless it is wholly owned by us except that we may own securities of 1-800-Pharmacy, Inc. pursuant to an agreement we have with them without obtaining the bond representative's consent;

- make any loan or advance to any person, except advances and similar expenditures in the ordinary course of business or under the terms of an employee stock or option plan approved by our Board of Directors;

- guarantee any indebtedness except for our trade accounts or those of a subsidiary arising in the ordinary course of business;

- make any investment other than investments in prime commercial paper, money market funds, certificates of deposit in any United States bank having a net worth in excess of $100,000,000 or obligations issued or guaranteed by the United States of America, in each case having a maturity not in excess of two years;

- incur any aggregate indebtedness in excess of $25,000, other than trade credit incurred in the ordinary course of business;

- increase or approve the compensation of our named executive officers, including benefits, bonuses and issuances of equity compensation;

- change our principal business, enter new lines of business, or exit the current line of business;

- sell, transfer, exclusively license, pledge or encumber technology or intellectual property;

- create or authorize the creation of or issue any other security convertible into or exercisable for any equity security, other than issuances to employees pursuant to equity compensation plans approved by our Board of Directors;

- purchase or redeem or pay any dividend on any capital stock, other than stock repurchased from former employees or consultants in connection with the cessation of their employment/services, at the lower of fair market value or cost; or

- increase the number of shares authorized for issuance to officers, directors, employees, consultants and advisors pursuant to equity incentive plans or arrangements.

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.

Proceeds from the sale of notes in the initial closing will be used to meet ongoing working capital and capital spending requirements.

6. EXHIBITS

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

Exhibit No.	Description
3.1	Fourth Amended and Restated Bylaws
4.1	Convertible Secured Subordinated Note Purchase Agreement, dated November 14, 2007, by and among Smart Online, Inc. and certain investors

4.2	Form of Convertible Secured Subordinated Promissory Note
10.1	Form of Amendment to Registration Rights Agreement, dated July 3, 2007, by and between Smart Online, Inc. and each of Magnetar Capital Master Fund, Ltd. and Herald Investment Management Limited on behalf of Herald Investment Trust PLC (incorporated herein by reference to Exhibit 10.55 to Amendment No. 3 to our Registration Statement on Form S-1 (Registration No. 333-141853), as filed with the SEC on July 31, 2007)
10.2	Form of Lock-In Agreement, dated July 30, 2007, by and between Smart Online, Inc. and certain of its affiliates (incorporated herein by reference to Exhibit 10.56 to Amendment No. 3 to our Registration Statement on Form S-1 (Registration No. 333-141853), as filed with the SEC on July 31, 2007)

10.3	Form of Restricted Stock Award Agreement (for employees) under Smart Online, Inc.'s 2004 Equity Compensation Plan (incorporated herein by reference to Exhibit 10.1 to our Current Report on Form 8-K, as filed with the SEC on August 21, 2007)
10.4	Employment Agreement, dated August 15, 2007, with Joseph Francis Trepanier III
10.5	Amendment, dated August 15, 2007, to Employment Agreement, dated April 1, 2004, with Thomas P. Furr
10.6	Registration Rights Agreement, dated November 14, 2007, by and among Smart Online, Inc. and certain investors
10.7	Security Agreement, dated November 14, 2007, among Smart Online, Inc. and Doron Roethler, as agent for certain investors
10.8	Promissory Note, Modification Number One to Loan Agreement, and Security Agreement, dated January 24, 2007, by and between Smart Online, Inc. and Wachovia Bank, NA
31.1	Certification of Principal Executive Officer Pursuant to Rule 13a-14(a) as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Principal Financial Officer Pursuant to Rule 13a-14(a) as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Principal Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. This exhibit is being furnished pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not, except to the extent required by that Act, be deemed to be incorporated by reference into any document or filed herewith for the purposes of liability under the Securities Exchange Act of 1934, as amended, or the Securities Act of 1933, as amended, as the case may be.
32.2	Certification of Principal Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. This exhibit is being furnished pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not, except to the extent required by that Act, be deemed to be incorporated by reference into any document or filed herewith for the purposes of liability under the Securities Exchange Act of 1934, as amended, or the Securities Act of 1933, as amended, as the case may be.

SIGNATURES

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

Dated: November 14, 2007

Smart Online, Inc.

/s/ David E. Colburn
David E. Colburn
Principal Executive Officer

Smart Online, Inc.

/s/ Nicholas Sinigaglia
Nicholas Sinigaglia
Principal Financial Officer and
Principal Accounting Officer

EXHIBIT INDEX

Exhibit No.	Description
3.1	Fourth Amended and Restated Bylaws
4.1	Convertible Secured Subordinated Note Purchase Agreement, dated November 14, 2007, by and among Smart Online, Inc. and certain investors
4.2	Form of Convertible Secured Subordinated Promissory Note
10.1	Form of Amendment to Registration Rights Agreement, dated July 3, 2007, by and between Smart Online, Inc. and each of Magnetar Capital Master Fund, Ltd. and Herald Investment Management Limited on behalf of Herald Investment Trust PLC (incorporated herein by reference to Exhibit 10.55 to Amendment No. 3 to our Registration Statement on Form S-1 (Registration No. 333-141853), as filed with the SEC on July 31, 2007)
10.2	Form of Lock-In Agreement, dated July 30, 2007, by and between Smart Online, Inc. and certain of its affiliates (incorporated herein by reference to Exhibit 10.56 to Amendment No. 3 to our Registration Statement on Form S-1 (Registration No. 333-141853), as filed with the SEC on July 31, 2007)
10.3	Form of Restricted Stock Award Agreement (for employees) under Smart Online, Inc.'s 2004 Equity Compensation Plan (incorporated herein by reference to Exhibit 10.1 to our Current Report on Form 8-K, as filed with the SEC on August 21, 2007)
10.4	Employment Agreement, dated August 15, 2007, with Joseph Francis Trepanier III
10.5	Amendment, dated August 15, 2007, to Employment Agreement, dated April 1, 2004, with Thomas P. Furr
10.6	Registration Rights Agreement, dated November 14, 2007, by and among Smart Online, Inc. and certain investors
10.7	Security Agreement, dated November 14, 2007, among Smart Online, Inc. and Doron Roethler, as agent for certain investors
10.8	Promissory Note, Modification Number One to Loan Agreement, and Security Agreement, dated January 24, 2007, by and between Smart Online, Inc. and Wachovia Bank, NA
31.1	Certification of Principal Executive Officer Pursuant to Rule 13a-14(a) as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Principal Financial Officer Pursuant to Rule 13a-14(a) as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Principal Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. This exhibit is being furnished pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not, except to the extent required by that Act, be deemed to be incorporated by reference into any document or filed herewith for the purposes of liability under the Securities Exchange Act of 1934, as amended, or the Securities Act of 1933, as amended, as the case may be.
32.2	Certification of Principal Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. This exhibit is being furnished pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not, except to the extent required by that Act, be deemed to be incorporated by reference into any document or filed herewith for the purposes of liability under the Securities Exchange Act of 1934, as amended, or the Securities Act of 1933, as amended, as the case may be.