SMART ONLINE INC
Form 10-Q
November 15, 2010

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

FORM 10-Q

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

For the quarterly period ended September 30, 2010

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 x 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	x

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

As of November 11, 2010, there were 18,343,542 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, 2010

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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements

SMART ONLINE, INC.
CONSOLIDATED BALANCE SHEETS

	September 30, 2010 (unaudited)	December 31, 2009
ASSETS		
Current Assets:		
Cash and Cash Equivalents	$ 56,686	$ 119,796
Accounts Receivable, Net	-	13,056
Note Receivable	-	-
Prepaid Expenses	203,339	240,840
Total current assets	260,025	373,692
Property and equipment, net	216,399	258,450
Capitalized software, net	-	450,782
Note Receivable, non-current	-	-
Prepaid expenses, non-current	-	110,700
Intangible assets, net	150,000	150,000
Other assets	5,000	2,496
TOTAL ASSETS	$ 631,424	$ 1,346,120
LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)		
Current liabilities		
Accounts payable	$ 537,928	$ 518,309
Notes payable (See Note 3)	2,124,678	1,964,281
Deferred revenue (See Note 2)	27,561	40,115
Accrued liabilities – Nouri	1,400,000	1,802,379
Accrued liabilities (See Note 2)	2,266,165	2,623,959
Total current liabilities	6,356,332	6,949,043
Long-term liabilities:		
Long-term portion of notes payable (See Note 3)	12,370,367	9,785,255
Deferred revenue (See Note 2)	1,153	5,601
Total long-term liabilities	12,371,520	9,790,856
Total liabilities	18,727,852	16,739,899
Commitments and contingencies (See Note 4)		
Stockholders' equity (deficit):		
Preferred stock, 0.001 par value, 5,000,000 shares authorized, no shares issued and outstanding at September 30, 2010 and December 31, 2009		
Common Stock, $.001 par value, 45,000,000 shares authorized, 18,342,542 and 18,332,542 shares Issued and Outstanding at September 30, 2010 and December 31, 2009 respectively.	18,343	18,333
Additional paid-in capital	67,059,722	67,036,836
Accumulated deficit	(85,174,493)	(82,448,948)
Total Stockholders' Deficit	(18,096,428)	(15,393,779)
TOTAL LIABILITIES AND STOCKHOLDERS' DEFICIT	$ 631,424	$ 1,346,120

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

SMART ONLINE, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended September 30, 2010	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
REVENUES:				
Subscription fees	$ 119,152	$ 159,149	$ 378,556	$ 610,751
Professional service fees	12,600	63,200	82,425	261,699
License fees	65,850	11,250	224,500	33,750
Hosting fees	37,722	33,751	119,716	139,007
Other revenue	25,644	26,300	79,389	100,777
Total revenues	260,968	293,650	884,586	1,145,984
COST OF REVENUES	344,156	430,967	1,046,400	1,125,901
GROSS PROFIT (LOSS)	(83,188)	(137,317)	(161,814)	20,083
OPERATING EXPENSES:				
General and administrative	408,004	2,355,353	1,469,892	4,112,993
Sales and marketing	181,132	180,759	513,408	707,289
Research and development	7,695	36,406	50,080	540,232
Loss on impairment	-	-	-	438,286
(Gain) loss on disposal of assets, net	398,962	(12,307)	398,962	(22,574)
Total operating expenses	995,793	2,560,211	2,432,342	5,776,226
LOSS FROM OPERATIONS	(1,078,981)	(2,697,528)	(2,594,156)	(5,756,143)
OTHER INCOME (EXPENSE):				
Interest expense, net	(244,189)	(169,609)	(687,909)	(455,951)
Gain on legal settlements, net	2,547	-	556,517	6,000
Other Income	-	-	-	10,267
Total other expense	(241,642)	(169,609)	(131,392)	(439,684)
NET LOSS	$ (1,320,623)	$ (2,867,137)	$ (2,725,548)	$ (6,195,827)
NET LOSS PER COMMON SHARE:				
Basic and fully diluted	$ (0.07)	$ (0.16)	$ (0.15)	$ (0.34)
WEIGHTED-AVERAGE NUMBER OF SHARES USED IN COMPUTING NET LOSS PER COMMON SHARE				
Basic and fully diluted	18,342,542	18,332,542	18,342,542	18,332,542

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

SMART ONLINE, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net Loss	$ (2,725,548)	$ (6,195,827)
Adjustments to reconcile let loss to net cash used in operating activities:		
Depreciation and amortization	100,892	462,761
Bad debt expense	377,348	2,207,685
Stock-based compensation expense	22,884	88,235
Loss on impairment of intangible assets		438,228
(Gain) loss on disposal of assets	398,962	(22,574)
Changes in assets and liabilities:		
Accounts receivable	(309,404)	213,010
Notes receivable	(54,888)	(3,228,038)
Prepaid expenses	148,204	126,005
Other assets	(2,504)	(352)
Deferred revenue	(17,002)	(188,170)
Accounts payable	19,619	1,768,181
Accrued and other expenses	(760,173)	1,627,739
Net cash used in operating activities	(2,801,610)	(2,703,117)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of furniture and equipment	(7,009)	(14,565)
Capitalized software	-	(206,835)
Proceeds from sale of furniture and equipment	-	45,362
Net Cash used in investing activities	(7,009)	(176,038)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Repayments on notes payable	(4,261,620)	(5,068,063)
Debt borrowings	7,007,129	7,947,365
Net cash provided by financing activities	2,745,509	2,879,302
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(63,110)	147
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	119,796	18,602
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 56,686	$ 18,749
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	$ 173,818	$ 461,360
Taxes	$ -	$ -

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

SMART ONLINE, INC.
NOTES TO CONSOLIDATED 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 small businesses that are delivered via a Software-as-a-Service (“SaaS”) model. The Company sells its SaaS products and services primarily through private-label marketing partners. In addition, the Company provides sophisticated and complex website consulting and development services, primarily in the e-commerce retail and direct-selling organization industries. 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, 2010 and 2009 included in this Quarterly Report on Form 10-Q are unaudited. The balance sheet as of December 31, 2009 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, 2009 filed with the Securities and Exchange Commission (the “SEC”) on April 15, 2010 (the “2009 Annual Report”).

The financial statements have been prepared in accordance with United State Generally Accepted Accounting Principles (“US GAAP”). In the opinion of the Company’s management, the unaudited statements in this Quarterly Report on Form 10-Q include all normal and recurring adjustments necessary for the fair presentation of the Company’s statement of financial position as of September 30, 2010, and its results of operations and cash flows for the three and nine months ended September 30, 2010 and 2009. The results for the three and nine months ended September 30, 2010 are not necessarily indicative of the results to be expected for the fiscal year ending December 31, 2010.

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, 2010 and 2009, 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 2009 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 10, 2010, the Company does have a commitment from its convertible secured subordinated noteholders to purchase up to an additional $2.6 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 $2.6 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 plans include the development of additional new products and applications, and further enhancement of its existing small-business applications and tools. The Company’s continuation as a going concern depends upon its capability to generate sufficient cash flows to meet its obligations on a timely basis, to obtain additional financing as may be required, and ultimately to attain profitable operations and positive cash flows.

Significant Accounting Policies - In the opinion of the Company’s management, the significant accounting policies used for the three and nine months ended September 30, 2010 are consistent with those used for the years ended December 31, 2009 and 2008. Accordingly, please refer to the 2009Annual Report for the Company’s significant accounting policies.

Use of Estimates - The preparation of financial statements in conformity with US 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.

Fair Value of Financial Instruments - US GAAP requires disclosures of fair value information about financial instruments, whether or not recognized in the balance sheet, for which it is practical to estimate that value. Due to the short period of time to maturity, the carrying amounts of cash equivalents, accounts receivable, accounts payable, accrued liabilities, and notes payable reported in the financial statements approximate the fair value.

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

Segments - Segmentation is based on an entity's internal organization and reporting of revenue and operating income based upon internal accounting methods commonly referred to as the "management approach." Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance. The Company's chief operating decision maker is its Interim Chief Executive Officer, who reviews financial information presented on a consolidated basis. Accordingly, the Company has determined that it has a single reporting segment and operating unit structure.

Concentration of Credit Risk - Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of cash and accounts receivable. At times, cash balances may exceed the Federal Deposit Insurance Corporation ("FDIC") insurable limits. See Note 6, "Major Customers and Concentration of Credit Risk," for further discussion of risk within accounts receivable.

Allowance for Doubtful Accounts - The Company maintains an allowance for doubtful accounts for estimated losses resulting from the inability, failure, or refusal of its customers to make required payments. The need for an allowance for doubtful accounts is evaluated based on specifically identified amounts that management believes to be potentially uncollectible. If actual collections experience changes, revisions to the allowance may be required.

From time to time, the Company, as part of its negotiated contracts, has granted extended payment terms to its strategic partners. As payments become due under the terms of the contract, they are invoiced and reclassified as accounts receivable. Based on these criteria, management determined that at September 30, 2010, an allowance for doubtful accounts of $1,199,859 was required, comprising the full outstanding balance of a direct-selling organization customers' account and contract receivable.

Intangible Assets - Intangible assets consist primarily of assets obtained through the acquisitions of iMart Incorporated ("iMart") in 2005 and includes the trade name. The iMart trade name is deemed by management to have an indefinite life and is not amortized.

Revenue Recognition - The Company derives revenue primarily from subscription fees charged to customers accessing its SaaS applications; the perpetual or term licensing of software platforms or applications; and professional services, consisting of consulting, development, hosting, and maintenance services. These arrangements may include delivery in multiple-element arrangements if the customer purchases a combination of products and/or services. Because the Company licenses, sells, leases, or otherwise markets computer software, it uses the residual method pursuant to the US GAAP, as amended. This method allows the Company to recognize revenue for a delivered element when such element has vendor specific objective evidence ("VSOE") of the fair value of the delivered element. If VSOE cannot be determined or maintained for an element, it could impact revenues as all or a portion of the revenue from the multiple-element arrangement may need to be deferred.

If multiple-element arrangements involve significant development, modification, or customization or if it is determined that certain elements are essential to the functionality of other elements within the arrangement, revenue is deferred until all elements necessary to the functionality are provided by the Company to a customer. The determination of whether the arrangement involves significant development, modification, or customization could be complex and require the use of judgment by management.

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

1. persuasive evidence of an arrangement exists

2. delivery has occurred

3. the fee is fixed or determinable

4. collectability is probable

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

Under the provisions of US GAAP, consulting, website design fees, and application development services are accounted for 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, revenues are recognized 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 the Company's consulting service contracts are on a time and material basis and are typically billed monthly based upon standard professional service rates.

Application development services are typically fixed price and of a longer term. As such, they are accounted for as long-term construction contracts that require revenue recognition to be based on estimates involving total costs to complete and the stage of completion. The 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, the associated costs of such projects are capitalized and included in costs in excess of billings on the balance sheet until such time that revenue recognition is permitted.

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. Subscriptions are generally payable on a monthly basis and are typically paid via credit card of the individual end user. Any payments received in advance of the subscription period are accrued as deferred revenue and amortized over the subscription period. 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 identified the fact that certain contracts required 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. The net effect of this reclassification of expenses only impacts gross revenue and certain gross expenses; it does not change our net income.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 the services are provided in accordance with US GAAP that includes the right to use software stored on another entity's hardware.

Deferred Revenue - Deferred revenue consists of billings or payments received in advance of revenue recognition, and it is recognized as the revenue recognition criteria are met. Deferred revenue also includes certain professional service fees and license fees where all the criteria of US GAAP were not met. Deferred revenue that will be recognized over the succeeding 12-month period is recorded as current and the remaining portion is recorded as non-current.

Cost of Revenues - Cost of revenues primarily is composed of costs related to third-party hosting services, salaries and associated costs of customer support and professional services personnel, credit card processing, depreciation of computer hardware and software used in revenue-producing activities, domain name and e-mail registrations, and allocated development expenses and general and administrative overhead.

The Company allocates development expenses to cost of revenues based on time spent by development personnel on revenue-producing customer projects and support activities. The Company allocates general and administrative overhead such as rent and occupancy expenses, depreciation, general office expenses, and insurance to all departments based on headcount. As such, general and administrative overhead expenses are reflected in cost of revenues and each operating expense category.

Software Development Costs - Current US GAAP requires 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, the Company had not developed detailed design plans for its 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. 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, resulted in the continued expensing of underlying costs as research and development.

On a continuing basis, we review the value of all assets of the Company. During the quarter ending September 30, 2010, we wrote off the entire value of the previously capitalized software for the Onebiz® product since there were no customers and the product was not competitive with similar offerings in the marketplace. In addition, management has changed the focus of sales and marketing efforts away from the OneBiz® product.

Advertising Costs - The Company expenses all advertising costs as they are incurred. The amounts charged to sales and marketing expense during the third quarter of 2010 and 2009 were $47,480 and $3,000, respectively. During the first nine months of 2010 and 2009, these amounts were $97,088 and $42,364, respectively.

Net Loss Per Share - Basic net loss per share is computed using the weighted-average number of common shares outstanding during the relevant periods. Diluted net loss per share is computed using the weighted-average number of common and dilutive common equivalent shares outstanding during the relevant periods. Common equivalent shares consist of convertible notes, stock options, and warrants that are computed using the treasury stock method.

Stock-Based Compensation - The Company adopted US GAAP provisions related to share-based payments which requires companies to expense the value of employee stock options, restricted stock, and similar awards and applies to all such securities outstanding and vested.

In computing the impact of stock-based compensation expense, the fair value of each award is estimated on the date of grant based on the Black-Scholes option-pricing model utilizing certain assumptions for a risk-free interest rate, volatility, and expected remaining lives of the awards. The assumptions used in calculating the fair value of share-based payment awards represent management’s best estimates, but these estimates involve inherent uncertainties and the application of management’s judgment. As a result, if factors change and the Company uses different assumptions, the Company’s stock-based compensation expense could be materially different in the future. In addition, the Company is required to estimate the expected forfeiture rate and only recognize expense for those shares expected to vest. In estimating the Company’s forfeiture rate, the Company analyzed its historical forfeiture rate, the remaining lives of unvested options, and the amount of vested options as a percentage of total options outstanding. If the Company’s actual forfeiture rate is materially different from its estimate, or if the Company reevaluates the forfeiture rate in the future, the stock-based compensation expense could be significantly different from what the Company has recorded in the current period.

The following is a summary of the Company’s stock-based compensation expense for the periods indicated:

	Three Months Ended September 30, 2010	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
Compensation expense included in G&A expense related to stock options	$ 8,393	$ 5,191	$ 17,184	$ 40,155
Compensation expense included in G&A expense related to restricted stock awards	2,850	560	5,700	48,080
Total expense	$ 11,243	$ 5,751	$ 22,884	$ 88,235

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, 2010 and 2009 were estimated using the Black-Scholes option-pricing model with the following weighted-average assumptions:

	Three Months Ended		Nine Months Ended	
	September 30, 2010	September 30, 2009	September 30, 2010	September 30, 2009
Dividend yield	0.0%	0.0%	0.0%	0.0%
Expected volatility	97%	70%	97%	69%
Risk-free interest rate	1.27%	2.37%	1.9%	2.3%
Expected lives (years)	4.0	4.0	4.0	4.0

The expected lives of the options represent the estimated period of time until exercise or forfeiture and are based on historical experience of similar awards. Expected volatility is partially based on the historical volatility of the Company’s common stock since the end of the prior fiscal year as well as management’s expectations for future volatility. The risk-free interest rate is based on the published yield available on U.S. treasury issues with an equivalent term remaining equal to the expected life of the option.

The following is a summary of the stock option activity for the nine months ended September 30, 2010:

	Shares	Weighted Average Exercise Price
BALANCE, December 31, 2009	132,500	$ 4.43
Granted	125,000	1.14
Forfeited	(42,500)	3.31
Exercised	-	-
BALANCE, September 30, 2010	215,000	$ 2.74

Recently Issued Accounting Pronouncements -. The current US GAAP pronouncements concerning the life of intangible assets require entities to consider their own historical experience in renewing or extending similar arrangements when developing assumptions regarding the useful lives of intangible assets and also mandates certain related disclosure requirements.

All other new and recently issued, but not yet effective, accounting pronouncements have been deemed to be not relevant to the Company and therefore are not expected to have any impact once adopted.

2. ASSETS & LIABILITIES

Prepaid Expenses

In July 2008, the Company entered into a 36-month sublease agreement with Advantis Real Estate Services Company for approximately 9,837 square feet of office space in Durham, North Carolina, into which the Company relocated its headquarters in September 2008. The agreement included the conveyance of certain furniture to the Company without a stated value and required a lump-sum, upfront payment of $500,000 that was made in September 2008. Management has assessed the fair market value of the furniture to be approximately $50,000, and this amount was capitalized and is subject to depreciation in accordance with the Company’s fixed asset policies. The remainder of the payment was recorded as prepaid expense; with the portion relating to rent for periods beyond the next twelve months classified as non-current, and is being amortized to rent expense over the term of the lease. The Company’s prepaid sublease with Advantis Real Estate Services Company includes an expiration date of September 2011.

Intangible Assets

The following table summarizes information about intangible assets at September 30, 2010:

Asset Category	Value Assigned	Residual Value	Weighted Average Amortization Period (in Years)	Accumulated Amortization	Carrying Value
Trade name	$ 150,000	N/A	N/A	N/A	$ 150,000
Totals	$ 150,000	$ -		$	$ 150,000

Intangible assets acquired were valued using the standard of "fair value" defined in US GAAP related to business combinations , as "the amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale."

Accrued Liabilities

At September 30, 2010, the Company had accrued liabilities totaling $3,666,165. This amount consisted primarily of $1,400,000 related to legal reserves for the settlement of legal fees on behalf of former officers and employees, Michael Nouri and Eric Reza Nouri, both of whom were convicted on criminal charges brought by the US Department of Justice; $126,030 of liability accrued related to the development of the Company's custom accounting application; $1,974,500 related to settlement costs and legal expenses associated with the Company's class action settlement agreement (see Note 4, "Commitments and Contingencies"); $22,946 of accrued payroll; $136,929 of convertible note interest payable and other liabilities of $5,760.

At September 30, 2009, the Company had accrued liabilities totaling $2,107,751. This amount consisted primarily of $117,102 of liability accrued related to the development of the Company's custom accounting application; $1,804,207 related to legal expenses associated with the settlement of claims brought by the Company's former officers and employees (see Note 4, "Commitments and Contingencies"); $24,518 for tax-related liabilities associated with the vesting of restricted stock; $10,043 of loss estimated on a long-term customer contract; $25,685 of accrued payroll; $87,688 of convertible note interest payable and other liabilities of $36,617.

Deferred Revenue

Deferred revenue comprises the following items:

· Subscription Fees - short-term and long-term portions of cash received related to one- or two-year subscriptions for domain names and/or email accounts

· License Fees - licensing revenue where customers did not meet all the criteria of US GAAP. Such deferred revenue will be recognized as cash is delivered or collectability becomes probable.

The components of deferred revenue for the periods indicated were as follows:

	September 30, 2010	December 31, 2009
Subscription fees	$ 28,714	$ 40,115
License fees	-	5,601
Totals	$ 28,714	$ 45,716

Current portion	$ 27,561	$ 40,115
Non-current portion	1,153	5,601
Totals	$ 28,714	$ 45,716

3. NOTES PAYABLE

Convertible Notes

As of September 30, 2010, the Company had $12.2 million aggregate principal amount of convertible secured subordinated notes due November 14, 2013 (the "notes") outstanding, after the $200,000 reduction of such current outstanding debt on account of the sale-leaseback described in item 4, Commitments and Contingencies, below. The convertible notes have been sold as follows:

Through the Quarter ending September 30, 2010

Note Buyer	Date of Purchase	Amount of Convertible Note	Interest Rate	Original Due Date	Restated due Date
Atlas Capital	November 14, 2007	$ 2,050,000	8%	11/14/2010	11/14/2013
Crystal Management	November 14, 2007	$ 500,000	8%	11/14/2010	11/14/2013
William Furr	November 14, 2007	$ 250,000	8%	11/14/2010	11/14/2013
Blueline Fund	November 14, 2007	$ 500,000	8%	11/14/2010	11/14/2013
Atlas Capital	August 12, 2008	$ 1,250,000	8%	11/14/2010	11/14/2013
Crystal Management	August 12, 2008	$ 250,000	8%	11/14/2010	11/14/2013
UBP, Union Bancaire Privee	November 21, 2008	$ 250,000	8%	11/14/2010	11/14/2013
HSBC Private Bank (Suisse), SA	November 21, 2008	$ 250,000	8%	11/14/2010	11/14/2013
Atlas Capital	January 6, 2009	$ 500,000	8%	11/14/2010	11/14/2013
Atlas Capital	February 24, 2009	$ 500,000	8%	11/14/2010	11/14/2013
Atlas Capital	April 3, 2009	$ 500,000	8%	11/14/2010	11/14/2013
Atlas Capital	June 2, 2009	$ 500,000	8%	11/14/2010	11/14/2013
Atlas Capital	July 16, 2009	$ 250,000	8%	11/14/2010	11/14/2013
Atlas Capital	August 26, 2009	$ 250,000	8%	11/14/2010	11/14/2013
Atlas Capital	September 8, 2009	$ 250,000	8%	11/14/2010	11/14/2013
Atlas Capital	October 5, 2009	$ 250,000	8%	11/14/2010	11/14/2013
UBP, Union Bancaire Privee	October 9, 2009	$ 250,000	8%	11/14/2010	11/14/2013
Atlas Capital	November 6, 2009	$ 500,000	8%	11/14/2010	11/14/2013
Atlas Capital	December 23, 2009	$ 750,000	8%	11/14/2010	11/14/2013
Atlas Capital	February 11, 2010	$ 500,000	8%	11/14/2010	11/14/2013
Atlas Capital	April 1, 2010	$ 350,000	8%	11/14/2013	
Atlas Capital	June 2, 2010	$ 600,000	8%	11/14/2013	
Atlas Capital	July 1, 2010	$ 250,000	8%	11/14/2013	
Atlas Capital	August 13, 2010	$ 100,000	8%	11/14/2013	

Atlas Capital	August 30, 2010	$	200,000	8%	11/14/2013
Atlas Capital	September 14, 2010	$	300,000	8%	11/14/2013
Atlas Capital	September 30, 2010	$	300,000	8%	11/14/2013

On August 12, 2008, the Company exercised its option to sell $1.5 million aggregate principal amount of notes (the "Additional Notes") with substantially the same terms and conditions as the initial subordinated notes sold in November 2007 (the "Initial Notes"). In connection with the sale of the Additional Notes, the noteholders holding a majority of the aggregate principal amount of the notes then outstanding agreed to increase the aggregate principal amount of notes that they are committed to purchase from $8.5 million to $15.3 million.

On February 24, 2009, the noteholders holding a majority of the aggregate principal amount of the notes outstanding agreed that the Company may sell up to $6 million aggregate principal amount of notes to new investors or existing noteholders at any time on or before December 31, 2009 with a maturity date of November 14, 2010 or later. In addition, the maturity date definition for each of the notes was changed from November 14, 2010 to the date upon which the note is due and payable, which is the earlier of (1) November 14, 2010, (2) a change of control, or (3) if an event of default occurs, the date upon which noteholders accelerate the indebtedness evidenced by the notes.

The formula for calculating the conversion price of the notes was also amended such that the conversion price of each outstanding note and any additional note sold in the future would be the same and set at the lowest "applicable conversion price," as described below.

The Company is obligated to pay interest on the notes at an annualized rate of 8% payable in quarterly installments commencing three months after the purchase date of the notes. The Company is not permitted to prepay the notes without approval of the holders of at least a majority of the principal amount of the notes then outstanding.
On March 5, 2010, the Company entered into the Fourth Amendment with the holders of a majority of the aggregate outstanding principal amount of the notes issued by the Company under the Convertible Subordinated Secured Note Purchase Agreement, dated November 14, 2007 (the "Note Purchase Agreement'). The Fourth Amendment extended the original maturity date of the notes from November 14, 2010 to November 14, 2013, and amended the Note Purchase Agreement, the notes and the Registration Rights Agreement, dated November 14, 2007, to reflect this maturity date extension.

On the earlier of November 14, 2013 or a merger or acquisition or other transaction pursuant to which existing stockholders of the Company hold less than 50% of the surviving entity, or the sale of all or substantially all of the Company's assets, or similar transaction, or event of default, each noteholder in its sole discretion shall have the option to:

- convert the principal then outstanding on its notes into shares of the Company's common stock, or

- receive immediate repayment in cash of the notes, including any accrued and unpaid interest.

If a noteholder elects to convert its notes under these circumstances, the conversion price for each note will be the lowest "applicable conversion price" determined for all of the notes. The "applicable conversion price" for each note shall be calculated by multiplying 120% by the lowest of:

- the average of the high and low prices of the Company's common stock on the OTC Bulletin Board averaged over the five trading days prior to the closing date of the issuance of such note,

- if the Company's common stock is not traded on the Over-The-Counter market, the closing price of the common stock reported on the Nasdaq National Market or the principal exchange on which the common stock is listed, averaged over the five trading days prior to the closing date of the issuance of such note, or

- the closing price of the Company's common stock on the OTC Bulletin Board, the Nasdaq National Market or the principal exchange on which the common stock is listed, as applicable, on the trading day immediately preceding the date such note is converted,

in each case as adjusted for stock splits, dividends or combinations, recapitalizations or similar events.

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

The notes and the common stock into which they may be converted have not been registered under the Securities Act of 1933, as amended (the “Securities Act”), or the securities laws of any other jurisdiction. As a result, offers and sales of the notes were made pursuant to Regulation D of the Securities Act and only made to accredited investors. The investors in the Initial Notes include (i) The Blueline Fund, which originally recommended Philippe Pouponnot, a former director of the Company, for appointment to the Company’s Board of Directors; (ii) Atlas Capital SA (“Atlas”), an affiliate of the Company that originally recommended Shlomo Elia, one of the Company’s current directors, for appointment to the Board of Directors; (iii) Crystal Management Ltd. (“Crystal”), which is owned by Doron Roethler, as the former Chairman of the Company’s Board of Directors and former Interim President and Chief Executive Officer of the Company, who serves as the noteholders’ bond representative; and (iv) William Furr, who is the father of Thomas Furr, who, at the time, was one of the Company’s directors and executive officers. The noteholders in the additional notes are Atlas and Crystal. The noteholders of the new notes are not affiliated with the Company. .

If the Company proposes to file a registration statement to register any of its common stock under the Securities Act in connection with the public offering of such securities solely for cash, subject to certain limitations, the Company shall give each noteholder who has converted its notes into common stock the opportunity to include such shares of converted common stock in the registration. The Company has agreed to bear the expenses for any of these registrations, exclusive of any stock transfer taxes, underwriting discounts, and commissions.

No fees to third parties are payable in connection with the sale of notes.

Line of Credit

On February 20, 2008, the Company entered into a $2.47 million revolving credit arrangement with Paragon Commercial Bank (“Paragon”) that was renewable on an annual basis subject to mutual approval to be used for general working capital. Any advances made on the line of credit were to be paid off no later than February 19, 2009, subject to extension due to renewal, with monthly payments being applied first to accrued interest and then to principal. Interest accrued on the unpaid principal balance at the Wall Street Journal’s published Prime Rate minus one half percent. The line of credit was secured by an irrevocable standby letter of credit in the amount of $2.5 million issued by HSBC with Atlas as account party with an original expiration date of February 18, 2010. The Company also agreed with Atlas that in the event of a default by the Company in the repayment of the line of credit that results in the letter of credit being drawn, the Company shall reimburse Atlas any sums that Atlas is required to pay under such letter of credit. At the sole discretion of Atlas, these payments may be made in cash or by issuing shares of the Company’s common stock at a set per-share price of $2.50.

On February 19, 2009, the Company renewed its revolving credit arrangement with Paragon. Any advances made on the line of credit were required to be paid off no later than February 19, 2010 with interest accruing on the unpaid principal balance at the Wall Street Journal's published Prime Rate, with a floor at 5.5%.

On February 25, 2010, the Company entered into a Modification Agreement with Paragon, with an effective date of February 22, 2010, relating to the Paragon Note, delivered by the Company to Paragon in the maximum principal amount of $2,500,000. The Modification Agreement (i) extended the maturity date of the Paragon Note from

February 11, 2010 to August 11, 2010, and (ii) changed the interest rate from a variable annual rate equal to The Wall Street Journal Prime Rate, with a floor of 5.50%, to a fixed annual rate of 6.50%. On August 19, 2010, the Paragon Note was further extended to October 10, 2010. Effective January 28, 2010, the expiration date of the standby letter of credit in the amount of $2,500,000 issued by HSBC securing the Paragon Note was extended from February 18, 2010 to October 17, 2010 and the expiration date of the letter of credit was subsequently extended through December 17, 2010. We are currently finalizing a new credit facility with a New York City based bank that we anticipate will provide approximately $6 million of term loans that will be due eighteen months from the date of the definitive agreements. The loans would be collateralized by letters of credit provided by UBS and HSBC to the bank on behalf of Atlas. A representative of the bank has informed us that the bank has completed its approval process for the proposed credit facility. The credit facility is anticipated to be available subject to execution of definitive agreements.

As of November 10, 2010, the Company had an outstanding balance of $2.05 million under the line of credit. As of September 30, 2010, the Company had notes payable totaling $14,495,045. The detail of these notes is as follows:

Note Description	Short-Term Portion	Long-Term Portion	TOTAL	Maturity	Rate
Paragon Commercial Bank credit line	$ 2,069,821	$ -	$ 2,069,821	Oct '10	6.5%
Various capital leases	22,472	170,367	192,839	Various	8-19%
Insurance premium note	32,385	-	32,385	Jul '11	5.4%
Convertible notes	-	12,200,000	12,200,000	Nov '13	8.0%
TOTAL	$ 2,124,678	$ 12,370,367	$ 14,495,045		

4. COMMITMENTS AND CONTINGENCIES

Lease Commitments

The Company leases computer and office equipment under capital lease agreements that expire through August 2019. Total amounts financed under these capital leases were $192,838 and $222,794 at September 30, 2010 and December 31, 2009, respectively, net of accumulated amortization of $55,376 and $69,608, respectively. The current and non-current portions of the capital leases have been recorded in current and long-term portions of notes payable on the balance sheets as of September 30, 2010 and December 31, 2009. See also Note 3, "Notes Payable."

In 2008, the Company entered into a non-cancelable sublease, subsequently restructured as a lease with the primary landlord, with a remaining term of 36 months to relocate its headquarters to another facility near Research Triangle Park, North Carolina. As described in Note 2, "Assets and Liabilities," the Company prepaid the lease and purchased existing furniture and fixtures for a lump-sum payment of $500,000, of which $450,080 was allocated to rent and is being amortized monthly over the remaining term of the lease. The Company also had a lease through October 2009 for an apartment near its headquarters that was utilized by its out of town executives and members of its Board of Directors. The lease was terminated as of August 4, 2009.

On September 4, 2009, the Company entered into a sale-leaseback agreement with the current bondholders. The bondholders paid a market rate cost of $200,000 through the reduction of current outstanding debt in exchange for all of the Company's office furniture, equipment and computers. The bondholders then leased all furniture, equipment and computers back to the company over a ten (10) year period. The monthly lease payment under the agreement is $2,427.

Rent expense for the nine months ended September 30, 2010 and 2009 was $163,059 and $129,572 respectively.

Development Agreement

In August 2005, the Company entered into a software assignment and development agreement with the developer of a customized accounting software application. In connection with this agreement, the developer would be paid up to $512,500 and issued up to 32,395 shares of the Company's common stock based upon the developer attaining certain milestones. This agreement was modified on March 26, 2008 to adjust the total number of shares issuable under the agreement to 29,014. As of September 30, 2010, the Company had paid $470,834 and issued 3,473 shares of common stock related to this obligation.

Legal Proceedings

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

On October 18, 2007, Robyn L. Gooden filed a purported class action lawsuit in the United States District Court for the Middle District of North Carolina naming the Company, certain of its current and former officers and directors, Maxim Group, LLC, 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 the Company's securities from May 2, 2005 through September 28, 2007 and were damaged. The complaint asserted violations of federal securities laws, including violations of Section 10(b) of the Securities Exchange Act of 1934, as amended, and Rule 10b-5. The complaint asserted 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 the Company's stock, allegedly causing plaintiffs to purchase the stock at an inflated price. The complaint requested 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 directors or officers of the Company during the class period as well as the Company's independent auditor.

On June 18, 2010, the Company entered into a Stipulation and Agreement of Settlement (the "Stipulation") with the lead plaintiff in the pending securities class action. Also included in the settlement are all the current and former officers, directors, shareholders and employees of the Company who had also been named as defendants in the securities class action, as well as Maxim Group. The Stipulation provides for the settlement of the securities class action on the terms described below. The settlement is subject to preliminary and final approval of the United States District Court for the Middle District of North Carolina, which the Company anticipates will occur in the fourth quarter of this year.

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

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

On July 2, 2009, Dennis Michael Nouri, a former officer of the Company, and Reza Eric Nouri, a former employee of the Company (together, the “Nouris”), were convicted of nine counts of criminal activity in a federal criminal action brought against them in the United States District Court for the Southern District of New York involving a fraudulent scheme to manipulate the Company’s stock price. On May 19, 2010, Dennis Michael Nouri was sentenced to eight years incarceration and two years supervised release; he filed a notice of appeal on June 1, 2010. On May 10, 2010, Reza Eric Nouri was sentenced to 18 months incarceration and 24 months supervised release; he filed a notice of appeal on May 27, 2010 and was allowed to remain out on bail pending appeal.

On September 24, 2009, the Nouris filed a motion in the Court of Chancery of the State of Delaware against the Company seeking the appointment of a receiver for the Company for the purpose of collecting a judgment in the amount of $826,798 entered against it by order of the Court of Chancery on August 6, 2009 (the “Order”) for the advancement of legal expenses incurred by the Nouris in their defense of criminal proceedings brought against them by the United States, and in their defense of civil proceedings brought against them by the Securities and Exchange Commission and the Company’s stockholders. Such legal expenses were in addition to legal fees and costs totaling $3 million that were paid out by the Company’s insurance carrier under the Company’s insurance policy, which exhausted the insurance coverage. The terms of the Order were previously reported in the Form 10-Q filed by the Company for the quarterly period ended June 30, 2009. The Company has recorded a total of unpaid legal expense obligations of $1,798,595 for this matter based on invoices received from the Nouris’ law firms through March 31, 2010, which figure does not include invoices generated but not yet received.

On June 18, 2010, the Company entered into a Settlement Agreement (the "Settlement Agreement") with Dennis Michael Nouri, Reza Eric Nouri, Henry Nouri and Ronna Loprete Nouri (collectively, the “Nouri Parties”). The Settlement Agreement provides for the payment by the Company of up to $1,400,000. Of that amount, $500,000 is payable within ten days after the date (the “Effective Date”) of preliminary judicial approval of the class action settlement described above (“Class Action Preliminary Judicial Approval”), and $900,000 is payable in twelve fixed monthly installments of $75,000 commencing 60 days after the Effective Date, with the last four scheduled installments totaling $300,000 subject to reduction to the extent that fees and disbursements for the Nouris' appeal are below certain levels or if the appeal is not taken to final adjudication. The Settlement Agreement provides for the exchange of mutual releases by the parties.

The Settlement Agreement is contingent upon Class Action Preliminary Judicial Approval.

On March 2, 2010, Nottingham Hall LLC, the primary landlord for the office space occupied by the Company under a sublease between our Company and Advantis Real Estate Services Company (Advantis), filed a Complaint in Summary Ejectment against Advantis and our Company. The suit sought to recoup the funds not paid by Advantis over term of the original lease between Nottingham Hall LLC and Advantis in the sum of approximately $121,000. Representatives for Nottingham Hall LLC indicated that Advantis had defaulted on the terms of the lease and Nottingham Hall pursued our Company for the differential in rent between our prepaid negotiated amount and the total actually due from Advantis.

On May 11, 2010 we reached an agreement with Nottingham Hall LLC that required the payment of the rent differential for the period August 2009 through May 2010 and the monthly payment of the rent differential ($4,900) for the remainder of the lease period through September 30, 2011. The Company entered into a lease with the primary landlord for the remaining lease term.

Please refer to Part I, Item 3 of our annual report on Form 10-K for the fiscal year ending December 31, 2009 for a further description of material legal proceedings.

5. STOCKHOLDERS' EQUITY

Preferred Stock

The Board of Directors is authorized, without further stockholder approval, subject to the approval of the Noteholders, to issue up to 5,000,000 shares of $0.001 par value preferred stock in one or more series and to fix the rights, preferences, privileges, and restrictions applicable to such shares, including dividend rights, conversion rights, terms of redemption, and liquidation preferences, and to fix the number of shares constituting any series and the designations of such series. There were no shares of preferred stock outstanding at September 30, 2010.

Common Stock

The Company is authorized to issue 45,000,000 shares of common stock, $0.001 par value per share. As of September 30, 2010, it had 18,342,542 shares of common stock outstanding. Holders of common stock are entitled to one vote for each share held.

Warrants

The Company entered into a Stock Purchase Warrant and Agreement (the "Warrant Agreement") with Atlas on January 15, 2007. Under the terms of the Warrant Agreement, Atlas received a warrant containing a provision for cashless exercise to purchase up to 444,444 shares of the Company's common stock at $2.70 per share at the termination of the line of credit or if the Company is in default under the terms of the line of credit with Wachovia. The fair value of the warrant was $734,303 as measured using the Black-Scholes option pricing model at the time the warrant was issued. This amount was recorded as deferred financing costs and was amortized to interest expense. In consideration for Atlas providing the Paragon line of credit (see Note 3, "Notes Payable"), the Company agreed to amend the Warrant Agreement to provide that the warrant is exercisable within 30 business days of the termination of the Paragon line of credit or if the Company is in default under the terms of the line of credit. If the warrant is exercised in full for cash, it will result in gross proceeds to the Company of approximately $1.2 million.

As part of the commission paid to Canaccord Adams, Inc. ("CA"), the Company's placement agent in the 2007 private placement transaction, CA was issued a warrant to purchase 35,000 shares of the Company's common stock at an exercise price of $2.55 per share. This warrant contains a provision for cashless exercise and must be exercised by February 21, 2012.

As of September 30, 2010, warrants to purchase up to 1,655,915 shares were outstanding.

Equity Compensation Plans

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

Restricted Stock – During the second quarter of 2010, we issued 10,000 restricted shares of stock to Mr. Shlomo Elia for his services as a member of the Board of Directors. No other shares of restricted stock were issued. There were no shares of restricted stock canceled during the first three quarters of 2010 due to terminations and payment of employee tax obligations resulting from share vesting. At September 30, 2010, there was $5,700 of unvested expense yet to be recorded related to all restricted stock outstanding.

Stock Options – The exercise price for incentive stock options granted under the 2004 Plan is required to be no less than the fair market value of the common stock on the date the option is granted, except for options granted to 10% stockholders, which are required to have an exercise price of not less than 110% of the fair market value of the common stock on the date the option is granted. Incentive stock options typically have a maximum term of ten years, except for option grants to 10% stockholders, which are subject to a maximum term of five years. Non-statutory stock options have a term determined by either the Board of Directors or the Compensation Committee. Options granted under the 2004 Plan are not transferable, except by will and the laws of descent and distribution.

The following is a summary of the stock option activity for the six months ended September 30, 2010:

	Shares	Weighted Average Exercise Price
BALANCE, December 31, 2009	132,500	$ 4.43
Granted	125,000	1.14
Exercised	-	-
Canceled	(42,500)	3.31
BALANCE, September 30, 2010	215,000	$ 2.74

The following table summarizes information about stock options outstanding at September 30, 2010:

				Currently Exercisable	
Exercise Price	Number of Options Outstanding	Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
$1.14	125,000	4.0	1.14		
From $2.50 to $3.50	45,000	4.8	$ 3.31	85,000	$ 3.14
$5.00	25,000	2.3	$ 5.00	25,000	$ 5.00
From $8.61	20,000	2.5	$ 8.61	20,000	$ 8.73
Totals	215,000	3.4	$ 6.10	130,000	$ 6.10

At September 30, 2010, there remains $67,361 of unvested expense yet to be recorded related to all options outstanding.

Dividends

The Company has not paid any cash dividends through September 30, 2010.

6. MAJOR CUSTOMERS AND CONCENTRATION OF CREDIT RISK

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

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

	Revenue Type	Three Months Ended September 30, 2010 Revenues	% of Total Revenues
Customer A	Subscription fees	$ 102,117	39.13%
Customer C	Subscription fees	39,622	15.18%
Customer D	Professional service fees	90,000	34.49%
Customer E	Professional service fees	28,731	11.01%
Others	Various	498	.19%
Total		$ 260,968	100%

	Revenue Type	Three Months Ended September 30, 2009 Revenues	% of Total Revenues
Customer A	Subscription fees	$ 106,499	36.27%
Customer C	Subscription fees	74,465	25.36%
Customer D	Professional service fees	75,150	25.59%
Customer E	Professional service fees	37,632	12.82%
Others	Various	-96	-0.04%
Total		$ 293,650	100%

	Revenue Type	Nine Months Ended September 30, 2010 Revenues	% of Total Revenues
Customer A	Subscription fees	$ 309,572	35.00%
Customer C	Subscription fees	136,981	15.49%
Customer D	Professional service fees	305,000	34.48%
Others	Various	133,033	15.03%
Total		$ 884,586	100%

	Revenue Type	Nine Months Ended September 30, 2009 Revenues	% of Total Revenues
Customer A	Subscription fees	$ 322,314	28.13%
Customer B	Professional service fees	222,725	19.44%
Customer C	Subscription fees	291,819	25.46%
Customer D	Professional service fees	120,578	10.52%
Customer E	Professional service fees	114,328	9.98%
Others	Various	74,220	6.47%
Total		$ 1,145,984	100%

As of September 30, 2010, two customers accounted for 59% and 41% of accounts receivable, respectively, before consideration of the allowance for doubtful accounts.   As of December 31, 2009, two customers accounted for 62% and 38% of accounts receivable, respectively.

7. SUBSEQUENT EVENTS

The information for this section has been updated through November 11, 2010.

The Company sold convertible secured subordinated notes as follows:

Note Buyer	Date of Purchase	Amount of Convertible Note	Interest Rate	l Due Date
Atlas Capital	November 9, 2010	300,000	8%	11/14/2013

On February 25, 2010, the Company entered into a Modification Agreement with Paragon, with an effective date of February 22, 2010, relating to the Paragon Note, delivered by the Company to Paragon in the maximum principal amount of $2,500,000. The Modification Agreement (i) extended the maturity date of the Paragon Note from February 11, 2010 to August 11, 2010, and (ii) changed the interest rate from a variable annual rate equal to The Wall Street Journal Prime Rate, with a floor of 5.50%, to a fixed annual rate of 6.50. On August 19, 2010, the Paragon Note was further extended to October 10, 2010. Effective January 28, 2010, the expiration date of the standby letter of credit in the amount of $2,500,000 issued by HSBC securing the Paragon Note was extended from February 18, 2010 to October 17, 2010 and the expiration date of the letter of credit was subsequently extended through December 17, 2010. We are currently finalizing a new credit facility with a New York City based bank that we anticipate will provide approximately $6 million of term loans, that will be due eighteen-month from the date of the definitive agreements. The loans would be collateralized by letters of credit provided by UBS and HSBC to the bank on behalf of Atlas Capital. A representative of the bank has informed us that the bank has completed its approval process for the proposed credit facility. The credit facility will be available subject to execution of definitive agreements.

During the October 21, 2010 Board of Directors meeting, the Board 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, representing the right to purchase an aggregate of 76,000 shares, varied by employee, responsibility and length of service.

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

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

The following discussion is designed to provide a better understanding of our unaudited financial statements, including a brief discussion of our business and products, key factors that impacted our performance, and a summary of our operating results. The following discussion should be read in conjunction with the unaudited financial statements and the notes thereto included in Part I, Item 1 of this Quarterly Report on Form 10-Q, and the consolidated financial statements and notes thereto and Management's Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-K for the year ended December 31, 2009. Historical results and percentage relationships among any amounts in the financial statements are not necessarily indicative of trends in operating results for any future periods.

Overview

We develop and market software products and services targeted to small businesses that are delivered via a Software-as-a-Service, or SaaS, model. We also provide website consulting and custom software development services, primarily in the e-commerce retail and direct-selling organization industries. We believe these relationships provide a cost- and time-efficient way to market to a diverse and fragmented yet very sizeable small-business sector. We also offer our products directly to end-user small businesses through our OneBiz® branded website.

We are developing a core industry-standard platform for small business and not-for-profit organizations with an architecture designed to integrate with a virtually unlimited number of other applications, services, and existing infrastructures. These applications include not only our own small-business applications, but also other applications we expect to arise from collaborative partnerships with third-party developers and service providers. In addition, we identified emerging-market opportunities using our Loyalty Clicks™ application suite targeted to not-for –profit organizations that leverage social media and smart-phone technology to provide increased engagement and fundraising online. We are refining and integrating the core platform in an effort to meet anticipated customer need. We believe, but cannot assure, this platform and associated applications will provide opportunities for new sources of revenue, including an increase in our subscription fees.

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 to customers for the hosting of platforms or applications
- Other revenue – revenues generated from non-core activities such as maintenance fees; original equipment manufacturer, or OEM, contracts; and miscellaneous other revenues

Our current primary focus is to target those established companies that have both a substantial base of small-business customers as well as a recognizable and trusted brand name in specific market segments. Our goal is to enter into partnerships with these established companies whereby they private label our products and offer them to their small-business customers. We believe, but cannot assure, the combination of the magnitude of their customer bases and their trusted brand names and recognition will help drive our subscription volume.

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. Applications for which subscriptions are available vary from our own internal development to applications provided to us by our partners. 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.

We generate professional service fees from our consulting and custom software development services. For example, a customer 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.

Because we retain ownership to our platform and applications, we provide hosting services to our customers and typically charge a monthly fee based on the number of users accessing the programs and the bandwidth consumed.

Other revenue primarily consists of non-core revenue sources such as maintenance 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 costs related to third-party hosting services, salaries and associated costs of customer support and professional services personnel, credit card processing, depreciation of computer hardware and software used in revenue-producing activities, domain name and e-mail registrations, and allocated development expenses and general and administrative overhead.

We allocate development expenses to cost of revenues based on time spent by development personnel on revenue-producing customer projects and support activities. We allocate general and administrative overhead such as rent and occupancy expenses, depreciation, general office expenses, and insurance to all departments based on headcount. As such, general and administrative overhead expenses are reflected in cost of revenues and each operating expense category.

Operating Expenses

We are devoting resources to the sale and marketing of our SaaS based applications including Loyalty Clicks™ and iMart® products, through both channel partners and direct sales efforts. Additionally, we have placed renewed emphasis on marketing our consulting and software development capabilities (iMart®) to support companies who require sophisticated and complex e-commerce websites.

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, public relations and advertising expenses. 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. In June 2008, we engaged a public relations firm and, as a result, our public relations expenses increased during the latter part of 2008. As we continue to execute our sales and marketing strategy, we expect associated costs to increase throughout 2010 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 or pursuant to revenue share arrangements.

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.

US GAAP concerning accounting for the costs of computer software to be sold, leased, or otherwise marketed requires 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.

Beginning in May 2008, we determined that it was strategically desirable to develop an industry-standard platform and to enhance our current SaaS applications. A detailed design plan indicated that the product was technologically feasible. In July 2008, we commenced development, and from that point in time, we have capitalized all related costs in accordance with US GAAP. Because of our scalable and secure multi-user architecture, we are able to provide all customers with a service based on a single version of our application. As a result, we do not have to maintain multiple versions, which means we do not have to incur certain development costs as do those companies who develop traditional enterprise software business models. As we further the development of our new applications throughout 2010, we expect that future research and development expenses will decrease in both absolute and relative dollars.

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. We anticipate general and administrative expenses will decrease slightly in 2010 as part of the objectives identified by current management. However, we are obligated to pay a material amount of indemnification costs in 2010 under settlement agreement described in detail in Part I, Item 3, "Legal Proceedings," in our Annual Report on Form 10-K for the year ended December 31, 2009 and in Note 4. "Commitments and Contingencies" Legal Proceedings, above, which would significantly increase our general and administrative expenses.

Stock-Based Expenses – Our operating expenses include stock-based expenses related to options, restricted stock awards, and warrants issued to employees and non-employees that are recognized at their fair market value utilizing the Black Sholes Model. These charges have been significant and are reflected in our historical financial results. In June 2007, we limited the issuance of awards under our 2004 Equity Compensation Plan, or the 2004 Plan, to awards of restricted or unrestricted stock. In June 2008, we made options available for grant under the 2004 Plan once again, primarily due to the adverse tax consequences to recipients of restricted stock upon the lapsing of restrictions.

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 accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues, and expenses and related disclosures of contingent assets and liabilities. "Critical accounting policies and estimates" are defined as those most important to the financial statement presentation and that require the most difficult, subjective, or complex judgments. We base our estimates on historical experience and on various other factors that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Under different assumptions and/or conditions, actual results of operations may materially differ. We periodically 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 and custom software development; 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. Because we license, sell, lease, or otherwise market computer software, we use the residual method pursuant to American Institute of Certified Public Accountants concerning Software Revenue Recognition. This method allows us to recognize revenue for a delivered element when such element has vendor specific objective evidence, or VSOE, of the fair value of the delivered element. If we cannot determine or maintain VSOE for an element, it could impact revenues, as we may need to defer all or a portion of the revenue from the multiple-element arrangement.

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. collection 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 deem 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.

Under the provisions of US GAAP concerning, Revenue Arrangements with Multiple Deliverables , 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 in 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 private-label 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 or the aggregating entity. Any payments received in advance of the subscription period are accrued as deferred revenue and amortized over the subscription period. 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 identified the fact that certain contracts required 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. The net effect of this reclassification of expenses only impacts gross revenue and certain gross expenses; it does not change our net income

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 concerning the arrangements that include the right to use software stored on another entity’s hardware.

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 we make such determination.

Impairment of Long-Lived Assets – We record our long-lived assets, such as property and equipment, at cost. We review the carrying value of our long-lived assets for possible impairment at the earlier of annually in the fourth quarter or whenever events or changes in circumstances indicate that the carrying amount of assets may not be recoverable in accordance with the provisions of US GAAP. We measure the recoverability of assets to be held and used by comparing the carrying amount of the asset to future net undiscounted cash flows expected to be generated by the asset. 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 of 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 the first, second or third quarter of 2010, or in 2009 and 2008, 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.

Overview of Results of Operations for the Three Months Ended September 30, 2010 and September 30, 2009

Total revenues were $260,968 for the three months ended September 30, 2010 compared to $293,650 for the same period in 2009, representing a decrease of $32,682, or 11%. Gross Loss decreased $54,129, or 39%, to Gross Loss $83,188 from Gross Loss $137,317. Operating expenses decreased $1,564,418 or 61%, to 995,793 from $2,560,211. Net loss decreased $1,546,514, or 54%, to $1,320,623 from $2,867,137.

The following table sets forth our consolidated statements of operations data expressed as a percentage of revenues for the periods indicated:

	Three Months Ended			
	September 30, 2010	% of Revenue	September 30, 2009	% of Revenue
REVENUES				
Subscription Fees	$ 119,152	45.66%	$ 159,149	54.2%
Professional service fees	12,600	4.83%	63,200	21.52%
License fees	65,850	25.23%	11,250	3.83%
Hosting Fees	37,722	14.45%	33,751	11.49%
Other revenue	25,644	9.83%	26,300	8.96%
Total Revenues	260,968	100.0%	293,650	100.0%
COST OF REVENUES	344,156	131.88%	430,967	146.76%
GROSS PROFIT (LOSS)	(83,188)	-31.88%	(137,317)	-46.76%
OPERATING EXPENSES				
General and administrative	408,004	156.34%	2,355,353	802.10%
Sales and marketing	181,132	69.41%	180,759	61.56%
Research and development	7,695	2.95%	36,406	12.4%
(Gain)/ Loss disposal of assets	398,962	152.88%	(12,307)	-4.19%
Total operating expenses	995,793	381.58%	2,560,211	871.86%
Total other income (expense)				
Interest Expense (net)	(244,189)	-93.57%	(169,609)	-57.76%
Gain on legal settlements (net)	2,547	0.98%	-	%
Total Other Income (Expense)	(241,642)	-92.59%	(169,609)	-57.76%
NET(LOSS)	$ (1,320,623)	-506.05%	$ (2,867,137)	-976.38%

Comparison of the Results of Operations for the Three Months Ended September 30, 2010 and September 30, 2009

Revenues. Total revenues for the three months ended September 30, 2010 were $260,968 compared to $293,650 for the same period in 2009, representing a decrease of $32,682, or 11%. This overall decrease in revenues was primarily attributable to decreases in subscription fees, and professional service fees.

Subscription Fees - Subscription fees for the three months ended September 30, 2010 were $119,152 compared to $159,149 for the same period in 2009, representing a decrease of $39,997, or 25%. This decrease is primarily due to a decrease in active subscribers to whom we provide e-commerce, domain name, email services, and related event ticket sale services for use as members of one of our primary customers, a direct-selling organization.

Professional Service Fees - Professional service fees for the three months ended September 30, 2010 were $12,600 compared to $63,200 for the same period in 2009, representing a decrease of $50,600, or 80%. This decrease is primarily due to the decrease in the number of customers to whom we provided professional services.

License Fees - License fees for the three months ended September 30, 2010 were $65,850 compared to $11,250 for the same period in 2009, representing an increase of $54,600, or 485%. This increase is primarily due to the fact that we continue to bill a customer for license services since January 2010 while the customer's project was in the development phase during the third quarter of 2009.

Hosting Fees – Hosting fees for the three months ended September 30, 2010 were $37,722 compared to $33,751 for the same period in 2009, representing an increase of $3,900, or 12%. This increase is primarily due to increased hosting services provided during the third quarter of 2010.

Other Revenue - Other revenue for the three months ended September 30, 2010 totaled $25,644 compared to $26,300 for the same period in 2009. This revenue is generated from non-core activities. We expect these revenue streams to continue to be insignificant in the future as we continue our strategy of focusing on the growth of our subscription and license revenues.

Cost of Revenues

Cost of revenues for the three months ended September 30, 2010 was $344,156 compared to $430,967 for the same period in 2009, representing a decrease of $86,811, or 20%. This decrease is primarily due to a reduction in domain name registrations, credit card processing fees, and business card printing for members of our direct-selling organization customers.

Operating Expenses

Operating expenses for the three months ended September 30, 2010 were $995,793 compared to $2,560,211 for the same period in 2009, representing a decrease of 1,564,418, or 61%. This decrease was primarily attributable to the fact that we had a significant write-off of approximately $1.8 million related to the reserve for uncollectable amounts due from the advancement of legal fees for the defense in criminal proceedings against Dennis Michael Nouri and Reza Eric Nouri, a former officer and employee of the Company during the third quarter of 2009 and no similar item in the third quarter of 2010.

General and Administrative - General and administrative expenses for the three months ended September 30, 2010 were $408,004 compared to $2,355,353 for the same period in 2009, representing an decrease of $1,947,349, or 83%. The decrease was primarily attributable to the establishment of a $1,804,763 bad-debt reserve for the estimated uncollectable amounts due from the advancement of legal fees for the defense in criminal proceedings against Dennis Michael Nouri and Reza Eric Nouri, a former officer and employee of the Company during the third quarter of 2009 while we had no such occurrence in the third quarter of 2010.

Sales and Marketing - Sales and marketing expenses for the three months ended September 30, 2010 were $181,132 compared to $180,759 for the same period in 2009, representing an increase of $373, or .02%. This increase is primarily attributable to the decrease in revenue sharing expense.

Research and Development - Research and development expenses for the three months ended September 30, 2010 were $7,695 compared to $36,406 for the same period in 2009, representing a decrease of $28,711, or 79%. This decrease is primarily due to the fact that the ongoing development expenses are now classified as part of the cost of operations.

(Gain) loss on disposal of assets – The loss on disposal of assets for the three months ended September 30, 2010 was $398,962 compared to a gain of $12,307 for the same period in 2009, representing an increase of $411,269 or 3,341%. This increase is due to the fact that we wrote off the previously capitalized software development costs for OneBiz® during the third quarter of 2010 since the product value could not be justified.

Other Income (Expense)

We incurred net interest expense of $244,189 for the three months ended September 30, 2010 compared to net interest expense of $169,609 for the same period in 2009, representing an increase of $74,580, or 44%. During the three months ended September 30, 2010, we carried a higher balance on our line of credit with Paragon Commercial Bank and borrowed additional funds from the bond noteholders.

Overview of Results of Operations for the Nine Months Ended September 30, 2010 and September 30, 2009

Total revenues were $884,586 for the nine months ended September 30, 2010 compared to $1,145,984 for the same period in 2009, representing a decrease of $261,398, or 23%. Gross profit decreased $181,897, to Gross (Loss) $(161,814) from Gross Profit of $20,083. Operating expenses decreased $3,343,885, or 58%, to $2,432,342 from $5,776,226. Net loss decreased $3,470,279 or 56%, to $2,725,548 from $6,195,827.

The following table sets forth our consolidated statements of operations data expressed as a percentage of revenues for the periods indicated:

	Nine Months Ended			
	September 30,	% of	September 30,	% of

	2010	Revenue	2009	Revenue
REVENUES				
Subscription Fees	$ 378,556	42.79%	$ 610,751	53.29%
Professional service fees	82,425	9.32%	261,699	22.84%
License fees	224,500	25.38%	33,750	2.95%
Hosting Fees	119,716	13.53%	139,007	12.13%
Other revenue	79,389	8.97%	100,777	8.79%
Total Revenues	884,586	100.0%	1,145,984	100.0%
COST OF REVENUES	1,046,400	118.29%	1,125,901	98.25%
GROSS PROFIT (LOSS)	(161,814)	-18.29%	20,083	1.75%
OPERATING EXPENSES				
General and administrative	1,469,892	166.17%	4,112,993	358.90%
Sales and marketing	513,408	58.04%	707,289	61.72%
Research and development	50,080	5.66%	540,232	47.14%
(Gain)/ Loss on impairment of assets	-	-	438,286	38.25
(Gain)/ Loss disposal of assets	398,962	45.10%	-	-%
Total operating expenses	2,432,342	274.97%	5,776,226	504.04%
Total other income (expense)				
Interest Expense (net)	(687,909)	-77.77%	(455,951)	-39.79%
Gain on legal settlements (net)	556,517	62.91%	6,000	0.52%
Other income		-	10,267	0.89%
Total Other Income (Expense)	(131,392)	-14.85%	(439,684)	-38.73%
NET (LOSS)	$ (2,725,548)	-308.16%	$ (6,195,827)	-540.66%

Comparison of the Results of Operations for the Nine Months Ended September 30, 2010 and September 30, 2009

Revenues. Total revenues for the nine months ended September 30, 2010 were $884,586 compared to $1,145,984 for the same period in 2009, representing a decrease of $261,398, or 23%. This overall decrease in revenues was primarily attributable to a decrease in subscription and professional service fees.

Subscription Fees – Subscription fees for the nine months ended September 30, 2010 were $378,556 compared to $ 610,751 for the same period in 2009, representing a decrease of $232,195, or 54%. This decrease was due to a reduction in membership revenue from a multi-level marketing organization that terminated its relationship with our Company in 2009.

Professional Service Fees - Professional service fees for the nine months ended September 30, 2010 were $82,425 compared to $261,699 for the same period in 2009, representing a decrease of $179,274, or 68%. This decrease was due to the loss of a major customer reported in 2009.

License Fees - License fees for the nine months ended September 30, 2010 were $224,500 compared to $33,750 for the same period in 2009, representing an increase of $190,750, or 565%. The increase in license revenue for the first nine months of 2010 relates to invoicing pursuant to a license agreement upon the completion of development work for one of our customers.

Hosting Fees – Hosting fees for the nine months ended September 30, 2010 were $119,716 as compared to $ 139,007 for the same period in 2009, representing a decrease of $19,289 or 14%. The decrease relates to the reduction in hosting services required by the customer that no longer uses our Company’s services as described in Professional Service fees above.

Other Revenue - Other revenue for the nine months ended September 30, 2010 totaled $79,389 compared to $100,777 for the same period in 2009. This revenue is generated from non-core activities. We expect these revenue streams to continue to be insignificant in the future as we continue our strategy of focusing on the growth of our subscription and license revenues.

Cost of Revenues

Cost of revenues for the nine months ended September 30, 2010 was $1,046,400 compared to $1,125,901 for the same period in 2009, representing a decrease of $79,501, or 7%. This decrease was primarily the result of the decrease of development personnel previously involved with the development and servicing of the major customer that left the Company during 2010

Operating Expenses

Operating expenses for the nine months ended September 30, 2010 were $2,432,342 compared to $ 5,776,226 for the same period in 2009 representing a decrease of $3,343,884, or 58%. This decrease was primarily attributable to a decrease in general and administrative expenses due to the accrual of expenses associated with the Nouri legal issues in the third quarter of 2009.

General and Administrative - General and administrative expenses for the nine months ended September 30, 2010 were $1,469,892 compared to $4,112,993 for the same period in 2009, representing a decrease of $2,643,101, or 64%. The decrease was primarily attributable to the fact that in 2009 we had established a $1,804,763 bad-debt reserve for the estimated uncollectable amounts due from the advancement of legal fees for the defense in criminal proceedings against Dennis Michael Nouri and Reza Eric Nouri, a former officer and employee of the Company and we did not require any additional reserve in 2010.   In addition, we had a reduction in salaries since our Chairman of the Board was functioning as our interim Chief Executive Officer without any additional compensation.

Sales and Marketing - Sales and marketing expenses for the nine months ended September 30, 2010 were $513,408 compared to $707,289 for the same period in 2009, representing a decrease of $193,881, or 27%. The decrease is primarily attributable to $144,000 decrease in payroll and benefit expense, and a decrease in revenue sharing costs with customers of $53,000 and offset by a minor increase in other expenses.

Research and Development - Research and development expenses for the nine months ended September 30, 2010 were $50,080 compared to $540,232 for the same period in 2009, representing a decrease of $490,152, or 91%. This decrease is primarily due to the reduction of ongoing development expense and the continuing maintenance and upgrade expense is now treated as part of the Cost of Revenues.

Impairment of Assets – During the nine month period ending September 30, 2010, the Company did not recognize any reduction in the value of intangibles while in the same nine month period ending September 30, 2009 we recognized a loss from the reduction of the value of an intangible asset in the amount of $438,286.

(Gain) loss on disposal of assets – the loss on disposal of assets for the nine months ended September 30, 2010 was $398,962 compared to a gain of $22,574 for the same period in 2009, representing an increase of $421,536 or 1,867%. This increase is due to the fact that we wrote off the previously capitalized software development costs for Onebiz during the third quarter of 2010 since the product value could not be justified

Other Income (Expense)

We incurred net interest expense of $687,909 for the nine months ended September 30, 2010 compared to net interest expense of $455,951 for the same period in 2009, representing a decrease of $231,958, or 51%. Interest expense totaled $764,574 and $494,582 and interest income totaled $76,665 and $38,631 during the first nine months of 2010 and 2009, respectively. Interest expense decreased as a result of the use of cash flow during the nine-month period to reduce the outstanding balance on the line of credit whenever possible.

During the first nine months of 2010, we recognized $556,517 in other income from a gain due to legal settlements, as compared to net gain of $6,000 for the gain on legal settlements with our insurance carrier as described in Note 4, “Commitments and Contingencies,” to the consolidated financial statements in this report.

During the first nine months of 2009, we recognized $10,267 net gain on the sale of assets. We had no sales of assets during the nine months ended September 30, 2010.

Provision for Income Taxes

We have not recorded a provision for income tax expense because we have been generating net losses. Furthermore, we have not recorded an income tax benefit for the third quarter of 2010 primarily due to continued substantial uncertainty based on objective evidence regarding our ability to realize our deferred tax assets, thereby warranting a full valuation allowance in our financial statements. We have approximately $52,000,000 in net operating loss carryforwards, which may be utilized to offset future taxable income.

Liquidity and Capital Resources

At September 30, 2010, our principal sources of liquidity were cash and cash equivalents totaling $56,686 and current accounts receivable of -0-. As of November 10, 2010, our principal sources of liquidity were cash and cash equivalents totaling approximately $229,000 and accounts receivable of $-0-. As of September 30, 2010, we had drawn approximately $2.1 million on our $2.47 million line of credit with Paragon, leaving approximately $370,000 available under the line of credit for our operations. As of November 10, 2010, we had drawn approximately $2.4 million on the Paragon line of credit. We expect to draw from the credit facility currently being negotiated with a New York City bank, described below, replacing the Paragon line of credit, as needed for working capital purposes. During the third quarter of 2008, management established automated sweeps among its accounts at Paragon whereby all available cash at the end of each day is used to pay down the line of credit with Paragon, the purpose of which is to reduce our interest expense. This line of credit expired in October 2010 and we are currently finalizing a new credit facility with a New York City based bank that we anticipate will provide approximately $6 million of term loans, that will be due eighteen-month from the date of the definitive agreements. The loans would be collateralized by letters of credit provided by UBS and HSBC to the bank on behalf of Atlas Capital. A representative of the bank has informed us that the bank has completed its approval process for the proposed credit facility. Paragon Bank continues to provide our banking facility, which is supported by the underlying irrevocable standby letter of credit remains in force. This letter of credit is currently scheduled to expire in December 2010. As of November 10, 2010, we also have the ability to call up to approximately $2.6 million of additional funding from our convertible noteholders. On November 9, 2010, the Company sold a note in the principal amount of $300,000 to a current noteholder with substantially the same terms and conditions as the previously outstanding notes.

During the quarter ended September 30, 2010, our working capital deficit decreased by approximately $479,045 to approximately $6,096,000 compared to a working capital deficit of $6,575,351 at December 31, 2009. As described more fully below, the working capital deficit at September 30, 2010 is primarily attributable to negative cash flows from operations, including a $377,348 increase in accounts receivable, a $54,888 increase in notes receivable, and a $148,204 decrease in prepaid expenses during the first nine months of 2010.

Cash Flow from Operations. Cash used in operations for the nine months ended September 30, 2010 totaled $2,801,610, up from $2,703,117 for the same period in 2009. This increase is primarily due to the increase in accounts payable and accrued expenses offset by the net increase in notes receivable and the related bad debt expense experienced in 2009.

Cash Flow from Investing Activities. Cash used in investing activities for the nine months ended September 30, 2010 totaled $7,009, down from $176,038 for the same period in 2009. This decrease is primarily due to the fact that the Company acquired less computer equipment and capitalized less software development in the first nine months of 2010 compared to the same period in 2009.

Cash Flow from Financing Activities. Cash provided by financing activities for the nine months ended September 30, 2010 totaled $2,745,509, down from $2,879,302 for the same period in 2009. This decrease is primarily due to cash raised in 2010 from debt borrowings to help fund operations.

Debt Financing.
On February 20, 2008, the Company entered into a $2.47 million revolving credit arrangement with Paragon that was renewable on an annual basis subject to mutual approval to be used for general working capital. Any advances made on the line of credit were to be paid off no later than February 19, 2009, subject to extension due to renewal, with monthly payments being applied first to accrued interest and then to principal. Interest accrued on the unpaid principal balance at the Wall Street Journal’s published Prime Rate minus one-half percent. The line of credit was secured by an irrevocable standby letter of credit in the amount of $2.5 million issued by HSBC with Atlas as account party with an original expiration date of February 18, 2010. The Company also agreed with Atlas that in the event of a default by the Company in the repayment of the line of credit that results in the letter of credit being drawn, the Company shall reimburse Atlas any sums that Atlas is required to pay under such letter of credit. At the sole discretion of Atlas, these payments may be made in cash or by issuing shares of the Company’s common stock at a set per-share price of $2.50.

On February 19, 2009, the Company renewed its revolving credit arrangement with Paragon. Any advances made on the line of credit were required to be paid off no later than February 19, 2010 with interest shall accruing on the unpaid principal balance at the Wall Street Journal's published Prime Rate, with a floor at 5.5%.

On February 25, 2010, the Company entered into a Modification Agreement with Paragon, with an effective date of February 22, 2010, relating to the Paragon Note, delivered by the Company to Paragon in the maximum principal amount of $2,500,000. The Modification Agreement (i) extended the maturity date of the Paragon Note from February 11, 2010 to August 11, 2010, and (ii) changed the interest rate from a variable annual rate equal to The Wall Street Journal Prime Rate, with a floor of 5.50%, to a fixed annual rate of 6.50%. On August 19, 2010, the Paragon Note was further extended to October 10, 2010. Effective January 28, 2010, the expiration date of the standby letter of credit in the amount of $2,500,000 issued by HSBC securing the Paragon Note was extended from February 18, 2010 to October 17, 2010 and the expiration date of the letter of credit was subsequently extended through December 17, 2010. We are currently finalizing a new credit facility with a New York City based bank that we anticipate will provide approximately $6 million of term loans that will be due eighteen months from the date of the definitive agreements. The loans would be collateralized by letters of credit provided by UBS and HSBC to the bank on behalf of Atlas. A representative of the bank has informed us that the bank has completed its approval process for the proposed credit facility. The credit facility will be available subject to execution of definitive agreements.

As of September 30, 2010, the Company had $12.2 million aggregate principal amount of convertible secured subordinated notes due November 14, 2013 (the “notes”) outstanding, after the $200,000 reduction of such current outstanding debt on account of the sale-leaseback described in Item 1, Note 4, Commitments and Contingencies. The convertible notes have been sold as follows:

Through the Quarter ending September 30, 2010

Note Buyer	Date of Purchase	Amount of Convertible Note	Interest Rate	Original Due Date	Restated due Date
Atlas Capital	November 14, 2007	$ 2,050,000	8%	11/14/2010	11/14/2013
Crystal Management	November 14, 2007	$ 500,000	8%	11/14/2010	11/14/2013
William Furr	November 14, 2007	$ 250,000	8%	11/14/2010	11/14/2013
Blueline Fund	November 14, 2007	$ 500,000	8%	11/14/2010	11/14/2013
Atlas Capital	August 12, 2008	$ 1,250,000	8%	11/14/2010	11/14/2013
Crystal Management	August 12, 2008	$ 250,000	8%	11/14/2010	11/14/2013
UBP, Union Bancaire Privee	November 21, 2008	$ 250,000	8%	11/14/2010	11/14/2013
HSBC Private Bank (Suisse), SA	November 21, 2008	$ 250,000	8%	11/14/2010	11/14/2013
Atlas Capital	January 6, 2009	$ 500,000	8%	11/14/2010	11/14/2013
Atlas Capital	February 24, 2009	$ 500,000	8%	11/14/2010	11/14/2013
Atlas Capital	April 3, 2009	$ 500,000	8%	11/14/2010	11/14/2013
Atlas Capital	June 2, 2009	$ 500,000	8%	11/14/2010	11/14/2013
Atlas Capital	July 16, 2009	$ 250,000	8%	11/14/2010	11/14/2013
Atlas Capital	August 26, 2009	$ 250,000	8%	11/14/2010	11/14/2013
Atlas Capital	September 8, 2009	$ 250,000	8%	11/14/2010	11/14/2013
Atlas Capital	October 5, 2009	$ 250,000	8%	11/14/2010	11/14/2013
UBP, Union Bancaire Privee	October 9, 2009	$ 250,000	8%	11/14/2010	11/14/2013
Atlas Capital	November 6, 2009	$ 500,000	8%	11/14/2010	11/14/2013
Atlas Capital	December 23, 2009	$ 750,000	8%	11/14/2010	11/14/2013
Atlas Capital	February 11, 2010	$ 500,000	8%	11/14/2010	11/14/2013
Atlas Capital	April 1, 2010	$ 350,000	8%	11/14/2013	
Atlas Capital	June 2, 2010	$ 600,000	8%	11/14/2013	
Atlas Capital	July 1, 2010	$ 250,000	8%	11/14/2013	
Atlas Capital	August 13, 2010	$ 100,000	8%	11/14/2013	
Atlas Capital	August 30, 2010	$ 200,000	8%	11/14/2013	
Atlas Capital	September 14, 2010	$ 300,000	8%	11/14/2013	
Atlas Capital	September 30, 2010	$ 300,000	8%	11/14/2013	

On August 12, 2008, the Company exercised its option to sell $1.5 million aggregate principal amount of Additional Notes with substantially the same terms and conditions as the Initial Notes sold in November 2007. In connection with the sale of the Additional Notes, the noteholders holding a majority of the aggregate principal amount of the notes then outstanding agreed to increase the aggregate principal amount of notes that they are committed to purchase from $8.5 million to $15.3 million.

On February 24, 2009, the noteholders holding a majority of the aggregate principal amount of the notes outstanding agreed that the Company may sell up to $6 million aggregate principal amount of notes to new investors or existing noteholders at any time on or before December 31, 2009 with a maturity date of November 14, 2010 or later. In addition, the maturity date definition for each of the notes was changed from November 14, 2010 to the date upon which the note is due and payable, which is the earlier of (1) November 14, 2010, (2) a change of control, or (3) if an event of default occurs, the date upon which noteholders accelerate the indebtedness evidenced by the notes.

The formula for calculating the conversion price of the notes was also amended such that the conversion price of each outstanding note and any additional note sold in the future would be the same and set at the lowest “applicable conversion price,” as described below.

The Company is obligated to pay interest on the notes at an annualized rate of 8% payable in quarterly installments commencing three months after the purchase date of the notes. The Company is not permitted to prepay the notes without approval of the holders of at least a majority of the principal amount of the notes then outstanding.

On March 5, 2010, the Company entered into the Fourth Amendment with the holders of a majority of the aggregate outstanding principal amount of the notes issued by the Company under the Note Purchase Agreement. The Fourth Amendment extends the original maturity date of the notes from November 14, 2010 to November 14, 2013, and amends the Note Purchase Agreement, the notes and the Registration Rights Agreement, dated November 14, 2007, to reflect this extension

On the earlier of November 14, 2013 or a merger or acquisition or other transaction pursuant to which existing stockholders of the Company hold less than 50% of the surviving entity, or the sale of all or substantially all of the Company’s assets, or similar transaction, or event of default, each noteholder in its sole discretion shall have the option to:

- convert the principal then outstanding on its notes into shares of the Company’s common stock, or

- receive immediate repayment in cash of the notes, including any accrued and unpaid interest.

If a noteholder elects to convert its notes under these circumstances, the conversion price for each note will be the lowest “applicable conversion price” determined for all of the notes. The “applicable conversion price” for each note shall be calculated by multiplying 120% by the lowest of:

- the average of the high and low prices of the Company's common stock on the OTC Bulletin Board averaged over the five trading days prior to the closing date of the issuance of such note,

- if the Company's common stock is not traded on the Over-The-Counter market, the closing price of the common stock reported on the Nasdaq National Market or the principal exchange on which the common stock is listed, averaged over the five trading days prior to the closing date of the issuance of such note, or

- the closing price of the Company's common stock on the OTC Bulletin Board, the Nasdaq National Market or the principal exchange on which the common stock is listed, as applicable, on the trading day immediately preceding the date such note is converted,

in each case as adjusted for stock splits, dividends or combinations, recapitalizations or similar events.

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

The notes and the common stock into which they may be converted have not been registered under the Securities Act, or the securities laws of any other jurisdiction. As a result, offers and sales of the notes were made pursuant to Regulation D of the Securities Act and only made to accredited investors. The investors in the Initial Notes include (i) The Blueline Fund, which originally recommended Philippe Pouponnot, a former director of the Company, for appointment to the Company’s Board of Directors; (ii) Atlas, an affiliate of the Company that originally recommended Shlomo Elia, one of the Company’s current directors, for appointment to the Board of Directors; (iii) Crystal, which is owned by Doron Roethler, the former Chairman of the Company’s Board of Directors, who serves as the noteholders’ bond representative; and (iv) William Furr, who is the father of Thomas Furr, who, at the time, was one of the Company’s directors and executive officers. The noteholders in the additional notes are Atlas and Crystal.

If the Company proposes to file a registration statement to register any of its common stock under the Securities Act in connection with the public offering of such securities solely for cash, subject to certain limitations, the Company shall give each noteholder who has converted its notes into common stock the opportunity to include such shares of converted common stock in the registration. The Company has agreed to bear the expenses for any of these registrations, exclusive of any stock transfer taxes, underwriting discounts, and commissions.

No fees to third parties are payable in connection with the sale of notes.

We have not yet achieved positive cash flows from operations, and our main sources of funds for our operations are the sale of securities in private placements, the sale of additional convertible notes, and bank lines of credit. We must continue to rely on these sources until we are able to generate sufficient revenue to fund our operations. We believe that anticipated cash flows from operations, funds available from our existing line of credit, and additional issuances of notes, together with cash on hand, and the anticipated extension of the due date for the existing notes will provide sufficient funds to finance our operations at least for the next 12 to 18 months, depending on our ability to achieve strategic goals outlined in our annual operating budget approved by our Board of Directors. Changes in our operating plans, lower than anticipated sales, increased expenses, or other events may cause us to seek additional equity or debt financing in future periods. There can be no guarantee that financing will be available on acceptable terms or at all. Additional equity financing could be dilutive to the holders of our common stock, and additional debt financing, if available, could impose greater cash payment obligations and more covenants and operating restrictions.

Going Concern

Our independent registered public accountants for fiscal 2009 have issued an explanatory paragraph in their report included in our Annual Report on Form 10-K for the year ended December 31, 2009 in which they express substantial doubt as tour ability to continue as an ongoing concern. The financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or classification of liabilities that might be necessary should we be unable to continue as a going concern. Our continuation as a going concern depends on our ability to generate sufficient cash flows to meet our obligations on a timely basis, to obtain additional financing that is currently required, an ultimately to attain profitable operations and positive cash flows. There can be no assurance that our efforts to raise capital or increase revenue will be successful. If our efforts are unsuccessful, we may have to cease operations and liquidate our business.

Recent Developments

For more information on recent developments, see Item 1, Note 7 – “Subsequent Events”.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Not applicable.

Item 4. Controls and Procedures

Our management, with the participation of our interim Chief Executive Officer has evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. The term “disclosure controls and procedures,” as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC’s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company’s management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, as ours are designed to do, and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on such evaluation, our Interim Chief Executive Officer and Interim Chief Financial Officer concluded that, as of the end of the period covered by this Quarterly Report on Form 10-Q, our disclosure controls and procedures were effective at the reasonable assurance level.

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

Review of our revenue recognition procedures during the fourth quarter of 2009 caused the restatement of financial statements for the first three quarters of 2009 and three quarters of 2008. The restatement included the presentation of net subscription revenue as compared to the gross subscription revenue. In the past, we recognized all subscription revenue on a gross basis and in accordance with our policy to periodically review our accounting procedures we identified the fact that certain contracts require the reporting of subscription revenue on a gross basis and others on a net basis according to US GAAP. As a result of our review, 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.

In order to address the material weakness we have implemented a system whereby each new contract entered into by the company must be reviewed and approved by the Chief Financial Officer.

We will continue to evaluate the effectiveness of our disclosure controls and procedures and internal control over financial reporting on an ongoing basis and will take action as appropriate. There have been no changes to our internal control over financial reporting, as such, term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act, during the three months ended September 30, 2010 that we believe materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Changes in Internal Control Over Financial Reporting

There were no changes in our internal control over financial reporting that occurred during the third quarter of fiscal year 2010 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II – OTHER INFORMATION

Item 1. Legal Proceedings

Please refer to Part I, Item 3 of our Annual Report on Form 10-K for the fiscal year ended December 31, 2009 and Part II, Item 1 of our Quarterly Reports on Form 10-Q for the quarterly periods ended March 31, 2010 and June 30, 2010 for a description of material legal proceedings, including the proceedings discussed below.

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

On October 18, 2007, Robyn L. Gooden filed a purported class action lawsuit in the United States District Court for the Middle District of North Carolina naming the Company, certain of its current and former officers and directors, Maxim Group, LLC, 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 the Company's securities from May 2, 2005 through September 28, 2007 and were damaged. The complaint asserted violations of federal securities laws, including violations of Section 10(b) of the Securities Exchange Act of 1934, as amended, and Rule 10b-5. The complaint asserted 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 the Company's stock, allegedly causing plaintiffs to purchase the stock at an inflated price. The complaint requested 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 directors or officers of the Company during the class period as well as the Company's independent auditor.

On June 18, 2010, the Company entered into a Stipulation and Agreement of Settlement (the "Stipulation") with the lead plaintiff in the pending securities class action. Also included in the settlement are all the current and former officers, directors, shareholders and employees of the Company who had also been named as defendants in the securities class action, as well as Maxim Group. The Stipulation provides for the settlement of the securities class action on the terms described below. The settlement is subject to preliminary and final approval of the United States District Court for the Middle District of North Carolina, which the Company anticipates will occur in the fourth quarter of this year.

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

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

On July 2, 2009, Dennis Michael Nouri, a former officer of the Company, and Reza Eric Nouri, a former employee of the Company (together, the "Nouris"), were convicted of nine counts of criminal activity in a federal criminal action brought against them in the United States District Court for the Southern District of New York involving a fraudulent scheme to manipulate the Company's stock price. On May 19, 2010, Dennis Michael Nouri was sentenced to eight years incarceration and two years supervised release; he filed a notice of appeal on June 1, 2010. On May 10, 2010, Reza Eric Nouri was sentenced to 18 months incarceration and 24 months supervised release; he filed a notice of appeal on May 27, 2010 and was allowed to remain out on bail pending appeal.

On September 24, 2009, the Nouris filed a motion in the Court of Chancery of the State of Delaware against the Company seeking the appointment of a receiver for the Company for the purpose of collecting a judgment in the amount of $826,798 entered against it by order of the Court of Chancery on August 6, 2009 (the “Order”) for the advancement of legal expenses incurred by the Nouris in their defense of criminal proceedings brought against them by the United States, and in their defense of civil proceedings brought against them by the Securities and Exchange Commission and the Company’s stockholders. Such legal expenses were in addition to legal fees and costs totaling $3 million that were paid out by the Company’s insurance carrier under the Company’s insurance policy, which exhausted the insurance coverage. The terms of the Order were previously reported in the Form 10-Q filed by the Company for the quarterly period ended June 30, 2009. The Company has recorded a total of unpaid legal expense obligations of $1,798,595 for this matter based on invoices received from the Nouris’ law firms through March 31, 2010, which figure does not include invoices generated but not yet received.

On June 18, 2010, the Company entered into a Settlement Agreement (the "Settlement Agreement") with Dennis Michael Nouri, Reza Eric Nouri, Henry Nouri and Ronna Loprete Nouri (collectively, the “Nouri Parties”). The Settlement Agreement provides for the payment by the Company of up to $1,400,000. Of that amount, $500,000 is payable within ten days after the date (the “Effective Date”) of preliminary judicial approval of the class action settlement described above (“Class Action Preliminary Judicial Approval”), and $900,000 is payable in twelve fixed monthly installments of $75,000 commencing 60 days after the Effective Date, with the last four scheduled installments totaling $300,000 subject to reduction to the extent that fees and disbursements for the Nouris’ appeal are below certain levels or if the appeal is not taken to final adjudication. The Settlement Agreement provides for the exchange of mutual releases by the parties.

The Settlement Agreement is contingent upon Class Action Preliminary Judicial Approval.

Item 1A. Risk Factors

Other than, with respect to the risk factors described below, there have been no changes in our risk factors for our quarter ended September 30, 2010 from those previously reported in our Quarterly Report on Form 10-Q filed on August 12, 2010.

We previously noted that the Paragon line of credit was set to expire on August 11, 2010. On August 10, 2010, Paragon Bank extended the maturity date of the Paragon note from August 11, 2010 to October 17, 2010 with the provision that the standby letter of credit in the amount of $2,500,000 securing the Paragon note is also extended to November 17, 2010. We are currently finalizing a new credit facility with a New York City-based bank that we anticipate will provide approximately $6 million of term loans that will be due eighteen months from the date of definitive agreements. If we are unable to establish this credit facility, we may have difficulty dealing with cash flow activities of daily business operations that will be disruptive to the future success of the business.

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

Our revolving line of credit from Paragon is secured by an irrevocable standby letter of credit issued by HSBC with Atlas as account party. Our convertible secured subordinated notes are secured by a first priority lien on all of our unencumbered assets.

We are currently finalizing a new credit facility with a New York City based bank that we anticipate will provide approximately $6 million of term loans, that will be due eighteen-month from the date of the definitive agreements. The loans would be collateralized by letters of credit provided by UBS and HSBC to the bank on behalf of Atlas Capital. A representative of the bank has informed us that the bank has completed its approval process for the proposed credit facility.

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.

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

During the first, second and third quarter of fiscal 2010, we did not sell any equity securities that were not registered under the Securities Act, other than the Convertible Notes as described in our Current Reports on Form 8-K filed in connection with such transactions.

There were no repurchases during the third quarter of fiscal 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. Exhibits

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

Exhibit No.	Description
31.1	Certification of Principal Executive Officer Pursuant to Rule 13a-14(a) as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Principal Financial Officer Pursuant to Rule 13a-14(a) as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Principal Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. This exhibit is being furnished pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not, except to the extent required by that Act, be deemed to be incorporated by reference into any document or filed herewith for the purposes of liability under the Securities Exchange Act of 1934, as amended, or the Securities Act of 1933, as amended, as the case may be.
32.2	Certification of Principal Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. This exhibit is being furnished pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not, except to the extent required by that Act, be deemed to be incorporated by reference into any document or filed herewith for the purposes of liability under the Securities Exchange Act of 1934, as amended, or the Securities Act of 1933, as amended, as the case may be.

SIGNATURES

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

	Smart Online, Inc.
	/s/ Dror Zoreff Dror Zoreff
Date: November 15, 2010	Interim Chief Executive Officer, President and Principal Executive Officer
	/s/ Thaddeus J. Shalek Thaddeus J. Shalek Chief Financial Officer and
Date: November 15, 2010	Principal Accounting Officer