SMART ONLINE INC
Form 10-Q/A
November 17, 2010

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

FORM 10-Q/A

(Mark One)

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

For the quarterly period ended June 30, 2009

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<br>(State or other jurisdiction of<br>incorporation or organization) | 95-4439334<br>(I.R.S. Employer<br>Identification No.) |
| 4505 Emperor Blvd., Ste. 320<br>Durham, North Carolina<br>(Address of principal executive offices) | 27703<br>(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 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 o No x

As of August 10, 2009, there were approximately 18,332,542 shares of the registrant’s common stock, par value $0.001 per share, outstanding.

EXPLANATORY NOTE

Smart Online, Inc. (the "Company") is filing this Amendment No. 1 to the Quarterly Report on Form 10-Q/A (the "Form 10-Q/A") to amend its Quarterly Report on Form 10-Q for the quarter ended June 30, 2009, which was filed with the Securities and Exchange Commission ("SEC") on August 12, 2009 (the "Original Filing" and together with the Form 10-Q/A, the "Form 10-Q") to include restated unaudited consolidated financial statements as described in Note 1 to the unaudited consolidated financial statements.

The Company has previously included the restated information in footnote 13 to the Annual Report on Form 10-K for the year ended December 31, 2009, which was filed with the Securities and Exchange Commission ("SEC") on April 15, 2010.

The Company has restated its previously issued consolidated financial statements as of and for the year ended December 31, 2008 and unaudited consolidated financial statements as of and for the quarters ended June 30, 2009 to include net subscription revenue as compared to gross subscription revenue as presented in the original filings. We typically have a revenue-share arrangement with our 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 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.

In addition to the restatement of subscription revenue, we restated the value of the iMart trade name as of December 31, 2008 because of a recalculation of the net royalty method of valuation. The restatement caused an increase in the amount of loss on impairment of intangible assets for the year ended December 31, 2008 in the amount of $230,000. The restated total loss on impairment of intangible assets is $3,702,141 as compared to the original loss of $3,472,141. The restated loss for the year ended December 31, 2008 decreased the total assets by $230,000 to $2,992,717 and increased the accumulated deficit to $72,908,076 as reflected in the restated Balance Sheet as of December 31, 2008.

This Form 10-Q/A amends Part I of the Company's Original Filing to reflect the restatement of revenue previously reported on a gross basis to a net revenue presentation. For the convenience of the reader, this Quarterly Report on Form 10-Q/A sets forth the Original Filing in its entirety. Other than, as described above and as indicated in Note 7, “Subsequent Events”, none of the other disclosures in the Original Filing have been amended or updated. Among other things, forward-looking statements made in the Original Filing have not been revised to reflect events that occurred or facts that became known to the Company after the filing of the Original Filing, and such forward-looking statements should be read in their historical context. Accordingly, this Quarterly Report on Form 10-Q/A should be read in conjunction with the Company's filings with the Securities and Exchange Commission subsequent to the Original Filing.

SMART ONLINE, INC.

FORM 10-Q/A
For the Quarterly Period Ended June 30, 2009

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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements

SMART ONLINE, INC.
BALANCE SHEETS

| | June 30, 2009 (unaudited) (Restated) | December 31, 2008 (Restated) |
|---|---|---|
| ASSETS | | |
| Current Assets: | | |
| Cash and Cash Equivalents | $ 32,712 | $ 18,602 |
| Accounts Receivable, Net | 27,842 | 184,930 |
| Note Receivable | - | 60,000 |
| Prepaid Expenses | 230,377 | 289,372 |
| Total current assets | 290,931 | 552,904 |
| Property and equipment, net | 287,703 | 365,993 |
| Capitalized software, net | 474,044 | 261,221 |
| Note Receivable, non-current | - | 372,317 |
| Prepaid expenses, non-current | 184,500 | 258,301 |
| Intangible assets, net | 471,252 | 1,180,245 |
| Other assets | 2,088 | 1,736 |
| TOTAL ASSETS | $ 1,710,518 | $ 2,992,717 |
| LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT) | | |
| Current liabilities | | |
| Accounts payable | $ 868,582 | $ 398,237 |
| Notes payable (See Note 3) | 1,922,291 | 2,341,177 |
| Deferred revenue (See Note 2) | 252,816 | 323,976 |
| Accrued liabilities (See Note 2) | 495,683 | 478,917 |
| Total current liabilities | 3,539,372 | 3,542,307 |
| Long-term liabilities: | | |
| Long-term portion of notes payable (See Note 3) | 7,312,609 | 5,327,211 |
| Deferred revenue (See Note 2) | 49,992 | 67,353 |
| Total long-term liabilities | 7,362,601 | 5,394,564 |
| Total liabilities | 10,901,973 | 8,936,871 |
| Commitments and contingencies (See Note 7) | | |
| Stockholders' equity (deficit): | | |
| Preferred stock, 0.001 par value, 5,000,000 shares authorozed, no shares issued and outstanding at June 30, 2009 and December 31, 2008 | | |
| Common Stock, $.001 par value, 45,000,000 shares authorized, 18,332,543 and 18,333,601 shares Issued and Outstanding at June 30, 2009 and December 31, 2008 respectively. | 18,333 | 18,334 |
| Additional paid-in capital | 67,026,977 | 66,945,588 |
| Accumulated deficit | (76,236,765) | (72,908,076) |
| Total Stockholders’ Equity (Deficit) | (9,191,455) | (5,944,154) |
| TOTAL LIABILITIES AND STOCKHOLDERS’ EQUITY (DEFICIT) | $ 1,710,518 | $ 2,992,717 |

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

SMART ONLINE, INC.
STATEMENTS OF OPERATIONS (unaudited)

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | June 30, 2009 (Restated) | June 30, 2008 (Restated | June 30, 2009 (Restated) | June 30, 2008 (Restated) |
| REVENUES: | (Re | | | |
| Subscription fees | $ 209,819 | $ 464,456 | $ 451,603 | $ 943,797 |
| Professional service fees | 79,726 | 932,444 | 198,499 | 1,436,527 |
| License fees | 11,250 | 3,750 | 22,500 | 103,750 |
| Hosting fees | 33,045 | 36,196 | 105,255 | 95,678 |
| Other revenue | 36,806 | 36,173 | 74,477 | 76,932 |
| Total revenues | 370,646 | 1,473,019 | 852,334 | 2,656,684 |
| | | | | |
| COST OF REVENUES | 202,333 | 647,528 | 694,934 | 1,359,195 |
| | | | | |
| GROSS PROFIT | 168,313 | 852,491 | 157,400 | 1,297,489 |
| | | | | |
| OPERATING EXPENSES: | | | | |
| General and administrative | 862,050 | 1,002,080 | 1,757,640 | 2,245,353 |
| Sales and marketing | 216,779 | 489,651 | 516,321 | 921,378 |
| Research and development | 226,950 | 458,409 | 503,826 | 910,533 |
| (Gain )loss on impairment of assets, net | 438,228 | - | 438,228 | - |
| | | | | |
| Total operating expenses | 1,744,007 | 1,950,140 | 3,216,015 | 4.077,264 |
| | | | | |
| LOSS FROM OPERATIONS | (1,575,694) | (1,124,649) | (3,058,615) | (2,779,775) |
| | | | | |
| OTHER INCOME (EXPENSE): | | | | |
| Interest expense, net | (158,343) | (190,922) | (286,342) | (369,236) |
| Gain on legal settlements, net | - | - | 6,000 | - |
| Other Income | - | 13,512 | 10,267 | 16,069 |
| Total other expense | (158,343) | (177,410) | (270,075) | (353,167) |
| | | | | |
| NET LOSS | $ (1,734,037 ) | $ (1,302,059) | $ (3,328,690) | $ (3,132,942) |
| | | | | |
| NET LOSS PER COMMON SHARE: | | | | |
| Basic and fully diluted | $ (0.09) | $ (0.08) | $ (0.18) | $ (0.19) |
| WEIGHTED-AVERAGE NUMBER OF SHARES USED IN COMPUTING NET LOSS PER COMMON SHARE | | | | |
| Basic and fully diluted | 18,332,765 | 17,252,639 | 18,333,140 | 16,728,010 |

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

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

| | Three Months Ended June 30, 2009 | Three Months Ended June 30, 2008 | Six Months Ended June 30, 2009 | Six Months Ended June 30, 2008 |
|---|---|---|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | | | |
| Net Loss | $ (1,734,037) | $ (1,302,059) | $ (3,328,690) | $ (3,132,942) |
| Adjustments to reconcile let loss to net cash used in operating activities: | | | | |
| Depreciation and amortization | 164,237 | 207,893 | 328,525 | 415,523 |
| Amortization of deferred financing costs | - | 112,971 | - | 225,942 |
| Bad debt expense | 197,929 | 9,532 | 421,922 | 45,000 |
| Stock-based compensation expense | 29,339 | 89,645 | 82,483 | 260,144 |
| Loss on impairment of intangible assets | 438,228 | - | 438,228 | - |
| Gain on disposal of assets | - | - | (10,267) | (2,665) |
| Changes in assets and liabilities: | | | | |
| Accounts receivable | 129,548 | (474,056) | 173,983 | (452,207) |
| Notes receivable | (1,417,331) | - | (1,420,581) | - |
| Costs in excess of billings | - | (60,437) | - | (60,437) |
| Prepaid expenses | 53,240 | 2,645 | 132,796 | (38,113) |
| Other assets | 900 | 10,560 | (351) | 25,560 |
| Deferred revenue | (40,571) | 85,014 | (88,522) | (4,262) |
| Accounts payable | 1,874,010 | (65,938) | 1,884,427 | (150,363) |
| Accrued and other expenses | (180,976) | (112,874) | 15,672 | 28,517 |
| Net cash used in operating activities | (485,484) | (1,497,104) | (1,370,375) | (2,840,303) |
| | | | | |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | | | |
| Purchases of furniture and equipment | - | (52,363) | (14,565) | (61,800) |
| Capitalized software | (98,745) | - | (212,824) | - |
| Proceeds from sale of furniture and equipment | - | - | 45,361 | 12,500 |
| Net Cash used in Investing Activities | (98,745) | (52,363) | (182,028) | (49,300) |
| | | | | |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | | | |
| Repayments on notes payable | (1,797,216) | (2,461) | (3,734,867) | (2,284,526) |
| Debt borrowings | 2,375,868 | 1,383,215 | 5,301,379 | 1,883,215 |
| Net cash provided by (used in) financing activities | 578,652 | 1,380,754 | 1,566,512 | (401,311) |
| | | | | |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | (5,577) | (168,713) | 14,110 | (3,290,914) |
| CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD | 38,289 | 351,758 | 18,602 | 3,473,959 |
| CASH AND CASH EQUIVALENTS, END OF PERIOD | $ 32,712 | $ 183,045 | $ 32,712 | $ 183,045 |
| | | | | |
| Supplemental disclosures of cash flow information: | | | | |
| Cash paid during the period for: | | | | |
| Interest | $ 46,068 | $ 190,215 | $ 173,818 | $ 383,064 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Taxes | $ | - | $ | 17,350 | $ | 10 | $ | 35,370 |
| Supplemental schedule of non-cash financing activities: | | | | | | | | |
| Conversion of debt to equity | $ | - | $ | - | $ | - | $ | 228,546 |

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

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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 (One Biz™) 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 six months ended June 30, 2009 and 2008 included in this Quarterly Report on Form 10-Q/A are unaudited. The balance sheet as of December 31, 2008 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, 2008 filed with the Securities and Exchange Commission (the “SEC”) on March 30, 2009 (the “2008 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/A include all normal and recurring adjustments necessary for the fair presentation of the Company’s statement of financial position as of June 30, 2009, and its results of operations and cash flows for the three and six months ended June 30, 2009 and 2008. The results for the three and six months ended June 30, 2009 are not necessarily indicative of the results to be expected for the fiscal year ending December 31, 2009.

The accompanying financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. During the three and six months ended June 30, 2009 and 2008, 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 2008 Annual Report), and had deficiencies in working capital. These factors indicate that the Company may be unable to continue as a going concern.

The financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or the amounts or classification of liabilities that might be necessary should the Company be unable to continue as a going concern. At August 10, 2009, the Company does have a commitment from its convertible secured subordinated noteholders to purchase up to an additional $8.5 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 $8.5 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 future plans include the introduction of its new One Biz™ platform, 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 six months ended June 30, 2009 are consistent with those used for the year ended December 31, 2008. Accordingly, please refer to the 2008 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 - US 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.

Principles of Consolidation - The accompanying financial statements for the three and six months ended June 30, 2008 include the accounts of the Company and its former wholly owned subsidiaries, Smart CRM, Inc. ("Smart CRM") and Smart Commerce, Inc. ("Smart Commerce"). All significant intercompany accounts and transactions have been eliminated. Subsidiary accounts are included only from the date of acquisition forward. On December 31, 2008, each of Smart CRM and Smart Commerce were merged into the Company.

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 the second quarter of 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. During the third quarter of 2008, this 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 in the third quarter of 2007 that called for contractual payments against a note receivable upon delivery and acceptance of a custom application. The Company and the customer are currently in discussions with respect to whether the application was delivered as per the specifications, and the customer has not commenced payment subject to the outcome of these discussions.

Based on these criteria, management determined that at June 30, 2009, an allowance for doubtful accounts of $850,080 was required, comprising the full outstanding balance of the direct-selling organization customer's account and contract receivable and one half of the real estate services customer's note receivable.

Intangible Assets - Intangible assets consist primarily of assets obtained through the acquisitions of Computility, Inc. ("Computility") and iMart Incorporated ("iMart") in 2005 and include customer bases, acquired technology, non-compete agreements, trademarks, and trade names. The Company also owns several copyrights and trademarks related to products, names, and logos used throughout its non-acquired product lines. All assets are amortized on a straight-line basis over their estimated useful lives with the exception of the iMart trade name, which is deemed by management to have an indefinite life and is not amortized. During the three month period ending June 30, 2009, we impaired the value of a portion of the customer base intangible asset due to the fact that the Company is no longer doing business with the customer.

Revenue Recognition - The Company derives revenue primarily from subscription fees charged to customers accessing its 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 the Company licenses, sells, leases, or otherwise markets computer software, it uses the residual method pursuant to US 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 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. collection 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 and custom software development 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. The Company typically has a revenue-share arrangement with these marketing partners in order to encourage them to market the Company's 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 the net income.

Because its customers generally do not have the contractual right to take possession of the software it licenses or markets at any time, the Company recognizes revenue on hosting and maintenance fees as the services are provided in accordance with US GAAP provisions relating to 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.

Stock-Based Compensation - The Company adopted US GAAP provisions related to share-based payments which require companies to expense the value of employee stock options, restricted stock, and similar awards and apply to all such securities outstanding and vested. Total stock-based compensation expense recognized under US GAAP provisions during the three and six months ended June 30, 2009 was approximately $29,339 and $82,483 respectively of which $20,937 and $47,499 related to the issuance of restricted stock and $8,402 and $34,984 was expense associated with stock options for the respective three and six month period. Total stock-based compensation expense during the three and six months ended June 30, 2008 was approximately $89,645 and $260,144 respectively, of which $62,703 and $184,940 related to the issuance of restricted stock and $26,942 and $75,204 was expense associated with stock options for the respective periods. No stock-based compensation was capitalized in the 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, expected remaining lives of the awards, and forfeiture rate. The forfeiture rate is the estimated percentage of equity grants that are expected to be forfeited or cancelled on an annual basis before becoming fully vested. The Company estimates pre-vesting forfeiture rates at the time of grant based on historical data and revises those estimates in subsequent periods if actual forfeitures differ from those estimates, with the cumulative effect on current and prior periods of such changes recognized in compensation cost in the period of the change. The Company records stock-based compensation expense only for those awards that are expected to vest, amortized on a straight-line basis over the requisite service periods of the awards, which are generally the vesting periods. The assumptions used in calculating the fair value of share-based payment awards, including if the Company's actual forfeiture rate is materially different from what the Company has recorded in the current period, 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.

The fair value of option grants under the Company's equity compensation plan during the three and six months ended June 30, 2009 and 2008 were estimated using the following weighted average assumptions:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2009 | 2008 | 2009 | 2008 |
| Dividend yield | 0.0% | 0.0% | 0.0% | 0.0% |
| Expected volatility | 102.1% | 40.0% | 101.28% | 50.0% |
| Risk free interest rate | 2.54% | 4.45% | 2.29% | 4.55% |
| Expected lives (years) | 3 | 4 | 3 | 5 |

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 1,796,535 and 1,704,500 on June 30, 2009 and 2008, respectively, were excluded from the calculation of common equivalent shares, as the impact was anti-dilutive.

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 disclosures.

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 July 2008, the Company entered into a 36-month sublease agreement for approximately 9,837 square feet of office space in Durham, North Carolina located near Research Triangle Park 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 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 June 30, 2009:

| Asset Category | Value Assigned | Residual Value | Weighted Average Amortization Period (in Years) | Accumulated Amortization | Carrying Value |
|---|---|---|---|---|---|
| Customer base | $ 1,012,421 | $ - | 6.2 | $ 750,845 | $ 261,576 |
| Acquired technology | 501,264 | - | 3.0 | 501,264 | - |
| Non-compete agreements | 801,785 | - | 4.0 | 743,322 | 58,463 |
| Trademarks and copyrights | 52,372 | - | 9.7 | 51,159 | 1,213 |
| Trade name | 150,000 | N/A | N/A | N/A | 150,000 |
| Totals | $ 2,517,842 | $ - | | $ 2,046,590 | $ 471,252 |

Intangible assets acquired were valued using the standard of "fair value" defined in SFAS No. 141, 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." Copyrights and trademarks were capitalized using the costs of all legal and application fees incurred.

We restated the value of the iMart trade name as of December 31, 2008, as presented in the Form 10-K filed for the year ended December 31, 2009, because of a recalculation of the net royalty method of valuation. The restatement caused an increase in the amount of loss on impairment of intangible assets for the year ended December 31, 2008 in the amount of $230,000 and resulted in a like reduction of the value of the trade name intangible asset.

Accrued Liabilities

At June 30, 2009, the Company had accrued liabilities totaling $495,683. This amount consisted primarily of $117,102 of liability related to the development of the Company's custom accounting application; $24,561 for tax-related liabilities associated with the vesting of restricted stock; $79,590 of estimated loss on a customer contract; $58,351 for accrued payroll; $189,662 of convertible note interest payable and $26,417 of other liabilities.

At December 31, 2008, the Company had accrued liabilities totaling $478,917. This amount consisted primarily of $117,102 of liability related to the development of the Company's custom accounting application; $137,500 related to legal reserves; $30,198 for tax-related liabilities associated with the vesting of restricted stock; $30,903 of estimated loss on a long-term customer contract; $79,300 of cash collected through the Company's merchant account on behalf of a customer; and $54,467 of convertible note interest payable and other liabilities of $29,447.

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 e-mail accounts.

- License fees – Licensing revenue where customers did not meet all the criteria of US GAAP. Such deferred revenue is recognized when delivery has occurred or collectability becomes probable.

- Professional service fees – A customer that purchased a license and paid professional service fees during 2008 and 2007 to develop a customized application decided in the latter part of 2008 to move the application to the Company's new technology platform. In connection with this new arrangement, the customer desires customization beyond the original scope of the project and will also be responsible for a monthly fee to maintain the application starting in

October 2009. This deferred revenue represents the difference between earned fees and unearned license and professional service fees to be recognized as professional service fees revenue in 2009.

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

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| | | June 30, 2009 | | December 31, 2008 |
|---|---|---|---|---|
| Subscription fees | $ | 69,258 | $ | 89,852 |
| License fees | | 86,250 | | 108,750 |
| Professional service fees | | 147,300 | | 192,727 |
| Totals | $ | 302,808 | $ | 391,329 |
| | | | | |
| Current portion | $ | 252,816 | $ | 323,976 |
| Non-current portion | | 49,992 | | 67,353 |
| Totals | $ | 302,808 | $ | 391,329 |

3. NOTES PAYABLE

Convertible Notes

As of June 30, 2009, the Company had $7.3 million aggregate principal amount of convertible secured subordinated notes due November 14, 2010 (the "notes") outstanding. On November 14, 2007, in an initial closing, the Company sold $3.3 million aggregate principal amount of notes (the "Initial Notes"). In addition, the noteholders committed to purchase on a pro rata basis up to $5.2 million aggregate principal amount of notes in future closings upon approval and call by the Company's Board of Directors. On August 12, 2008, the Company exercised its option to sell $1.5 million aggregate principal amount of notes with substantially the same terms and conditions as the Initial Notes (the "Additional 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, the Company sold $500,000 aggregate principal amount of notes (the "New Notes") to two new investors with substantially the same terms and conditions as the previously outstanding notes.

On each of January 6, 2009, February 24, 2009, April 3, 2009, and June 2, 2009 the Company sold $500,000 aggregate principal amount of notes (total $2,000,000) to a current noteholder with substantially the same terms and conditions as the previously outstanding notes.

On July 16, 2009, the Company sold a $250,000 principal amount note to a current noteholder with substantially the same terms and conditions as the previously outstanding notes.

Also 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 the earlier of November 14, 2010 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 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,

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, who subsequently served as Chairman of the Company’s Board of Directors and Interim President and Chief Executive Officer from December 9, 2008 until May 19, 2009, and 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 investors in the Additional Notes are Atlas and Crystal. The investors in the New Notes are not affiliated with the Company. Atlas purchased the notes issued in 2009.

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.

Lines of Credit

On November 14, 2006, the Company entered into a revolving credit arrangement with Wachovia Bank, NA (“Wachovia”) for $1.3 million to be used for general working capital. Any advances made on the line of credit were to be paid off no later than August 1, 2007, with monthly payments of accrued interest on any outstanding balance commencing on December 1, 2006. The interest accrued on the unpaid principal balance at the LIBOR Market Index

Rate plus 0.9%. The line of credit was secured by the Company's deposit account at Wachovia and an irrevocable standby letter of credit in the amount of $1.3 million issued by HSBC Private Bank (Suisse) SA ("HSBC") with Atlas, a current stockholder, as account party.

On January 24, 2007, the Company entered into an amendment to its line of credit with Wachovia to increase the available principal from $1.3 million to $2.5 million and to extend the maturity date from August 1, 2007 to August 1, 2008. The amended line of credit was secured by the Company's deposit account at Wachovia and a modified irrevocable standby letter of credit in the amount of $2.5 million issued by HSBC with Atlas as account party. On February 15, 2008, the Company repaid the full outstanding principal balance of $2,052,000 and accrued interest of $2,890.

On February 20, 2008, the Company entered into a revolving credit arrangement with Paragon Commercial Bank ("Paragon") that is renewable on an annual basis subject to mutual approval. The line of credit advanced by Paragon is $2.47 million and can 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. The interest accrued 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 with Atlas as account party that expires 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 the Company, 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 must be paid off no later than February 11, 2010. Interest shall accrue on the unpaid principal balance at the Wall Street Journal's published Prime Rate, but at no time shall the interest rate be less than 5.5%. As of August 10, 2009, the Company had an outstanding balance of $2.16 million under the line of credit.

As of June 30, 2009, the Company had notes payable totaling $9,234,900. The detail of these notes is as follows:

| Note Description | Short-Term Portion | Long-Term Portion | Total | Maturity | Rate |
|---|---|---|---|---|---|
| Paragon Commercial Bank credit line | $ 1,894,076 | $ 0 | $ 1,894,076 | Feb 2010 | Prime, not less than 5.5 % |
| Insurance premium note | 0 | 0 | 0 | Jul 2009 | 6.1% |
| Various capital leases | 28,215 | 12,609 | 40,824 | Various | 10.7-18.9% |
| Convertible notes | - | 7,300,000 | 7,300,000 | Nov 2010 | 8.0% |
| Totals | $ 1,922,291 | $ 7,312,609 | $ 9,234,900 | | |

## 4. COMMITMENTS AND CONTINGENCIES

### Lease Commitments

The Company leases computer and office equipment under capital lease agreements that expire through July 2011. Total amounts financed under these capital leases were $40,824 and $53,517 at June 30, 2009 and December 31, 2008, respectively, net of accumulated amortization of $27,806 and $18,647, 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 June 30, 2009 and December 31, 2008. See also Note 3, "Notes Payable."

In 2008, the Company entered into a non-cancelable sublease 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, "Balance Sheet Accounts," 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 has a non-cancelable lease through October 2009 for an apartment near its headquarters that is utilized by its out of town executives and members of its Board of Directors. As of June 30, 2009, future annual minimum operating lease payments for 2009 are $7,980.

Rent expense for the six months ended June 30, 2009 and 2008 was $87,727 and $76,947 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 June 30, 2009, the Company had paid $470,834 and issued 3,473 shares of common stock related to this obligation.

Legal Proceedings

As previously reported in the Company's Form 8-K filed on June 4, 2009, Dennis Michael Nouri and Reza Eric Nouri (together, the "Nouris"), a former officer and employee of the Company, respectively, filed a complaint (the "Nouri Complaint") to bring a summary proceeding against the Company in the Court of Chancery of the State of Delaware. The Nouri Complaint sought to compel the Company to advance legal fees and costs in the amount of $826,798 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, together with future verified expenses that will be incurred by the Nouris in defending the actions against them and the expenses incurred by the Nouris in prosecuting the advancement action against the Company.

On July 29, 2009, the Court of Chancery granted summary judgment of the Nouri Complaint in favor of the Nouris. By order dated August 6, 2009, the Company is obligated to pay to the Nouris $826,798 in advanced expenses for legal services performed by counsel to the Nouris through April 2009. The total amount of the legal fees the Company will ultimately be required to advance to the Nouris is expected to be in excess of $1.9 million. Though the Nouris have entered into an undertaking that requires them to repay to the Company any amounts advanced by it in the event the Nouris are ultimately determined not to be entitled to indemnification for the expenses incurred, it is uncertain at this time that the Company will be able to recover such amounts advanced without considerable expense to the Company, or whether the Company will be able to recover any of the amounts advanced at all.

Please refer to Part I, Item 3 of our Annual Report on Form 10-K for the fiscal year ended December 31, 2008 for a further description of material legal proceedings.

5. STOCKHOLDERS' EQUITY

Preferred Stock

The Board of Directors is authorized, without further stockholder approval, to issue up to 5,000,000 shares of $0.001 par value preferred stock in one or more series and to fix the rights, preferences, privileges, and restrictions applicable to such shares, including dividend rights, conversion rights, terms of redemption, and liquidation preferences, and to fix the number of shares constituting any series and the designations of such series. There were no shares of preferred stock outstanding at June 30, 2009.

Common Stock

The Company is authorized to issue 45,000,000 shares of common stock, $0.001 par value per share. As of June 30, 2009, it had 18,332,543 shares of common stock outstanding. Holders of common stock are entitled to one vote for each share held.

In January 2008, the Company issued 28,230 shares of common stock to a consulting firm as full payment of the outstanding obligation related to fees accrued for services rendered in conjunction with the 2005 acquisitions of iMart and Computility.

Warrants

As incentive to modify a letter of credit relating to the Wachovia line of credit (see Note 3, “Notes Payable”), 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 the amount of $37,657 per month over the remaining period of the modified line of credit, which expired on August 2008. As of December 31, 2007, the deferred financing costs to be amortized to interest expense over the remaining eight months, or $301,249, were classified as current assets. 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.

Under a Securities Purchase Agreement with two investors entered in connection with a 2007 private placement of the Company’s common stock, the investors were issued warrants for the purchase of an aggregate of 1,176,471 shares of common stock at an exercise price of $3.00 per share. These warrants contain a provision for cashless exercise and must be exercised by February 21, 2010.

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 June 30, 2009, 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 first and second quarters of 2009, no shares of restricted stock were issued. A total of 479 shares of restricted stock were canceled during the first two quarters of 2009 due to terminations and payment of employee tax obligations resulting from share vesting. At June 30, 2009, there remains $35,207 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 June 30, 2009:

| | Shares | Weighted Average Exercise Price |
|---|---|---|
| BALANCE, December 31, 2008 | 271,250 | $ 5.89 |
| Granted | 40,000 | 1.10 |
| Exercised | - | - |
| Canceled | (53,550) | 5.75 |
| BALANCE, June 30, 2009 | 257,700 | $ 4.84 |

The following table summarizes information about stock options outstanding at June 30, 2009:

| | | | | Currently Exercisable | |
|---|---|---|---|---|---|
| Exercise Price | Number of Options Outstanding | Average Remaining Contractual Life (Years) | Weighted Average Exercise Price | Number of Shares | Weighted Average Exercise Price |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| $1.10 | 40,000 | 1.0 | $ | 1.10 | - | $ | - |
| From $2.50 to $3.50 | 85,000 | 6.3 | $ | 3.15 | 75,000 | $ | 3.14 |
| $5.00 | 25,000 | 6.0 | $ | 5.00 | 15,000 | $ | 5.00 |
| $7.00 | 75,000 | 0.0 | $ | 7.00 | 75,000 | $ | 7.00 |
| From $8.61 to $9.00 | 32,500 | 6.5 | $ | 8.73 | 19,500 | $ | 8.73 |
| $9.60 | 200 | 6.5 | $ | 9.60 | 120 | $ | 9.60 |
| Totals | 257,700 | 3.6 | $ | 4.84 | 184,620 | $ | 5.46 |

At June 30, 2009, there remains $35,767 of unvested expense yet to be recorded related to all options outstanding.

Dividends - The Company has not paid any cash dividends through June 30, 2009.

6. MAJOR CUSTOMERS AND CONCENTRATION OF CREDIT RISK

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

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

| | | Three Months Ended June 30, 2009 | |
|---|---|---|---|
| | Revenue Type | Revenues (Restated) | % of Total Revenues (Restated) |
| Customer A | Subscription fees | $ 109,521 | 30% |
| Customer B | Professional service fees | 73,049 | 20% |
| Customer C | Subscription fees | 92,216 | 25% |
| Others | Various | 95,860 | 25% |
| Total | | $ 370,646 | 100% |

| | | Three Months Ended June 30, 2008 | |
|---|---|---|---|
| | Revenue Type | Revenues (Restated) | % of Total Revenues (Restated) |
| Customer B | Professional service fees | 401,805 | 27% |
| Customer C | Subscription fees | 307,913 | 21% |
| Customer D | Professional service fees | 182,068 | 12% |
| Customer E | Professional service fees | 348,750 | 24 |
| Others | Various | 232,483 | 16% |
| Total | | $ 1,473,019 | 100% |

| | | Six Months Ended June 30, 2009 | |
|---|---|---|---|
| | Revenue Type | Revenues (Restated) | % of Total Revenues (Restated) |
| Customer A | Subscription fees | $ 215,815 | 25% |
| Customer B | Professional service fees | 229,749 | 27% |
| Customer C | Subscription fees | 217,719 | 26% |
| Others | Various | 189,051 | 22% |
| Total | | $ 852,334 | 100% |

| | Revenue Type | Six Months Ended June 30, 2008 Revenues (Restated) | % of Total Revenues (Restated) |
|---|---|---|---|
| Customer B | Professional service fees | 784,996 | 30% |
| Customer C | Subscription fees | 669,003 | 26% |
| Customer D | Professional service fees | 398,351 | 15% |
| Customer E | Professional service fees | 348,750 | 13% |
| Others | Various | 455,584 | 16% |
| Total | | $ 2,656,684 | 100% |

As of June 30, 2009, one customer accounted for 80% of accounts receivable. As of December 31, 2008, one customer accounted for 93% of accounts receivable.

7. SUBSEQUENT EVENTS

The information for this section has been updated through November 15, 2010.

The Company sold convertible secured subordinated notes as follows:

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

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 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.

To fill a vacancy in the Board, the members of the Board unanimously appointed Amir Elbaz as a director of the Company, effective January 15, 2010, to serve until his successor is duly elected and qualified.

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

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.

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 have indicated that Advantis has 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 the 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.

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 2010.

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.

Once approved, 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 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 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Information set forth in this Quarterly Report on Form 10-Q/A 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," 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/A, 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, 2008. 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

Through our OneBiz™ platform, 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 reach small businesses primarily through arrangements with channel partners that private label our software applications and market them to their customer bases through their corporate websites. 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.

In the second half of 2007, we commenced an overall evaluation of our business model as well as our current technologies, the outcome of which was our decision to develop a core industry-standard platform for small business with an architecture designed to integrate with a virtually unlimited number of other applications, services, and existing infrastructures. These applications would include not only our own small-business applications, which we are currently optimizing, 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 in the small-business segment to leverage social networking and community building. We are currently refining and integrating these capabilities into the core platform in an effort to meet any anticipated customer need. We believe that, but cannot assure this platform and associated applications will provide opportunities for new sources of revenue, including an increase in our subscription fees. As we near completion of the development of our industry-standard platform, as evidenced by the release of OneBiz™ 1.1, we have begun increasing our focus on the sales and marketing of the new platform.

In light of our new operating strategy involving the industry-standard platform, the consolidation of all operations into our North Carolina headquarters, and other factors including certain income tax advantages, we concluded in the latter part of 2008 that it was no longer necessary to operate with the Smart Commerce, Inc. and Smart CRM, Inc. subsidiaries. As a result, an upstream merger was completed as of December 31, 2008 that merged the subsidiaries with the parent corporation.

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

On July 14, 2009, we launched our new industry-standard platform (OneBiz™ 1.1) that contains relevant applications targeted to small businesses, and we are devoting resources to the sale and marketing of these SaaS based applications 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 2009 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 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 don’t 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 2009, 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 2009 as part of the objectives identified by current management. However, we may be obligated to pay a material amount of indemnification costs in 2009 related to the previously reported Securities and Exchange Commission, or SEC, litigation against certain former officers and directors described in detail in Part I, Item 3, "Legal Proceedings," in our Annual Report on Form 10-K for the year ended December 31, 2008 and in item 4. 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. These charges have been significant and are reflected in our historical financial results. Effective January 1, 2006, we adopted provisions of US GAAP which resulted and will continue to result in material costs on a prospective basis as long as a significant number of options are outstanding. 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 US GAAP. 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 regarding 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 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 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.

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 or second quarter of 2009, or in 2008 and 2007, 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.

Results of Operations for the Three Months Ended June 30, 2009 and June 30, 2008

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

| | Three Months Ended June 30, 2009 | Three Months Ended June 30, 2008 |
|---|---|---|

| | Dollars (Restated) | % of Revenue (Restated) | Dollars (Restated) | % of Revenue (Restated) |
|---|---|---|---|---|
| Total revenues | $ 370,646 | 100.0% | $ 1,473,019 | 100.0% |
| Cost of revenues | 202,333 | 54.6% | 647,528 | 44.0% |
| | | | | |
| Gross profit | $ 168,313 | 45.4% | $ 852,491 | 56.0% |
| | | | | |
| Operating expenses | 1,744,007 | 470.5% | 1,950,140 | 132.4% |
| | | | | |
| Loss from operations | $ (1,575,694) | -425.1% | $ (1,124,649) | -76.4% |
| | | | | |
| Other income (expense), net | (158,343) | -42.7% | (177,410) | -12.0% |
| | | | | |
| Net loss | $ (1,734,037) | -467.8% | $ (1,302,059) | -88.4% |
| | | | | |
| Net loss per common share | $ (0.07) | | $ (0.07) | |

Revenues

Revenues for the three months ended June 30, 2009 and 2008 comprise the following:

| | Three Months Ended June 30, | | Change | |
|---|---|---|---|---|
| | 2009 (Restated) | 2008 (Restated) | Dollars (Restated) | Percent (Restated) |
| Subscription fees | $ 209,819 | $ 464,456 | $ (254,637) | -54.8% |
| Professional service fees | 79,726 | 932,444 | (852,718) | -91.4% |
| License fees | 11,250 | 3,750 | 7,500 | 200.0% |
| Hosting fees | 33,045 | 36,196 | (3,151) | -8.7% |
| Other revenue | 36,806 | 36,173 | 633 | 1.7% |
| Total revenues | $ 370,646 | $ 1,473,019 | $ (1,102,373) | -74.8% |

Revenues decreased 74.8% to $370,646 for the three months ended June 30, 2009 from $1,473,019 for the same period in 2008. Our overall decrease in revenues was driven by substantial declines in subscription fees, professional service fees, and license fees. Select items are discussed in detail below.

Subscription Fees

Revenues from subscription fees for the three months ended June 30, 2009 and 2008 are as follows:

| | Three Months Ended June 30, | | Change | |
|---|---|---|---|---|
| | 2009 (Restated) | 2008 (Restated) | Dollars (Restated) | Percent (Restated) |
| Subscription fees | $ 209,819 | $ 464,456 | $ (254,637) | -54.8% |
| Percent of total revenues | 56.6% | 31.5% | | |

Revenues from subscription fees decreased 54.8% to $209,819 for the three months ended June 30, 2009 from $464,456 for the same period in 2008. This decline is primarily attributable to the ongoing migration of one direct-selling organization customer to its own technology solution that has resulted in a continuous decline in subscription fees.

Professional Service Fees

Revenues from professional service fees for the three months ended June 30, 2009 and 2008 are as follows:

| | Three Months Ended June 30, | | Change | |
|---|---|---|---|---|
| | 2009 (Restated) | 2008 (Restated) | Dollars (Restated) | Percent (Restated) |
| Professional service fees | $ 79,726 | $ 932,444 | $ (852,718) | -91.4% |
| Percent of total revenues | 21.5% | 63.3% | | |

Revenues from professional service fees decreased 91% to $79,726 for the three months ended June 30, 2009 from $932,444 for the same period in 2008. This decrease is primarily due to a significant decline in web consulting services provided to customers during the second quarter of 2009.

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License Fees

Revenues from license fees for the three months ended June 30, 2009 and 2008 are as follows:

| | Three Months Ended June 30, | | Change | |
|---|---|---|---|---|
| | 2009 (Restated) | 2008 (Restated) | Dollars (Restated) | Percent (Restated) |
| License fees | $ 11,250 | $ 3,750 | $ 7,500 | 200.0% |
| Percent of total revenues | 3.0% | .2% | | |

Revenues from license fees increased 200% to $11,250 for the three months ended June 30, 2009 from $3,750 for the same period in 2008. License fee revenue recognized in the second quarter of 2009 comprised the ratable recognition of a term license that commenced in June 2008. We expect that license fees will continue to represent a small percentage of our revenues in the future as we focus on increasing our subscription fees revenue derived from our SaaS applications.

Hosting Fees

Revenues from hosting fees for the three months ended June 30, 2009 and 2008 are as follows:

| | Three Months Ended June 30, | | Change | |
|---|---|---|---|---|
| | 2009 (Restated) | 2008 (Restated) | Dollars (Restated) | Percent (Restated) |
| Hosting fees | $ 33,045 | $ 36,196 | $ -3,151 | -8.7% |
| Percent of total revenues | 8.9% | 2.5% | | |

Revenues from hosting fees decreased 8.7% to $33,045 for the three months ended June 30, 2009 from $36,196 for the same period in 2008. This decrease is due to the reduction of services provided to clients.

Other Revenue

Revenues from other sources for the three months ended June 30, 2009 and 2008 are as follows:

| | Three Months Ended June 30, | | Change | |
|---|---|---|---|---|
| | 2009 (Restated) | 2008 (Restated) | Dollars (Restated) | Percent (Restated) |
| Other revenue | $ 36,806 | $ 36,173 | $ 633 | 1.7% |
| Percent of total revenues | 9.9% | 2.5% | | |

Revenues from non-core activities increased 1.7% to $36,806 for the three months ended June 30, 2009 from $36,173 for the same period in 2008. We expect these revenue streams to continue to be insignificant in the future as we focus on the growth of our subscription fees revenue.

Cost of Revenues

Cost of revenues for the three months ended June 30, 2009 and 2008 are as follows:

| | Three Months Ended June 30, | | Change | |
|---|---|---|---|---|
| | 2009 (Restated) | 2008 (Restated) | Dollars (Restated) | Percent (Restated) |
| Cost of revenues | $ 202,333 | $ 647,528 | $ (445,195) | -68.8% |
| Percent of total revenues | 54.6% | 44.0% | | |

Cost of revenues decreased 68.8% to $202,333 for the three months ended June 30, 2009 from $647,528 for the same period in 2008. This decrease is the result of lower professional services costs associated with professional service fees revenue, which is generally billed on a time and material basis. In addition, we have allocated lower amounts of development and general and administrative expenses as a result of an overall reduction in those areas.

Operating Expenses

Operating expenses for the three months ended June 30, 2009 and 2008 comprise the following:

| | Three Months Ended June 30, | | Change | |
|---|---|---|---|---|
| | 2009 (Restated) | 2008 (Restated) | Dollars (Restated) | Percent (Restated) |
| Sales and marketing | $ 216,779 | $ 489,651 | $ (272,872) | -55.7% |
| Research and development | 226,950 | 458,409 | (231,459) | -50.5% |
| General and administrative | 862,050 | 1,002,080 | (140,030) | -13.9% |
| Gain (loss) on impairment of assets, net | 438,228 | - | (438,228) | 100% |
| Total operating expenses | $ 1,744,007 | $ 1,950,140 | $ (206,133) | -10.6% |

Operating expenses decreased 10.6% to $1,744,007 for the three months ended June 30, 2009 from $1,950,140 for the same period in 2008. This decrease is the direct result of our concerted efforts during the latter part of 2008 and into 2009 to reduce operating expenses by improving efficiencies and eliminating unnecessary costs offset by the recognition of loss on the reevaluation of an intangible asset. Select items are discussed in detail below.

Sales and Marketing

Sales and marketing expenses for the three months ended June 30, 2009 and 2008 are as follows:

| | Three Months Ended June 30, | | Change | |
|---|---|---|---|---|
| | 2009 (Restated) | 2008 (Restated) | Dollars (Restated) | Percent (Restated) |
| Sales and marketing | $ 216,779 | $ 489,651 | $ (272,872) | -55.7% |
| Percent of total revenues | 58.5% | 33.2% | | |

Sales and marketing expenses decreased 55.7% to $216,779 for the three months ended June 30, 2009 from $489,651 for the same period in 2008. This variance is primarily attributable to reductions associated with revenue-sharing arrangements with our channel partners.

Research and Development

Research and development expenses for the three months ended June 30, 2009 and 2008 are as follows:

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| | Three Months Ended June 30, | | Change | |
|---|---|---|---|---|
| | 2009 (Restated) | 2008 (Restated) | Dollars (Restated) | Percent (Restated) |
| Research and development | $ 226,950 | $ 458,409 | $ (231,459) | -50.5% |
| Percent of total revenues | 61.2% | 31.1% | | |

Research and development expenses decreased 51% to $226,950 for the three months ended June 30, 2009 from $458,409 for the same period in 2008. This decrease is primarily attributable to a reduction in outside contractor fees incurred during the first quarter of 2008 as we worked on enhancing our business tools and applications that were not incurred in the first quarter of 2009.

General and Administrative

General and administrative expenses for the three months ended June 30, 2009 and 2008 are as follows:

| | Three Months Ended June 30, | | Change | |
|---|---|---|---|---|
| | 2009 (Restated) | 2008 (Restated) | Dollars (Restated) | Percent (Restated) |
| General and administrative | $ 862,050 | $ 1,002,080 | $ (140,030) | -13.9% |
| Percent of total revenues | 232.6% | 68.0% | | |

General and administrative expenses decreased 14% to $862,050 for the three months ended June 30, 2009 from $1,002,080 for the same period in 2008. This decrease is primarily attributable to reductions in personnel costs of $97,000; and $67,000 stock-based compensation expense resulting from employee turnover and a decrease in new equity grants; and $35,000 in rent due to closing of Michigan operations; and $30,000 in management consulting expenses; and $29,000 reduction in outside accounting and audit fees; $49,000 reduction in the amount of amortization of intangible costs. These decreases were offset in part by a net increase of $189,000 in bad debt expense on trade accounts and notes receivable.

Gain (loss) on disposal of assets, net

Gain (loss) on disposal of assets, net for the three months ended June 30, 2009 and 2008 are as follows:

| | Three Months Ended June 30, | | Change | |
|---|---|---|---|---|
| | 2009 (Restated) | 2008 (Restated) | Dollars (Restated) | Percent (Restated) |
| Gain (loss) on impairment of assets, net | $ (438,228) | $ - | $ (438,226) | -100% |
| Percent of total revenues | -118.2% | -% | | |

(Loss) on disposal of assets, net increased by 100% due to the reevaluation of certain intangibles assets as of June 30, 2009 and the determination that the intangible asset no longer had any remaining value.

Other Income (Expense)

Other income (expense) for the three months ended June 30, 2009 and 2008 comprise the following:

| | Three Months Ended June 30, | | Change | |
|---|---|---|---|---|
| | 2009 | 2008 | Dollars | Percent |
| Interest expense, net | $ (158,343) | $ (190,922) | $ (32,579) | -17% |
| Other income (expense) | - | 13,512 | (13,512) | -100% |
| Total other expense | $ (158,343) | $ (177,410) | $ (19,067) | -26% |

Net other expense decreased 26% to $158,343 for the three months ended June 30, 2009 from $177,410 for the same period in 2008. This net decrease was primarily attributable to the net reduction of interest expense at June 30, 2009.

Interest Expense, Net

Interest expense, net of interest income, for the three months ended June 30, 2009 and 2008 is as follows:

| | Three Months Ended June 30, | | Change | |
|---|---|---|---|---|
| | 2009 (Restated) | 2008 (Restated) | Dollars (Restated) | Percent (Restated) |
| Interest expense, net | $ 158,343 | $ 190,922 | $ (32,579) | -17.0% |
| Percent of total revenues | 42.7% | 12.9% | | |

Net interest expense decreased 17% to $158,343 for the three months ended June 30, 2009 from $190,922 for the same period in 2008. This decrease is primarily associated with the $113,000 of interest expense recognized in the second quarter of 2008 relating to the warrants issued to Atlas Capital SA, or Atlas, in connection with the extension of our line of credit with Wachovia Bank, NA, or Wachovia, that was fully amortized by the end of 2008, offset in part by an increase in convertible bond interest due to additional borrowings of $81,000.

Results of Operations for the Six Months Ended June 30, 2009 and June 30, 2008

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

| | Six Months Ended June 30, 2009 | | Six Months Ended June 30, 2008 | |
|---|---|---|---|---|
| | Dollars (Restated) | % of Revenue (Restated) | Dollars (Restated) | % of Revenue (Restated) |
| Total revenues | $ 852,334 | 100.0% | $ 2,656,684 | 100.0% |
| Cost of revenues | 694,934 | 81.5% | 1,359,195 | 51.2% |
| Gross profit | $ 157,400 | 18.5% | $ 1,297,489 | 48.8% |
| Operating expenses | 3,216,015 | 377.3% | 4,077,264 | 153.5% |
| Loss from operations | $ (3,058,615) | -358.8% | $ (2,779,775) | -104.7% |
| Other income (expense), net | (270,075) | -31.7% | (353,167) | -13.3% |
| Net loss | $ (3,328,690) | -390.5% | $ (3,132,942) | -118.0% |
| Net loss per common share | $ (0.17) | | $ (0.15) | |

Revenues

Revenues for the six months ended June 30, 2009 and 2008 comprise the following:

| | Six Months Ended June 30, | | Change | |
|---|---|---|---|---|
| | 2009 (Restated) | 2008 (Restated) | Dollars (Restated) | Percent (Restated) |
| Subscription fees | $ 451,603 | $ 943,797 | $ (492,194) | -52.2% |
| Professional service fees | 198,499 | 1,436,527 | (1,238,028) | -86.2% |
| License fees | 22,500 | 103,750 | (81,250) | -78.3% |
| Hosting fees | 105,255 | 95,678 | 9,577 | 10.0% |
| Other revenue | 74,477 | 76,932 | (2,455) | -3.2% |
| Total revenues | $ 852,334 | $ 2,656,684 | $ (1,804,350) | -67.9% |

Revenues decreased 67.9% to $852,334 for the six months ended June 30, 2009 from $2,656,684 for the same period in 2008. Our overall decrease in revenues was driven by substantial declines in subscription fees, professional service fees, and license fees. Select items are discussed in detail below.

Subscription Fees

Revenues from subscription fees for the six months ended June 30, 2009 and 2008 are as follows:

| | Six Months Ended June 30, | | Change | |
|---|---|---|---|---|
| | 2009 (Restated) | 2008 (Restated) | Dollars (Restated) | Percent (Restated) |
| Subscription fees | $ 451,603 | $ 943,797 | $ (492,194) | -52.2% |
| Percent of total revenues | 52.9% | 35.5% | | |

Revenues from subscription fees decreased 52.2% to $451,603 for the six months ended June 30, 2009 from $943,797 for the same period in 2008. This decline is primarily attributable to the ongoing migration of one direct-selling organization customer to its own technology solution that has resulted in a continuous decline in subscription fees.

Professional Service Fees

Revenues from professional service fees for the six months ended June 30, 2009 and 2008 are as follows:

| | Six Months Ended June 30, | | Change | |
|---|---|---|---|---|
| | 2009 (Restated) | 2008 (Restated) | Dollars (Restated) | Percent (Restated) |
| Professional service fees | $ 198,499 | $ 1,436,527 | $ (1,238,028) | -86.2% |
| Percent of total revenues | 23.3% | 54.1% | | |

Revenues from professional service fees decreased 86.2% to $198,499 for the six months ended June 30, 2009 from $1,436,527 for the same period in 2008. This decrease is primarily due to a significant decline in web consulting services provided to customers during the second quarter of 2009.

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License Fees

Revenues from license fees for the six months ended June 30, 2009 and 2008 are as follows:

| | Six Months Ended June 30, | | Change | |
|---|---|---|---|---|
| | 2009 (Restated) | 2008 (Restated) | Dollars (Restated) | Percent (Restated) |
| License fees | $ 22,500 | $ 103,750 | $ (81,250) | -78.3% |
| Percent of total revenues | 2.6% | 3.99% | | |

Revenues from license fees decreased 78.3% to $22,500 for the six months ended June 30, 2009 from $103,750 for the same period in 2008. License fee revenue recognized in the first and second quarter of 2009 comprised the ratable recognition of a term license that commenced in June 2008. We expect that license fees will continue to represent a small percentage of our revenues in the future as we focus on increasing our subscription fees revenue derived from our SaaS applications.

Hosting Fees

Revenues from hosting fees for the six months ended June 30, 2009 and 2008 are as follows:

| | Six Months Ended June 30, | | Change | |
|---|---|---|---|---|
| | 2009 (Restated) | 2008 (Restated) | Dollars (Restated) | Percent (Restated) |
| Hosting fees | $ 105,225 | $ 95,678 | $ 9,577 | 10.0% |
| Percent of total revenues | 12.4% | 3.6% | | |

Revenues from hosting fees increased 10% to $105,255 for the six months ended June 30, 2009 from $95,678 for the same period in 2008. This increase is due to the additional customer traffic for clients.

Other Revenue

Revenues from other sources for the six months ended June 30, 2009 and 2008 are as follows:

| | Six Months Ended June 30, | | Change | |
|---|---|---|---|---|
| | 2009 (Restated) | 2008 (Restated) | Dollars (Restated) | Percent (Restated) |
| Other revenue | $ 74,477 | $ 76,932 | $ (2,455) | -3.2% |
| Percent of total revenues | 8.7% | 2.9% | | |

Revenues from non-core activities decreased 3.2% to $74,477 for the six months ended June 30, 2009 from $76,932 for the same period in 2008. We expect these revenue streams to continue to be insignificant in the future as we focus on the growth of our subscription fees revenue.

Cost of Revenues

Cost of revenues for the six months ended June 30, 2009 and 2008 are as follows:

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| | Six Months Ended June 30, | | Change | |
|---|---|---|---|---|
| | 2009 (Restated) | 2008 (Restated) | Dollars (Restated) | Percent (Restated) |
| Cost of revenues | $ 694,934 | $ 1,359,195 | $ (664,261) | -48.9% |
| Percent of total revenues | 81.5% | 51.2% | | |

Cost of revenues decreased 48.9% to $694,934 for the six months ended June 30, 2009 from $1,359,195 for the same period in 2008. This decrease is the result of lower professional services costs associated with professional service fees revenue, which is generally billed on a time and material basis. In addition, we have allocated lower amounts of development and general and administrative expenses as a result of an overall reduction in those areas.

Operating Expenses

Operating expenses for the six months ended June 30, 2009 and 2008 comprise the following:

| | Six Months Ended June 30, | | Change | |
|---|---|---|---|---|
| | 2009 (Restated) | 2008 (Restated) | Dollars (Restated) | Percent (Restated) |
| Sales and marketing | $ 516,321 | $ 921,378 | $ (405,057) | -43.9% |
| Research and development | 503,826 | 910,533 | (406,707) | -44.7% |
| General and administrative | 1,757,640 | 2,245,353 | (487,713) | -21.7% |
| Gain (loss) on impairment of assets, net | 438,228 | - | 438,228 | -100 |
| Total operating expenses | $ 3,216,015 | $ 4,077,264 | $ (861,249) | -21.1% |

Operating expenses decreased 21.1% to $3,216,015 for the six months ended June 30, 2009 from $4,077,264 for the same period in 2008. This decrease is the direct result of our concerted efforts during the latter part of 2008 and into 2009 to reduce operating expenses by improving efficiencies and eliminating unnecessary costs offset by the recognition of loss on the reevaluation of an intangible asset. Select items are discussed in detail below.

Sales and Marketing

Sales and marketing expenses for the six months ended June 30, 2009 and 2008 are as follows:

| | Six Months Ended June 30, | | Change | |
|---|---|---|---|---|
| | 2009 (Restated) | 2008 (Restated) | Dollars (Restated) | Percent (Restated) |
| Sales and marketing | $ 516,321 | $ 921,378 | $ (405,057) | -44.0% |
| Percent of total revenues | 60.6% | 34.7% | | |

Sales and marketing expenses decreased 44% to $516,321 for the six months ended June 30, 2009 from $921,378 for the same period in 2008. This variance is primarily attributable to reductions associated with revenue-sharing arrangements with our channel partners.

Research and Development

Research and development expenses for the six months ended June 30, 2009 and 2008 are as follows:

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| | Six Months Ended June 30, | | Change | |
|---|---|---|---|---|
| | 2009 (Restated) | 2008 (Restated) | Dollars (Restated) | Percent (Restated) |
| Research and development | $ 503,826 | $ 910,533 | $ (406,707 ) | -44.7 % |
| Percent of total revenues | 59.1 % | 34.3% | | |

Research and development expenses decreased 45% to $503,829 for the six months ended June 30, 2009 from $910,533 for the same period in 2008. This decrease is primarily attributable to a reduction in outside contractor fees incurred during the first and second quarter of 2008 as we worked on enhancing our business tools and applications that were not incurred in the first and second quarter of 2009.

General and Administrative

General and administrative expenses for the six months ended June 30, 2009 and 2008 are as follows:

| | Six Months Ended June 30, | | Change | |
|---|---|---|---|---|
| | 2009 (Restated) | 2008 (Restated) | Dollars (Restated) | Percent (Restated) |
| General and administrative | $ 1,757,640 | $ 2,245,353 | $ (487,713) | -21.7% |
| Percent of total revenues | 206.2% | 84.5% | | |

General and administrative expenses decreased 22% to $1,757,640 for the six months ended June 30, 2009 from $2,245,353 for the same period in 2008. This decrease is primarily attributable to reductions in personnel costs of $498,000; and $35,000 stock-based compensation expense resulting from employee turnover and a decrease in new equity grants; and $69,000 in rent due to closing of Michigan operations; and $30,000 in management consulting expenses; and $101,000 reduction in outside accounting and audit fees; $98,000 reduction in the amount of amortization of intangible costs. These decreases were offset in part by a net increase of $377,000 in bad debt expense on trade accounts and notes receivable.

Gain (loss) on disposal of assets, net

Gain (loss) on impairment of assets, net for the six months ended June 30, 2009 and 2008 are as follows:

| | Six Months Ended June 30, | | Change | |
|---|---|---|---|---|
| | 2009 (Restated) | 2008 (Restated) | Dollars (Restated) | Percent (Restated) |
| Gain (loss) on impairment of assets, net | $ (438,228) | $ - | $ (438,228) | -100% |
| Percent of total revenues | -51.4% | -% | | |

(Loss) on disposal of assets, net increased by 100% due to the reevaluation of certain intangibles assets as of June 30, 2009 and the determination that the intangible asset no longer had any remaining value.

Other Income (Expense)

Other income (expense) for the six months ended June 30, 2009 and 2008 comprise the following:

| | Six Months Ended June 30, | | | | Change | |
|---|---|---|---|---|---|---|
| | 2009 | | 2008 | | Dollars | Percent |
| Interest expense, net | $ (286,342) | $ | (369,236) | $ | 82,894 | -22.5% |
| | | | | | | |
| Gain on legal settlements, net | 6,000 | | - | | 6,000 | 100 % |
| Other income (expense) | 10,267 | | 16,069 | | 5,802 | -36.1% |
| Total other expense | $ (270,075) | $ | (353,167) | $ | 83,092 | -23.5% |

Net other expense decreased 24% to $270,075 for the six months ended June 30, 2009 from $353,167 for the same period in 2008. This net decrease was primarily attributable to the net reduction in interest expense for the six months ending June 30, 2009.

Interest Expense, Net

Interest expense, net of interest income, for the six months ended June 30, 2009 and 2008 is as follows:

| | Six Months Ended June 30, | | Change | |
|---|---|---|---|---|
| | 2009 (Restated) | 2008 (Restated) | Dollars (Restated) | Percent (Restated) |
| Interest expense, net | $ 286,342 | $ 369,236 | $ (82,894) | -23% |
| Percent of total revenues | 33.6% | 13.9% | | |

Net interest expense decreased 23% to $286,342 for the six months ended June 30, 2009 from $369,236 for the same period in 2008. This decrease is primarily associated with the $226,000 of interest expense recognized in the first and second quarter of 2008 relating to the warrants issued to Atlas Capital SA, or Atlas, in connection with the extension of our line of credit with Wachovia Bank, NA, or Wachovia, that was fully amortized by the end of 2008, offset in part by an increase in convertible bond interest due to additional borrowings of $125,000 and additional interest expense of $25,000 paid to Paragon National Bank on the funds borrowed on the line of credit.

Provision for Income Taxes

We have not recorded a provision for income tax expense because we have been generating net losses. Furthermore, we have not recorded an income tax benefit for the first or second quarter of 2009 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 $49.0 million in net operating loss carryforwards, which may be utilized to offset future taxable income.

Utilization of our net operating loss carryforwards may be subject to substantial annual limitation due to the ownership change limitations provided by the Internal Revenue Code of 1986, as amended and similar state provisions. Such an annual limitation could result in the expiration of the net operating loss carryforwards before utilization.

Liquidity and Capital Resources

Overview

As of June 30, 2009, our principal sources of liquidity were cash and cash equivalents totaling $33,000 and current accounts receivable of $28,000, as compared to $19,000 of cash and cash equivalents and $185,000 in accounts receivable as of December 31, 2008. We maintain a low cash balance because of automated sweeps among our accounts at Paragon whereby all available cash at the end of each day is used to pay down our line of credit with Paragon, the purpose of which is to reduce our interest expense. As of June 30, 2009, we had drawn approximately $1,894,000 on the $2,470,000 line of credit, leaving approximately $576,000 available under the line of credit for our operations. Deferred revenue at June 30, 2009 was $303,000 as compared to $391,000 at December 31, 2008.

As of August 10, 2009, our principal sources of liquidity were cash and cash equivalents totaling approximately $48,000 and accounts receivable of approximately $18,000. In addition, we had drawn approximately $2,160,000 on the Paragon line of credit, leaving approximately $310,000 available under the line of credit for operations. As of August 10, 2009, we also have a commitment from our convertible secured subordinated noteholders to purchase up to an additional $7.75 million in convertible notes upon approval and call by our Board of Directors.

Cash Flows

During the six months ended June 30, 2009, our working capital deficit increased by approximately $259,000 to $3,248,000 from a working capital deficit of $2,989,000 at December 31, 2008. As described more fully below, the working capital deficit at June 30, 2009 is primarily attributable to negative cash flows from operations, offset in part by net debt borrowings.

Cash Flows from Operating Activities

| | Six Months Ended June 30, | | Change | |
|---|---|---|---|---|
| | 2009 | 2008 | Dollars | Percent |
| Net cash used in operating activities | $ 1,370,375 | $ 2,840,303 | $ (1,469,928) | -59% |

Net cash used in operating activities decreased 59% to $1,370,375 for the six months ended June 30, 2009 from $2,840,303 for the same period in 2008. This decrease is primarily attributable an increase in bad debt expense, recognition of the impairment of intangible assets, increase in accounts payable. These items are offset in part by an increase in short term notes receivable and decrease in deferred revenue.

Cash Flows from Investing Activities

| | Six Months Ended June 30, | | Change | |
|---|---|---|---|---|
| | 2009 | 2008 | Dollars | Percent |
| Net cash provided by (used in) investing activities | $ (182,028) | $ (49,300) | $ (132,728) | 269.6% |

Net cash used in investing activities increased 269.6% to $182,028 for the six months ended June 30, 2009 from $49,300 for the same period in 2008. This net use of cash is attributable to the capitalization of software costs related to our new industry-standard platform that we commenced in the latter part of 2008, offset in part by proceeds from the sale of equipment to a customer.

Cash Flows from Financing Activities

| | Six Months Ended June 30, | | Change | |
|---|---|---|---|---|
| | 2009 | 2008 | Dollars | Percent |
| Net cash provided by (used in) financing activities | $ 1,566,512 | $ (401,311) | $ 1,967,823 | 490% |

Net cash provided by financing activities increased 490% to $1,566,512 for the six months ended June 30, 2009 from net cash used in financing activities of $401,311 for the same period in 2008. This net source of cash is primarily due to net debt borrowings in the first and second quarters of 2009 versus the repayment of the Wachovia line of credit in the first quarter of 2008, as described below.

The net cash for the second quarter of 2009 from our financing activities was generated through debt financing, as described below.

Debt Financing. In November 2006, we established a $1.3 million revolving credit arrangement with Wachovia to be used for general working capital purposes, which we increased to $2.5 million in January 2007. The line of credit was secured by our deposit account at Wachovia and an irrevocable standby letter of credit issued by HSBC Private Bank (Suisse) SA, or HSBC, with Atlas, a current stockholder and affiliate, as account party. Any advances made on the line of credit were to be paid off no later than August 1, 2008. On February 15, 2008, we repaid the full outstanding principal balance of $2,052,000 and accrued interest of $2,890 outstanding under the line of credit, and our deposit account and the irrevocable standby letter of credit were both released by Wachovia.

On February 20, 2008, we entered into a revolving credit arrangement with Paragon that is renewable on an annual basis subject to mutual approval. The line of credit advanced by Paragon is $2.47 million and can 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. The interest accrued 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 with Atlas as account party, expiring February 18, 2010. We also have agreed with Atlas that in the event of our default in the repayment of the line of credit that results in the letter of credit being drawn, we will reimburse Atlas any sums that Atlas is required to pay under such letter of credit. At our sole discretion, these payments may be made in cash or by issuing shares of our common stock at a set per-share price of $2.50.

The Paragon line of credit replaced our line of credit with Wachovia. As an incentive for the letter of credit from Atlas to secure the Wachovia line of credit, we had entered into a stock purchase warrant and agreement with Atlas. Under the terms of the agreement, Atlas received a warrant to purchase up to 444,444 shares of our common stock at $2.70 per share within 30 business days of the termination of the Wachovia line of credit or if we are in default under the terms of the line of credit with Wachovia. In consideration for Atlas providing the letter of credit to secure the Paragon line of credit, we agreed to amend the agreement to provide that the warrant is exercisable within 30 business days of the termination of the Paragon line of credit or if we are in default under the terms of the line of credit with Paragon.

On February 19, 2009, we renewed our revolving credit arrangement with Paragon. Any advances made on the line of credit must be paid off no later than February 11, 2010. Interest shall accrue on the unpaid principal balance at the Wall Street Journal's published Prime Rate, but at no time shall the interest rate be less than 5.5%.

As of June 30, 2009, we had $7.3 million aggregate principal amount of convertible secured subordinated notes due November 14, 2010, or the notes, outstanding. On November 14, 2007, in an initial closing, we sold $3.3 million aggregate principal amount of notes, or the initial notes. In addition, the noteholders committed to purchase on a pro rata basis up to $5.2 million aggregate principal amount 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 amount of notes with substantially the same terms and conditions as the initial notes, or the additional 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, or the new notes, to two new investors with substantially the same terms and conditions as the previously outstanding notes. On each of January 6, 2009 and February 24, 2009, we sold $500,000 aggregate principal amount of notes to a current noteholder with substantially the same terms and conditions as the previously outstanding notes. Additional notes with similar terms of $500,000 each were sold on April 3, 2009 and June 2, 2009.

On July 16, 2009, the Company sold a $250,000 principal amount note to a current shareholder with substantially the same terms and conditions as the previously outstanding notes.

Also on February 24, 2009, the noteholders holding a majority of the aggregate principal amount of the notes outstanding agreed that we 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.

We are 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. We are 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 the earlier of November 14, 2010 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 our 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 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 our 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 our 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 our 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 we enter 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, 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, who subsequently became Chairman of our Board of Directors and Interim President and Chief Executive Officer until May 19, 2009 and 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 investors in the additional notes are Atlas and Crystal Management Ltd. The investors in the new notes are not affiliated with the Company. Atlas purchased the notes issued in 2009.

If we propose 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, we must give each noteholder who has converted its notes into common stock the opportunity to include such shares of converted common stock in the registration. We have agreed to bear the expenses for any of these registrations, exclusive of any stock transfer taxes, underwriting discounts, and commissions.

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 secured subordinated notes, and bank lines of credit. We must continue to rely on these sources until we are able to generate sufficient cash from revenues to fund our operations. We believe that anticipated cash flows from operations, funds available from our existing line of credit, and additional issuances of notes, together with cash on hand, will provide sufficient funds to finance our operations at least for the next 12 to 18 months, depending on our ability to achieve strategic goals outlined in our annual operating budget that is 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 could require additional covenants and operating restrictions. In addition, existing indemnification obligations in favor of certain former officer and employees will put further strain on the cash flow of the Company (see item 4 Legal Proceedings.)

Going Concern

Our independent registered public accountants for fiscal 2008 have issued an explanatory paragraph in their report included in our Annual Report on Form 10-K for the year ended December 31, 2008 in which they express substantial doubt as to our ability to continue as a going concern. The financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or the amounts or classification of liabilities that might be necessary should we be unable to continue as a going concern. Our continuation as a going concern depends on our ability to generate sufficient cash flows to meet our obligations on a timely basis, to obtain additional financing that is currently required, and ultimately to attain profitable operations and positive cash flows. There can be no assurance that our efforts to raise capital or increase revenue will be successful. If our efforts are unsuccessful, we may have to cease operations and liquidate our business.

Recent Developments

For more information on recent developments, see Item 1, Note 7 – "Subsequent Events", which is incorporated herein by reference.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Not applicable.

Item 4. Controls and Procedures

Not applicable.

Item 4T. Controls and Procedures

Item 4(T). Controls and Procedures

Evaluation of Disclosure Controls and Procedures

As required by Exchange Act Rules 13a-15(b) or 15d-15(b) in connection with this Quarterly Report on Form 10-Q/A, our management, with the participation of our interim Chief Executive Officer and interim Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures. 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. Based on the evaluation of our disclosure controls and procedures, our interim Chief Executive Officer and interim Chief Financial Officer concluded that, our disclosure controls and procedures were not effective at the reasonable assurance level due to the material weaknesses described below, which required us to restate our unaudited financial statements at and for the period ended June 30, 2009.

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Review of our revenue recognition procedures caused the financial statements to be restated to include net subscription revenue as compared to the gross subscription revenue as presented in prior filings for 2009 and 2008. 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 for the fourth quarter of 2009, 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.

- Review of our intangible asset values caused the financial statements to be restated. The value of the iMart trade name as of December 31, 2008 was restated because of a recalculation of the net royalty method of valuation.

Since our evaluation of the above, we performed additional analysis and other post closing procedures to ensure our financial statements were prepared in accordance with generally accepted accounting principles. Accordingly, we believe that the financial statements included in this report fairly present in all material respects, our financial condition, results of operations and cash flows for the periods presented.

Changes in Internal Control Over Financial Reporting

There were no changes in our internal control over financial reporting that occurred during the second quarter of fiscal year 2009 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, 2008 for a description of material legal proceedings.

As previously reported in the Company's Form 8-K filed on June 4, 2009, Dennis Michael Nouri and Reza Eric Nouri (together, the "Nouris"), a former officer and employee of the Company, respectively, filed a complaint (the "Nouri Complaint") to bring a summary proceeding against the Company in the Court of Chancery of the State of Delaware. The Nouri Complaint sought to compel the Company to advance legal fees and costs in the amount of \$826,798 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, together with future verified expenses that will be incurred by the Nouris in defending the actions against them and the expenses incurred by the Nouris in prosecuting the advancement action against the Company.

On July 29, 2009, the Court of Chancery granted summary judgment of the Nouri Complaint in favor of the Nouris. By order dated August 6, 2009, the Company is obligated to pay to the Nouris \$826,798 in advanced expenses for legal services performed by counsel to the Nouris through April 2009. The total amount of the legal fees the Company will ultimately be required to advance to the Nouris is expected to be in excess of \$1.9 million, which amount has been included in the accounts payable of the Company as of June 30, 2009. A current note receivable is recorded for the same amount due from the individuals. Though the Nouris have entered into an undertaking that requires them to repay to the Company any amounts advanced by it in the event the Nouris are ultimately determined not to be entitled to indemnification for the expenses incurred, it is uncertain at this time that the Company will be able to recover such amounts advanced without considerable expense to the Company, or whether the Company will be able to recover any of the amounts advanced at all.

Please refer to Part I, Item 3 of our Annual Report on Form 10-K for the fiscal year ended December 31, 2008 for a further description of material legal proceedings.

### Item 1A. Risk Factors

We operate in a dynamic and rapidly changing business environment that involves substantial risk and uncertainty, and these risks may change over time. The following discussion addresses some of the risks and uncertainties that could cause, or contribute to causing, actual results to differ materially from expectations. In evaluating our business, you should pay particular attention to the descriptions of risks and uncertainties described below. If any of these risks actually occur, our business, financial condition, or results of operations could be materially and adversely affected.

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

We have had recurring losses from operations and continue to have negative cash flows. If we do not become cash flow positive through additional financing or growth, we may have to cease operations and liquidate our business. Our working capital, including our revolving line of credit with Paragon and convertible note financing should fund our operations for the next 12 to 18 months. As of August 10, 2009, we have approximately \$310,000 available on our line of credit and \$7.75 million available through our convertible note financing. Factors such as the commercial success of our existing services and products, the timing and success of any new services and products, the progress of our research and development efforts, our results of operations, the status of competitive services and products, the timing and success of potential strategic alliances or potential opportunities to acquire technologies or assets, the charges filed against a former officer and a former employee by the SEC and the United States Attorney General, and the pending shareholder class action lawsuit may require us to seek additional funding sooner than we expect. If we fail to raise sufficient financing, we will not be able to implement our business plan and may not be able to sustain our business.

In addition, our current primary credit facilities consisting of the Paragon line of credit and the convertible note financing both have maturity dates in 2010. Should we be unable to repay the principal then due from operations or from new or renegotiated capital funding sources, we may not be able to sustain our business. As of August 10, 2009, we have approximately $2.16 million outstanding on our line of credit and $7.55 million aggregate principal amount of convertible notes outstanding.

Our independent registered public accountants for fiscal 2008 indicated that they have substantial doubts that we can continue as a going concern. Their opinion may negatively affect our ability to raise additional funds, among other things. If we fail to raise sufficient capital, we will not be able to implement our business plan, we may have to liquidate our business, and you may lose your investment.

Sherb & Co., LLP, our independent registered public accountants for fiscal 2008, has expressed substantial doubt in their report included with our Annual Report on Form 10-K for the year ended December 31, 2008 about our ability to continue as a going concern given our recurring losses from operations and deficiencies in working capital and equity, which are described in the first risk factor above. This opinion could materially limit our ability to raise additional funds by issuing new debt or equity securities or otherwise. If we fail to raise sufficient capital, we will not be able to implement our business plan, we may have to liquidate our business, and you may lose your investment. You should consider our independent registered public accountants’ comments when determining if an investment in us is suitable.

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

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

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

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

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

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

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

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

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

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

Our 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.

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

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

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

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

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

Legal and other fees related to these actions have also reduced our available cash for operations. We make no assurance that we will not continue to experience additional harm as a result of these matters. The time spent by our management team and directors dealing with issues related to these actions detracts from the time they spend on our operations, including strategy development and implementation. These actions also have harmed our reputation in the business community, jeopardized our relationships with vendors and customers, and decreased our ability to attract qualified personnel, especially given the media coverage of these events.

In addition, we face uncertainty regarding amounts that we may have to pay as indemnification to certain current and former officers, directors, and employees under our Bylaws and Delaware law with respect to these actions, and we may not recover all of these amounts from our directors' and officers' liability insurance policy carrier. Our Bylaws and Delaware law generally require us to advance legal expenses to current and former officers, directors, and employees against claims arising out of such person's status or activities as our officer, director, or employee, and indemnify an officer, director or employee from such claims unless any such indemnitee (i) did not act in good faith and in a manner the person reasonably believed to be in or not opposed to our best interests; or (ii) had reasonable cause to believe his conduct was unlawful. Also, there is a stockholder class action lawsuit pending against us and certain of our current and former officers, directors, and employees, as described in Part I, Item 3, "Legal Proceedings," of our Annual Report on Form 10-K for the year ended December 31, 2008.

Generally, we are required to advance defense expenses prior to any final adjudication of an employee's, officer's or director's culpability. The expense of indemnifying our current and former directors, officers, and employees for their defenses or related expenses in connection with the current actions may be significant. Our Bylaws require that any director, officer, employee, or agent requesting advancement of expenses enter into an undertaking with us to repay any amounts advanced unless it is ultimately determined that such person is entitled to be indemnified for the expenses incurred. This provides us with an opportunity, depending upon the final outcome of the matters and the Board's subsequent determination of such person's right to indemnity, to seek to recover amounts advanced by us. However, we may not be able to recover any amounts advanced if the person to whom the advancement was made lacks the financial resources to repay us. If we are unable to recover the amounts advanced, or can do so only at great expense, our operations may be substantially harmed as a result of loss of capital.

As reported on the Form 8-K filed by the Company on June 4, 2009, our insurance coverage for advancement claims has been exhausted. As noted herein in Item 4, "Commitments and Contingencies – Legal Proceedings", by order dated August 6, 2009, the Company is obligated to pay to Dennis Michael Nouri and Reza Eric Nouri $826,798 in advanced expenses for legal services performed by counsel to the Nouris through April 2009. The total amount of the legal fees the Company will ultimately be required to advance to the Nouris is expected to be in excess of $1.9 million. In addition, a number of our current and former employees were asked to appear as witnesses in the criminal action and may seek advancement of legal expenses from us. Payment of these amounts would adversely impact our financial condition and results of operations, which could result in a significant reduction in the amounts available to fund working capital, capital expenditures, and other general corporate objectives and could ultimately require us to file for bankruptcy.

Finally, our insurance policies provide that, under certain conditions, our insurance carriers may have the right to seek recovery of any amounts they paid to us or the individual insureds. As of August 10, 2009, we do not know and can offer no assurances about whether these conditions will apply or whether the insurance carriers will change their position regarding coverage related to the current actions. Therefore, we can offer no assurances that our insurance carriers will not seek to recover any amounts paid under their policies from us or the individual insureds. If such recovery is sought, then we may have to expend considerable financial resources in defending and potentially settling or otherwise resolving such a claim, which could substantially reduce the amount of capital available to fund our operations and could ultimately require us to file for bankruptcy.

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

As a public company, we have incurred and will continue to incur significant legal, accounting, and other expenses that we did not incur as a private company. We incur costs associated with our public company reporting requirements and with corporate governance and disclosure requirements, including requirements under the Sarbanes-Oxley Act of 2002, or Sarbanes-Oxley, and new rules implemented by the SEC and the Financial Industry Regulatory Authority, or

FINRA. We expect these rules and regulations to increase our legal and financial compliance costs and to make some activities more time consuming and costly.

We currently are required to comply with the requirements of Section 404 of Sarbanes-Oxley involving management's assessment of our internal control over financial reporting, and our independent accountant's audit of our internal control over financial reporting is required for fiscal 2009. To comply with these requirements, we are evaluating and testing our internal controls, and where necessary, taking remedial actions, to allow management to report on, and our independent auditors to attest to, our internal control over financial reporting. As a result, we have incurred and will continue to incur expenses and diversion of management's time and attention from the daily operations of the business, which may increase our operating expenses and impair our ability to achieve profitability.

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

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

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

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

We may issue shares of our common stock in the future for a variety of reasons. For example, under the terms of our stock purchase warrant and agreement with Atlas, it may elect to purchase up to 444,444 shares of our common stock at $2.70 per share upon termination of, or if we are in breach under the terms of, our line of credit with Paragon. In connection with our private financing in February 2007, we issued warrants to the investors to purchase an additional 1,176,471 shares of our common stock at $3.00 per share and a warrant to our placement agent in that transaction to purchase 35,000 shares of our common stock at $2.55 per share. Upon maturity of their convertible notes, our noteholders may elect to convert all, a part of, or none of their notes into shares of our common stock at a floating conversion price. In addition, we may raise funds in the future by issuing additional shares of common stock or other securities.

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

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

Future sales of substantial amounts of our shares in the public market, or the appearance that a large number of our shares are available for sale, could adversely affect market prices prevailing from time to time and could impair our ability to raise capital through the sale of our securities. At August 10, 2009, 18,332,542 shares of our common stock were issued and outstanding, and a significant number of shares may be issued upon the exercise of outstanding options, warrants, and convertible notes.

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

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

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

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

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

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

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

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

Our executive management team is critical to the execution of our business plan and the inability to attract and retain qualified personnel could have a severely negative impact on our business.

Our executive management team has undergone significant changes since 2008, including the resignation of our Chief Executive Officer on December 9, 2008, the resignation of our Chairman of the Board and Interim Chief Executive Officer on May 19, 2009. It may be difficult to attract highly qualified candidates to serve on our executive management team on a permanent basis. If we cannot attract and retain qualified personnel and integrate new members of our executive management team effectively into our business, then our business and financial results may suffer. In addition, all of our executive team works at the same location, which could make us vulnerable to the loss of our entire team in the event of a natural or other disaster. We do not maintain key man insurance policies on any of our employees.

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

During the first and second quarter of fiscal 2009, we sold equity securities totaling $219 and $876, respectively, that were not registered under the Securities Act, as described in our Current Reports on Form 8-K filed in connection with such transactions.

The following table lists all repurchases during the first and second quarters of fiscal 2009 of any of our securities registered under Section 12 of the Exchange Act by or on behalf of us or any affiliated purchaser.

Issuer Purchases of Equity Securities

| Period | Total Number of Shares Purchased | Average Price Paid Per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares That May Yet Be Purchased Under the Plans or Programs |
|---|---|---|---|---|
| January 1 – January 31, 2009 | - | $ - | - | - |
| February 1 – February 28, 2009 | - | $ - | - | - |
| | | | | |
| March 1 – March 31, 2009 (1) | 146 | $ 1.50 | - | - |
| April 1 – June 30, 2009 | 580 | 1.51 | - | - |
| Total | 726 | $ 1.50 | - | - |

(1)Represents 146 and 580 shares repurchased in connection with tax withholding obligations under the 2004 Plan.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

As reported in a Form 8-K filed by the Company on June 12, 2009, the Annual Meeting of Stockholders of the Company was convened as scheduled on June 16, 2009, and then immediately adjourned and held on July 15, 2009. The annual meeting was held for the purposes of electing directors to serve until the next annual meeting of stockholders or until their successors are appointed and qualified. As reported in the reports on Form 8-K filed by the Company on May 22, 2009 and June 12, 2009, two of the director nominees named in the Company ’ s April 30, 2009 proxy statement has resigned as directors prior to the Annual Meeting, and were not candidates for re-election.

C. James Meese, Jr., Dror Zoreff and Shlomo Elia were each elected as directors of the Company, with the number of votes for and withheld, respectively, for such persons as follows:

| | For | Withheld |
|---|---|---|
| C. James Meese, Jr. | 13,451,661 | 290 |
| Dror Zoreff | 13,451,461 | 490 |
| Shlomo Elia | 13,451,461 | 490 |

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/Principal Accounting 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/Principal Accounting 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. |
| | By: /s/ Dror Zoreff |
| November 16,2010 | Dror Zoreff |
| | Principal Executive Officer |
| | By: /s/ Thaddeus J. Shalek |
| November 16, 2010 | Thaddeus J. Shalek |
| | Principal Financial Officer and Principal Accounting Officer |

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EXHIBIT INDEX

| Exhibit No. | Description |
|---|---|
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