

SMART ONLINE INC
Form 10-Q
May 14, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2012

OR

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

Commission File Number: 001-32634

SMART ONLINE, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

95-4439334
(I.R.S. Employer
Identification No.)

4505 Emperor Blvd., Ste. 320
Durham, North Carolina
(Address of principal executive offices)

27703
(Zip Code)

(919) 765-5000

(Registrant's telephone number, including area code)

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

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

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

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Large accelerated filer

Accelerated filer

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

Smaller reporting company

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

As of May 7, 2012, there were 18,352,542 shares of the registrant's common stock, par value \$0.001 per share, outstanding.

SMART ONLINE, INC.

FORM 10-Q
For the Quarterly Period Ended March 31, 2012

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PART I – FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS
SMART ONLINE, INC.

BALANCE SHEETS

	March 31, 2012 (unaudited)	December 31, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 106,865	\$ 165,139
Restricted cash	51,111	70,445
Accounts receivable, net	78,550	6,630
Prepaid expenses	63,188	53,073
Total current assets	299,714	295,287
Property and equipment, net	171,011	164,657
Capitalized software, net	418,976	172,510
Intangible assets, net	122,280	117,685
Other assets	17,874	16,836
TOTAL ASSETS	\$ 1,029,855	\$ 766,975
LIABILITIES AND STOCKHOLDERS' DEFICIT		
Current liabilities:		
Accounts payable	\$ 592,448	\$ 580,850
Notes payable (See Note 3)	5,025,366	5,037,815
Deferred revenue	88,909	31,658
Settlement related financial instrument liability (See Note 2)	2,050,250	1,770,000
Accrued liabilities	418,360	520,967
Total current liabilities	8,175,333	7,941,290
Long-term liabilities:		
Notes payable (See Note 3)	16,695,769	15,625,075
Deferred revenue	6,962	1,505
Total long-term liabilities	16,702,731	15,626,580
Total liabilities	24,878,064	23,567,870
Commitments and contingencies (See Note 4)		
Stockholders' deficit:		
Preferred stock, \$0.001 par value, 5,000,000 shares authorized, no shares issued and outstanding at March 31, 2012 and December 31, 2011	-	-
Common stock, \$0.001 par value, 45,000,000 shares authorized, 18,352,542 shares issued and outstanding at March 31, 2012 and December 31, 2011	18,353	18,353
Additional paid-in capital	67,127,160	67,118,452
Accumulated deficit	(90,993,722)	(89,937,700)
Total stockholders' deficit	(23,848,209)	(22,800,895)

TOTAL LIABILITIES AND STOCKHOLDERS' DEFICIT	\$	1,029,855	\$	766,975
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The accompanying notes are an integral part of these financial statements.

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SMART ONLINE, INC.

STATEMENTS OF OPERATIONS
(unaudited)

	Three Months Ended	
	March 31, 2012	March 31, 2011
REVENUES:		
Subscription fees	\$ 83,708	\$ 103,272
Professional service fees	18,100	-
License fees	12,467	-
Hosting fees	324	-
Other revenue	24,636	35,466
Total revenues	139,235	138,738
COST OF REVENUES	88,396	192,316
GROSS PROFIT	50,839	(53,578)
OPERATING EXPENSES:		
Sales and marketing	195,754	142,055
Research and development	16,041	158,892
General and administrative	240,864	338,966
Total operating expenses	452,659	639,913
LOSS FROM OPERATIONS	(401,820)	(693,491)
OTHER INCOME (EXPENSE):		
Interest expense, net	(374,052)	(294,329)
Gain on legal settlements, net	100	22
Change in market value of settlement related financial instrument	(280,250)	-
Total other expense	(654,202)	(294,307)
NET LOSS	\$ (1,056,022)	\$ (987,798)
NET LOSS PER COMMON SHARE:		
Basic and fully diluted	\$ (0.06)	\$ (0.05)
WEIGHTED-AVERAGE NUMBER OF SHARES USED IN COMPUTING NET LOSS PER COMMON SHARE:		
Basic and fully diluted	18,352,542	18,352,542

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

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

	Three Months Ended	
	March 31, 2012	March 31, 2011
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	\$ (1,056,022)	\$ (987,798)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	11,234	14,215
Equity-based compensation	8,708	25,936
Changes in assets and liabilities:		
Accounts receivable	(53,120)	8,931
Contracts receivable	(18,800)	-
Prepaid expenses	(10,113)	59,031
Other assets	(1,038)	5,000
Accounts payable	86,598	266,805
Deferred revenue	62,708	(6,135)
Accrued and other expenses	177,642	(604,730)
Net cash used in operating activities	(792,203)	(1,218,745)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(12,281)	(2,480)
Purchase of software license	(75,000)	-
Capitalized patent development costs	(5,886)	-
Capitalized software	(250,481)	-
Net cash provided by (used in) investing activities	(343,648)	(2,480)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Restricted cash used to pay IDB interest expense	50,580	27,556
Deposit of cash to IDB restricted account	(31,247)	-
Proceeds from debt borrowings	1,075,000	575,000
Repayments of debt borrowings	(16,756)	(16,257)
Net cash provided by financing activities	1,077,577	586,299
NET (DECREASE) IN CASH AND CASH EQUIVALENTS	(58,274)	(634,926)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	165,139	860,211
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$ 106,865	\$ 225,285
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	\$ 364,296	\$ 294,332

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

SMART ONLINE, INC.

NOTES TO FINANCIAL STATEMENTS
For the Quarterly Period Ended March 31, 2012
(unaudited)

1. SUMMARY OF BUSINESS AND SIGNIFICANT ACCOUNTING POLICIES

Description of Business - Smart Online, Inc. (the "Company") was incorporated in the State of Delaware in 1993. The Company develops and markets software products and services targeted to businesses that are delivered via a Software-as-a-Service ("SaaS") model. The Company's principal products and services include:

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

Basis of Presentation - The financial statements as of and for the three months ended March 31, 2012 and 2011 included in this Quarterly Report on Form 10-Q are unaudited. The balance sheet as of December 31, 2011 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, 2011 filed with the Securities and Exchange Commission (the "SEC") on March 30, 2012 (the "2011 Annual Report").

The financial statements have been prepared in accordance with accounting principles generally accepted in the United States ("U.S. GAAP"). In the opinion of the Company's management, the unaudited statements in this Quarterly Report on Form 10-Q include all normal and recurring adjustments necessary for the fair presentation of the Company's statement of financial position as of March 31, 2012, and its results of operations and cash flows for the three months ended March 31, 2012 and 2011. The results for the three months ended March 31, 2012 are not necessarily indicative of the results to be expected for the fiscal year ending December 31, 2012.

The accompanying financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. During the three months ended March 31, 2012 and 2011, the Company incurred net losses as well as negative cash flows 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. On May 9, 2012, the Company has a commitment from its convertible secured subordinated noteholders to purchase up to an additional \$2.9 million in convertible notes upon approval and call by the Company's Board of Directors. There can be no assurance that, if the noteholders do not purchase the \$2.950 million in convertible notes, the Company will be able to obtain alternative funding. There can be no assurance that the Company's efforts to raise capital or increase revenue will be successful. If these efforts are unsuccessful, the Company may have to cease operations and liquidate the business. The Company's continuation as a going concern depends upon its ability to generate sufficient cash flows to meet its obligations on a timely basis, to obtain additional financing as may be required, and ultimately to attain profitable operations and positive cash flows.

Significant Accounting Policies - In the opinion of the Company's management, the significant accounting policies used for the three months ended March 31, 2012 are consistent with those used for the year ended December 31, 2011. Accordingly, please refer to the 2011 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 and the determination of allowances on our deferred tax assets. Actual results could differ materially from those estimates.

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 loss or stockholders' deficit.

Stock-Based Compensation - The Company follows US GAAP for the recognition of stock-based compensation. Stock-based compensation is recognized on the straight-line method over the requisite service period. Total stock-based compensation expense recognized was \$8,708 and \$25,936 for the three months ended March 31, 2012 and 2011 respectively. No stock-based compensation was capitalized in the consolidated financial statements.

The fair value of option grants under the Company's equity compensation plan for the three months ended March 31, 2012 and 2011 were estimated using the following weighted average assumptions:

	Three Months Ended March 31,	
	2012	2011
Dividend yield	0.0%	0.0%
Expected volatility	89.3%	92.5%
Risk-free interest rate	1.64%	2.86%
Expected lives (years)	10.0	10.0

Net Loss Per Share - Basic net loss per share is computed by dividing net loss by the weighted average number of common shares outstanding during the periods. Diluted net loss per share is computed using the weighted average number of common and dilutive common equivalent shares outstanding during the periods. Common equivalent shares consist of convertible notes, stock options, and warrants that are computed using the treasury stock method. The 1,475,000 shares that will be issued to the claimants in the Class Action Settlement described in Notes 2 and 4 below based upon the District Court's decision on July 1, 2011 are not included in the calculation of net loss per share at March 31, 2012. Shares issuable upon the exercise of stock options and warrants, totaling 300,900 on March 31, 2012, were excluded from the calculation of common equivalent shares, as the impact was anti-dilutive.

2. BALANCE SHEET ACCOUNTS

Capitalized software consists of the following:

The Company began capitalizing the development of the costs associated with its SmartOn Mobile platform on October 1, 2011. The Company demonstrated technological feasibility through the presentation of its working model of the software product. During the three months ended March 31, 2012, the Company capitalized \$250,481 of costs incurred to continue the development of its platform. The Company will continue to capitalize costs associated with the further development of additional AppBlocks, (functional components), for its SmartOn Mobile platform. The Company officially released the product platform on February 28, 2012 and began amortizing the capitalized costs at that date on a straight-line basis over a seven-year period, which is anticipated to approximate the economic life of the current platform.

	March 31, 2012	December 31, 2011
Capitalized software	\$ 422,991	\$ 172,510
Less accumulated amortization	(4,015)	-
Capitalized software, net	\$ 418,976	\$ 172,510