

SMART ONLINE INC  
Form 10-Q  
August 12, 2011

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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 June 30, 2011

OR

Transition report pursuant to Section 13 or 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 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.

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|                         |    |                           |   |
|-------------------------|----|---------------------------|---|
| Large accelerated filer | .. | Accelerated filer         | o |
| Non-accelerated filer   | .. | Smaller reporting company | p |

(Do not check if a smaller reporting company)

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

As of August 6, 2011, there were approximately 18,352,543 shares of the registrant's common stock, par value \$0.001 per share, outstanding.

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SMART ONLINE, INC.

FORM 10-Q  
For the Quarterly Period Ended June 30, 2011

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## PART I – FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

SMART ONLINE, INC.  
BALANCE SHEETS

|  | June 30,<br>2011<br>(unaudited) | December 31,<br>2010 |
|--|---------------------------------|----------------------|
| <b>ASSETS</b>  |                                 |                      |
| Current Assets:  |                                 |                      |
| Cash and cash equivalents  | \$ 826,631                      | \$ 860,211           |
| Restricted cash  | 171,445                         | 249,998              |
| Accounts receivable, net   | 1,958                           | 8,931                |
| Prepaid expenses   | 86,267                          | 164,692              |
| Total current assets   | 1,086,301                       | 1,283,832            |
| Property and equipment, net  | 179,903                         | 202,922              |
| Other assets   | 15,370                          | 5,000                |
| <b>TOTAL ASSETS</b>  | <b>\$ 1,281,574</b>             | <b>\$ 1,491,754</b>  |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)</b>  |                                 |                      |
| Current liabilities  |                                 |                      |
| Accounts payable   | \$ 698,831                      | \$ 551,759           |
| Notes payable (See Note 3)   | 5,015,753                       | 40,564               |
| Deferred revenue   | 18,157                          | 22,271               |
| Accrued liabilities - Nouri  | 667,227                         | 1,400,000            |
| Accrued liabilities (See Note 2)   | 1,906,603                       | 2,119,376            |
| Total current liabilities  | 8,306,571                       | 4,133,970            |
| Long-term liabilities:   |                                 |                      |
| Long-term portion of notes payable (See Note 3)  | 14,033,436                      | 16,666,469           |
| Deferred revenue   | 2,424                           | 294                  |
| Total long-term liabilities  | 14,035,860                      | 16,666,763           |
| Total liabilities  | 22,342,431                      | 20,800,733           |
| Commitments and contingencies (See Note 4)   |                                 |                      |
| Stockholders' equity (deficit):  |                                 |                      |
| Preferred stock, 0.001 par value, 5,000,000 shares authorized, no shares issued and outstanding at June 30, 2011 and December 31, 2010                                     | -                               | -                    |
| Common stock, \$.001 par value, 45,000,000 shares authorized, 18,352,543 and 18,342,543 shares Issued and outstanding at June 30, 2011 and December 31, 2010 respectively. | 18,353                          | 18,343               |
| Additional paid-in capital   | 67,106,737                      | 67,070,568           |
| Accumulated deficit  | (88,185,947)                    | (86,397,890)         |
| Total Stockholders' Equity (Deficit)   | (21,060,857)                    | (19,308,979)         |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)</b>  | <b>\$ 1,281,574</b>             | <b>\$ 1,491,754</b>  |

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

SMART ONLINE, INC.  
STATEMENTS OF OPERATIONS  
(unaudited)

|  | Three Months Ended  |                     | Six Months Ended      |                       |
|--|---------------------|---------------------|-----------------------|-----------------------|
|  | June 30,<br>2011    | June 30, 2010       | June 30, 2011         | June 30, 2010         |
| <b>REVENUES:</b>   |                     |                     |                       |                       |
| Subscription fees  | \$ 90,375           | \$ 123,146          | \$ 193,647            | \$ 259,404            |
| Professional service fees  | -                   | 7,050               | -                     | 69,825                |
| License fees   | -                   | 70,850              | -                     | 158,650               |
| Hosting fees   | -                   | 37,722              | -                     | 81,994                |
| Other revenue  | 20,697              | 20,950              | 56,162                | 53,745                |
| Total revenues   | 111,072             | 259,718             | 249,809               | 623,618               |
| <b>COST OF REVENUES</b>  | <b>201,889</b>      | <b>336,310</b>      | <b>394,205</b>        | <b>702,244</b>        |
| <b>GROSS LOSS</b>  | <b>(90,817)</b>     | <b>(76,592)</b>     | <b>(144,396)</b>      | <b>(78,626)</b>       |
| <b>OPERATING EXPENSES:</b>   |                     |                     |                       |                       |
| General and administrative   | 308,763             | 389,469             | 647,731               | 1,061,888             |
| Sales and marketing  | 146,888             | 179,640             | 288,942               | 332,275               |
| Research and development   | 104,932             | 10,380              | 263,821               | 42,385                |
| Loss on disposal of assets, net  | 3,471               | -                   | 3,471                 | -                     |
| Total operating expenses   | 564,054             | 579,489             | 1,203,965             | 1,436,548             |
| <b>LOSS FROM OPERATIONS</b>  | <b>(654,871)</b>    | <b>(656,081)</b>    | <b>(1,348,361)</b>    | <b>(1,515,174)</b>    |
| <b>OTHER INCOME (EXPENSE):</b>   |                     |                     |                       |                       |
| Interest expense, net  | (322,386)           | (233,025)           | (616,715)             | (443,720)             |
| Gain on legal settlements, net   | 177,000             | 401,107             | 177,019               | 553,970               |
| Total other (expense) income   | (145,386)           | 168,082             | (439,696)             | 110,250               |
| <b>NET LOSS</b>  | <b>\$ (800,257)</b> | <b>\$ (487,999)</b> | <b>\$ (1,788,057)</b> | <b>\$ (1,404,924)</b> |
| <b>NET LOSS PER COMMON SHARE:</b>  |                     |                     |                       |                       |
| Basic and fully diluted  | \$ (0.04)           | \$ (0.03)           | \$ (0.10)             | \$ (0.08)             |
| <b>WEIGHTED-AVERAGE NUMBER OF SHARES USED IN COMPUTING NET LOSS PER COMMON SHARE</b> |                     |                     |                       |                       |
| Basic and fully diluted  | 18,352,543          | 18,342,542          | 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)

|   | Six Months<br>Ended<br>June 30, 2011 | Six Months<br>Ended<br>June 30, 2010 |
|---|--------------------------------------|--------------------------------------|
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                |                                      |                                      |
| Net Loss  | \$ (1,788,057)                       | \$ (1,404,924)                       |
| Adjustments to reconcile net loss to net cash used in operating activities: |                                      |                                      |
| Depreciation  | 26,145                               | 69,046                               |
| Bad debt expense  | -                                    | 249,760                              |
| Stock-based compensation expense  | 36,180                               | 11,642                               |
| Loss on disposal of assets  | 4,376                                | -                                    |
| Changes in assets and liabilities:  |                                      |                                      |
| Accounts receivable   | 6,973                                | (185,426)                            |
| Notes receivable  | -                                    | (51,278)                             |
| Prepaid expenses  | 78,425                               | 110,701                              |
| Other assets  | (10,370)                             | 2,496                                |
| Deferred revenue  | (1,984)                              | (8,163)                              |
| Accounts payable  | 147,072                              | (183,570)                            |
| Accrued and other expenses  | (945,545)                            | (332,385)                            |
| Net cash used in operating activities                                       | (2,446,785)                          | (1,722,101)                          |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                |                                      |                                      |
| Purchases of furniture and equipment  | (7,506)                              | (4,372)                              |
| Net cash used in investing activities                                       | (7,506)                              | (4,372)                              |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                |                                      |                                      |
| Restricted cash used to pay IDB interest expense and fees                   | 78,555                               | -                                    |
| Repayments on notes payable   | (32,844)                             | (2,991,573)                          |
| Debt borrowings   | 2,375,000                            | 4,620,566                            |
| Net cash provided by financing activities                                   | 2,420,711                            | 1,628,993                            |
| <b>NET (DECREASE) IN CASH AND CASH EQUIVALENTS</b>                          | <b>(33,580)</b>                      | <b>(97,480)</b>                      |
| <b>CASH AND CASH EQUIVALENTS,<br/>BEGINNING OF PERIOD</b>                   | <b>860,211</b>                       | <b>119,796</b>                       |
| <b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>                             | <b>\$ 826,631</b>                    | <b>\$ 22,316</b>                     |
| Supplemental disclosures of cash flow information:                          |                                      |                                      |
| Cash paid during the period for:  |                                      |                                      |
| Interest  | \$ 593,673                           | \$ 467,489                           |
| Taxes   | \$ -                                 | \$ -                                 |

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

SMART ONLINE, INC.  
NOTES TO FINANCIAL STATEMENTS  
(unaudited)

1. SUMMARY OF BUSINESS AND SIGNIFICANT ACCOUNTING POLICIES

Description of Business - Smart Online, Inc. (the "Company") was incorporated in the State of Delaware in 1993. The Company develops and markets software products and services targeted to businesses and not-for profit organizations. These products 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](http://www.smartonline.com).

Basis of Presentation - The financial statements as of and for the three and six months ended June 30, 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 financial position as of June 30, 2011, and its results of operations for the three and six months ended June 30, 2011 and 2010. The results for the three and six months ended June 30, 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 and six months ended June 30, 2011 and 2010, the Company incurred net losses as well as negative cash flows, was involved in a class action lawsuit (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 August 4, 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 and six months ended June 30, 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. Stock-based compensation is recognized on the straight-line method over the requisite service period. Total stock-based compensation expense recognized under US GAAP provisions during the three and six months ended June 30, 2011 was \$10,243 and \$36,180, respectively, of which \$ -0- and \$13,850 related to the issuance of restricted stock and \$10,243 and \$22,330 was expensed associated with stock options. Total stock-based compensation expense during the three and six months ended June 30, 2010 was \$8,095 and \$11,656, respectively, of which \$2,850 and \$2,850 related to the issuance of restricted stock and \$5,245 and \$8,806 was expensed associated with stock options for the respective periods. No stock-based compensation was capitalized in the financial statements.



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The fair value of option grants under the Company's equity compensation plan during the three and six months ended June 30, 2011 and 2010 were estimated using the following weighted average assumptions:

|                         | Three Months Ended June<br>30, |       | Six Months Ended June<br>30, |       |
|-------------------------|--------------------------------|-------|------------------------------|-------|
|                         | 2011                           | 2010  | 2011                         | 2010  |
| Dividend yield          | 0.0%                           | 0.0%  | 0.0%                         | 0.0%  |
| Expected volatility     | 90.59%                         | 98.3% | 91.52%                       | 98.5% |
| Risk free interest rate | 2.51%                          | 1.40% | 2.68%                        | 1.79% |
| Expected lives (years)  | 3.75                           | 3     | 3.5                          | 3     |

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. The 1,475,000 shares that will be issued to the claimants in the settled Class Action Settlement described in Notes 4 and 7 below based upon the District Court's decision on July 1, 2011 are not included in the calculation of net loss per share at June 30, 2011. Shares issuable upon the exercise of stock options and warrants, totaling 1,859,035 and 1,794,035 on June 30, 2011 and 2010, respectively, were excluded from the calculation of common equivalent shares, as the impact was anti-dilutive.

## 2. BALANCE SHEET ACCOUNTS

### Accrued Liabilities

Accrued liabilities, in addition to the accrued liabilities related to the Company's litigation related to certain Nouri Parties (see Note 4 below), consisted of the following:

|  | June 30,<br>2011    | December 31,<br>2010 |
|--|---------------------|----------------------|
| Class Action law suit settlement                     | 1,622,500           | 1,874,500            |
| Accrued payroll and related costs                    | 154                 | 3,406                |
| Custom accounting development cost                   | 75,436              | 75,436               |
| Professional services                                | 14,594              | -                    |
| Interest payable to IDB and Bondholders (See Note 3) | 165,174             | 141,895              |
| Other accrued items                                  | 28,745              | 24,139               |
|  | <b>\$ 1,906,603</b> | <b>\$ 2,119,376</b>  |

## 3. NOTES PAYABLE

As of June 30, 2011, the Company had notes payable totaling \$19,049,189. The detail of these notes is as follows:

| Note Description       | As of<br>June 30, 2011 | As of<br>December 31, 2010 | Maturity  | Rate                       |
|------------------------|------------------------|----------------------------|-----------|----------------------------|
| IDB credit facility    | \$ 5,000,000           | \$ 4,000,000               | May 2012  | Prime, not less than 4.0 % |
| Insurance premium note | -                      | 21,778                     | July 2011 | 5.4%                       |
| Various capital leases | 174,189                | 185,255                    | Various   | 8.0-18.0%                  |
| Convertible notes      | 13,875,000             | 12,500,000                 |           | 8.0%                       |

November  
2013

|                              |               |               |
|------------------------------|---------------|---------------|
| Totals                       | 19,049,189    | 16,707,033    |
| Less current portion of debt | 5,015,753     | 40,564        |
| Long -term portion of debt   | \$ 14,033,436 | \$ 16,666,469 |

## Line 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 a \$6,500,000 Term Loan Facility (the "Letter Agreement"), each with Israel Discount Bank of New York ("IDB") as lender.

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 June 30, 2011, the Company had \$13.875 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 June 30, 2011            |                      |                                  |                  |            |
|--------------------------------|----------------------|----------------------------------|------------------|------------|
| Note Buyer                     | Date of Purchase     | Amount of<br>Convertible<br>Note | Interest<br>Rate | Due Date   |
| Atlas Capital                  | Various              | \$ 11,425,000                    | 8%               | 11/14/2013 |
| Blueline Fund                  | November 14,<br>2007 | 500,000                          | 8%               | 11/14/2013 |
| Crystal Management             | Various              | 750,000                          | 8%               | 11/14/2013 |
| HSBC Private Bank (Suisse), SA | November 21,<br>2008 | 250,000                          | 8%               | 11/14/2013 |
| UBP, Union Bancaire Privee     | Various              | 900,000                          | 8%               | 11/14/2013 |
| William Furr                   | November 14,<br>2007 | 250,000                          | 8%               | 11/14/2013 |
| Less – lease conversion        | September 4,<br>2009 | (200,000)                        |                  |            |
| Total Convertible Notes        |                      | \$ 13,875,000                    |                  |            |

The Company may sell up to \$20.3 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 of default 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.

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.

During a Board of Directors Meeting, held on June 15, 2011, the Board unanimously approved a resolution to increase the total aggregate principal amount of Notes for sale to new convertible noteholders or existing noteholders from \$15.3 million to \$20.3 million. The terms of sale, maturity and interest rate remain consistent with the Notes already sold.

#### 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 in Durham, N.C., 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 six months ended June 30, 2011 and 2010 was \$106,152 and \$107,509, respectively.

## 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 (the "District Court") issued an order preliminarily approving the settlement on January 13, 2011, the final settlement hearing was held on May 11, 2011. The District Court approved the Stipulation and directed that the terms of the Stipulation should be consummated.

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. As per the terms of the Stipulation, the settlement class has received total consideration of a cash payment of \$350,000 made by the Company, and a cash payment of \$112,500 made by Maxim Group. In addition, Henry Nouri is required to transfer 25,000 shares of Company common stock to the settlement class and the Company is required to issue 1,475,000 shares of Company common stock to the class. 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 are 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 District Court, issued the Order Preliminarily Approving Settlement and Providing Notice. Based upon the Nouri Settlement Agreement and the January 13, 2011 District Court 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, April 15, 2011, June 14, 2011 and July 14, 2011, \$7,773 was paid on May 12, 2011, and an additional \$592,227 is payable in seven 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 Company was ordered by a Court of proper jurisdiction to withhold \$67,227 for future payment of adjudicated debt owed by the Nouris. The Settlement Agreement provides for the exchange of mutual releases by the parties.

On July 1, 2011, the District Court issued the Final Judgment and Order of Partial Dismissal with Prejudice in the Class Action case. The Court approved the Stipulation and directed that the terms of the Stipulation should be consummated.

## 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 June 30, 2011.

### Common Stock

The Company is authorized to issue 45,000,000 shares of common stock, \$0.001 par value per share. As of June 30, 2011, it had 18,352,543 shares of common stock outstanding and will issue 1,475,000 shares to the lead plaintiff's counsel as per the Stipulation described in Note 4 above. Holders of common stock are entitled to one vote for each share held.

### Warrants

As part of the commission paid to Canaccord Adams, Inc. ("CA"), the Company's placement agent in the 2007 private placement 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 is exercisable until 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 June 30, 2011, including the warrants described in the foregoing paragraph, the Company had outstanding warrants to purchase up to an aggregate of 479,444 shares of its common stock.

### 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. 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.

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 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 six months ended June 30, 2011:

|                            | Shares  | Weighted<br>Average<br>Exercise<br>Price |
|----------------------------|---------|--|
| BALANCE, December 31, 2010 | 283,000 | \$ 2.34                                  |
| Granted                    | -       | -  |
| Exercised                  | -       | -  |
| Canceled                   | (2,500) | 1.10                                     |
| BALANCE, June 30, 2011     | 280,500 | \$ 2.36                                  |

The following table summarizes information about stock options outstanding at June 30, 2011:

| Exercise Price        | Number of<br>Options<br>Outstanding | Average<br>Remaining<br>Contractual<br>Life (Years) | Currently Exercisable                    |                     |
|-----------------------|-------------------------------------|---|--|---------------------|
|                       |                                     |   | Weighted<br>Average<br>Exercise<br>Price | Number of<br>Shares |
| \$1.10                | 65,500                              | 9.5   | \$ 1.10                                  | 14,500              |
| \$1.14                | 125,000                             | 8.5   | \$ 1.14                                  | 68,750              |
| From \$2.50 to \$3.50 | 45,000                              | 3.9   | \$ 3.31                                  | 45,000              |
| \$5.00                | 25,000                              | 3.8   | \$ 5.00                                  | 25,000              |
| \$8.61                | 20,000                              | 4.0   | \$ 8.61                                  | 20,000              |
| Totals                | 280,500                             | 7.3   | \$ 2.36                                  | 173,250             |

At June 30, 2011, there remains \$74,247 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:

|            |                                     | Three Months Ended<br>June 30, 2011 |                        |
|------------|-------------------------------------|-------------------------------------|------------------------|
|            | Revenue Type                        | Revenues                            | % of Total<br>Revenues |
| Customer A | Subscription fees and other revenue | \$ 88,383                           | 80%                    |
| Customer B | Subscription fees                   | 22,588                              | 20%                    |
| Others     | Various                             | 101                                 | -%                     |
| Total      |                                     | \$ 111,072                          | 100%                   |

|            |                                     | Three Months Ended<br>June 30, 2010 |                        |
|------------|-------------------------------------|-------------------------------------|------------------------|
|            | Revenue Type                        | Revenues                            | % of Total<br>Revenues |
| Customer A | Subscription fees and other revenue | \$ 95,573                           | 37%                    |
| Customer B | Subscription fees                   | 44,919                              | 17%                    |
| Others     | Various                             | 119,226                             | 46%                    |
| Total      |                                     | \$ 259,718                          | 100%                   |

|            |                                     | Six Months Ended<br>June 30, 2011 |                        |
|------------|-------------------------------------|-----------------------------------|------------------------|
|            | Revenue Type                        | Revenues                          | % of Total<br>Revenues |
| Customer A | Subscription fees and other revenue | \$ 196,772                        | 79%                    |
| Customer B | Subscription fees                   | 50,657                            | 20%                    |
| Others     | Various                             | 2,380                             | 1%                     |
| Total      |                                     | \$ 249,809                        | 100%                   |

|            |                                     | Six Months Ended<br>June 30, 2010 |                        |
|------------|-------------------------------------|-----------------------------------|------------------------|
|            | Revenue Type                        | Revenues                          | % of Total<br>Revenues |
| Customer A | Subscription fees and other revenue | \$ 207,454                        | 33%                    |
| Customer B | Subscription fees                   | 97,359                            | 16%                    |

|        |         |    |         |      |
|--------|---------|----|---------|------|
| Others | Various |    | 318,805 | 51%  |
| Total  |         | \$ | 623,618 | 100% |

As of June 30, 2011, we had current accounts receivable of \$ 737,346 and a note receivable from a customer of \$100,000; we have established a reserve of \$835,388 for bad debts against the total. As of December 31, 2010, one customer accounted for 100% of accounts receivable.

## 7. SUBSEQUENT EVENTS

During a meeting of our Board of Directors held on June 15, 2011, the Board unanimously approved a resolution to increase the total aggregate principal amount of Notes for sale to new convertible noteholders or existing noteholders from \$15.3 million to \$20.3 million. The terms of sale, maturity and interest rate remain consistent with the Notes already sold.

On July 1, 2011, the District Court issued the Final Judgment and Order of Partial Dismissal with Prejudice in the Class Action case. The District Court approved the Stipulation and directed that the terms of the Stipulation should be consummated.

## 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 and other federal securities laws. 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," in our Annual Report on Form 10-K for the year ended December 31, 2010 and our subsequent periodic reports filed with the Securities and Exchange Commission 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 businesses and not-for-profit organizations. The products are delivered via a SaaS model. We also provide website-consulting services and customized mobile applications. We reach our customers primarily through direct sales, web-site marketing and community involvement.

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. 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. 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. Subscription fees are recognized as earned through our revenue sharing arrangements.

Professional service fees – fees related to consulting services, some of which complement our other products and applications. For example, a customer may request that we re-design its website to better accommodate our products or to improve its own website traffic or adapt our mobile platform to their specific requirements. We typically bill professional service fees on a time and material basis. These fees are recognized upon the delivery of services and acceptance by the customer.

License fees – fees charged for perpetual or term license agreements for the use of the SmartOn™ Cause, SmartOn™ Mobile, SmartOn™ CommUnity or any of our applications that may be offered as part of our platforms. Revenue is generally recognized on a monthly basis during the term of contract.

Hosting fees – fees charged to customers with network accessibility for any of the Smart Online platform products or applications. Revenue is generally recognized on a monthly basis as services are provided.

Other revenue – revenues generated from non-core activities such as maintenance fees; original equipment manufacturer, or OEM, contracts; 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 the 2010 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. During the first six months of 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 mobile solution products to businesses and 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; 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 products to market, we expect associated costs to increase in 2011 due to targeting new partnerships, advertising campaigns, and additional sales and marketing personnel

Research and Development – Research and development expenses include costs associated with the development of new 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. We have adopted accounting standards that resulted in 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 June 30, 2011 and June 30, 2010

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

|                                    | Three Months Ended<br>June 30, 2011 |                 |   | Three Months Ended<br>June 30, 2010 |                 |   | 2011 vs 2010<br>Change |         |   |
|------------------------------------|-------------------------------------|-----------------|---|-------------------------------------|-----------------|---|------------------------|---------|---|
|                                    | Dollars                             | % of<br>Revenue |   | Dollars                             | % of<br>Revenue |   | Dollars                | Percent |   |
| <b>REVENUES:</b>                   |                                     |                 |   |                                     |                 |   |                        |         |   |
| Subscription fees                  | \$90,375                            | 81.4            | % | \$123,146                           | 47.4            | % | \$(32,771 )            | -27     | % |
| Professional service fees          | -                                   | -               | % | 7,050                               | 2.7             | % | (7,050 )               | -100    | % |
| License fees                       | -                                   | -               | % | 70,850                              | 27.3            | % | (70,850 )              | -100    | % |
| Hosting fees                       | -                                   | -               | % | 37,722                              | 14.5            | % | (37,722 )              | -100    | % |
| Other revenue                      | 20,697                              | 18.6            | % | 20,950                              | 8.1             | % | (253 )                 | -1      | % |
| Total revenues                     | 111,072                             | 100.0           | % | 259,718                             | 100.0           | % | (148,646 )             | -57     | % |
| <b>COST OF REVENUES</b>            | 201,889                             | 181.8           | % | 336,310                             | 129.5           | % | (134,421 )             | -40     | % |
| <b>GROSS LOSS</b>                  | (90,817 )                           | -81.8           | % | (76,592 )                           | -29.5           | % | 14,225                 | 19      | % |
| <b>OPERATING EXPENSES:</b>         |                                     |                 |   |                                     |                 |   |                        |         |   |
| General and administrative         | 308,763                             | 278.0           | % | 389,469                             | 150.0           | % | (80,706 )              | -21     | % |
| Sales and marketing                | 146,888                             | 132.2           | % | 179,640                             | 69.2            | % | (32,752 )              | -18     | % |
| Research and development           | 104,932                             | 94.5            | % | 10,380                              | 4.0             | % | 94,552                 | 911     | % |
| Loss on disposal of assets         | 3,471                               | 3.1             | % | -                                   | -               |   | 3,471                  | 100     | % |
| Total operating expenses           | 564,054                             | 507.8           | % | 579,489                             | 223.1           | % | (15,435 )              | -3      | % |
| <b>LOSS FROM OPERATIONS</b>        | (654,871 )                          | -589.6          | % | (656,081 )                          | -252.6          | % | (1,210 )               | -1      | % |
| <b>OTHER INCOME<br/>(EXPENSE):</b> |                                     |                 |   |                                     |                 |   |                        |         |   |
| Interest expense, net              | (322,386 )                          | -290.2          | % | (233,025 )                          | -89.7           | % | 89,361                 | 38      | % |
| Gain on legal settlements, net     | 177,000                             | 159.4           | % | 401,107                             | 154.4           | % | (224,107 )             | -56     | % |
| Total other expense                | (145,386 )                          | -130.9          | % | 168,082                             | 64.7            | % | (313,468 )             | -187    | % |
| <b>NET LOSS</b>                    | \$(800,257 )                        | -720.5          | % | \$(487,999 )                        | -187.9          | % | \$312,258              | 64      | % |

#### Revenues

Revenues decreased 57% to \$111,072 for the three months ended June 30, 2011 from \$259,718 for the same period in 2010. Our overall decrease in revenues was driven by substantial declines in subscription fees, license fees and hosting fees. During the period, we focused time and efforts to market and promote our newly released SmartOn™ Mobile product. Select items are discussed in detail below.

#### Subscription Fees

Revenues from subscription fees decreased 27% to \$90,375 for the three months ended June 30, 2011 from \$123,146 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 coupled with a decrease in demand for new subscription relationships during the second quarter of 2011.

#### Professional Service Fees

Revenues from professional service fees decreased 100% to \$ -0- for the three months ended June 30, 2011 from \$7,050 for the same period in 2010. This decrease is primarily due to a significant decline in web consulting services provided to customers and no new sales of professional services as we focused time and efforts to market and promote our newly released SmartOn™ Mobile product during the second quarter of 2011.

#### License Fees

Revenues from license fees decreased 100% to \$ -0- for the three months ended June 30, 2011 from \$70,850 for the same period in 2010. There was no license fee revenue recognized in the second quarter of 2011 due to the cancellation of a term license that commenced in December 2009.



### Hosting Fees

Revenues from hosting fees decreased 100% to \$ -0- for the three months ended June 30, 2011 from \$37,722 for the same period in 2010. This decrease is due to the loss of clients that required hosting services.

### Other Revenue

Revenues from non-core activities decreased 1% to \$20,697 for the three months ended June 30, 2011 from \$20,950 for the same period in 2010. We expect these revenue streams to continue to be insignificant in the future as we focus on the growth of our subscription fees revenue.

### Cost of Revenues

Cost of revenues decreased 40% to \$201,889 for the three months ended June 30, 2011 from \$336,310 for the same period in 2010. This decrease is the result of reduction in costs directly related to the decrease in revenues.

### Operating Expenses

#### General and Administrative

General and administrative expenses decreased 21% to \$308,763 for the three months ended June 30, 2011 from \$389,469 for the same period in 2010. This decrease is primarily attributable to reductions in bad debt expense \$70,000; and \$38,000 in audit fees. Bad debt expense was reduced because we chose not to continue to do service for and invoice customers who were unable to pay. Audit fees were reduced due to reduction of additional services required and increased efficiencies in our finance and accounting function. These decreases were offset by a \$10,000 increase in bank fees to secure additional financing; a \$5,000 increase in professional fees for initial implementation of XBRL, newly required SEC reporting requirements; and a \$9,000 additional payroll processing and compensation expense during the three month period ending June 30, 2011.

#### Sales and Marketing

Sales and marketing expenses decreased 18% to \$146,888 for the three months ended June 30, 2011 from \$179,640 for the same period in 2010. This variance is primarily attributable to reductions associated with revenue-sharing arrangements with our multi-level marketing partners while we focused time and efforts to market and promote our newly released SmartOn™ Mobile product.

#### Research and Development

Research and development expenses increased 911% to \$104,932 for the three months ended June 30, 2011 from \$10,380 for the same period in 2010. This increase is primarily attributable to an increase in the allocation of internal technical resources to research and development during the second quarter of 2011.

#### Other Income (Expense)

Other income (expense) for the three months ended June 30, 2011 and 2010 comprise the following:

| Three Months Ended |      | Change  |         |
|--------------------|------|---------|---------|
| June 30,           |      | Dollars | Percent |
| 2011               | 2010 |         |         |

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|                                |              |              |              |       |
|--------------------------------|--------------|--------------|--------------|-------|
| Interest (expense) net         | \$ (322,386) | \$ (233,025) | \$ 89,361    | 38%   |
| Gain on legal settlements, net | 177,000      | 401,107      | (224,107)    | -56%  |
| Total other income (expense)   | \$ (145,386) | \$ 168,082   | \$ (313,468) | -187% |

Net other income (expense) decreased 187% to an expense of \$145,386 for the three months ended June 30, 2011 from an income of \$168,082 for the same period in 2010. This net increase was primarily attributable to the settlement of the Nouri litigation.

Interest Expense, NetNet interest expense increased 38% to \$322,386 for the three months ended June 30, 2011 from \$233,025 for the same period in 2010. This increase is primarily related to additional borrowings in 2011.

Gain on legal settlements, Net

Net gain on legal settlements decreased 56% to \$177,000 for the three months ended June 30, 2011 from \$401,107 for the same period in 2010. This net decrease was primarily attributable to the results of the negotiations to settle the Nouri litigation in 2010 compared to the reduction of final Class Action costs in 2011.

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Results of Operations for the Six Months Ended June 30, 2011 and June 30, 2010

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

|                                 | Six Months Ended June 30, 2011 |                 | Six Months Ended June 30, 2010 |                 | 2011 vs 2010      |                 |
|---------------------------------|--------------------------------|-----------------|--------------------------------|-----------------|-------------------|-----------------|
|                                 | Dollars                        | % of Revenue    | Dollars                        | % of Revenue    | Change Dollars    | Percent         |
| <b>REVENUES:</b>                |                                |                 |                                |                 |                   |                 |
| Subscription fees               | \$ 193,647                     | 77.5 %          | \$ 259,404                     | 41.6 %          | \$(65,757 )       | -25.3 %         |
| Professional service fees       | -                              | -               | 69,825                         | 11.2 %          | (69,825 )         | -100.0 %        |
| License fees                    | -                              | -               | 158,650                        | 25.4 %          | (158,650 )        | -100.0 %        |
| Hosting fees                    | -                              | -               | 81,994                         | 13.1 %          | (81,994 )         | -100.0 %        |
| Other revenue                   | 56,162                         | 22.5 %          | 53,745                         | 8.6 %           | 2,417             | 4.5 %           |
| <b>Total revenues</b>           | <b>249,809</b>                 | <b>100.0 %</b>  | <b>623,618</b>                 | <b>100.0 %</b>  | <b>(373,809 )</b> | <b>-59.9 %</b>  |
| <b>COST OF REVENUES</b>         | <b>394,205</b>                 | <b>157.8 %</b>  | <b>702,244</b>                 | <b>112.6 %</b>  | <b>(308,039 )</b> | <b>-43.9 %</b>  |
| <b>GROSS LOSS</b>               | <b>(144,396 )</b>              | <b>-57.8 %</b>  | <b>(78,626 )</b>               | <b>-12.6 %</b>  | <b>65,770</b>     | <b>83.6 %</b>   |
| <b>OPERATING EXPENSES:</b>      |                                |                 |                                |                 |                   |                 |
| General and administrative      | 647,731                        | 259.3 %         | 1,061,888                      | 170.3 %         | (414,157 )        | -39.0 %         |
| Sales and marketing             | 288,942                        | 115.7 %         | 332,275                        | 53.3 %          | (43,333 )         | -13.0 %         |
| Research and development        | 263,821                        | 105.6 %         | 42,385                         | 6.8 %           | 221,436           | 522.4 %         |
| Loss on disposal of assets, net | 3,471                          | 1.4 %           | -                              | -               | 3,471             | 100 %           |
| <b>Total operating expenses</b> | <b>1,203,965</b>               | <b>482.0 %</b>  | <b>1,436,548</b>               | <b>230.4 %</b>  | <b>(232,583 )</b> | <b>-16.2 %</b>  |
| <b>LOSS FROM OPERATIONS</b>     | <b>(1,348,361 )</b>            | <b>-539.8 %</b> | <b>(1,515,174 )</b>            | <b>-243.0 %</b> | <b>(166,813 )</b> | <b>-11.0 %</b>  |
| <b>OTHER INCOME (EXPENSE):</b>  |                                |                 |                                |                 |                   |                 |
| Interest expense, net           | (616,715 )                     | -246.9 %        | (443,720 )                     | -71.2 %         | 172,995           | 39.0 %          |
| Gain on legal settlements, net  | 177,019                        | 70.9 %          | 553,970                        | 88.8 %          | (376,951 )        | -68.0 %         |
| <b>Total other expense</b>      | <b>(439,696 )</b>              | <b>-176.0 %</b> | <b>110,250</b>                 | <b>17.7 %</b>   | <b>(549,946 )</b> | <b>-498.8 %</b> |
| <b>NET LOSS</b>                 | <b>\$(1,788,057 )</b>          | <b>-715.8 %</b> | <b>\$(1,404,924 )</b>          | <b>-225.3 %</b> | <b>\$383,133</b>  | <b>27.3 %</b>   |

Revenues

Revenues decreased 59.9% to \$249,809 for the six months ended June 30, 2011 from \$623,618 for the same period in 2010. Our overall decrease in revenues was driven by substantial declines in subscription, professional service, license and hosting fees. During the period, we focused time and efforts to market and promote our newly released SmartOn™ Mobile product. Select items are discussed in detail below.

Subscription Fees

Revenues from subscription fees decreased 25.3% to \$193,647 for the six months ended June 30, 2011 from \$259,404 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 coupled with a decrease in demand for new subscription relationships during the first and second quarters of 2011.

#### Professional Service Fees

Revenues from professional service fees decreased 100% to \$ -0- for the six months ended June 30, 2011 from \$69,825 for the same period in 2010. This decrease is primarily due to a significant decline in web consulting services provided to customers and no new sales of professional services as we focused time and efforts to market and promote our newly released SmartOn™ Mobile product during the first and second quarters of 2011.

#### License Fees

Revenues from license fees decreased 100% to \$ -0- for the six months ended June 30, 2011 from \$158,650 for the same period in 2010. There was no license fee revenue recognized in the first and second quarter of 2011 due to the cancellation of a term license that commenced in December 2009 and no new sales.

#### Hosting Fees

Revenues from hosting fees decreased 100% to \$ -0- for the six months ended June 30, 2011 from \$81,994 for the same period in 2010. This decrease is caused by lack of customer traffic for clients and the loss of clients that required hosting services.

#### Other Revenue

Revenues from non-core activities increased 4.5% to \$ 56,162 for the six months ended June 30, 2011 from \$53,745 for the same period in 2010. We expect these revenue streams to continue to be insignificant in the future as we focus on the growth of our subscription fees revenue.

#### Cost of Revenues

Cost of revenues decreased 43.9% to \$394,205 for the six months ended June 30, 2011 from \$702,244 for the same period in 2010. This decrease is the result of decreased professional services costs associated with subscription fees revenue.

#### Operating Expenses

Operating expenses decreased 16.2% to \$1,203,965 for the six months ended June 30, 2011 from \$1,436,548 for the same period in 2010. This decrease is the direct result of our concerted efforts to reduce operating expenses by improving efficiencies and eliminating unnecessary costs. Select items are discussed in detail below.

#### General and Administrative

General and administrative expenses decreased 39% to \$647,731 for the six months ended June 30, 2011 from \$1,061,888 for the same period in 2010. This decrease is primarily attributable to reductions in: bad debt expense of \$250,000 because we chose not to continue to do services for and invoice customers who were unable to pay; \$136,000 of legal expense because we have been able to settle the outstanding litigation that we were involved with since 2007; \$46,000 in audit fees due to a reduction of additional services required and increased efficiencies in our finance and accounting function; and a \$19,000 decrease in insurance expense due to change in coverage. These decreases were offset by the recognition of an additional \$11,000 in compensation expense associated with the grant of stock options to current employees; \$11,000 of additional expense for the granting of restricted stock to Board Member Shlomo Elia; and \$15,000 of additional information technology and payroll processing costs during the six-month period ended June 30, 2011.



### Sales and Marketing

Sales and marketing expenses decreased 13% to \$288,942 for the six months ended June 30, 2011 from \$332,275 for the same period in 2010. This variance is primarily attributable to reductions associated with revenue-sharing arrangements with our channel partners while we focused time and efforts to market and promote our newly released SmartOn™ Mobile product.

### Research and Development

Research and development expenses increased 522.4% to \$263,821 for the six months ended June 30, 2011 from \$42,385 for the same period in 2010. This increase is primarily attributable to an emphasis on research and continued product development during the first and second quarters of 2011.

### Other Income (Expense)

Other income (expense) for the six months ended June 30, 2011 and 2010 comprise the following:

|                                | Six Months Ended June |              | Change       |         |
|--------------------------------|-----------------------|--------------|--------------|---------|
|                                | 2011                  | 2010         | Dollars      | Percent |
| Interest expense, net          | \$ (616,715)          | \$ (443,720) | \$ 172,995   | 39.0%   |
| Gain on legal settlements, net | 177,019               | 553,970      | (376,951)    | -68.0%  |
| Total other (expense) income   | \$ (439,696)          | \$ 110,250   | \$ (549,946) | -498.8% |

Net other (expense) income decreased 498.8% to an overall expense of (\$439,696) for the six months ended June 30, 2011 from income of \$110,250 for the same period in 2010. This net decrease was primarily attributable to the net increase in interest expense offset by a lesser gain on legal settlements for the six months ended June 30, 2011.

### Interest Expense, Net

Net interest expense increased 39% to \$616,715 for the six months ended June 30, 2011 from \$443,720 for the same period in 2010. This increase is primarily the result of additional borrowings during 2011.

### Gain on legal settlements, Net

Net gain on legal settlements decreased 68% to \$177,019 for the six months ended June 30, 2011 from \$553,970 for the same period in 2010. This net increase was primarily attributable to the results of the negotiations to settle the Nouri and Class Action litigation.

### 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 or second 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 \$52.1 million in net operating loss carryforwards, which may be utilized to offset future taxable income.

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. The net operating loss carryforward amount will expire between 2011 and 2029.

## Liquidity and Capital Resources

### Overview

As of June 30, 2011, our principal sources of liquidity were cash and cash equivalents totaling \$998,076 and current accounts receivable of \$1,958, net of allowance for doubtful accounts, as compared to \$1,110,209 of cash and cash equivalents and \$8,931 in accounts receivable as of December 31, 2010. As of June 30, 2011, we had drawn \$5,000,000 on the \$6,500,000 line of credit, leaving approximately \$1,500,000 available under the credit facility for our operations. Deferred revenue at June 30, 2011 was \$21,000 as compared to \$23,000 at December 31, 2010.

As of August 4, 2011, our principal sources of liquidity were cash and cash equivalents totaling approximately \$696,000 and accounts receivable of approximately \$9,600. In addition, we had drawn approximately \$5,000,000 on the IDB Bank credit facility. As of August 4, 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 six months ended June 30, 2011, our working capital deficit increased by approximately \$4.37 million to \$7.22 million from a working capital deficit of \$2.85 million at December 31, 2010. As described more fully below, the working capital deficit at June 30, 2011 is primarily attributable to negative cash flows from operations, offset in part by net debt borrowings.



## Cash Flows from Operating Activities

|   | Six Months Ended June 30, |                | Change     |         |
|---|---------------------------|----------------|------------|---------|
|   | 2011                      | 2010           | Dollars    | Percent |
| Net cash (used) in operating activities | \$ (2,446,785)            | \$ (1,722,101) | \$ 724,684 | 42.1%   |

Net cash used in operating activities increased 42% to \$2,446,785 for the six months ended June 30, 2011 from \$1,722,101 for the same period in 2010. This increase is primarily attributable to an increase in accrued liabilities and accounts payable, and a decrease in accounts receivable, offset by a decrease in bad debt reserve allowance.

## Cash Flows from Investing Activities

|   | Six Months Ended June 30, |            | Change   |         |
|---|---------------------------|------------|----------|---------|
|   | 2011                      | 2010       | Dollars  | Percent |
| Net cash (used) in investing activities | \$ (7,506)                | \$ (4,372) | \$ 3,134 | 71.7%   |

Net cash used in investing activities increased 71.7% to \$7,506 for the six months ended June 30, 2011 from \$4,372 for the same period in 2010. This net increase in use of cash is attributable to the purchase of additional purchase of equipment during the six-month period ended June 30, 2011.

## Cash Flows from Financing Activities

|   | Six Months Ended June 30, |              | Change     |         |
|---|---------------------------|--------------|------------|---------|
|   | 2011                      | 2010         | Dollars    | Percent |
| Net cash provided by financing activities | \$ 2,420,710              | \$ 1,628,993 | \$ 791,717 | 48.6%   |

Net cash provided by financing activities increased 48.6% to \$2,420,710 for the six months ended June 30, 2011 from \$1,628,993 for the same period in 2010. This net source of cash is primarily due to debt borrowings in each period, as described below.

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

## Debt Financing

As of June 30, 2011, we had notes payable totaling \$19,049,189. The detail of these notes is as follows:

| Note Description             | As of June 30, 2011 | As of December 31, 2010 | Maturity      | Rate                       |
|------------------------------|---------------------|-------------------------|---------------|----------------------------|
| IDB credit facility          | \$ 5,000,000        | \$ 4,000,000            | May 2012      | Prime, not less than 4.0 % |
| Insurance premium note       | -                   | 21,778                  | July 2011     | 5.4%                       |
| Various capital leases       | 174,189             | 185,255                 | Various       | 8.0-18.0%                  |
| Convertible notes            | 13,875,000          | 12,500,000              | November 2013 | 8.0%                       |
| Totals                       | 19,049,189          | 16,707,033              |               |                            |
| Less current portion of debt | 5,015,753           | 40,564                  |               |                            |

|                            |    |            |    |            |
|----------------------------|----|------------|----|------------|
| Long -term portion of debt | \$ | 14,033,436 | \$ | 16,666,469 |
|----------------------------|----|------------|----|------------|

Line 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 a \$6,500,000 Term Loan Facility (the "Letter Agreement"), each with Israel Discount Bank of New York ("IDB") as lender.

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

We have issued convertible subordinated notes, as amended, or the Notes, under the Convertible Secured Subordinated Note Purchase Agreement, dated November 14, 2007 or, as amended, the Note Purchase Agreement, between the Company and the convertible noteholders, under which we are 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 June 30, 2011, we had \$13.875 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 our equipment with the noteholders in 2009. The Notes have been sold as follows:

| As of June 30, 2011            |                      |                                  |                  |            |
|--------------------------------|----------------------|----------------------------------|------------------|------------|
| Note Buyer                     | Date of Purchase     | Amount of<br>Convertible<br>Note | Interest<br>Rate | Due Date   |
| Atlas Capital                  | Various              | \$ 11,425,000                    | 8%               | 11/14/2013 |
| Blueline Fund                  | November 14,<br>2007 | 500,000                          | 8%               | 11/14/2013 |
| Crystal Management             | Various              | 750,000                          | 8%               | 11/14/2013 |
| HSBC Private Bank (Suisse), SA | November 21,<br>2008 | 250,000                          | 8%               | 11/14/2013 |
| UBP, Union Bancaire Privee     | Various              | 900,000                          | 8%               | 11/14/2013 |
| William Furr                   | November 14,<br>2007 | 250,000                          | 8%               | 11/14/2013 |
| Less – lease conversion        | September 4,<br>2009 | (200,000)                        |                  |            |
| Total Convertible Notes        |                      | \$ 13,875,000                    |                  |            |

During a Board of Directors Meeting, held on June 15, 2011, the Board unanimously approved a resolution to increase the total aggregate principal amount of Notes for sale to new convertible noteholders or existing noteholders from \$15.3 million to \$20.3 million. The terms of sale, maturity and interest rate remain consistent with the Notes already sold. We may now sell up to \$20.3 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 of default 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 Company's 2010 Annual Report on Form 10-K for the year ended December 31, 2010.

On April 6, 2011, we 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, we 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.

#### Going Concern

Our independent registered public accountants for the fiscal year ended December 31, 2010 have issued an explanatory paragraph in their report included in our Annual Report on Form 10-K for the year ended December 31, 2010 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.

#### Legal Proceeding Development

On July 1, 2011, the United States District Court Middle District of North Carolina issued the Final Judgment and Order of Partial Dismissal with Prejudice in the Class Action case. The District Court approved the Stipulation and directed that the terms of the Stipulation should be consummated.

Please refer to Part I, Item 3 of our Annual Report on Form 10-K for the fiscal year ended December 31, 2010 and Notes 4 and 7 to our financial statements contained elsewhere in this Quarterly Report on Form 10-Q for a further description of material legal proceedings.

#### ITEM QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

3.

Not applicable.

#### ITEM CONTROLS AND PROCEDURES

4.

Our management, with the participation of our interim Chief Executive Officer has evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. 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 such evaluation, our Interim Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this Quarterly Report on Form 10-Q, our disclosure controls and

procedures were effective at the reasonable assurance level.

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 June 30, 2011 that has materially affected, or that is reasonably likely to materially affect, our internal control over financial reporting.

PART II – OTHER INFORMATION

ITEM 6. EXHIBITS

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

Exhibit Description  
No.

|         |   |
|---------|---|
| 31.1*   | Certification of Principal Executive Officer Pursuant to Rule 13a-14(a)   |
| 31.2*   | Certification of Principal Financial Officer Pursuant to Rule 13a-14(a)   |
| 32.1**  | Certification of Principal Executive Officer Pursuant to 18 U.S.C. Section 1350   |
| 32.2**  | Certification of Principal Financial Officer Pursuant to 18 U.S.C. Section 1350   |
| 101.1** | The following materials from the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2011, formatted in XBRL (extensible Business Reporting Language): (i) the Balance Sheets, (ii) the Statements of Operations, (iii) the Statements of Cash Flows and (iv) related notes to these financial statements, tagged as blocks of text.** |

\* = Filed herewith.

\*\* = Furnished herewith.

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.

August 12, 2011

By: /s/ Dror Zoreff  
Dror Zoreff  
Principal Executive Officer, Interim  
CEO and President

SMART ONLINE, INC.

August 12, 2011

By: /s/ Thaddeus J. Shalek  
Thaddeus J. Shalek  
Principal Accounting Officer and Chief  
Financial Officer



EXHIBIT INDEX

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| 32.2**      | Certification of Principal Financial Officer/Principal Accounting Officer Pursuant to 18 U.S.C. Section 1350  |
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