

SMART ONLINE INC
Form 10-Q
May 13, 2011

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2011

OR

- Transition report pursuant to Section 13 of 15(d) of the Securities Exchange Act of 1934

Commission File Number: 001-32634

SMART ONLINE, INC.
(Exact name of registrant as specified in its charter)

| | |
|--|---|
| Delaware (State or other jurisdiction of incorporation or organization) | 95-4439334 (I.R.S. Employer Identification No.) |
| 4505 Emperor Blvd., Ste. 320 Durham, North Carolina (Address of principal executive offices) | 27703 (Zip Code) |

(919) 765-5000
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant 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 during

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the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company

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

As of May 11, 2011, there were approximately 18,342,543 shares of the registrant's common stock, par value \$0.001 per share, outstanding.

SMART ONLINE, INC.

FORM 10-Q

For the Quarterly Period Ended March 31, 2011

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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements

SMART ONLINE, INC.
BALANCE SHEETS

| | March 31, 2011 (unaudited) | December 31, 2010 |
|--|----------------------------------|----------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 225,285 | \$ 860,211 |
| Restricted cash | 222,442 | 249,998 |
| Accounts receivable, net | - | 8,931 |
| Prepaid expenses | 105,661 | 164,692 |
| Total current assets | 553,388 | 1,283,832 |
| Property and equipment, net | 191,187 | 202,922 |
| Other assets | - | 5,000 |
| TOTAL ASSETS | \$ 744,575 | \$ 1,491,754 |
| LIABILITIES AND STOCKHOLDERS' DEFICIT | | |
| Current liabilities: | | |
| Accounts payable | \$ 818,567 | \$ 551,759 |
| Notes payable | 28,282 | 40,564 |
| Deferred revenue | 16,000 | 22,271 |
| Accrued liabilities | 2,914,646 | 3,519,376 |
| Total current liabilities | 3,777,495 | 4,133,970 |
| Long-term liabilities: | | |
| Notes payable | 17,237,492 | 16,666,469 |
| Deferred revenue | 430 | 294 |
| Total long-term liabilities | 17,237,922 | 16,666,763 |
| Total liabilities | 21,015,417 | 20,800,733 |
| Commitments and contingencies | | |
| Stockholders' deficit: | | |
| Preferred stock, \$0.001 par value, 5,000,000 shares authorized, no shares issued and outstanding at March 31, 2011 and December 31, 2010 | - | - |
| Common stock, \$0.001 par value, 45,000,000 shares authorized, 18,352,543 and 18,342,542 shares issued and outstanding at March 31, 2011 and December 31, 2010, respectively | 18,353 | 18,343 |
| Additional paid-in capital | 67,096,493 | 67,070,568 |
| Accumulated deficit | (87,385,688) | (86,397,890) |
| Total stockholders' deficit | (20,270,842) | (19,308,979) |
| TOTAL LIABILITIES AND STOCKHOLDERS' DEFICIT | \$ 744,575 | \$ 1,491,754 |

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

SMART ONLINE, INC.
STATEMENTS OF OPERATIONS
(unaudited)

| | Three Months Ended | |
|---|---------------------|---------------------|
| | March 31, 2011 | March 31, 2010 |
| REVENUES: | | |
| Subscription fees | \$ 103,272 | \$ 136,258 |
| Professional service fees | - | 62,775 |
| License fees | - | 87,800 |
| Hosting fees | - | 44,272 |
| Other revenue | 35,466 | 32,795 |
| Total revenues | 138,738 | 363,900 |
| COST OF REVENUES | 192,316 | 365,934 |
| GROSS PROFIT | (53,578) | (2,034) |
| OPERATING EXPENSES: | | |
| Sales and marketing | 142,055 | 152,635 |
| Research and development | 158,892 | 32,005 |
| General and administrative | 338,966 | 672,419 |
| Total operating expenses | 639,913 | 857,059 |
| LOSS FROM OPERATIONS | (693,491) | (859,093) |
| OTHER INCOME (EXPENSE): | | |
| Interest expense, net | (294,329) | (210,695) |
| Gain on legal settlements, net | 22 | 152,863 |
| Total other expense | (294,307) | (57,832) |
| NET LOSS | \$ (987,798) | \$ (916,925) |
| NET LOSS PER COMMON SHARE: | | |
| Basic and fully diluted | \$ (0.05) | \$ (0.05) |
| WEIGHTED-AVERAGE NUMBER OF SHARES USED IN COMPUTING NET LOSS PER COMMON SHARE: | | |
| Basic and fully diluted | 18,352,543 | 18,342,542 |

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

SMART ONLINE, INC.
STATEMENTS OF CASH FLOWS
(unaudited)

| | Three Months Ended | |
|---|--------------------|-------------------|
| | March 31, 2011 | March 31, 2010 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net loss | \$ (987,798) | \$ (916,925) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Depreciation and amortization | 14,215 | 16,209 |
| Provision for doubtful accounts | - | 179,517 |
| Equity-based compensation | 25,936 | 3,561 |
| Changes in assets and liabilities: | | |
| Accounts receivable | 8,931 | (121,343) |
| Notes receivable | - | (45,118) |
| Prepaid expenses | 59,031 | 55,029 |
| Other assets | 5,000 | 1,401 |
| Accounts payable | 266,805 | 234,492 |
| Deferred revenue | (6,135) | (6,561) |
| Accrued and other expenses | (604,730) | (191,456) |
| Net cash used in operating activities | (1,218,745) | (791,194) |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchases of property and equipment | (2,480) | (835) |
| Capitalized software | - | 17,273 |
| Net cash provided by (used in) investing activities | (2,480) | 16,438 |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Restricted cash used to pay IDB interest expense | 27,556 | - |
| Proceeds from debt borrowings | 575,000 | 1,982,698 |
| Repayments of debt borrowings | (16,257) | (1,305,261) |
| Net cash provided by financing activities | 586,299 | 677,437 |
| NET (DECREASE) IN CASH AND CASH EQUIVALENTS | (634,926) | (97,319) |
| CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD | 860,211 | 119,796 |
| CASH AND CASH EQUIVALENTS, END OF PERIOD | \$ 225,285 | \$ 22,477 |
| Supplemental disclosures of cash flow information: | | |
| Cash paid during the period for: | | |
| Interest | \$ 294,332 | \$ 228,981 |
| Income taxes | \$ - | \$ - |

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

SMART ONLINE, INC.
NOTES TO FINANCIAL STATEMENTS
For the Quarterly Period Ended March 31, 2011
(unaudited)

1. SUMMARY OF BUSINESS AND SIGNIFICANT ACCOUNTING POLICIES

Description of Business - Smart Online, Inc. (the "Company") was incorporated in the State of Delaware in 1993. The Company develops and markets software products and services targeted to small businesses that are delivered via a Software-as-a-Service ("SaaS") model. The Company sells its SaaS products and services through direct sales representatives and private-label marketing partners. In addition, the Company provides website consulting services, mobile websites and mobile applications, primarily in the e-commerce retail and direct-selling organization industries. The Company maintains a website for potential partners containing certain corporate information located at www.smartonline.com.

Basis of Presentation - The financial statements as of and for the three months ended March 31, 2011 and 2010 included in this Quarterly Report on Form 10-Q are unaudited. The balance sheet as of December 31, 2010 is obtained from the audited financial statements as of that date. The accompanying statements should be read in conjunction with the audited financial statements and related notes, together with management's discussion and analysis of financial condition and results of operations, contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2010 filed with the Securities and Exchange Commission (the "SEC") on March 31, 2011 (the "2010 Annual Report").

The financial statements have been prepared in accordance with accounting principles generally accepted in the United States ("U.S. GAAP"). In the opinion of the Company's management, the unaudited statements in this Quarterly Report on Form 10-Q include all normal and recurring adjustments necessary for the fair presentation of the Company's statement of financial position as of March 31, 2011, and its results of operations and cash flows for the three months ended March 31, 2011 and 2010. The results for the three months ended March 31, 2011 are not necessarily indicative of the results to be expected for the fiscal year ending December 31, 2011.

The accompanying financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. During the three months ended March 31, 2011 and 2010, the Company incurred net losses as well as negative cash flows, settled a class action lawsuit (subject to court approval), (See Note 7, "Commitments and Contingencies," in the 2010 Annual Report), and had deficiencies in working capital. These factors indicate that the Company may be unable to continue as a going concern.

The financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or the amounts or classification of liabilities that might be necessary should the Company be unable to continue as a going concern. At May 9, 2011, the Company has a commitment from its convertible secured subordinated noteholders to purchase up to an additional \$1.225 million in convertible notes upon approval and call by the Company's Board of Directors. There can be no assurance that, if the noteholders do not purchase the \$1.225 million in convertible notes, the Company will be able to obtain alternative funding. There can be no assurance that the Company's efforts to raise capital or increase revenue will be successful. If these efforts are unsuccessful, the Company may have to cease operations and liquidate the business. The Company's continuation as a going concern depends upon its ability to generate sufficient cash flows to meet its obligations on a timely basis, to obtain additional financing as may be required, and ultimately to attain profitable operations and positive cash flows.

Significant Accounting Policies - In the opinion of the Company's management, the significant accounting policies used for the three months ended March 31, 2011 are consistent with those used for the year ended December 31, 2010. Accordingly, please refer to the 2010 Annual Report for the Company's significant accounting policies.

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

Reclassifications - Certain prior year and comparative period amounts have been reclassified to conform to current year presentation. These reclassifications had no effect on previously reported net income or stockholders' deficit.

Stock-Based Compensation - Effective January 1, 2006, the Company began recognizing stock based compensation, using the Modified Prospective Approach based on the grant date fair value estimated in accordance with US GAAP. Under the Modified Prospective Approach, the amount of compensation cost recognized includes (i) compensation cost for all share-based payments granted prior to, but not yet vested as of, January 1, 2006, and (ii) compensation cost for all share-based payments that are granted subsequent to January 1, 2006. Stock-based compensation is recognized on the straight-line method over the requisite service period. Total stock-based compensation expense recognized was \$25,936 and \$3,561 for the quarters ended March 31, 2011 and 2010 respectively. No stock-based compensation was capitalized in the consolidated financial statements.

The fair value of option grants under the Company's equity compensation plan for the three months ended March 31, 2011 and 2010 were estimated using the following weighted average assumptions:

| | Three Months Ended March 31, | |
|-------------------------|------------------------------|-------|
| | 2011 | 2010 |
| Dividend yield | 0.0% | 0.0% |
| Expected volatility | 92.5% | 98.7% |
| Risk-free interest rate | 2.86% | 3.19% |
| Expected lives (years) | 10.0 | 4.0 |

Net Loss Per Share - Basic net loss per share is computed by dividing net loss by the weighted average number of common shares outstanding during the periods. Diluted net loss per share is computed using the weighted average number of common and dilutive common equivalent shares outstanding during the periods. Common equivalent shares consist of convertible notes, stock options, and warrants that are computed using the treasury stock method. Shares issuable upon the exercise of stock options and warrants, totaling 762,444 on March 31, 2011, were excluded from the calculation of common equivalent shares, as the impact was anti-dilutive.

2. BALANCE SHEET ACCOUNTS

Accrued Liabilities

Accrued liabilities consisted of the following:

| | March 31, 2011 | December 31, 2010 |
|--|-------------------|----------------------|
| Class Action law suit settlement (See Note 4) | \$1,799,500 | \$ 1,874,500 |
| Nouri legal fee settlement (See Note 4) | 825,000 | 1,400,000 |
| Accrued payroll and related costs | 29,798 | 3,406 |
| Custom accounting development cost | 75,436 | 75,436 |
| Hosting service costs | 25,530 | - |
| Professional services | 3,791 | - |
| Interest payable to IDB and Bondholders (See Note 3) | 154,847 | 141,895 |
| Other accrued items | 744 | 24,139 |
| | \$2,914,646 | \$ 3,519,376 |

3. NOTES PAYABLE

As of March 31, 2011, the Company had notes payable totaling \$17,265,774. The detail of these notes is as follows:

| Note Description | As of March 31, 2011 | As of December 31, 2010 | Maturity | Rate |
|---|-------------------------|----------------------------|----------|----------------------------|
| IDB Israeli Discount Bank credit facility | \$ 4,000,000 | \$ 4,000,000 | May 2012 | Prime, not less than 4.0 % |
| Insurance premium note | 10,984 | 21,778 | Jul 2011 | 5.4% |
| Various capital leases | 179,790 | 185,255 | Various | 8.0-18.0% |
| Convertible notes | 13,075,000 | 12,500,000 | Nov 2013 | 8.0% |
| Totals | 17,265,774 | 16,707,033 | | |
| Less current portion of debt | 28,282 | 40,564 | | |
| Long -term portion of debt | \$ 17,237,492 | \$ 16,666,469 | | |

Lines of Credit

On December 6, 2010, the Company entered into (i) a \$6,500,000 Promissory Note (the “IDB Note”), as borrower, and (ii) a Letter Agreement for the \$6,500,000 Term Loan Facility (the “Letter Agreement”), each with Israel Discount Bank of New York (“IDB”) as lender.

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Under the IDB Note and Letter Agreement, IDB will make available to the Company one or more term loan advances in the maximum aggregate principal amount of \$6,500,000 (the “IDB Credit Facility”). The IDB Credit Facility is secured by two irrevocable standby letters of credit issued by UBS Switzerland in favor of IDB in the aggregate amount of \$6,500,000 (the “SBLC”), each issued with Atlas Capital S.A. (“Atlas”) as account party. Atlas and the Company anticipate finalizing in the near future the terms of the Company’s reimbursement of Atlas for any future drawdowns on the SBLC. Any advances drawn on the IDB Credit Facility must be repaid on the earlier of (a) May 31, 2012 or (b) 180 days prior to the expiration date of the SBLC. Interest on each advance under the IDB Credit Facility accrues, at the Company’s election, at LIBOR plus 300 basis points or IDB’s prime rate plus 100 basis points, provided that the annual rate of interest for each advance shall never be less than four percent. Interest accrued on each advance is due quarterly and payable in arrears on the last day of each February, May, August and November commencing on the last day of February 2011.

Convertible Notes

The Company has issued convertible subordinated notes, as amended, (the “Notes”) under the Convertible Secured Subordinated Note Purchase Agreement, dated November 14, 2007 (as amended, the “Note Purchase Agreement”), between the Company and the convertible noteholders, under which the Company is entitled to elect to sell to the convertible noteholder, and the convertible noteholders are obligated to buy Notes.

Sales of Notes to the convertible noteholders are subject to certain conditions, including the absence of events or conditions that could reasonably be expected to have a material adverse effect on the ability of the Company to perform its obligations under the Note Purchase Agreement.

As of March 31, 2011, the Company had \$13.075 million aggregate principal amount of Notes due November 14, 2013 outstanding, after a \$200,000 reduction of such current outstanding debt on account of a sale-leaseback of the Company’s equipment with the noteholders in 2009. The Notes have been sold as follows:

| As of March 31, 2011 | | | | | |
|-----------------------------------|-------------------|----------------------------------|------------------|------------|--|
| Note Buyer | Date of Purchase | Amount of Convertible Note | Interest Rate | Due Date | |
| Atlas Capital | Various | \$ 11,025,000 | 8% | 11/14/2013 | |
| Blueline Fund | November 14, 2007 | 500,000 | 8% | 11/14/2013 | |
| Crystal Management | Various | 750,000 | 8% | 11/14/2013 | |
| HSBC Private Bank (Suisse), SA | November 21, 2008 | 250,000 | 8% | 11/14/2013 | |
| UBP, Union Bancaire Privee | Various | 500,000 | 8% | 11/14/2013 | |
| William Furr | November 14, 2007 | 250,000 | 8% | 11/14/2013 | |
| Less – lease conversion | September 4, 2009 | (200,000) | | | |
| Total Convertible Notes | | \$ 13,075,000 | | | |

The Company may sell up to \$15.3 million aggregate principal amount of Notes to new convertible noteholders or existing noteholders with an outside maturity date of November 14, 2013. In addition, the maturity date definition for each of the Notes is the date upon which the note is due and payable, which is the earlier of (1) November 14, 2013, (2) a change of control, or (3) if an event occurs, the date upon which noteholders accelerate the indebtedness evidenced by the Notes. The conversion price for each outstanding Note and any additional Notes sold in the future is the same and set at the lowest applicable conversion price for all the Notes, determined according to the formula described in Note 6 in the 2010 Annual Report.

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On February 7, 2011, the Company sold a Note to Atlas in the principal amount of \$250,000, and on March 4, 2011, the Company sold a Note to Atlas in the principal amount of \$325,000, each due November 14, 2013, upon substantially the same terms and conditions as the previously issued Notes.

On April 6, 2011, the Company sold a Note to Atlas in the principal amount of \$400,000 due November 14, 2013, upon substantially the same terms and conditions as the previously issued Notes. On May 4, 2011, the Company sold a Note to UBP, Union Bancaire Privee in the principal amount of \$400,000 due November 14, 2013, upon substantially the same terms and conditions as the previously issued Notes. The Notes sold in April and May 2011 are not included in the chart above.

4. COMMITMENTS AND CONTINGENCIES

Lease Commitments

In 2008, the Company entered into a non-cancellable sublease to relocate its North Carolina headquarters to another facility near Research Triangle Park, under which the Company prepaid rent in the total amount of \$450,080 and purchased existing furniture and fixtures for an additional \$49,920, which furniture and fixtures were capitalized for depreciation purposes. Effective May 1, 2010, the sublease was restructured as a direct lease with the owner of the property, with a termination date of September 30, 2011 (the "Lease"). On April 28, 2011, the Company entered into the Lease Amendment (the "Lease Amendment") with Nottingham Hall IC, LLC ("Nottingham"), extending the termination date of the Lease from September 30, 2011 to November 15, 2013.

Rent expense for the three months ended March 31, 2011 and 2010 was \$53,076 and \$53,765, respectively.

Development Agreement

In August 2005, the Company entered into a software assignment and development agreement with the developer of a customized accounting software application. In connection with this agreement, the developer would be paid up to \$512,500 and issued up to 32,395 shares of the Company's common stock based upon the developer attaining certain milestones. This agreement was modified on March 26, 2008 to adjust the total number of shares issuable under the agreement to 29,014. In 2008, the Company had paid \$470,834 and issued 3,473 shares of common stock related to this obligation.

Legal Proceedings

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

On June 18, 2010, the Company entered into a Stipulation and Agreement of Settlement (the "Stipulation") with the lead plaintiff in the securities class action involving the Company in the case captioned Mary Jane Beauregard vs. Smart Online, Inc., et al, filed in the United States District Court for the Middle District of North Carolina (the "Class Action"). The Stipulation provides for the settlement of the Class Action on the terms described below. The United States District Court for the Middle District of North Carolina issued an order preliminarily approving the settlement on January 13, 2011 and the final settlement hearing is scheduled for May 11, 2011.

The Stipulation provides for the certification of a class consisting of all persons who purchased the Company's publicly-traded securities between May 2, 2005 and September 28, 2007, inclusive. The settlement class will receive total consideration of a cash payment of \$350,000 to be made by the Company, a cash payment of \$112,500 to be made by Maxim Group, the transfer from Henry Nouri to the class of 25,000 shares of Company common stock and the issuance by the Company to the class of 1,475,000 shares of Company common stock. Under the terms of the Stipulation, counsel for the settlement class may sell some or all of the common stock received in the settlement before distribution to the class, subject to the limitation that it cannot sell more than 10,000 shares on one day or 50,000 shares in 30 calendar days. Subject to the terms of the Stipulation, we paid the lead plaintiff \$75,000 on July 14, 2010, \$100,000 on September 15, 2010, \$100,000 on December 14, 2010 and \$75,000 on March 14, 2011.

The stipulation provides that all claims against the settling defendants will be dismissed with prejudice. The claims of the lead plaintiff against Jesup & Lamont Securities Corp. and the Company's former independent registered public accounting firm, Sherb & Co., are not being dismissed and will continue. The Stipulation contains no admission of fault or wrongdoing by the Company or the other settling defendants.

On June 18, 2010, the Company entered into a Settlement Agreement (the "Settlement Agreement") with Dennis Michael Nouri, Reza Eric Nouri, Henry Nouri and Ronna Loprete Nouri (collectively, the "Nouri Parties") in settlement of claims filed by the Nouri Parties against the Company in the Court of Chancery of the State of Delaware for advancement of legal expenses and indemnification. The Settlement Agreement provides for the payment by the Company of up to \$1,400,000 for the benefit of the Parties.

On January 13, 2011 (the "Effective Date"), the United States District Court, Middle District of North Carolina, presiding over the Class Action suit, issued the Order Preliminarily Approving Settlement and Providing Notice. Based upon the Nouri Settlement Agreement, and the January 13, 2011 United States District Court, Middle District of North Carolina Order Preliminarily Approving Settlement and Providing Notice, the following amounts were paid for the benefit of the Nouri Parties: the amount of \$500,000 was paid on January 22, 2011 and \$75,000 was paid on March 16, 2011, and an additional \$825,000 is payable in eleven fixed monthly installments of \$75,000 based on the Effective Date, with the last four scheduled installments totaling \$300,000 subject to reduction to the extent that fees and disbursements for the Nouris' appeal are below certain levels or if the appeal is not taken to final adjudication. The Settlement Agreement provides for the exchange of mutual releases by the parties.

5. STOCKHOLDERS' DEFICIT

Preferred Stock

The Board of Directors is authorized, without further stockholder approval, to issue up to 5,000,000 shares of \$0.001 par value preferred stock in one or more series and to fix the rights, preferences, privileges, and restrictions applicable to such shares, including dividend rights, conversion rights, terms of redemption, and liquidation preferences, and to fix the number of shares constituting any series and the designations of such series. There were no shares of preferred stock outstanding at March 31, 2011.

Common Stock

The Company is authorized to issue 45,000,000 shares of common stock, \$0.001 par value per share. As of March 31, 2011, it had 18,352,543 shares of common stock outstanding. Holders of common stock are entitled to one vote for each share held.

In March 2011, the Company issued 10,000 shares of restricted common stock to Mr. Shlomo Elia, for service as a Board Member.

Warrants

As part of the commission paid to Canaccord Adams, Inc. ("CA"), the Company's placement agent in the transaction that closed in February 2007, CA was issued a warrant to purchase 35,000 shares of the Company's common stock at an exercise price of \$2.55 per share. This warrant contains a provision for cashless exercise and must be exercised by February 21, 2012. CA and the Company also entered into a Registration Rights Agreement (the "CA RRA"). Under the CA RRA, the shares issuable upon exercise of the warrant must be included on the same registration statement the Company was obligated to file under a previous registration rights agreement, but CA was not entitled to any penalties for late registration or effectiveness.

As of March 31, 2011, warrants to purchase up to 479,444 shares were outstanding.

Equity Compensation Plans

The Company adopted its 2004 Equity Compensation Plan (the "2004 Plan") as of March 31, 2004. The 2004 Plan provides for the grant of incentive stock options, non-statutory stock options, restricted stock, and other direct stock awards to employees (including officers) and directors of the Company as well as to certain consultants and advisors. In June 2007, the Company temporarily limited the issuance of shares of its common stock reserved under the 2004 Plan to awards of restricted or unrestricted stock and in June 2008 again made options available for grant under the 2004 Plan. The total number of shares of common stock reserved for issuance under the 2004 plan is 5,000,000 shares, subject to adjustment in the event of a stock split, stock dividend, recapitalization, or similar capital change.

Restricted Stock – During the first quarter of 2011, 10,000 shares of restricted stock were issued. At March 31, 2011, there remains no unvested expense yet to be recorded related to all restricted stock outstanding.

Stock Options – The exercise price for incentive stock options granted under the 2004 Plan is required to be no less than the fair market value of the common stock on the date the option is granted, except for options granted to 10% stockholders, which are required to have an exercise price of not less than 110% of the fair market value of the common stock on the date the option is granted. Incentive stock options typically have a maximum term of ten years, except for option grants to 10% stockholders, which are subject to a maximum term of four years. Non-statutory stock

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options have a term determined by either the Board of Directors or the Compensation Committee. Options granted under the 2004 Plan are not transferable, except by will and the laws of descent and distribution.

The following is a summary of the stock option activity for the three months ended March 31, 2011:

| | Shares Outstanding | Weighted Average Exercise Price |
|----------------------------|-----------------------|---------------------------------------|
| BALANCE, December 31, 2010 | 283,000 | \$ 2.34 |
| Granted | - | - |
| Exercised | - | - |
| Canceled | - | - |
| BALANCE, March 31, 2011 | 283,000 | \$ 2.34 |

The following table summarizes information about stock options outstanding at March 31, 2011:

| Exercise Price | Number of Options Outstanding | Average Remaining Contractual Life (Years) | Weighted Average Exercise Price | Currently Exercisable | |
|-----------------------|-------------------------------------|---|--|-----------------------|--|
| | | | | Number of Shares | Weighted Average Exercise Price |
| \$ 1.10 | 68,000 | 9.8 | \$ 1.10 | 17,000 | \$ 1.10 |
| \$ 1.14 | 125,000 | 8.8 | \$ 1.14 | 68,750 | \$ 1.14 |
| From \$2.50 to \$3.50 | 45,000 | 4.2 | \$ 3.31 | 45,000 | \$ 3.31 |
| \$ 5.00 | 25,000 | 4.0 | \$ 5.00 | 25,000 | \$ 5.00 |
| From \$8.61 to \$9.00 | 20,000 | 4.3 | \$ 8.61 | 20,000 | \$ 8.61 |
| Totals | 283,000 | 6.2 | \$ 2.84 | 175,750 | \$ 2.34 |

At March 31, 2011, there remains \$87,488 of unvested expense yet to be recorded related to all options outstanding.

6. MAJOR CUSTOMERS AND CONCENTRATION OF CREDIT RISK

Financial instruments that potentially subject the Company to credit risk principally consist of trade receivables. The Company believes the concentration of credit risk in its trade receivables is substantially mitigated by ongoing credit evaluation processes, relatively short collection terms, and the nature of the Company's customer base, primarily mid- and large-size corporations with significant financial histories. Collateral is not generally required from customers. The need for an allowance for doubtful accounts is determined based upon factors surrounding the credit risk of specific customers, historical trends, and other information.

A significant portion of revenues is derived from certain customer relationships. The following is a summary of customers that represent greater than 10% of total revenues:

| Revenue Type | Three Months Ended March 31, 2011 | |
|--------------|--------------------------------------|------------------------|
| | Revenues | % of Total Revenues |
| Customer A | \$ 108,389 | 78 % |
| Customer B | 28,069 | 20 % |
| Others | 2,280 | 2 % |
| Total | \$ 138,738 | 100 % |

| Revenue Type | Three Months Ended March 31, 2010 | |
|--------------|--------------------------------------|------------------------|
| | Revenues | % of Total Revenues |
| Customer A | \$ 111,882 | 31 % |
| Customer B | 52,440 | 14 % |
| Others | 199,578 | 55 % |
| Total | \$ 363,900 | 100 % |

As of March 31, 2011, we had current accounts receivable of \$ 735,389 and a note receivable from a customer of \$100,000, both of which are fully reserved. As of December 31, 2010, one customer accounted for 100% of accounts receivable.

7. SUBSEQUENT EVENTS

On April 6, 2011, the Company sold a Note to Atlas in the principal amount of \$400,000 upon substantially the same terms and conditions as the previously issued Notes, as described in Part I, Item 1, Note 3, Notes Payable, of this Quarterly Report on Form 10-Q. On May 4, 2011, the Company sold a Note to UBP, Union Bancaire Privee in the principal amount of \$400,000 upon substantially the same terms and conditions as the previously issued Notes, as described in Part I, Item 1, Note 3, Notes Payable, of this Quarterly Report on Form 10-Q.

On April 28, 2011, the Company entered into the Lease Amendment with Nottingham, extending the termination date of the Lease from September 30, 2011 to November 15, 2013.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Information set forth in this Quarterly Report on Form 10-Q contains various forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, or the Securities Act, and Section 21E of the Securities Exchange Act of 1934, or the Exchange Act. Forward-looking statements consist of, among other things, trend analyses, statements regarding future events, future financial performance, our plan to build our business and the related expenses, our anticipated growth, trends in our business, the effect of interest rate fluctuations on our business, the potential impact of current litigation or any future litigation, the potential availability of tax assets in the future and related matters, and the sufficiency of our capital resources, all of which are based on current expectations, estimates, and forecasts, and the beliefs and assumptions of our management. Words such as "expect," "anticipate," "project," "intend," "plan," "estimate," variations of such words, and similar expressions also are intended to identify such forward-looking statements. These forward-looking statements are subject to risks, uncertainties, and assumptions that are difficult to predict. Therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. Readers are directed to risks and uncertainties identified under Part II, Item 1A, "Risk Factors," 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.

The following discussion is designed to provide a better understanding of our unaudited financial statements, including a brief discussion of our business and products, key factors that impacted our performance, and a summary of our operating results. The following discussion should be read in conjunction with the unaudited financial statements and the notes thereto included in Part I, Item 1 of this Quarterly Report on Form 10-Q, and the consolidated financial statements and notes thereto and Management's Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-K for the year ended December 31, 2010. Historical results and percentage relationships among any amounts in the financial statements are not necessarily indicative of trends in operating results for any future periods.

Overview

We develop and market software products and services targeted to small businesses that are delivered via a SaaS model. We also provide website consulting services, primarily in the e-commerce retail industry. We reach small businesses primarily through arrangements with channel partners that private label our software applications and market them to their customer bases through their corporate websites.

We 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 Notes, and bank lines of credit. We must continue to rely on these sources until we are able to generate sufficient cash from revenues to fund our operations. We believe that anticipated cash flows from operations, funds available from our existing credit facility (which expires May 2012, as described above) and additional issuances of notes, together with cash on hand, will provide sufficient funds to finance our operations at least for the next 12 to 18 months, depending on our ability to achieve strategic goals outlined in our annual operating budget approved by our Board of Directors. Changes in our operating plans, lower than anticipated sales, increased expenses, or other events may cause us to seek additional equity or debt financing in future periods. There can be no guarantee that financing will be available on acceptable terms or at all. Additional equity financing could be dilutive to the holders of our common stock, and additional debt financing, if available, could impose greater cash payment obligations and more covenants and operating restrictions. The settlement of the Class Action suit will cause current shareholders to be further diluted due to the issuance of an additional 1,475,000 shares of common stock pursuant to the terms of the Stipulation.

Sources of Revenue

We derive revenues from the following sources:

- Subscription fees – monthly fees charged to customers for access to our SaaS applications
- Professional service fees – fees related to consulting services, some of which complement our other products and applications
 - License fees – fees charged for perpetual or term licensing of platforms or applications
- Hosting fees – fees charged for providing network accessibility for our customers using our customized platforms
- Other revenues – revenues generated from non-core activities such as original equipment manufacturer, or OEM, credit card processing fees; and miscellaneous other revenues

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

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

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

Hosting fees charged for providing our customers with network accessibility.

Other revenues – revenues generated from non-core activities such as original equipment manufacturer, or OEM, credit card processing fees; and miscellaneous other revenues.

Cost of Revenues

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

Operating Expenses

During 2008 and 2009, our primary business initiatives included increasing subscription fee revenue and professional services revenue, making organizational improvements, concentrating our development efforts on enhancements and customization of our platforms and applications, and shifting our strategic focus to the sales and marketing of our products. In 2011, we provided services for our subscription fee customers and focused our efforts on improving our current technology for those industries that we have historically serviced and we began providing our SmartOnCause products to not-for-profit organizations.

General and Administrative – General and administrative expenses are composed primarily of costs associated with our executive, finance and accounting, legal, human resources, and information technology personnel and consist of salaries and related compensation costs; professional services (such as outside legal counsel fees, audit, and other compliance costs); depreciation and amortization; facilities and insurance costs; and travel and other costs.

Sales and Marketing – Sales and marketing expenses are composed primarily of costs associated with our sales and marketing activities and consist of salaries and related compensation costs of our sales and marketing personnel, travel and other costs, and marketing and advertising expenses. In the past, sales and marketing also included the amounts we paid to our marketing partners as part of the subscription revenue received; in the past, the subscription revenue was presented as a gross amount as was the amount included in the sales and marketing category. As part of our ongoing review of accounting pronouncements, we have reclassified the revenues and sales and marketing expenses to reflect net revenue and expense. Historically, we spent limited funds on marketing, advertising, and public relations, particularly due to our business model of partnering with established companies with extensive small-business customer bases. As we continue to execute our sales and marketing strategy to take our enhanced products to market, we expect associated costs to increase in 2011 due to targeting new partnerships, development of channel partner enablement programs, advertising campaigns, additional sales and marketing personnel, and the various percentages of revenues we may be required to pay to future partners as marketing fees.

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

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

Stock-Based Expenses – Our operating expenses include stock-based expenses related to options, restricted stock awards, and warrants issued to employees and non-employees. These charges have been significant and are reflected in our historical financial results. Effective January 1, 2006, we adopted accounting standards that resulted and will continue to result in material costs on a prospective basis as long as a significant number of options are outstanding.

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Results of Operations for the Three Months Ended March 31, 2011 and March 31, 2010

The following table sets forth certain statements of operations data for the periods indicated:

| | Three Months Ended March 31, 2011 | | Three Months Ended March 31, 2010 | | 2011 vs 2010 Change | |
|------------------------------------|--------------------------------------|-----------------|--------------------------------------|-----------------|------------------------|---------|
| | Dollars | % of Revenue | Dollars | % of Revenue | Dollars | Percent |
| REVENUES: | | | | | | |
| Subscription fees | \$ 103,272 | 74.4 % | \$ 136,258 | 37.4 % | \$ (32,986) | -24 % |
| Professional service fees | - | - % | 62,775 | 17.3 % | (62,775) | -100 % |
| License fees | - | - % | 87,800 | 24.1 % | (87,800) | -100 % |
| Hosting fees | - | - % | 44,272 | 12.2 % | (44,272) | -100 % |
| Other revenue | 35,466 | 25.6 % | 32,795 | 9.0 % | 2,671 | 8 % |
| Total revenues | 138,738 | 100.0 % | 363,900 | 100.0 % | (225,162) | -62 % |
| COST OF REVENUES | 192,316 | 138.6 % | 365,934 | 100.6 % | (173,618) | -47 % |
| GROSS PROFIT | (53,578) | -38.6 % | (2,034) | -0.6 % | (51,544) | 2534 % |
| OPERATING EXPENSES: | | | | | | |
| Sales and marketing | 142,055 | 102.4 % | 152,635 | 41.9 % | (10,580) | -7 % |
| Research and development | 158,892 | 114.5 % | 32,005 | 8.8 % | 126,887 | 396 % |
| General and administrative | 338,966 | 244.3 % | 672,419 | 184.8 % | (333,453) | -50 % |
| Total operating expenses | 639,913 | 461.2 % | 857,059 | 235.5 % | (217,146) | -25 % |
| LOSS FROM OPERATIONS | (693,491) | -499.9 % | (859,093) | -236.1 % | 165,602 | -19 % |
| OTHER INCOME (EXPENSE): | | | | | | |
| Interest expense, net | (294,329) | -212.1 % | (210,695) | -57.9 % | (83,634) | 40 % |
| Gain on disposal of assets, net | - | - % | - | - % | - | - % |
| Gain on legal settlements, net | 19 | 0.0 % | 152,863 | 42.0 % | (152,844) | -100 % |
| Other expense | - | - % | - | - % | - | - % |
| Total other expense | (294,310) | -212.1 % | (57,832) | -15.9 % | (236,478) | 409 % |
| NET LOSS | (987,801) | -712.0 % | \$ (916,925) | -252.0 % | (70,876) | 8 % |

Revenue

Subscription Fees

Revenues from subscription fees decreased 24% to \$103,000 for the three months ended March 31, 2011 from \$136,000 for the same period in 2010. This decline is primarily attributable to the ongoing migration of one direct-selling organization customer to its own technology solution and the decline in membership of another direct-selling organization that has resulted in a continuous decline in subscription fees.

Professional Service Fees

Revenues from professional service fees decreased 100% to \$ 0 for the three months ended March 31, 2011 from \$63,000 for the same period in 2010. This decrease is primarily due to a lack of web consulting services provided to customers during the first quarter of 2011.

License Fees

Revenues from license fees decreased 100% to \$ 0 for the three months ended March 31, 2011 from \$88,000 for the same period in 2010. No license fees were recognized in the first quarter of 2011.

Hosting Fees

Revenues from hosting fees decreased 100% to \$ 0 for the three months ended March 31, 2011 from \$44,000 for the same period in 2010. The loss of revenue is due to the fact that one of our direct-selling organization customers lost a large number of members and was unable to pay for hosting services.

Other Revenue

Revenues from non-core activities increased 8% to \$35,000 for the three months ended March 31, 2011 from \$33,000 for the same period in 2010. This increase is primarily attributable to larger billed credit card and payment gateway fees during the first quarter of 2011.

Cost of Revenues

Cost of revenues for the three months ended March 31, 2011 and 2010 are as follows:

Cost of revenues decreased 47% to \$192,000 for the three months ended March 31, 2011 from \$366,000 for the same period in 2010. This decrease is the result of lower professional services costs associated with professional service fees revenue, which is generally billed on a time and material basis. In addition, we have allocated lower amounts of development and general and administrative expenses as a result of an overall reduction in those areas.

Operating Expenses

Sales and Marketing

Sales and marketing expenses decreased 7% to \$142,000 for the three months ended March 31, 2011 from \$153,000 for the same period in 2010. This variance is primarily attributable to reallocation of the sales and marketing efforts to subsequent quarters of 2011.

Research and Development

Research and development expenses increased 396% to \$159,000 for the three months ended March 31, 2011 from \$32,000 for the same period in 2010. This increase is primarily attributable to the focus of the Company on increased research in mobile products development during the first quarter of 2011.

General and Administrative

General and administrative expenses decreased 49% to \$339,000 for the three months ended March 31, 2011 from \$672,000 for the same period in 2010. This decrease is primarily attributable to the reduction of \$142,000 in legal costs due to the settlements concluded in 2010; \$180,000 in bad debt expenses as a result of no longer billing the direct selling customer for services that were not paid; \$10,000 reduction of insurance premiums due to change in coverage as approved by the Board of Directors.

Interest Expense

Net other expense increased 409% to \$294,000 for the three months ended March 31, 2011 from \$58,000 for the same period in 2010. This net increase was primarily attributable to an increase in interest expense due to an increase in the amount of borrowings.

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 first quarter of 2011 primarily due to continued substantial uncertainty based on objective evidence regarding our ability to realize our deferred tax assets, thereby warranting a full valuation allowance in our financial statements. We have approximately \$51 million in net operating loss carryforwards, which may be utilized to offset future taxable income. These net operating losses begin to expire in 2010.

Utilization of our net operating loss carryforwards may be subject to substantial annual limitation due to the ownership change limitations provided by the Internal Revenue Code of 1986, as amended, and similar state provisions. Such an annual limitation could result in the expiration of the net operating loss carryforwards before utilization.

Liquidity and Capital Resources

Overview

We require cash to fund our operating expenses and working capital requirements, including outlays for capital expenditures and debt service. As of March 31, 2011, our principal sources of liquidity were cash and cash equivalents totaling \$447,727 and current accounts receivable of \$0, as compared to \$1,110,209 of cash and cash equivalents and \$8,931 in accounts receivable as of December 31, 2010. As of March 31, 2011, we had drawn \$4,000,000 on the \$6,500,000 credit facility, leaving \$2,500,000 available under the credit facility with IDB Bank for our operations. Deferred revenue at March 31, 2011 was \$16,430 as compared to \$22,565 at December 31, 2010.

As of May 9, 2011, our principal sources of liquidity were cash and cash equivalents totaling approximately \$769,000. In addition, we had drawn approximately \$4,000,000 on the IDB Bank credit facility, leaving approximately \$2,500,000 available under credit facility for operations. As of May 9, 2011, we also have a commitment from our convertible secured subordinated noteholders to purchase up to an additional \$1.225 million in Notes upon approval and call by our Board of Directors.

Cash Flows

During the three months ended March 31, 2011, our working capital deficit increased by approximately \$400,000 to \$3,244,107 from a working capital deficit of \$2,850,138 at December 31, 2010. As described more fully below, the working capital deficit at March 31, 2011 is primarily attributable to negative cash flows from operations, offset in part by net debt borrowings. During the first quarter of 2011, we paid \$75,000 of Class Action settlement and \$575,000 of the Nouri legal settlement amount.

Cash Flows from Operating Activities

| | Three Months Ended | | Change | | |
|---------------------------------------|--------------------|-----------|-----------|---------|---|
| | March 31, | | Dollars | Percent | |
| | 2011 | 2010 | | | |
| Net cash used in operating activities | \$1,218,745 | \$791,194 | \$427,551 | 54 | % |

Net cash used in operating activities increased 54% to \$1,219,000 for the three months ended March 31, 2011 from \$791,000 for the same period in 2010. This increase is primarily attributable to the net loss for the period and a decrease in accrued liabilities.

Cash Flows from Investing Activities

| | Three Months Ended | | Change | | |
|---|--------------------|----------|------------|---------|---|
| | March 31, | | Dollars | Percent | |
| | 2011 | 2010 | | | |
| Net cash provided by (used in) investing activities | \$(2,480) | \$16,438 | \$(18,918) | -115 | % |

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Net cash used in investing activities decreased 115% to \$2,480 for the three months ended March 31, 2011 from net cash provided by investing activities from \$16,000 for the same period in 2010. This net cash used is attributable to the purchase of \$2,480 of equipment compared to the \$17,000 of cash provided by the amortization of capitalized software for the same period in 2010.

Cash Flows from Financing Activities

| | Three Months Ended | | Change | |
|---|--------------------|-----------|-------------|---------|
| | 2011 | 2010 | Dollars | Percent |
| Net cash provided by (used in) financing activities | \$586,299 | \$677,437 | \$(91,138) | -13 % |

Net cash provided by financing activities decreased 18% to \$586,000 for the three months ended March 31, 2011 from net cash provided by financing activities of \$677,000 for the same period in 2010. This net source of cash is primarily due to net increase in debt borrowings in the first quarter of 2011.

The net cash for the first quarter of 2011 from our financing activities was generated through debt financing, as described below.

Debt Financing.

Information concerning Debt Financing is reported in Note 3 to the Financial Statements above.

Going Concern

Our independent registered public accountants have issued an explanatory paragraph in their report included in our 2010 Annual Report in which they express substantial doubt as to our ability to continue as a going concern. The financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or the amounts or classification of liabilities that might be necessary should we be unable to continue as a going concern. Our continuation as a going concern depends on our ability to generate sufficient cash flows to meet our obligations on a timely basis, to obtain additional financing that is currently required, and ultimately to attain profitable operations and positive cash flows. There can be no assurance that our efforts to raise capital or increase revenue will be successful. If our efforts are unsuccessful, we may have to cease operations and liquidate our business.

Recent Developments

On April 6, 2011, the Company sold a Note to Atlas in the principal amount of \$400,000, upon substantially the same terms and conditions as the previously issued Notes, as described in Part I, Item 1, Note 3, Notes Payable, of this Quarterly Report on Form 10-Q. On May 4, 2011, the Company sold a Note to UBP, Union Bancaire Privee in the principal amount of \$400,000 upon substantially the same terms and conditions as the previously issued Notes, as described in Part I, Item 1, Note 3, Notes Payable, of this Quarterly Report on Form 10-Q.

In 2008, the Company entered into a non-cancellable sublease to relocate its North Carolina headquarters to another facility near Research Triangle Park, under which the Company prepaid rent in the total amount of \$450,080 and purchased existing furniture and fixtures for an additional \$49,920, which furniture and fixtures were capitalized for depreciation purposes. Effective May 1, 2010, the sublease was restructured as a lease with the owner of the property, with a termination date of September 30, 2011. On April 28, 2011, the Company entered into the Lease Amendment with Nottingham, extending the termination date of the Lease from September 30, 2011 to November 15, 2013.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Not applicable.

Item 4. Controls and Procedures

Our management, with the participation of our interim Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of March 31, 2011. The term “disclosure controls and procedures,” as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the

time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, as ours are designed to do, and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of March 31, 2011, our interim Chief Executive Officer and Chief Financial Officer concluded that, as of such date, our disclosure controls and procedures were effective.

We routinely review our internal control over financial reporting and from time to time make changes intended to enhance the effectiveness of our internal control over financial reporting.

We will continue to evaluate the effectiveness of our disclosure controls and procedures and internal control over financial reporting on an ongoing basis and will take action as appropriate. There have been no changes to our internal control over financial reporting, as such, term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act, during the three months ended March 31, 2011 that we believe materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II – OTHER INFORMATION

Item 1. Legal Proceedings

Please refer to Part I, Item I, Note 4, to the Financial Statements, above, for a description of material legal proceedings.

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

Item 1A. Risk Factors

As a smaller reporting company, we are not required to report Risk Factors under this Item 1A. There have been no material changes in our risk factors from those reported in Part I, Item 1 A of our 2010 Annual Report.

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

None.

Item 3. Default Upon Securities

None.

Item 5. Other Information

None.

Item 6. Exhibits

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

EXHIBIT INDEX

| Exhibit No. | Description |
|-------------|--|
| 31.1 | Certification of Principal Executive Officer Pursuant to Rule 13a-14(a) as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of Principal Financial Officer/Principal Accounting 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/Principal Accounting 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 |

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filed herewith for the purposes of liability under the Securities Exchange Act of 1934, as amended, or the Securities Act of 1933, as amended, as the case may be.

SIGNATURES

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

SMART ONLINE, INC.

May 12 2011
By: /s/ Dror Zoreff
Dror Zoreff
Interim Chief Executive Officer

May 12, 2011
By: /s/ Thaddeus J. Shalek
Thaddeus J. Shalek
Chief Financial Officer

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