SMART ONLINE INC
Form 10-K
March 31, 2011

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2010

or

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from __________ to __________

Commission file number 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)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
N/A	N/A

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, $0.001 par value
(Title of Class)

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

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

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

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

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

The aggregate market value of common stock held by non-affiliates of the registrant as of June 30, 2010 was approximately $20,177,896 (based on the closing sale price of $1.10 per share).

The number of shares of the registrant's Common Stock, $0.001 par value per share, outstanding as of March 18, 2011 was 18,342,543.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive Proxy Statement to be delivered to stockholders in connection with the Annual Meeting of Stockholders to be held June 15, 2011 are incorporated by reference into Part III.

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PART I

Special Note Regarding Forward-Looking Statements

This Annual Report on Form 10-K contains forward-looking statements, within the meaning of Section 27A of the Securities Act of 1933, or the Securities Act, and Section 21E of the Securities Exchange Act of 1934, or the Exchange Act, regarding our plans, objectives, expectations, intentions, future financial performance, future financial condition, and other statements that are not historical facts. You can identify these statements by our use of the future tense, or by forward-looking words such as “may,” “will,” “expect,” “anticipate,” “believe,” “intend,” “estimate,” “continue,” a similar words and phrases. Examples of sections containing forward-looking statements include Part I, Item 1, “Business” and Part II, Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operations.” These forward-looking statements are subject to risks, uncertainties, and assumptions that are difficult to predict. Therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. Readers are directed to risks and uncertainties identified in Part I, Item 1A, “Risk Factors” and elsewhere in this report for factors that may cause actual results to be different than those expressed in these forward-looking statements. Except as required by law, we undertake no obligation to revise or update publicly any forward-looking statements for any reason.

Item 1. Business

General

In this Annual Report on Form 10-K, we refer to Smart Online, Inc. as “Smart Online,” the “Company,” “us,” “we,” and “our.” Smart Online was incorporated in Delaware in August 1993 and became a public company through a self-registration in February 2005. Smart Online’s common stock trades on the OTC Bulletin Board, or the OTCBB, under the symbol “SOLN.”

We develop and market software products and services targeted to small businesses that are delivered via a Software-as-a-Service, or SaaS, model. We also provide website and mobile consulting services to not-for-profit organizations and businesses.

History

During the early stages of our development, we offered application-specific software using the “shrink-wrapped” method of distribution of diskettes and CD-ROMs, primarily through large office supply retailers. In 2000, we undertook a significant shift in our business strategy by moving away from the development and sale of shrink-wrapped software products and began developing SaaS applications for sale over the Internet.

Unlike the shrink-wrapped distribution method that requires the end user to install, configure, and maintain hardware, software, and network services internally to support the software applications, or the ASP model that permits access to the software resident on a server by a user from one dedicated PC, our proprietary multi-tenant SaaS applications allow small businesses to subscribe and access those applications via a browser from any PC on an as-needed basis, with no installation or maintenance required by the end user.

In October 2005, we acquired substantially all of the assets of Computility, Inc., or Computility, an Iowa-based, privately held developer and distributor of sales force automation and customer relationship management, or SFA/CRM, software applications. We operated this business under the name Smart CRM, Inc. (d/b/a Computility), or Smart CRM. Upon our integration of Smart CRM’s SFA/CRM application into our OneBiz ® platform, we determined that the remaining operations of Smart CRM, specifically consulting and network management, were not integral to

our ongoing operations and business model. During the latter months of 2010, we decided that the market for OneBiz platform products was saturated and therefore no longer market or support the product.

In October 2005, we purchased all of the capital stock of iMart Incorporated, or iMart, a Michigan-based company providing multi-channel e-commerce systems. Subsequently, we operated this business as our wholly owned subsidiary, Smart Commerce, Inc., or Smart Commerce.

In 2007, we operated our company as two segments. The two segments were our core operations, or the Smart Online segment, and the operations of our wholly owned subsidiary Smart Commerce, or the Smart Commerce segment. The Smart Online segment generated revenues from the development and distribution of Internet-delivered SaaS small-business applications through a variety of channels. The Smart Commerce segment generated revenues primarily from subscriptions to our multi-channel e-commerce systems, including domain name registration and e-mail solutions, e-commerce solutions, and website design, as well as website hosting and consulting services. We included costs that were not allocated to specific segments, such as corporate general and administrative expenses and share-based compensation expenses, in the Smart Online segment. During late 2007 and the first quarter of 2008, we realigned certain production and development functions and eliminated redundant administrative functions and now report the business as a single business segment.

In 2010, we focused on the use of our e-commerce technology knowledge in the not-for-profit industry by introducing the Loyalty Clicks product, now renamed as SmartOnCause. The strategy of the e-commerce marketing is to provide funding sources for not-for-profit organizations while creating revenue for our Company.

In addition, we recognized that smart phones are the primary communications device purchased today and therefore our research team is developing cross platform mobile phone applications that we market to the not-for-profit industry and businesses.

Principal Products and Services

Our principal products and services include:

- SaaS applications for business management, web marketing, and e-commerce;
- Software business tools that assist customers in developing written content;
- Services that are designed to complement our product offerings and allow us to create custom business solutions that fit our end users’ and channel partners’ needs;
- Services that assist not-for-profit organizations in their fundraising efforts, and
- Mobile phone applications used to provide specialized communications and e-commerce opportunities for not-for-profit organizations and industry.

Our SaaS applications are designed to allow end users to access and work on information securely from any location where an Internet browser can be accessed. These applications include:

e-Commerce – Our e-commerce applications are designed to give customers the capability to conduct transactions online. These applications also include shopping cart, financial transactions, shipping, domain name registration and business-to-business communication for small businesses. We provide consulting services such as website design and launch, among others, in connection with these applications. Our e-commerce offerings are designed to help direct marketers increase sales, better leverage corporate resources, and deliver superior customer service.

We also provide services that are designed to complement our product offerings and allow us to create custom business solutions that fit our channel partners' needs. These services include business consulting, graphic design, website content syndication, specialized compensation calculations, online order management, domain name registration, personalized e-mail creation, and warehouse order fulfillment.

In addition, our nonprofit sector background and understanding of nonprofits' missions, pain points and challenges allows us to deliver mobile applications that resolve problems and provide robust and innovative mobile service architecture and infrastructure; cutting edge push messaging, integrated newsfeeds and geo-location services.

Mode of Operations

Software-as-a-Service Model – We follow the SaaS model for delivering our products and services to end users. The on-demand SaaS model developed using multi-tenant architecture enables end users to visit a website and use the SaaS applications, all via a web browser, with no installation, no special information technology knowledge, and no maintenance. The SaaS application is transformed into a service that can be used anytime and anywhere by the end user. Multi-tenant SaaS applications also permit us to add needed functionality to our applications in one location for the benefit of all end users. This capability allows us to provide upgrades universally.

Integration and Sharing – Our SaaS applications have the capability to allow sharing of information (with selectivity and control options) among members of an organization. Each company that subscribes to our SaaS applications can have multiple members or employees who share information with one another. Information entered by one employee can be shared and modified by one or more other employees who have the appropriate access authority.

Target Market and Sales Channels

Our focus has been to design software products and services to help run businesses in a more efficient and cost-effective manner. The small-business market is diverse and fragmented, yet very large and, we believe, underserved. We have focused on offering a wide range of software products that combine simplicity and affordability and that meet the needs of small businesses with capabilities that typically can be afforded only by much larger companies. We follow a two-prong approach to target these small business and entrepreneurial end users that access our software products and services via the Internet. The first is an indirect approach via marketing partners that are vertical intermediaries in industries such as agriculture, finance, telecommunications, direct selling, retail, and technology as channels to reach these small-business customers. The second approach is the direct sales approach with our own sales staff selling directly to end-users.

Principal Customers

During 2010, we consider three customers as our major customers, and the loss of any one of these customers could have a material adverse effect on our business.

UR Association, or URA, is a multi-level-marketing organization that sells memberships and subscriptions to independent business owners, or IBOs. The net of the subscriptions from these IBOs represented approximately 39% of our revenues for the year ended December 31, 2010. URA became a customer in 2007 and represented 29% of our revenues in 2009. Since our revenue is derived from the IBOs, URA can directly influence the memberships and actions of the IBOs, this revenue has been netted for purposes of this Annual Report on Form 10-K.

1-800-Pharmacy, Inc. is a mail-order pharmacy that offers customers access both through a toll-free number and website, and gives customers rebates on their pharmaceutical and health & beauty purchases, as well as credit for referring others. 1-800-Pharmacy accounted for approximately 30% of our revenues for the year ended December 31, 2010. 1-800-Pharmacy became a customer in 2007 and represented 13% of our revenues in 2009.

Britt Worldwide, or BWW, is a multi-level-marketing entity that indirectly controls a significant number of independent business operators (“IBOs”) that currently subscribe to our services. The aggregate of the subscriptions from these IBOs represented approximately 17% of our revenues for the year ended December 31, 2010. BWW became a customer after we acquired iMart in October 2005 and represented 25% of our revenues in 2009. Although our revenue is derived from the IBOs, BWW can influence the actions of the IBOs, so this revenue has been aggregated for purposes of this Annual Report on Form 10-K. During 2009, BWW terminated its primary relationship with our Company. As of December 31, 2010, notwithstanding such termination, several IBOs have chosen to retain their subscriptions for our services

Research and Development

In the second half of 2007, as part of a general restructuring, we began to conduct an evaluation of our technology, platforms, and applications in an effort to document and improve upon our current product offerings and determine which applications, if any, should be discontinued. During 2008, we decided to develop an industry-standard platform that would allow significant technological flexibility with current and future customers. We devoted a substantial amount of time and effort in 2008 and 2009 to developing this platform, updating and migrating our business

applications and tools to the new platform, and enhancing the user interface of the products. During 2009, we continued the development work of SaaS applications for the not-for profit segment of the marketplace. We call this SmartOnCause. During 2010, we expanded our focus to include the delivery of mobile applications, which allow our customers to better communicate with their members, customers and constituents.

Our research and development costs were approximately $146,000 and $586,000 in 2010 and 2009, respectively. We have not engaged in any customer-sponsored research and development.

Competition

The market for small-business software applications in both the traditional and SaaS environments is highly competitive and subject to rapid changes in technology and delivery. The direct competition we face depends on the software application within our platforms and the delivery model capabilities of our competitors.

We have two primary categories of competitors: large companies that offer a wide range of products for small- to medium-size businesses, and companies that offer only one or two software products that compete with our broad range of software products. Our principal direct competition is a number of very large vendors of SaaS applications for small businesses that sell many products similar to ours. These competitors include, but are not limited to, Microsoft, Oracle, NetSuite, Intuit, SAP, Sage, Yahoo!, and Google.

Companies that offer only one or two products that compete with our suite of SaaS applications include:

- Accounting software applications: NetSuite, Intuit, SAP, Sage, Microsoft, ZOHO and others
- Human resource software applications: ADP, Sage, and others
- SFA/CRM applications: Microsoft, Sage, salesforce.com, NetSuite, and others
- e-Commerce solutions: Register.com, GoDaddy.com, 1and1 Internet, eBay's Storefront, Yahoo! Store, Microsoft, NetSuite, Intuit, and others

We also expect to face competition from new entrants marketing SaaS applications similar to ours to small businesses.

Although we believe we offer highly competitive services and software, many of our competitors do or may have greater resources and a larger number of total customers for their products and services. In addition, a number of our competitors already sell certain products to our current and potential customers, as well as to systems integrators and other vendors and service providers. These competitors may be able to respond more quickly to new or emerging technologies and changes in customer requirements, or to devote greater resources to the development, promotion, and sale of their products, than we can. It is also possible that new competitors or alliances among competitors or other third parties may emerge and rapidly acquire market share. Increased competition may result in price reductions, reduced gross margins, and change in market share, any of which could adversely impact our revenue and profitability targets and timetables.

On each competitive front, we seek to compete against these larger and better-financed companies primarily by offering a specialized set of SaaS applications that are useful to small businesses. We believe we offer SaaS applications and features specifically targeted to small businesses. To meet our business objectives, we will need to continue to develop high quality and competitively priced new applications for our SaaS offerings. If we are unable to do so, our revenue and profitability targets and timetables could be adversely impacted.

To compete effectively in the SaaS market, we leverage the marketing resources and small-business customer relationships of our private-label marketing partners that sell our SaaS applications by offering innovative and value-added products and services.

Intellectual Property

Our success depends, in part, upon our proprietary technology, processes, trade secrets, and other proprietary information and our ability to protect this information from unauthorized disclosure and use. We rely on a combination of copyright, trade secret, and trademark laws, confidentiality procedures, contractual provisions, and other similar measures to protect our proprietary information. We do not own any issued patents or have any patent

applications pending. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy or design around certain aspects of our SaaS offerings or to obtain and use information that we regard as proprietary, and third parties may attempt to develop similar technology independently. In addition, the laws of some foreign countries do not protect our proprietary rights to the same extent as do the laws of the United States, and we expect that it will become more difficult to monitor use of our products if we develop an international presence.

We have registered copyrights, trademarks, and registered service marks on several products and data services. These marks include, but are not limited to Smart Online ®, OneBiz ®, Smart Attorney ®, Smart Business Plan ®, Smart Marketing Plan ®, iMart TM, and OneDomain ®.

As part of our efforts to protect our proprietary information, we enter into license agreements with our customers and nondisclosure agreements with certain of our employees, consultants, and corporate partners. These agreements generally contain restrictions on disclosure, use, and transfer of our proprietary information for a period of three years. We also employ various physical and technological security measures to protect our software source codes, technology, and other proprietary information.

Employees

As of December 31, 2010, we had 22 full-time employees and no part-time employees. No employees are known by us to be represented by a collective bargaining agreement, and we have never experienced a strike or similar work stoppage.

Directors and Executive Officers of the Company

The members of our current Board of Directors are the following:

Dror Zoreff
Chairman of the Board and Interim President and Chief Executive Officer: President and CEO of Donor Management Services, Inc., a New York-based company that provides major donors, corporations, and foundations a unique set of tools and services to ensure their charitable gifts are properly used and achieve the desired impact.

Shlomo Elia
Director of 3Pen Ltd., a private holding company focusing on business opportunities in Internet infrastructure and telecommunications.

Amir Elbaz
Mr. Elbaz currently advises technology and renewable energy companies on business strategy, restructuring and business development initiatives. Mr. Elbaz served as the Executive Vice President & Chief Financial Officer of Lithium Technology Corporation (“LTC”) until November 2008. Mr. Elbaz joined LTC in 2006 to oversee finances and marketing, as well as business development.

Our current executive officers are the following:

Dror Zoreff
Interim President and Chief Executive Officer

Thaddeus Shalek
Chief Financial Officer

Available Information

Our corporate information is accessible through our main web portal at www.smartonline.com. We are not including the information contained on our website as a part of, or incorporating it by reference into, this Annual Report on Form 10-K. Although we endeavor to keep our website current and accurate, there can be no guarantees that the information on our website is up to date or correct. We make available, free of charge, access to all reports filed with the U.S. Securities and Exchange Commission, or SEC, including our Annual Reports on Form 10-K, our Quarterly Reports on Form 10-Q, our Current Reports on Form 8-K, and amendments to these reports, filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act, as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC. These reports may be accessed by following the link under "About Us - Investor Relations" on our website.

ITEM 1A. Risk Factors

We operate in a dynamic and rapidly changing business environment that involves substantial risk and uncertainty, and these risks may change over time. The following discussion addresses some of the risks and uncertainties that could cause, or contribute to causing, actual results to differ materially from expectations. In evaluating our business, you should pay particular attention to the descriptions of risks and uncertainties described below. These risks and uncertainties are not the only ones we face. Additional risks and uncertainties not presently known to us that we currently deem immaterial, or that are similar to those faced by other companies in our industry or business in general, may also affect our business. If any of the risks described below actually occur, our business, financial condition, or results of operations could be materially and adversely affected.

Historically, we have operated at a loss, and we continue to do so.

We have had recurring losses from operations and continue to have negative cash flows. If we do not become cash flow positive through additional financing or growth, we may have to cease operations and liquidate our business. Our working capital, which is dependent on our convertible note financing facility, should fund our operations for the next 12 to 18 months. As of March 21, 2011, we have approximately $2,500,000 available from our credit facility with Israeli Discount Bank of New York ("IDB") and approximately $2.025 million available through our convertible note financing facility. Factors such as the commercial success of our existing services and products, the timing and success of any new services and products, the progress of our research and development efforts, our results of operations, the status of competitive services and products, the timing and success of potential strategic alliances or potential opportunities to acquire technologies or assets, and expenses on account of lawsuits brought by a former officer and a former employee for advancement of indemnification expenses and the tentative settlement of the shareholder class action lawsuit (see Part I, Item 3, "Legal Proceedings" and Part II, Item 8, Note 7, "Commitments and Contingencies – Legal Proceedings", below) will require us to seek additional funding sooner than we expect. If we fail to raise sufficient financing, we will not be able to implement our business plan and may not be able to sustain our business.

In addition, our current primary credit facilities consist of the IDB Bank credit facility with a due date of May 31, 2012 and the convertible note financing with a maturity date on November 14, 2013. Should we be unable to repay the principal then due from operations or from new or renegotiated capital funding sources, we may not be able to sustain our business. As of March 16, 2011, we have approximately $4.0 million outstanding on our credit facility with IDB Bank and $13.075 million aggregate principal amount of convertible Notes outstanding.

Our independent registered public accountants indicate that they have substantial doubts that we can continue as a going concern. Our independent registered public accountants' opinion may negatively affect our ability to raise

additional funds, among other things. If we fail to raise sufficient capital, we will not be able to implement our business plan, we may have to liquidate our business, and you may lose your investment.

Cherry, Bekaert & Holland, L.L.P. our independent registered public accountants have expressed substantial doubt in their reports included with this Annual Report on Form 10-K about our ability to continue as a going concern given our recurring losses from operations and deficiencies in working capital and equity, which are described in the first risk factor above. This opinion could materially limit our ability to raise additional funds by issuing new debt or equity securities or otherwise. If we fail to raise sufficient capital, we will not be able to implement our business plan, we may have to liquidate our business, and you may lose your investment. You should consider our independent registered public accountants’ comments when determining if an investment in us is suitable.

Current economic uncertainties in the global economy could adversely impact our growth, results of operations, and our ability to forecast future business.

Since 2008 there has been a downturn in the global economy, slower economic activity, decreased consumer confidence, reduced corporate profits and capital spending, adverse business conditions, and liquidity concerns. These conditions make it difficult for our customers and us to accurately forecast and plan future business activities, and they could cause our customers to slow or defer spending on our products and services, which would delay and lengthen sales cycles, or change their willingness to enter into longer-term licensing and support arrangements with us. Furthermore, during challenging economic times our customers may face issues gaining timely access to sufficient credit, which could result in an impairment of their ability to make timely payments to us. If that were to occur, we may be required to increase our allowance for doubtful accounts and our results would be negatively impacted.

We may also face difficulties in obtaining additional credit or renewing existing credit at favorable terms, or at all, which could impact our ability to fund our operations or to meet debt repayment requirements as they come due.

We cannot predict the timing, strength, or duration of any economic slowdown or subsequent economic recovery. If the downturn in the general economy or markets in which we operate persists or worsens from present levels, our business, financial condition, and results of operations could be materially and adversely affected.

Our business is dependent upon the development and market acceptance of our applications.

Our future financial performance and revenue growth will depend, in part, upon the successful development, integration, introduction, and customer acceptance of our software applications. Thereafter, other new products, whether developed or acquired, and enhanced versions of our existing applications will be critically important to our business. Our business could be harmed if we fail to deliver timely enhancements to our current and future solutions that our customers desire. We also must continually modify and enhance our services and products to keep pace with market demands regarding hardware and software platforms, database technology, information security, and electronic commerce technical standards. Our business could be harmed if we fail to achieve the improved performance that customers want with respect to our current and future product offerings. There can be no assurance that our products will achieve widespread market penetration or that we will derive significant revenues from the sale or licensing of our platforms or applications.

We have not yet demonstrated that we have a successful business model.

We have invested significantly in infrastructure, operations, and strategic relationships to support our SaaS delivery model, which represents a significant departure from the delivery strategies that we and other software vendors have traditionally employed. To maintain positive margins for our small-business services, our revenues will need to continue to grow more rapidly than the cost of such revenues. We anticipate that our future financial performance and revenue growth will depend, in large part, upon our Internet-based SaaS business model and the results of our sales efforts to reach agreements with marketing partners with small-business customer bases, but this business model may become ineffective due to forces beyond our control that we do not currently anticipate. Although we currently have various agreements and continue to enter into new agreements, our success depends in part on the ultimate success of our marketing partners and referral partners and their ability to market our products and services successfully. Our partners are not obligated to provide potential customers to us and may have difficulty retaining customers within certain markets that we serve. In addition, some of these third parties have entered, and may continue to enter, into strategic relationships with our competitors. Further, many of our strategic partners have multiple strategic relationships, and they may not regard us as significant for their businesses. Our strategic partners may terminate their respective relationships with us, pursue other partnerships or relationships, or attempt to develop or acquire products or services that compete with our products or services. Our strategic partners also may interfere with our ability to

enter into other desirable strategic relationships. If we are unable to maintain our existing strategic relationships or enter into additional strategic relationships, we will have to devote substantially more resources to the distribution, sales, and marketing of our products and services.

In addition, our end users currently do not sign long-term contracts. They have no obligation to renew their subscriptions for our services after the expiration of their initial subscription period and, in fact, they have often elected not to do so. Our end users also may renew for a lower-priced edition of our services or for fewer users. These factors make it difficult to accurately predict customer renewal rates. Our customers' renewal rates may decline or fluctuate as a result of a number of factors, including when we begin charging for our services, their dissatisfaction with our services, and their capability to continue their operations and spending levels. If our customers do not renew their subscriptions for our services or we are not able to increase the number of subscribers, our revenue may decline and our business will suffer.

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

Our credit facility with IDB Bank is secured by an irrevocable standby letter of credit issued by UBS Private Bank, with Atlas Capital SA, or Atlas, as account party. Our secured subordinated convertible notes are secured by a first priority lien on all of our unencumbered assets.

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

If our security measures are breached and unauthorized access is obtained to our customers' data or our data, our service may be perceived as not being secure, customers may curtail or stop using our service, and we may incur significant legal and financial exposure and liabilities.

Our service involves the storage and transmission of customers' proprietary information. If our security measures are breached as a result of third-party action, employee error, malfeasance or otherwise and, as a result, unauthorized access is obtained to our customers' data or our data, our reputation could be damaged, our business may suffer, and we could incur significant liability. In addition, third parties may attempt to fraudulently induce employees or customers to disclose sensitive information such as user names, passwords, or other information in order to gain access to our customers' data or our data, which could result in significant legal and financial exposure and a loss of confidence in the security of our service that would harm our future business prospects. Because the techniques used to obtain unauthorized access, or to sabotage systems, change frequently and generally are not recognized until launched against a target, we may be unable to anticipate these techniques or to implement adequate preventative measures. If an actual or perceived breach of our security occurs, the market perception of the effectiveness of our security measures could be harmed and we could lose sales and customers.

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

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

Legal and other fees related to these actions have also reduced our available cash for operations. We make no assurance that we will not continue to experience additional harm as a result of these matters. The time spent by our management team and directors dealing with issues related to these actions detracts, and despite the tentative

settlement of the class action continue to detract, from the time they spend on our operations, including strategy development and implementation. These actions, more fully described in Part I, Item 3, "Legal Proceedings" and Part II, Item 8, Note 7, "Contingencies – Legal Proceedings" in this Annual Report on Form 10-K, also have harmed our reputation in the business community, jeopardized our relationships with vendors and customers, and decreased our ability to attract qualified personnel, especially given the media coverage of these events.

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

As a public company, we have incurred and will continue to incur significant legal, accounting, and other expenses that we did not incur as a private company. We incur costs associated with our public company reporting requirements and with corporate governance and disclosure requirements, including requirements under the Sarbanes-Oxley Act of 2002, or Sarbanes-Oxley, and rules implemented by the SEC and the Financial Industry Regulatory Authority, or FINRA. We expect these rules and regulations to increase our legal and financial compliance costs and to make some activities more time consuming and costly.

We currently are required to comply with the requirements of Section 404 of Sarbanes-Oxley involving management's assessment of our internal control over financial reporting. To comply with this requirement, we are evaluating and testing our internal controls, and where necessary, taking remedial actions, to allow management to report on our internal control over financial reporting. As a result, we have incurred and will continue to incur expenses and diversion of management's time and attention from the daily operations of the business, which may increase our operating expenses and impair our ability to achieve profitability.

Officers, directors, and principal stockholders control us. This might lead them to make decisions that do not align with interests of minority stockholders.

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

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

Any issuance of shares of our common stock in the future could have a dilutive effect on the value of our existing stockholders' shares.

We may issue shares of our common stock or other securities in the future for a variety of reasons. Upon maturity of their convertible Notes, our convertible noteholders may elect to convert all, a part of, or none of their Notes into shares of our common stock at a floating conversion price.

Under the terms of the class action settlement, the settlement consideration would include 1,475,000 shares of Company common stock. 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. This issuance and sale may have a further dilutive effect on the value of the Company's outstanding shares.

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

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

Future sales of substantial amounts of our shares in the public market, or the appearance that a large number of our shares are available for sale, could adversely affect market prices prevailing from time to time and could impair our ability to raise capital through the sale of our securities. At March 18, 2011, 18,342,543 shares of our common stock were issued and outstanding, and a significant number of shares may be issued upon the exercise of outstanding options, warrants, and convertible notes.

In addition, our stock historically has been very thinly traded. Our stock price may decline if the resale of shares under Rule 144, in addition to the resale of registered shares, at any time in the future exceeds the market demand for our stock.

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

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

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

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

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

The penny stock rules require a broker-dealer, prior to a transaction in a penny stock not otherwise exempt from those rules, to deliver a standardized risk disclosure document prescribed by the SEC and certain other information related to the penny stock, the broker-dealer’s compensation in the transaction, and the other penny stocks in the customer’s account.

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

The executive management team is critical to the execution of our business plan, and the frequency of management turnover has been disruptive to the success of the business.

Our executive management team underwent significant changes during 2008 and 2009, including the resignation of our former Chief Executive Officer in December 2008, our former interim Chief Executive Officers in May 2009 and November 2009 and the resignation of our former Chief Financial Officer in May 2009, among others. Furthermore, in light of the prior SEC charges filed against us, and the related adverse publicity from the criminal trial and conviction of the Nouris (defined below), it may be difficult to attract highly qualified candidates to serve on our executive management team. If we cannot attract and retain qualified personnel and integrate new members of our executive management team effectively into our business, then our business and financial results may suffer. In addition, all of our executive team works at the same location, which could make us vulnerable to the loss of our

entire team in the event of a natural or other disaster. We do not maintain key man insurance policies on any of our employees.

Item 1B. Unresolved Staff Comments

Not applicable.

Item 2. Properties

Our corporate headquarters and research and development facility is located in Durham, North Carolina near Research Triangle Park and consists of approximately 9,837 square feet of office space held under a prepaid sublease that expires in September 2011.

Item 3. Legal Proceedings

Gooden v. Smart Online, Inc. – On October 18, 2007, Robyn L. Gooden filed a purported class action lawsuit in the United States District Court for the Middle District of North Carolina naming us, certain of our current and former officers and directors, Maxim Group, LLC, Jesup & Lamont Securities Corp. and Sherb & Co. (our former independent registered accounting firm) as defendants. The lawsuit was filed on behalf of all persons other than the defendants who purchased our securities from May 2, 2005 through September 28, 2007 and were damaged. The complaint asserts violations of federal securities laws, including violations of Section 10(b) of the Exchange Act and Rule 10b-5. The complaint asserts that the defendants made material and misleading statements with the intent to mislead the investing public and conspired in a fraudulent scheme to manipulate trading in our stock, allegedly causing plaintiffs to purchase the stock at an inflated price. The complaint requests certification of the plaintiff as class representative and seeks, among other relief, unspecified compensatory damages including interest, plus reasonable costs and expenses including counsel fees and expert fees. On June 24, 2008, the court entered an order appointing a lead plaintiff for the class action. On September 8, 2008, the plaintiff filed an amended complaint that added additional defendants who had served as our directors or officers during the class period as well as our independent auditor. The Company and the lead plaintiff in the action negotiated an agreement which has been signed providing for the settlement of the securities class action on the following terms. The settlement requires a cash payment of $350,000 to be made by the Company and the issuance to the class of 1,475,000 shares of Company common stock, in consideration for which all claims against the settling defendants would be dismissed with prejudice, with no admission of fault or wrongdoing by the Company or the other defendants. The Company's additional charge to expenses for 2009 as a result of this settlement was approximately $2,150,000. There are no charges to expense in 2010. An order preliminarily approving the settlement was issued in January 2011 and the final settlement hearing is scheduled for May 2011.

Item 4. [Removed and Reserved]

PART II

Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Our common stock is quoted on the OTCBB under the symbol “SOLN.” The following table sets forth the range of high and low sales prices of our common stock quoted on the OTCBB for the quarterly periods indicated. These quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not necessarily represent actual transactions.

	High	Low
Year Ended December 31, 2009:		
First Quarter	$ 2.60	$ 1.10
Second Quarter	$ 2.00	$ 1.01
Third Quarter	$ 1.70	$ 0.41
Fourth Quarter	$ 1.50	$ 1.11
Year Ended December 31, 2010:		
First Quarter	$ 1.14	$ 1.14
Second Quarter	$ 1.20	$ .76
Third Quarter	$ 1.18	$ .60
Fourth Quarter	$ 1.25	$ .55

At March 19, 2011, there were 189 holders of record of our common stock.

We have never declared or paid any cash dividends on our common stock and do not intend to declare or pay dividends for the foreseeable future. As long as our convertible notes are outstanding, we must receive approval from the agent designated by the noteholders in order to pay any dividend on our capital stock.

During 2010, by private placements of convertible notes to accredited investors under Regulation D, equity securities were sold that were not registered under the Securities Act, as described in our quarterly reports on Form 10-Q and current reports on Form 8-K filed in connection with such transactions, and more fully described in Part II, Item VII, “Management’s Discussion and Analysis of Financial Condition and Results of Operations”, under the sub-heading Debt Financing, in this Annual Report on Form 10-K.

We did not repurchase any shares during 2010 of any of our securities registered under Section 12 of the Exchange Act by or on behalf of us or any affiliated purchaser.

Item 6. Selected Financial Data

Not applicable.

Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations

Executive Summary

The following discussion is designed to provide a better understanding of our financial statements, including a brief discussion of our business and products, key factors that impacted our performance, and a summary of our operating results. This executive summary should be read in conjunction with the more detailed discussion and analysis of our financial condition and results of operations in this Item 7; Item 1A, “Risk Factors”; and our financial statements and the notes thereto included in Item 8, “Financial Statements and Supplementary Data.”

Overview

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

Sources of Revenue

We derive revenues from the following sources:

- Subscription fees – monthly fees charged to customers for access to our SaaS applications

- Professional service fees – fees related to consulting services, some of which complement our other products and applications

- License fees – fees charged for perpetual or term licensing of platforms or applications

- Hosting fees – fees charged for providing network accessibility for our customers using our customized platforms

- Other revenues – revenues generated from non-core activities such as syndication and integration fees; original equipment manufacturer, or OEM, contracts; and miscellaneous other revenues

Subscription fees primarily consist of sales of subscriptions through private-label marketing partners to end users. We typically have a revenue-share arrangement with these private-label marketing partners in order to encourage them to market our products and services to their customers. We make subscription sales either on a subscription or on a "for fee" basis. Subscriptions are generally payable on a monthly basis and are typically paid via credit card of the individual end user. We are focusing our efforts on enlisting new channel partners as well as diversifying with vertical intermediaries in various industries. In the past, we recognized all subscription revenue on a gross basis and in accordance with our policy to periodically review our accounting policies we recognized that certain contracts require the reporting of subscription revenue on a gross basis and others on a net basis according to United States Generally Accepted Accounting Principles ("US GAAP"). On that basis, we continue to report subscription revenue from certain contracts on a gross basis and others on a net basis. The net effect of this reclassification of expenses only impacts gross revenue and certain gross expenses; it does not change the net income. We discuss this matter in more depth in Note 1 to the financial statements.

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

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

Hosting fees charged for providing our customers with network accessibility.

Other revenues primarily consist of non-core revenue sources such as syndication and integration fees, miscellaneous web services, and OEM revenue generated through sales of our applications bundled with products offered by other manufacturers.

Cost of Revenues

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

Operating Expenses

During 2008 and 2009, our primary business initiatives included increasing subscription fee revenue and professional services revenue, making organizational improvements, concentrating our development efforts on enhancements and customization of our platforms and applications, and shifting our strategic focus to the sales and marketing of our products. In 2010, we provided services for our subscription fee customers and focused our efforts on improving our current technology for those industries that we have historically serviced and we began providing our SmartOnCause products to not-for-profit organizations.

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

Sales and Marketing – Sales and marketing expenses are composed primarily of costs associated with our sales and marketing activities and consist of salaries and related compensation costs of our sales and marketing personnel, travel and other costs, and marketing and advertising expenses. In the past, sales and marketing also included the amounts we paid to our marketing partners as part of the subscription revenue received; in the past, the subscription revenue was presented as a gross amount as was the amount included in the sales and marketing category. As part of our ongoing review of accounting pronouncements, we have reclassified the revenues and sales and marketing expenses to reflect net revenue and expense – see Note 1 to the financial statements for further details. Historically, we spent limited funds on marketing, advertising, and public relations, particularly due to our business model of partnering with established companies with extensive small-business customer bases. As we continue to execute our sales and marketing strategy to take our enhanced products to market, we expect associated costs to increase in 2011 due to targeting new partnerships, development of channel partner enablement programs, advertising campaigns, additional sales and marketing personnel, and the various percentages of revenues we may be required to pay to future partners as marketing fees.

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

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

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

On February 1, 2010, the Board of Directors approved the grant of an option to purchase 75,000 shares to Mr. Bob Dieterle, newly hired General Manager and Vice President of Operations, with an initial vesting date of February 1, 2011.

On March 26, 2010, the Board of Directors approved the grant of an option to purchase 30,000 shares to Mr. Dror Zoreff, Chairman of the Board of Directors and Interim Chief Executive Officer, and the option to purchase 20,000 shares to Mr. Amir Elbaz, Chairman of the Audit Committee and member of the Board of Directors with an initial vesting date of March 26, 2010, as a result $22,485 of expense is recognized in 2010.

On October 21, 2010, the Board of Directors approved the grant of additional options to current employees who have been with the Company for six months or longer as of October 1, 2010. The number of options approved, representing the right to purchase an aggregate of 68,000 shares, varied by employee, responsibility and length of service. The initial vesting date for the majority of the options is January 15, 2011.

Critical Accounting Policies and Estimates

Our discussion and analysis of financial condition and results of operations are based upon our financial statements, which we prepared in accordance with United States Generally Accepted Accounting Principles ("US GAAP"). The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues, and expenses and related disclosures of contingent assets and liabilities. "Critical accounting policies and estimates" are defined as those most important to the financial statement presentation and that require the most difficult, subjective, or complex judgments. We base our estimates on historical experience and on various other factors that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Under different assumptions and/or conditions, actual results of operations may materially differ. We periodically reevaluate our critical accounting policies and estimates, including those related to revenue recognition, provision for doubtful accounts, expected lives of customer relationships, useful lives of intangible assets and property and equipment, provision for income taxes, valuation of deferred tax assets and liabilities, and contingencies and litigation reserves. We believe the following critical accounting policies involve the most significant judgments and estimates used in the preparation of our financial statements.

Revenue Recognition – We derive revenue primarily from subscription fees charged to customers accessing our SaaS applications; professional service fees, consisting primarily of consulting; the perpetual or term licensing of software platforms or applications; and hosting and maintenance services. These arrangements may include delivery in multiple-element arrangements if the customer purchases a combination of products and/or services. We license, sell, lease, or otherwise market computer software that is more than incidental to the underlying customer arrangement. Accordingly, we account for those arrangements in accordance with ASC Subtopic 985-605. For arrangements that do not have vendor specific objective evidence of fair value (VSOE) for the delivered element in our arrangements (when applicable), , we use the residual method to allocate revenue to the delivered element(s) in our arrangements when VSOE exists for all undelivered elements in that arrangement If we cannot determine or maintain sufficient VSOE for an element, it could impact revenues, as we may be required to defer all or a portion of the revenue from the delivered items in a multiple-element arrangement.

We also enter into multiple-element arrangements where some of the elements are within the scope of ASC Subtopic 605-25 for purposes of the separation and allocation of the related revenue and other elements in the arrangement are within the scope of other Codification Topics. For these arrangements, we follow the guidance in ASC Subtopic 605-25 to determine whether we can separate and allocate the revenue for those elements within the scope of other Codification Topics (e.g. ASC Subtopic 985-605) from those within the scope of ASC Subtopic 605-25.

If multiple-element arrangements involve significant development, modification, or customization, or if we determine that certain elements are essential to the functionality of other elements within the arrangement, we defer revenue until we provide to the customer all elements necessary to the functionality. The determination of whether the arrangement involves significant development, modification, or customization could be complex and require the use of judgment by our management.

Under US GAAP, provided the arrangement does not require significant development, modification, or customization, we recognize revenue when all of the following criteria have been met:

1. persuasive evidence of an arrangement exists
2. delivery has occurred
3. the fee is fixed or determinable
4. collectability is probable

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

We account for consulting, website design fees and application development services separately from the license of associated software platforms when these services have value to the customer and there is objective and reliable evidence of fair value of each deliverable. When accounted for separately, we recognize revenue as the services are rendered for time and material contracts, and when milestones are achieved and accepted by the customer for fixed price or long-term contracts. The majority of our consulting service contracts are on a time and material basis, and we typically bill our customers monthly based upon standard professional service rates.

Application development services are typically fixed price and of a longer term. As such, we account for them as long-term construction contracts that require us to recognize revenue based on estimates involving total costs to

complete and the stage of completion. Our assumptions and estimates made to determine the total costs and stage of completion may affect the timing of revenue recognition, with changes in estimates of progress to completion and costs to complete accounted for as cumulative catch-up adjustments. If the criteria for revenue recognition on construction-type contracts are not met, we capitalize the associated costs of such projects and include them in costs in excess of billings on the balance sheet until such time that we are permitted to recognize revenue.

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 marketing partners in order to encourage them to market our products and services to their customers. Subscriptions are generally payable on a monthly basis and are typically paid via credit card of the individual end user. We accrue any payments received in advance of the subscription period as deferred revenue and amortize them over the subscription period. In accordance with our policy to periodically review our accounting policies we determined that certain contracts require the reporting of subscription revenue on a gross basis and others on a net basis according to US GAAP. On that basis, we continue to report subscription revenue from certain contracts on a gross basis and others on a net basis.

Because our customers generally do not have the contractual right to take possession of the software we license or market at any time, we recognize revenue on hosting and maintenance fees as we provide the services in accordance with US GAAP.

Provision for Doubtful Accounts – We maintain an allowance for doubtful accounts for estimated losses resulting from the inability, failure, or refusal of our customers to make required payments. We evaluate the need for an allowance for doubtful accounts based on specifically identified amounts that we believe to be potentially uncollectible. Although we believe that our allowances are adequate, if the financial conditions of our customers deteriorate, resulting in an impairment of their ability to make payments, or if we underestimate the allowances required, additional allowances may be necessary, which will result in increased expense in the period in which such determination is made.

Impairment of Long-Lived Assets – We record our long-lived assets, such as intangibles, property and equipment, at cost. We review the carrying value of our indefinite lived intangibles for possible impairment at least annually in the fourth quarter, and all long-lived assets whenever events or changes in circumstances indicate that the carrying amount of assets may not be recoverable in accordance with the US GAAP. We measure the recoverability of assets to be held and used by comparing the carrying amount of the asset to the fair value. If we consider such assets to be impaired, we measure the impairment as the amount by which the carrying amount exceeds the fair value, and we recognize it as an operating expense in the period in which the determination is made. We report assets to be disposed at the lower of the carrying amount or fair value less costs to sell. Although we believe that the carrying values of our long-lived assets are appropriately stated, changes in strategy or market conditions or significant technological developments could significantly impact these judgments and require adjustments to recorded asset balances.

In addition to the recoverability assessment, we also routinely review the remaining estimated useful lives of our long-lived assets. Any reduction in the useful-life assumption will result in increased depreciation and amortization expense in the period when such determinations are made, as well as in subsequent periods.

Income Taxes – We are required to estimate our income taxes in each of the jurisdictions in which we operate. This involves estimating our current tax liabilities in each jurisdiction, including the impact, if any, of additional taxes resulting from tax examinations, as well as making judgments regarding our ability to realize our deferred tax assets. Such judgments can involve complex issues and may require an extended period to resolve. In the event we determine that we will not be able to realize all or part of our net deferred tax assets, we would make an adjustment in the period we make such determination. We recorded no income tax expense in 2010 and 2009, as we have experienced significant operating losses to date. If utilized, we may apply the benefit of our total net operating loss carryforwards to reduce future tax expense. Since our utilization of these deferred tax assets is dependent on future profits, which are not assured, we have recorded a valuation allowance equal to the net deferred tax assets. These carryforwards would also be subject to limitations, as prescribed by applicable tax laws. As a result of prior equity financings and the equity issued in conjunction with certain acquisitions, we have incurred ownership changes, as defined by applicable tax laws. Accordingly, our use of the acquired net operating loss carryforwards may be limited. Further, to the extent that any single-year loss is not utilized to the full amount of the limitation, such unused loss is carried over to subsequent

years until the earlier of its utilization or the expiration of the relevant carryforward period.

2010 Summary

The following is a summary of key financial results and certain non-financial results achieved for the year ended December 31, 2010:

- Our total revenues for the year were $1.0 million, a decrease from 2009 of $0.4 million, or 28%. This overall decrease in revenues was primarily attributable to decreases in professional and subscription fees.

- Our gross loss for the year was $277,000, an increase from 2009 of $152,000 or 121%. This increase was primarily attributable to lower revenue.

- Operating expenses for the year were $2.8 million, a decrease from 2009 of $6.0 million, or 68%. A significant portion of this decrease was a reduction in the amount of legal expenses and the settlement cost associated with the Class Action and Nouri lawsuits recognized in 2009. The remaining increase was in research, development, sales and marketing expenses.

- Our loss from operations for the year was $3.0 million, a decrease from 2009 of $5.9 million, or 66%. Net loss per basic and fully diluted share was $0.22 in 2010 compared to $0.52 in 2009.

- Cash and cash equivalents at December 31, 2010 were $1,100,000 compared to $120,000 at December 31, 2009. The primary reason for this increase is that in 2010, we borrowed $4.0 million on the IDB Bank credit facility at the end of the accounting period.

Business Outlook

We believe that the current economic recession will spawn a record number of new, highly fragmented and underserved small businesses seeking low-cost tools and applications to help them operate. We also believe that trade organizations and other membership- or subscription-driven agencies and companies will recognize an increased need for customer retention and will look for new and innovative ways to achieve this. Both of these events could increase our ability to obtain new channel partners and end-user businesses in 2011. However, we also believe that competition for Internet-delivered business solutions will increase. We anticipate focusing on the following key areas, among others, during 2010 in response to these opportunities and competitive environment:

- Investment in technology, product development, and infrastructure. We have shifted our investments toward the rapid growth of mobile smartphones and how they can be utilized in the segments that we know, non-profits and direct selling organizations. We are developing mobile cross-platform native application solutions that move non-profit and direct selling organizations to all the top selling smartphones. Specifically, our SmartOn Mobile platform is modular and multi-tenant with popular pre-built mobile functionality modules that allows us the flexibility too quickly and efficiently package unique and innovative branded solutions for each client and deploy to each of the smartphone’s application stores for easy distribution to the client’s constituents.

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- Investment in marketing. In 2009 and 2010, we began to shift our focus from development to sales and marketing of our products. We expect to increase this effort in 2011 through public relations, attendance at trade shows, print and electronic advertisements, e-mail marketing, white-paper placement, webcasts, blogging, and paid search, among other tactics.

- Expansion of our sales channels. We intend to expand our sales force and channel partner relationships to reach more small-business end users.

- Continuation of operating improvements. We continue to streamline our operations in an effort to reduce cash burn, reach profitability, and improve efficiencies. We will continue to focus on this critical area in 2011 by questioning current practices, closely scrutinizing actual-to-budget variances to identify deviations early, and realigning the business as required to meet the needs of our operations.

Results of Operations

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

	2010		2009	
	Dollars	% of Revenue	Dollars	% of Revenue
Total revenues	$ 1,028,879	100.00%	$ 1,419,502	100.00%
Cost of revenues	1,305,922	126.93%	1,544,861	108.83%
Gross loss	$ (277,043)	(26.93)%	$ (125,359)	(8.83)%
Operating expenses	2,716,266	264.00%	8,772,163	617.97%
Loss from operations	$ (2,993,309)	(290.93)%	$ (8,897,522)	(626.81)%
Other expense, net	(955,633)	(92.88)%	(643,349)	(45.32)%
Net loss	$ (3,948,942)	(383.81)%	$ (9,540,871)	(672.13)%
Net loss per common share	$ (.22)		$ (0.52)	

Revenues

Revenues for 2010 and 2009 comprise the following:

	Years Ended December 31,		Year-Over-Year Change	
	2010	2009	Dollars	Percent
Subscription fees	$ 482,219	$ 756,233	$ (274,014)	(36.23)%
Professional service fees	82,425	335,079	(252,654)	(75.40)%
License fees	224,500	45,000	179,500	398.89%
Hosting fees	137,788	156,053	(18,265)	(11.70)%
Other revenue	101,947	127,137	(25,190)	(19.81)%
Total revenues	$ 1,028,879	$ 1,419,502	$ (390,623)	(27.52)%

Revenues decreased 28% to $1.0 million in 2010 from $1.4 million in 2009. Our overall decrease in revenues was the result of decreased professional service and subscription fees. Select items are discussed in detail below.

Subscription Fees

Revenues from subscription fees for 2010 and 2009 are as follows:

	Years Ended December 31,		Year-Over-Year Change	
	2010	2009	Dollars	Percent
Subscription fees	$ 482,219	$ 756,233	$ (274,014)	(36.2)%
Percent of total revenues	46.9%	53.3%		

Revenue from subscription fees decreased 36% to $482,000 in 2010 from $756,000 in 2009. This decrease is primarily attributable to the loss of a direct-selling organization customer.

Professional Service Fees

Revenues from professional service fees for 2010 and 2009 are as follows:

	Years Ended December 31,		Year-Over-Year Change	
	2010	2009	Dollars	Percent
Professional service fees	$ 82,425	$ 335,079	$ (252,654)	(75.4)%
Percent of total revenues	8.01%	23.6%		

Revenue from professional service fees decreased 75% to $82,000 in 2010 from $335,000 in 2009. This decrease was due to a decrease in customers requesting additional project consulting services for their web initiatives.

License Fees

Revenues from license fees for 2010 and 2009 are as follows:

	Years Ended December 31,		Year-Over-Year Change	
	2010	2009	Dollars	Percent
License fees	$224,500	$ 45,000	$179,500	398.9 %
Percent of total revenues	21.8 %	3.2 %		

Revenue from license fees increased 399% to $224,000 in 2010 from $45,000 in 2009. License fee revenue recognized in 2010 comprised the receipt of fees from a license that commenced in June 2008.

Hosting Fees

Revenues from hosting fees for 2010 and 2009 are as follows:

	Years Ended December 31,		Year-Over-Year Change	
	2010	2009	Dollars	Percent
Hosting fees	$ 137,788	$ 156,053	$ (18,265)	(11.7)%
Percent of total revenues	13.4%	11.0%		

Hosting fees for 2010 decreased to $138,000 from $156,000.

Other Revenue

Revenues from other sources for 2010 and 2009 are as follows:

	Years Ended December 31,		Year-Over-Year Change	
	2010	2009	Dollars	Percent
Other revenue	$ 101,947	$ 127,137	$ (25,190)	(19.8)%
Percent of total revenues	9.9%	8.9%		

Revenue from non-core activities decreased 20% to $102,000 in 2010 from $127,000 in 2009. This decrease is primarily attributable to a reduction in commissions derived from an existing customer.

Cost of Revenues

Cost of revenues for 2010 and 2009 are as follows:

	Years Ended December 31,		Year-Over-Year Change	
	2010	2009	Dollars	Percent
Cost of revenues	$ 1,305,922	$ 1,544,861	$ (238,939)	(15.5)%
Percent of total revenues	126.9%	108.8%		

Cost of revenues decreased 15% to $1.3 million in 2010 from $1.5 million in 2009. This decrease is primarily the result of the reduction in labor costs incurred due to the loss of a significant customer in 2010.

Operating Expenses

Operating expenses for 2010 and 2009 comprise the following:

	Years Ended December 31,		Year-Over-Year Change	
	2010	2009	Dollars	Percent
General and administrative	$ 1,914,164	$ 4,554,435	$ (2,640,271)	(58.0)%
Sales and marketing	721,912	887,999	(166,087)	(18.7)%
Research and development	145,820	586,254	(440,434)	(75.1)%
Loss on impairment of intangible assets	548,962	626,685	(77,723)	(12.4)%
(Gain) loss on legal settlements	(614,592)	2,139,364	(2,753,956)	(128.7)%
(Gain) on disposal of assets, net		(22,574)	22,574	100.0 %
Total operating expenses	$ 2,716,266	$ 8,772,163	$ (6,055,897)	(69.0)%

Operating expenses decreased 68% to $2.7 million in 2010 from $8.8 million in 2009. This decrease was, in part related to the reduction in workforce, resulting in a reduction of compensation related expenses of $995,000, a $1.7 million reduction in the amount of bad debt expense, a reduction of $404,000 in the amount of write-off of intangible assets, $386,000 reduction in legal fees and the gain from the settlement of litigation in the amount of $615,000 in 2010 compared to a loss of $2.1 million in 2009.

General and Administrative

General and administrative expenses for 2010 and 2009 are as follows:

	Years Ended December 31,		Year-Over-Year Change	
	2010	2009	Dollars	Percent
General and administrative	$ 1,914,164	$ 4,554,435	$ (2,640,271)	(58.0)%
Percent of total revenues	186.0%	320.8%		

General and administrative expenses decreased 58% to $2.0 million in 2010 from $4.6 million in 2009. The decrease is primarily due to a $1.7 million reduction in the amount of bad debt expense, a reduction of $404,000 in the amount of write-off of intangible assets, $386,000 reduction in legal fees and the reduction of $105,000 in payroll and related costs during 2010.

Sales and Marketing

Sales and marketing expenses for 2010 and 2009 are as follows:

	Years Ended December 31,		Year-Over-Year Change	
	2010	2009	Dollars	Percent
Sales and marketing	$ 721,912	$ 887,999	$ (166,087)	(18.7)%
Percent of total revenues	70.2%	62.6%		

Sales and marketing expenses decreased 19% to $722,000 in 2010 from $888,000 in 2009. This decrease is primarily attributable to $235,000 reduction in payroll and related costs due to reduction in employee headcount.

Research and Development

Research and development expenses for 2010 and 2009 are as follows:

	Years Ended December 31,		Year-Over-Year Change	
	2010	2009	Dollars	Percent
Research and development	$ 145,820	$ 586,254	$ (440,434)	(75.1)%
Percent of total revenues	14.2%	41.3%		

Research and development expenses decreased 75% to $146,000 in 2010 from $586,000 in 2009. This net decrease is primarily attributable to a decrease of $440,000 in wages and benefits during 2010.

Loss on Impairment of Intangible Assets

On a periodic basis, we review our long-lived assets, including intangible assets, for possible impairment. Loss on impairment of intangible assets for 2010 and 2009 are as follows:

	Years Ended December 31,		Year-Over-Year Change	
	2010	2009	Dollars	Percent
Loss on impairment of intangible assets	$ 548,962	$ 626,685	$ (77,723)	(12.4)%
Percent of total revenues	53.4%	44.1%		

The loss on impairment of intangible assets in 2010 decreased to $549,000 from $627,000 in 2009. The decrease is due to the fact that our write-offs of value of intangible assets in 2010 were less than those in 2009 and no further write-offs will be required since all Intangible Assets have been written-off after appropriate review and evaluation by management.

Loss on legal settlements

Loss on legal settlements for 2010 and 2009 are as follows:

	Years Ended December 31,		Year-Over-Year Change	
	2010	2009	Dollars	Percent
(Gain) Loss on legal settlements	$ (614,592)	$ 2,139,364	$ (2,753,956)	(128.7)%
Percent of total revenues	(59.7)%	150.7%		

The loss on legal settlements is primarily attributable to the recognition of the loss derived from the tentative settlement reached on the Class Action lawsuit that was filed against the Company in 2007.

(Gain) on disposal of assets

(Gain) on disposal of assets for 2010 and 2009 are as follows:

	Years Ended December 31,		Year-Over-Year Change	
	2010	2009	Dollars	Percent
(Gain) on disposal of assets	$	(22,574)	$ 22,574	100.0 %
Percent of total revenues	%	1.6 %		

During 2009, we sold computer equipment to a former customer and recognized a gain; there were no sales of assets during 2010.

Other Income (Expense)

Other income (expense) for 2010 and 2009 comprise the following:

	Years Ended December 31,		Year-Over-Year Change	
	2010	2009	Dollars	Percent
Interest expense, net	$ (955,633)	$ (643,349)	$ (312,284)	(48.5)%

Interest expense increased 49% to $956,000 in 2010 from $643,000 in 2009. This net increase was caused by the requirement to borrow additional funds for operations during 2010.

Provision for Income Taxes

We did not record a provision for income tax expense in 2010 or 2009 because we have been generating net losses. Furthermore, we have not recorded an income tax benefit for 2010 or 2009 primarily due to continued substantial uncertainty regarding our ability to realize our deferred tax assets. Based upon available objective evidence, there has been sufficient uncertainty regarding our ability to realize deferred tax assets to warrant a full valuation allowance in our financial statements. As of December 31, 2010, we had approximately $50 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.

Liquidity and Capital Resources

Overview

We require cash to fund our operating expenses and working capital requirements, including outlays for capital expenditures and debt service. As of December 31, 2010, our principal sources of liquidity were cash and cash equivalents totaling $1,110,000 and current accounts receivable of $8,900, as compared to $120,000 of cash and cash equivalents and $13,000 in accounts receivable as of December 31, 2009. As of December 31, 2010, we had drawn $4.0 million on the $6.5 million IDB Bank credit facility, discussed below under “Debt Financing,” leaving approximately $2.5 million available under the credit facility for our operations. Deferred revenue at December 31, 2010 was $22,000 as compared to $46,000 at December 31, 2009.

As of March 18, 2011, our principal sources of liquidity were cash and cash equivalents totaling approximately $279,000 and no accounts receivable. In addition, we had drawn approximately $4.0 million on the IDB Bank credit facility, leaving approximately $2.5 million available under the terms of the credit agreement to fund future operations. As of March 18, 2011, we also have the ability to call up to approximately $2.025 million of additional funding from our convertible noteholders.

Cash Flows

During the year ended December 31, 2010, our working capital deficit decreased by approximately $3,725,000 to $2,850,000 from a working capital deficit of $6,575,000 at December 31, 2009. As described more fully below, the working capital deficit at December 31, 2010 is primarily attributable to negative cash flows from operations, offset in

part by net debt borrowings.

Cash Flows from Operating Activities

	Years Ended December 31,		Year-Over-Year Change	
	2010	2009	Dollars	Percent
Net cash used in operating activities	$ 3,959,212	$ 3,821,194	$ (138,018)	(3.6)%

Net cash used in operating activities increased 4% to $4.0 million in 2010 from $3.8 million in 2009. This increase is primarily attributable to the 2010 decrease in accrued liabilities.

Cash Flows from Investing Activities

	Years Ended December 31,		Year-Over-Year Change	
	2010	2009	Dollars	Percent
Net cash used in investing activities	$ 7,872	$ 158,765	$ (150,893)	