SMART ONLINE INC
Form 10-Q
November 17, 2011

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2011

OR

¨ Transition report pursuant to Section 13 of 15(d) of the Securities Exchange Act of 1934
Commission File Number: 001-32634

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

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days: Yes þ 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 (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes þ No ¨

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

Large accelerated filer	¨	Accelerated filer	¨

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

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

As of November 11, 2011, there were 18,352,543 shares of the registrant's common stock, par value $0.001 per share, outstanding.

SMART ONLINE, INC.

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

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PART I – FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

SMART ONLINE, INC.
BALANCE SHEETS

	September 30, 2011 (unaudited)	December 31, 2010
ASSETS		
Current Assets:		
Cash and Cash Equivalents	$ 230,766	$ 860,211
Restricted cash	121,000	249,998
Accounts receivable, net	970	8,931
Prepaid Expenses	47,693	164,692
Total current assets	400,429	1,283,832
Property and equipment, net	171,819	202,922
Other assets	15,371	5,000
TOTAL ASSETS	$ 587,619	$ 1,491,754
LIABILITIES AND STOCKHOLDERS' DEFICIT		
Current liabilities		
Accounts payable	$ 547,312	$ 551,759
Notes payable (See Note 4)	5,050,053	40,564
Deferred revenue	21,534	22,271
Accrued liabilities – Nouri	442,227	1,400,000
Accrued liabilities (See Note 2)	303,820	2,119,376
Settlement related financial instrument liability (See Note 3)	1,917,500	-
Total current liabilities	8,282,446	4,133,970
Long-term liabilities:		
Long-term portion of notes payable (See Note 4)	14,529,297	16,666,469
Deferred revenue	4,633	294
Total long-term liabilities	14,533,930	16,666,763
Total liabilities	22,816,376	20,800,733
Commitments and contingencies (See Note 5)		
Stockholders' deficit:		
Preferred stock,$ 0.001 par value, 5,000,000 shares authorized, no shares issued and outstanding at September 30, 2011 and December 31, 2010		
Common Stock, $.001 par value, 45,000,000 shares authorized, 18,352,543 and 18,342,542 shares Issued and Outstanding at September 30, 2011 and December 31, 2010, respectively.	18,353	18,343
Additional paid-in capital	67,111,974	67,070,568
Accumulated deficit	(89,359,084)	(86,397,890)
Total Stockholders' Deficit	(22,228,757)	(19,308,979)
TOTAL LIABILITIES AND STOCKHOLDERS' DEFICIT	$ 587,619	$ 1,491,754

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

SMART ONLINE, INC.

STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended September 30, 2011	Three Months Ended September 30, 2010	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
REVENUES:				
Subscription fees	$ 88,101	$ 119,152	$ 281,748	$ 378,556
Professional service fees	-	12,600	-	82,425
License fees	-	65,850	-	224,500
Hosting fees	-	37,722	-	119,716
Other revenue	26,988	25,644	83,150	79,389
Total revenues	115,089	260,968	364,898	884,586
COST OF REVENUES	205,215	344,156	599,420	1,046,400
GROSS LOSS	(90,126)	(83,188)	(234,522)	(161,814)
OPERATING EXPENSES:				
General and administrative	232,874	408,004	880,605	1,469,892
Sales and marketing	125,866	181,132	414,808	513,408
Research and development	92,280	7,695	356,104	50,080
Loss on disposal of assets, net	-	398,962	3,471	398,962
Total operating expenses	451,020	995,793	1,654,988	2,432,342
LOSS FROM OPERATIONS	(541,146)	(1,078,981)	(1,889,510)	(2,594,156)
OTHER INCOME (EXPENSE):				
Interest expense, net	(336,988)	(244,189)	(953,703)	(687,909)
Gain on legal settlements, net	-	2,547	177,019	556,517
Change in market value of settlement related financial instruments	(295,000)	-	(295,000)	-
Total other expense	(631,988)	(241,642)	(1,071,684)	(131,392)
NET LOSS	$ (1,173,134)	$ (1,320,623)	$ (2,961,194)	$ (2,725,548)
NET LOSS PER COMMON SHARE:				
Basic and fully diluted	$ (0.06)	$ (0.07)	$ (0.16)	$ (0.15)
WEIGHTED-AVERAGE NUMBER OF SHARES USED IN COMPUTING NET LOSS PER COMMON SHARE				
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)

	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net Loss	$ (2,961,194)	$ (2,725,548)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	37,683	100,892
Change in market value of settlement related financial instruments	295,000	-
Bad debt expense	-	377,348
Stock-based compensation expense	41,416	22,884
(Gain) loss on disposal of assets	3,471	398,962
Changes in assets and liabilities:		
Accounts receivable	7,961	(309,404)
Notes receivable	-	(54,888)
Prepaid expenses	116,998	148,204
Other assets	(10,370)	(2,504)
Deferred revenue	5,387	(17,002)
Accounts payable	(4,447)	19,619
Accrued and other expenses	(1,152,612)	(760,173)
Net cash used in operating activities	(3,620,707)	(2,801,610)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of furniture and equipment	(10,052)	(7,009)
Net cash used in investing activities	(10,052)	(7,009)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Repayments on notes payable	(2,683)	(4,261,620)
Restricted cash used to pay IDB interest and fees	128,997	-
Debt borrowings	2,875,000	7,007,129
Net cash provided by financing activities	3,001,314	2,745,509
NET DECREASE IN CASH AND CASH EQUIVALENTS	(629,445)	(63,110)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	860,211	119,796
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 230,766	$ 56,686
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	$ 926,931	$ 173,818

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. 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. The Company maintains a website that offers additional information about these capabilities as well as certain corporate information at www.smartonline.com.

Basis of Presentation - The financial statements as of and for the three and nine months ended September 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 September 30, 2011, and its results of operations for the three and nine months ended September 30, 2011 and 2010. The results for the three and nine months ended September 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 nine months ended September 30, 2011 and 2010, the Company incurred net losses as well as negative cash flows and had deficiencies in working capital. In addition, the Company was involved in the settlement of a class action lawsuit (See Note 7 “Commitments and Contingencies,” in the 2010 Annual Report), and the settlement of a lawsuit for legal fees advanced on behalf of former officers and employees who were convicted in Federal Court. 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 November 11, 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.

Fair value of financial assets and liabilities - The Company measures the fair value of financial assets and liabilities in accordance with U.S. GAAP which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements.

U.S. GAAP defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. U.S. GAAP also establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. U.S. GAAP describes three levels of inputs that may be used to measure fair value:

Level 1 – quoted prices in active markets for identical assets or liabilities

Level 2 – quoted prices for similar assets and liabilities in active markets or inputs that are observable

Level 3 – inputs that are unobservable (for example cash flow modeling inputs based on assumptions)

The following table summarizes assets and liabilities measured at fair value on a recurring basis at September 30, 2011 and December 31, 2010, respectively:

	September 30, 2011				December 31, 2010			
	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
Fair Value Measurements Using:								
Liabilities								
Settlement related financial instrument liability (shares of common stock)	$ 1,917,500	$ -	$ —	$ 1,917,500	$ —	$ —	$ —	$ —

The table below provides a reconciliation of the beginning and ending balances for the assets and liabilities measured at fair value using significant observable inputs (Level 1). The table reflects net gains and losses for all financial assets and liabilities as of September 30, 2011 and December 31, 2010.

	$	Number of Shares Common Stock
Liabilities:		
Class Action financial instrument liability as of January 1, 2011	$ -	-
July 1, 2011, the District Court approved the Class Action settlement agreement calling for the future issuance of shares of common stock	1,622,500	1,475,000
Increase in fair value of shares of common stock	295,000	—
Settlement related financial instrument liability as of September 30, 2011	$ 1,917,500	1,475,000

Significant Accounting Policies - In the opinion of the Company's management, the significant accounting policies used for the three and nine months ended September 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. In particular, the liability for the settlement of the Class Action Law suit (see Note 5) was revised as of September 30, 2011 to account for the fluctuation in the closing stock price of the Company's common stock as of September 30, 2011.

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 U.S. GAAP provisions during the three and nine months ended September 30, 2011 was $5,236 and $41,416, respectively, of which $ -0- and $13,850 related to the issuance of restricted stock and $5,236 and $27,566 was expensed associated with stock options. Total stock-based compensation expense during the three and nine months ended September 30, 2010 was $11,243 and $22,884, respectively, of which $2,850 and $5,700 related to the issuance of restricted stock and $8,393 and $17,184 was expensed for the respective periods. No stock-based compensation was capitalized in the financial statements.

	Three Months Ended September 30, 2011	Three Months Ended September 30, 2010	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
Compensation expense included in G&A expense related to stock options	$ 5,236	$ 8,393	$ 27,566	$ 17,184
Compensation expense included in G&A expense related to restricted stock awards	-	2,850	13,850	5,700
Total expense	$ 5,236	$ 11,243	$ 41,416	$ 22,884

The fair value of option grants under the Company's equity compensation plan and other stock option issuances during the three months and nine months ended September 30, 2011 and 2010 were estimated using the Black-Scholes option-pricing model with the following weighted-average assumptions:

	Three Months Ended September 30, 2011	Three Months Ended September 30, 2010	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
Dividend yield	0.0%	0.0%	0.0%	0.0%
Expected volatility	92%	97%	92%	97%
Risk-free interest rate	1.44%	1.27%	1.44%	1.9%
Expected lives (years)	4.0	4.0	4.0	4.0

Net Loss Per Share - Basic net loss per share is computed by dividing net loss by the weighted average number of common shares outstanding during the periods. Diluted net loss per share is computed using the weighted average number of common and dilutive common equivalent shares outstanding during the periods. Common equivalent shares consist of convertible notes, stock options, and warrants that are computed using the treasury stock method. The 1,475,000 shares that will be issued to the claimants in the settled Class Action Settlement described in Notes 3 and 5 below based upon the District Court's decision on July 1, 2011 are not included in the calculation of net loss per share at September 30, 2011. Shares issuable upon the exercise of stock options and warrants, totaling 343,900 and 1,793,415 on September 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 5 below), consisted of the following:

	September 30, 2011	December 31, 2010
Class Action law suit settlement (See Note5)	$ -	$ 1,874,500
Accrued payroll and related costs	24,804	3,406
Custom accounting development cost	75,436	75,436
Professional services	2,000	-
Interest payable to IDB and Bondholders (See Note 4)	169,255	141,895
Other accrued items	32,325	24,139
	$ 303,820	$ 2,119,376

Since the shares have not been issued to the Class Action class, the accrued liability for the Class Action lawsuit settlement is currently accounted for as a Financial Instrument, described in Note 3, rather than as a n accrued liability as in the past.

3. SETTLEMENT RELATED FINANCIAL INSTRUMENT LIABILITY:

The Company generally does not use derivative instruments to hedge exposures to cash-flow risks or market-risks that may affect the fair values of its financial instruments. However, in connection with the Company's Class Action lawsuit settlement approved by the District Court on July 1, 2011 (see Note 5), we are required to issue 1,475,000 shares of our common stock to the Class Action class. Through July 1, 2011, our liability related to these shares was accounted for as an accrued liability on our balance sheet and changes in the value of the shares were generally not reflected on our statements of operations, absent certain significant events, such as the approval of the settlement. Now that the Class Action has been settled, because we have not yet issued the shares, the liability is now accounted for as a financial instrument liability on our balance sheet and, until the shares are issued, changes in their value will be reflected on our statements of operations as losses or gains, as applicable. The number of shares to be issued will not change, and these losses or gains are not cash items that will impact our income or loss from operations.

The following tabular presentation reflects the components of derivative assets and liabilities as of September 30, 2011 and December 31, 2010:

December 31,

	September 30, 2011	2010
Shares into which financial instrument liability can be settled:		
Unrestricted shares of common stock, when issued	1,475,000	-