SMART ONLINE INC
Form 10-Q
May 14, 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 March 31, 2010

OR

o 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 o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ¨ No ¨

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

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 o No x

As of May 11, 2010, there were approximately 18,342,542 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 March 31, 2010

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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements

SMART ONLINE, INC.
BALANCE SHEETS

	March 31, 2010 (unaudited)	December 31, 2009
ASSETS		
Current assets:		
Cash and cash equivalents	$ 22,477	$ 119,796
Accounts receivable, net	-	13,056
Note receivable	-	-
Prepaid expenses	222,710	240,840
Total current assets	245,187	373,692
Property and equipment, net	243,075	258,450
Capitalized software, net	433,509	450,782
Unbilled receivable, non-current	-	-
Prepaid expenses, non-current	73,800	110,700
Intangible assets, net	150,000	150,000
Other assets	1,095	2,496
TOTAL ASSETS	$ 1,146,666	$ 1,346,120
LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)		
Current liabilities:		
Accounts payable	$ 752,800	$ 518,309
Notes payable	2,147,183	1,964,281
Deferred revenue	27,215	40,115
Accrued liabilities – Nouri	1,802,379	1,802,379
Accrued liabilities	2,432,503	2,623,959
Total current liabilities	7,162,080	6,949,043
Long-term liabilities:		
Notes payable	10,279,790	9,785,255
Deferred revenue	11,940	5,601
Total long-term liabilities	10,291,730	9,790,856
Total liabilities	17,453,810	16,739,899
Commitments and contingencies		
Stockholders' equity (deficit):		
Preferred stock, $0.001 par value, 5,000,000 shares authorized, no shares issued and outstanding at March 31, 2009 and December 31, 2008	-	-
Common stock, $0.001 par value, 45,000,000 shares authorized, 18,342,542 and 18,333,122 shares issued and outstanding at March 31, 2010 and December 31, 2009, respectively	18,343	18,333
Additional paid-in capital	67,040,385	67,036,836
Accumulated deficit	(83,365,872)	(82,448,948)
Total stockholders' deficit	(16,307,144)	(15,393,779)
TOTAL LIABILITIES AND STOCKHOLDERS' DEFICIT	$ 1,146,666	$ 1,346,120

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

SMART ONLINE, INC.
STATEMENTS OF OPERATIONS
(unaudited)

	Three Months Ended March 31, 2010	Three Months Ended March 31, 2009
REVENUES:		
Subscription fees	$ 136,258	$ 241,782
Professional service fees	62,775	118,773
License fees	87,800	11,250
Hosting fees	44,272	72,211
Other revenue	32,795	37,671
Total revenues	363,900	481,687
COST OF REVENUES	365,934	492,601
GROSS PROFIT	(2,034)	(10,914)
OPERATING EXPENSES:		
Sales and marketing	152,635	299,539
Research and development	32,005	276,879
General and administrative	672,419	895,590
Total operating expenses	857,059	1,472,008
LOSS FROM OPERATIONS	(859,093)	(1,482,922)
OTHER INCOME (EXPENSE):		
Interest expense, net	(210,695)	(127,998)
Gain on legal settlements, net	152,863	6,000
Other income	-	10,267
Total other expense	(57,832)	(111,731)
NET LOSS	$ (916,925)	$ (1,594,653)
NET LOSS PER COMMON SHARE:		
Basic and fully diluted	$ (0.05)	$ (0.09)
WEIGHTED-AVERAGE NUMBER OF SHARES USED IN COMPUTING NET LOSS PER COMMON SHARE:		
Basic and fully diluted	18,342,542	18,333,518

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

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

	Three Months Ended March 31, 2010	Three Months Ended March 31, 2009
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (916,925)	$ (1,594,653)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	16,209	164,288
Amortization of deferred financing costs	-	-
Provision for doubtful accounts	179,517	223,993
Equity-based compensation	3,561	53,144
Gain on disposal of assets	-	(10,267)
Changes in assets and liabilities:		
Accounts receivable	(121,343)	44,435
Notes receivable	(45,118)	(3,250)
Prepaid expenses	55,029	79,556
Other assets	1,401	(1,251)
Accounts payable	234,492	10,417
Deferred revenue	(6,561)	(47,951)
Accrued and other expenses	(191,456)	196,647
Net cash used in operating activities	(791,194)	(884,892)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(835)	(14,565)
Proceeds from sale of equipment	-	45,362
Capitalized software	17,273	(114,078)
Net cash provided by (used in) investing activities	16,438	(83,281)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from debt borrowings	1,982,698	2,925,511
Repayments of debt borrowings	(1,305,261)	(1,937,651)
Net cash provided by (used in) financing activities	677,437	987,860
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(97,319)	19,687
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	119,796	18,602
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 22,477	$ 38,289
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	$ 228,981	$ 127,750
Income taxes	$ -	$ 10

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

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

1. SUMMARY OF BUSINESS AND SIGNIFICANT ACCOUNTING POLICIES

Description of Business - Smart Online, Inc. (the "Company") was incorporated in the State of Delaware in 1993. The Company develops and markets software products and services targeted to 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 website consulting services, primarily in the e-commerce retail and direct-selling organization industries. The Company maintains a website for potential partners containing certain corporate information located at www.smartonline.com.

Basis of Presentation - The financial statements as of and for the three months ended March 31, 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 accounting principles generally accepted in the United States ("U.S. GAAP"). In the opinion of the Company's management, the unaudited statements in this Quarterly Report on Form 10-Q include all normal and recurring adjustments necessary for the fair presentation of the Company's statement of financial position as of March 31, 2010, and its results of operations and cash flows for the three months ended March 31, 2010 and 2009. The results for the three months ended March 31, 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 months ended March 31, 2010 and 2009, the Company incurred net losses as well as negative cash flows, is involved in a class action lawsuit (See Note 7, "Commitments and Contingencies," in the 2009 Annual Report), and had deficiencies in working capital. These factors indicate that the Company may be unable to continue as a going concern.

The financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or the amounts or classification of liabilities that might be necessary should the Company be unable to continue as a going concern. At May 11, 2010, the Company does have a commitment from its convertible secured subordinated noteholders to purchase up to an additional $4.65 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 $4.65 million in convertible notes, the Company will be able to obtain alternative funding. There can be no assurance that the Company's efforts to raise capital or increase revenue will be successful. If these efforts are unsuccessful, the Company may have to cease operations and liquidate the business. The Company's continuation as a going concern depends upon its ability to generate sufficient cash flows to meet its obligations on a timely basis, to obtain additional financing as may be required, and ultimately to attain profitable operations and positive cash flows.

Significant Accounting Policies - In the opinion of the Company's management, the significant accounting policies used for the three months ended March 31, 2010 are consistent with those used for the year ended December 31, 2009. Accordingly, please refer to the 2009 Annual Report for the Company's significant accounting policies.

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

Fair Value of Financial Instruments - U.S. GAAP requires disclosures of fair value information about financial instruments, whether or not recognized in the balance sheet, for which it is practicable 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 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.

Additionally, 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. During 2008, the Company entered into a web services agreement with a direct-selling organization customer that provided for extended payment terms related to both professional services and the grant of a software license. The customer began experiencing cash flow difficulties and has since significantly slowed its payments to the Company. In addition, the Company entered into a web services agreement with a real estate services customer and a mail-order pharmacy.. There are significant amounts due and unpaid under the terms of their agreements and accordingly the Company has established reserves as described below.

Based on these criteria, management determined that at March 31, 2010, an allowance for doubtful accounts of $1,002,028 was required for amounts due from customers. The allowance is comprised of the full outstanding balance of the direct-selling organization and mail–order pharmacy services customers' account receivable and the real estate customers' note receivable. In addition to the allowance for doubtful accounts from customers, the Company has established an allowance of $1,798,595 related to the Nouri legal fee advance.

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

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

Revenue Recognition - The Company derives revenue primarily from subscription fees charged to customers accessing its SaaS applications; professional service fees, consisting primarily of consulting; the perpetual or term licensing of software platforms or applications; and hosting and maintenance services. These arrangements may include delivery in multiple-element arrangements if the customer purchases a combination of products and/or services. Because the Company licenses, sells, leases, or otherwise markets computer software, it uses the residual method pursuant to U.S. GAAP. 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 U.S. 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. collectibility 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 collectibility 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 U.S. 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 in 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.

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Subscription fees primarily consist of sales of subscriptions through private-label marketing partners to end users. We typically have a revenue-share arrangement with these marketing partners in order to encourage them to market our products and services to their customers. Subscriptions are generally payable on a monthly basis and are typically paid via credit card of the individual end user. We accrue any payments received in advance of the subscription period as deferred revenue and amortize them over the subscription period. In the past, we recognized all subscription revenue on a gross basis and in accordance with our policy to periodically review our accounting policies we determined that certain contracts require the reporting of subscription revenue on a gross basis and others on a net basis according to US GAAP. On that basis, we continue to report subscription revenue from certain contracts on a gross basis and others on a net basis. The net effect of this reclassification of expenses only impacts gross revenue and certain gross expenses; it does not change the 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.

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 U.S. 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.

Stock-Based Compensation - Effective January 1, 2006, the Company began recognizing stock based compensation, using the Modified Prospective Approach based on the grant date fair value estimated in accordance with US GAAP. Under the Modified Prospective Approach, the amount of compensation cost recognized includes (i) compensation cost for all share-based payments granted prior to, but not yet vested as of, January 1, 2006, and (ii) compensation cost for all share-based payments that are granted subsequent to January 1, 2006. Stock-based compensation is recognized on the straight-line method over the requisite service period. Total stock-based compensation expense recognized was $3,561 and $53,144 for the quarters ended March 31, 2010 and 2009 respectively. No stock-based compensation was capitalized in the consolidated financial statements.

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 fair value of option grants under the Company's equity compensation plan during the years ended December 31, 2009 and 2008 were estimated using the following weighted average assumptions:

	Three Months Ended March 31,	
	2010	2009
Dividend yield	0.0%	0.0%
Expected volatility	98.7%	100.5%
Risk-free interest rate	3.19%	2.00%
Expected lives (years)	4.0	4.0

Dividend yield – The Company has never declared or paid dividends on its common stock and does not anticipate paying dividends in the foreseeable future.

Expected volatility – Volatility is a measure of the amount by which a financial variable such as share price has fluctuated (historical volatility) or is expected to fluctuate (expected volatility) during a period. The Company used the Company's monthly historical volatility since April 2005 to calculate the expected volatility.

Risk - free interest rate – The risk-free interest rate is based on the published yield available on U.S. Treasury issues with a remaining term similar to the expected life of the option.

Expected lives – 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.

Net Loss Per Share - Basic net loss per share is computed by dividing net loss by the weighted average number of common shares outstanding during the periods. Diluted net loss per share is computed using the weighted average number of common and dilutive common equivalent shares outstanding during the periods. Common equivalent shares consist of convertible notes, stock options, and warrants that are computed using the treasury stock method. Shares issuable upon the exercise of stock options and warrants, totaling 1,913,615 on March 31, 2010, were excluded from the calculation of common equivalent shares, as the impact was anti-dilutive.

Recently Issued Accounting Pronouncements - In April 2008, the US Financial Accounting Standards Board suggested rules concerning the determination of the useful life of intangible assets. The standard requires 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. The rules are effective for fiscal years beginning after December 15, 2008, with early adoption prohibited. The Company has adopted the rules.

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. BALANCE SHEET ACCOUNTS

Prepaid Expenses

In 2008, the Company entered into a non-cancelable sublease for approximately 9,837 square feet of office space, restructured as a prime lease beginning May 1, 2010 with a termination date of September 30, 2011, for its North Carolina headquarters. 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 12 months classified as non-current, and is being amortized to rent expense over the term of the lease.

Intangible Assets

The following table summarizes information about intangible assets at March 31, 2010:

Asset Category	Value Assigned	Weighted Average Amortization Period (in Years)	Impairments	Accumulated Amortization and Prior Impairment	Carrying Value
Customer bases	$ 1,944,347	6.2	-	$ 1,944,347	$ -
Acquired technology	501,264	3.0	-	501,264	-
Non-compete agreements	801,785	4.0	-	801,785	-
Trademarks and copyrights	52,372	9.7	-	52,372	-
Trade name	380,000	N/A	-	230,000	150,000
Totals	$ 3,679,768	-		$ 3,529,768	$ 150,000

We record our long-lived assets, such as intangibles, property and equipment, at cost. We review the carrying value of our indefinite lived intangibles for possible impairment at least annually in the fourth quarter, and all long-lived assets whenever events or changes in circumstances indicate that the carrying amount of assets may not be recoverable in accordance with the US GAAP. We measure the recoverability of assets to be held and used by comparing the carrying amount of the asset to future net discounted 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 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.
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Accrued Liabilities

At March 31, 2010 and December 31, 2009, the Company has recorded a total of unpaid legal expense obligations of $1,802,379 in connection with the Nouri Matters (defined below) based on invoices received from the law firms of Dennis Michael Nouri and Reza Eric Nouri (together, the “Nouris”) through March 31, 2010 which figure does not include invoices generated but not yet received. The Company and the Nouris have been engaged in settlement negotiations for the settlement of the Nouris’ advancement and indemnification claims (the “Nouri Matters”) against the Company, but no definitive agreement has yet been signed.

At March 31, 2010, the Company had accrued liabilities totaling $2,432,503. This amount consisted of the following: $2,145,716 of liability related to the estimated cost of settlement for the class action lawsuit, after giving effect to certain settlement payments made during the first quarter totaling $157,000, that was filed against the Company during 2007 (the “Class Action”), pursuant to the terms of a tentative settlement agreement reached between the Company and the lead plaintiff in the class action; $75,436 of liability related to the development of the Company’s custom accounting application; $50,594 related to hosting services; $31,804 for liabilities associated with the settlement of office rent negotiations; $3,791 for other professional services; $20,887 for accrued payroll; and $104,275 of convertible note interest payable.

At December 31, 2009, the Company had accrued liabilities totaling $2,623,959. This amount consisted primarily of $2,302,158 of liability related to the estimated cost of settlement for the Class Action law suit based upon the tentative settlement agreement reached between the Company and the lead plaintiff in the class action, plus other accrued legal fees, $75,436 of liability related to the development of the Company’s custom accounting application; $50,594 related to hosting services; $18,174 for liabilities associated with the settlement of office rent negotiations $3,791 for other professional services, $71,159 for accrued payroll and $102,647 of convertible note interest payable.

Deferred Revenue

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 services fees and licensing revenues where all the criteria described earlier 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 noncurrent.

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

		March 31, 2010		December 31, 2009
Subscription fees	$	39,155	$	40,115
License fees		-		5,601
Totals	$	39,155	$	45,716
Current portion	$	27,215	$	40,115
Non-current portion		11,940		5,601
Totals	$	39,155	$	45,716

3. NOTES PAYABLE

Convertible Notes

On November 14, 2007, in an initial closing, the Company sold $3.3 million aggregate principal amount of convertible secured subordinated notes (as amended, the “Notes”) under the Convertible Secured Subordinated Note Purchase Agreement, dated November 14, 2007 (as amended, the “Note Purchase Agreement”). The Notes bear an 8% interest rate and interest is paid quarterly.

In addition, at the initial closing, the noteholders committed to purchase on a pro rata basis up to $5.2 million aggregate principal of Notes in future closings upon approval and call by our Board of Directors. On August 12, 2008, we exercised our option to sell $1.5 million aggregate principal of Notes (the “Additional Notes”) to existing noteholders, with substantially the same terms and conditions as the Notes sold in the initial closing (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 November 21, 2008, we sold $500,000 aggregate principal amount of Notes to two new convertible noteholders (the “New Notes”), with substantially the same terms and conditions as the Initial Notes and the Additional Notes. At December 31, 2008, $5.3 million aggregate principal amount of Notes were outstanding.

On January 6, 2009, the Company sold $500,000 aggregate principal amount of Notes to Atlas Capital SA (“Atlas”), on substantially the same terms and conditions as the previously issued Notes.

On February 24, 2009, the Company sold $500,000 aggregate principal amount of Notes to Atlas on substantially the same terms and conditions as the previously issued Notes. On the same date, 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 Additional Notes to new convertible noteholders 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 was 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.

On each of April 3, 2009 and June 2, 2009, the Company sold a Note in the principal amount of $500,000 to Atlas on substantially the same terms and conditions as the previously issued Notes. On each of July 16, 2009, August 26, 2009, September 8, 2009, and October 5, 2009, the Company sold a Note in the principal amount of $250,000 to Atlas on substantially the same terms and conditions as the previously issued Notes. On October 9, 2009, the Company sold a Note in the principal amount of $250,000 to UBP, Union Bancaire Privee, an existing noteholder, on substantially the same terms and conditions as the previously issued Notes. On November 6, 2009, the Company sold a Note to Atlas in the principal amount of $500,000, on December 23, 2009 the Company sold a Note to Atlas in the principal amount of $750,000, and on February 11, 2010, the Company sold a Note to Atlas in the principal amount of $500,000, all upon substantially the same terms and conditions as the previously issued Notes.

On March 5, 2010, the Company and Atlas, as the holder of a majority of the aggregate outstanding principal amount of the Notes (the “Requisite Percentage Holder”), together with other noteholders, entered into the Fourth Amendment to Convertible Secured Subordinated Note Purchase Agreement, Second Amendment to Convertible Secured Subordinated Promissory Notes and Third Amendment to Registration Rights Agreement (the “Fourth Amendment”). 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 and the Registration Rights Agreement, dated November 14, 2007, to reflect this extension.

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 and the Registration Rights Agreement, dated November 14, 2007, to reflect this extension.

The Fourth Amendment further provides that on the earlier of the maturity date of November 14, 2013 or a merger or acquisition or other transaction pursuant to which our existing stockholders hold less than 50% of the surviving entity, or the sale of all or substantially all of our 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.

On April 1, 2010, the Company sold a Note to Atlas in the principal amount of $350,000, due November 14, 2013, upon substantially the same terms and conditions as the previously issued Notes

If a noteholder elects to convert its Notes on the maturity date, the conversion price will be the lowest "applicable conversion price" determined for each Note. 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,

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 noteholders of the Initial Notes include (i) The Blueline Fund, or Blueline, which originally recommended Philippe Pouponnot, one of our former directors, for appointment to the Board of Directors; (ii) Atlas, an affiliate that originally recommended Shlomo Elia, one of our current directors, for appointment to the Board of Directors; (iii) Crystal Management Ltd., which is owned by Doron Roethler, the former Chairman of our Board of Directors and former Interim Chief Executive Officer and who currently serves as the noteholders' bond representative; and (iv) William Furr, who is the father of Thomas Furr, who, at the time, was one of our directors and executive officers. The noteholders of the Additional Notes are Atlas and Crystal Management Ltd. 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.

Lines of Credit

On February 20, 2008, the Company entered into a revolving credit arrangement with Paragon Commercial Bank ("Paragon") that was renewable on an annual basis subject to mutual approval and delivered to Paragon a secured promissory note, dated February 20, 2008 (the "Paragon Note") . The total line of credit advanced by Paragon is $2.5 million and can be used for general working capital. Any advances made on the line of credit were required to be paid off no later than February 19, 2009, with monthly payments being applied first to accrued interest and then to principal. Interest accrues on the unpaid principal balance at the Wall Street Journal's published Prime Rate minus one-half percent. The line of credit is secured by an irrevocable standby letter of credit in the amount of $2.5 million issued by HSBC Private Bank (Suisse) SA ("HSBC") with Atlas, a current stockholder, as account party that was scheduled to expire on February 18, 2010. The Company also has 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 by issuing shares of the Company's common stock at a set per-share price of $2.50 or the issuance of additional bonds.

On February 25, 2010, the Company entered into a Modification Agreement (the "Modification Agreement") with Paragon, with an effective date of February 22, 2010, relating to the Paragon Note. The Modification Agreement (i) extends the maturity date of the Paragon Note from February 11, 2010 to August 11, 2010, and (ii) changes 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%. The Company has been advised that, 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 has been extended from February 18, 2010 to September 17, 2010.

As of March 31, 2010, the Company had notes payable totaling $12,426,973. The detail of these notes is as follows:

Note Description	Short-Term Portion	Long-Term Portion