SMART ONLINE INC
Form 10-Q/A
November 22, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-Q/A
(Amendment No.1)

(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, 2005

OR

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

Commission File Number: 333-119385

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

Delaware **(State of other jurisdiction of incorporation or organization)**	**95-4439334** **(IRS Employer Identification No.)**

2530 Meridian Parkway, 2nd Floor
Durham, North Carolina 27713
(Address of principal executive offices)

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

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

Indicate by check mark whether the Registrant is an accelerated filer (as described in Rule 12b-2 of the Securities Exchange Act of 1934). Yes [ ] No [X]

As of June 30, 2005, there were approximately 12,498,435 million shares of the Registrant’s Common Stock outstanding.

Smart Online, Inc.

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PART I. FINANCIAL INFORMATION

EXPLANATORY NOTE

The purpose of this Amendment No. 1 to Quarterly Report on Form 10-Q/A is to restate the unaudited financial statements of Smart Online, Inc. (the "Company") for the quarter ended June 30, 2005, filed with the Securities and Exchange Commission ("SEC") on August 15, 2005 to correct the accounting treatment of certain warrants. As originally filed in its Form 10-Q, Smart Online incorrectly reported $506,000 of expense associated with certain warrants issued during 2003. Since these warrants were part of permanent equity, Smart Online should not have applied the mark to market provisions of Emerging Issues Task Force (EITF) 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled In, a Company's Own Stock.* The Items which are amended and restated herein are:

1. Part I, Item 1 - Financial Statements (including applicable footnotes);
2. Part I, Item 2 - Management's Discussion and Analysis of Financial Condition and Results of Operations (including Risk Factors); and
3. Part II, Item 6 - Exhibits

Except as otherwise expressly noted herein, this Amendment No. 1 to Quarterly Report on Form 10-Q/A does not reflect events occurring after the August 15, 2005 filing of our Quarterly Report on Form 10-Q in any way, except as those required to reflect the effects of this restatement of our financial statements for the periods presented, as deemed necessary in connection with the completion of restated financial statements.

The remaining Items contained within this Amendment No. 1 to our Quarterly Report on Form 10-Q/A consist of all other Items originally contained in our Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2005 in the form filed with the SEC on August 15, 2005. These remaining Items are not amended hereby, but are included for the convenience of the reader. In order to preserve the nature and character of the disclosures set forth in such Items as originally filed, except as expressly noted herein, this report continues to speak as of the date of the original filing, and we have not updated the disclosures in this report to speak as of a later date. While this report primarily relates to the historical periods covered, events may have taken place since the original filing that might have been reflected in this report if they had taken place prior to the original filing.

PART I. FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

Smart Online, Inc.
Balance Sheets

Assets	June 30, 2005 (Unaudited) (Restated)	December 31, 2004
CURRENT ASSETS:		
Cash and cash equivalents	$ 552,407	$ 173,339
Marketable securities	-	395,000
Accounts receivable, net	30,706	30,904
Other accounts receivable	-	43,455
Prepaid expenses	259,739	24,850
Total current assets	842,852	667,548
PROPERTY AND EQUIPMENT, net	141,600	75,636
INTANGIBLE ASSETS, net	15,394	16,623
OTHER ASSETS	13,540	13,894
TOTAL ASSETS	$ 1,013,386	$ 773,701
CURRENT LIABILITIES:		
Accounts payable	$ 190,283	$ 186,382
Accrued payroll	160,088	110,079
Accrued payroll taxes, penalties and interest	11,528	574,827
Deferred revenue	531,479	721,689
Total current liabilities	893,378	1,592,977
LONG-TERM LIABILITIES:		
Deferred compensation, notes payable and interest	-	1,091,814
Total long-term liabilities	-	1,091,814
Total liabilities	893,378	2,684,791
COMMITMENTS AND CONTINGENCIES	-	-
STOCKHOLDERS' EQUITY (DEFICIT):		
Common stock, $.001 par value, 45,000,000 shares authorized, shares issued and outstanding: June 30, 2005 - 12,498,435; December 31, 2004 —11,631,832	12,498	11,632
Additional paid-in capital	38,000,363	34,809,832
Accumulated deficit	(37,892,853)	(36,732,554)
Total stockholders' equity (deficit)	120,008	(1,911,090)
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)	$ 1,013,386	$ 773,701

See Notes to Financial Statements

SMART ONLINE, INC.
STATEMENTS OF OPERATIONS
(unaudited)

	Three Months Ended		Six Months Ended	
	June 30, 2005 (Restated)	**June 30, 2004**	**June 30, 2005 (Restated)**	**June 30, 2004**
REVENUES:				
Integration fees	$ 252,198	$ 89,931	$ 381,720	$ 193,750
Syndication fees	103,602	30,621	195,642	61,242
OEM revenue	12,000	13,750	24,000	28,436
Web services	25,731	18,276	40,890	34,990
Other revenues	12,585	755	17,102	2,130
Related party revenues	-	82,512	-	165,025
Total revenues	406,116	235,845	659,354	485,573
COST OF REVENUES	21,911	43,408	53,638	100,427
GROSS PROFIT	384,205	192,437	605,716	385,146
OPERATING EXPENSES:				
General and administrative	724,162	593,250	1,243,198	1,042,507
Sales and marketing	287,946	179,232	582,678	277,631
Development	246,403	127,643	501,630	292,021
Total operating expenses	1,258,511	900,125	2,327,506	1,612,159
LOSS FROM OPERATIONS	(874,306)	(707,688)	(1,721,790)	(1,227,013)
OTHER INCOME (EXPENSE):				
Interest income (expense), net	4,197	(6,945)	10,195	(114,597)
Gain on debt forgiveness	9,293	21,847	556,634	49,395
Total other income (expense)	13,490	14,902	566,829	(65,202)
NET LOSS	(860,816)	(692,786)	(1,154,961)	(1,292,215)
Preferred stock dividends and accretion of discount on preferred stock	-	-	-	(2,215,625)
Accretive dividend issued in connection with registration rights agreement	(3)	-	(3)	-
Converted preferred stock inducement cost	-	-	-	(3,225,410)
Net loss attributed to common stockholders	$ (860,819)	$ (692,786)	$ (1,154,964)	$ (6,733,250)
NET LOSS PER SHARE:				

Net loss attributed to common stockholders - Basic and Diluted	$	(0.07)	$	(0.06)	$	(0.10)	$	(0.75)
SHARES USED IN COMPUTING NET LOSS PER SHARE Basic and Diluted		12,387,333		10,722,507		12,110,013		9,022,107

See notes to financial statements.

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

	Three Months Ended		Six Months Ended	
	June 30, 2005 (Restated)	June 30, 2004	June 30, 2005 (Restated)	June 30, 2004
CASH FLOWS FROM OPERATING ACTIVITIES:				
Net loss	$ (860,819)	$ (692,786)	$ (1,154,964)	$ (1,292,215)
Adjustments to reconcile net loss to net cash used in operating activities:				
Depreciation	13,155	11,975	24,248	22,079
Common shares, warrants, or options issued in lieu of compensation	79,279	-	79,279	161,000
Common shares issued for extension of loan	-	-	-	75,000
Issuance of warrants	-		19,231	
Gain on debt forgiveness	(9,293)	(21,847)	(556,634)	(49,395)
Changes in assets and liabilities:				
Accounts receivable	(18,517)	(28,506)	198	29,720
Related party receivable		5,625		38,682
Other accounts receivable	(4,999)	4,583	33,769	(13,750)
Prepaid expenses	(185,422)	8,559	(225,203)	(17,116)
Legal settlement obligation	-	(181,563)	-	(181,563)
Other assets	3,653	-	1,433	-
Deferred revenue	(142,382)	(117,261)	(190,210)	(300,981)
Accounts payable	(26,477)	214,003	31,332	(128,691)
Accrued payroll	43,741	28,345	55,961	29,717
Accrued payroll taxes payable	(49,341)	25,352	(49,341)	(965,506)
Accrued interest payable	-	3,166	-	(134,998)
Deferred compensation, notes payable, and interest	-	(35,649)	(1,091,814)	(76,343)
Net cash used in operating activities	(1,157,422)	(776,004)	(3,022,715)	(2,651,674)
CASH FLOWS FROM INVESTING ACTIVITIES:				
Purchases of furniture and equipment	(34,841)	(24,264)	(86,104)	(24,908)
Redemption of marketable securities	-	-	395,000	-
Net cash provided by (used in) investing activities	(34,841)	(24,264)	308,896	(24,908)
CASH FLOWS FROM FINANCING ACTIVITIES:				
Repayments on notes payable	-	-	-	(350,000)
Repayments from stockholder	-	-	-	(86,480)
Issuance of common stock	357,887	1,045,142	3,092,887	3,333,641
Net cash provided by financing activities	357,887	1,045,142	3,092,887	2,897,161

NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS		(834,376)		244,874		379,068		220,579
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD		1,386,783		77,191		173,339		101,486
CASH AND CASH EQUIVALENTS, END OF PERIOD	$	552,407	$	322,065	$	552,407	$	322,065
Supplemental disclosures:								
Cash payment during the period for interest:	$	-	$	-	$	154,288	$	164,055
Non-cash financing activities:								
Non-cash accretion of preferred stock redemption value	$	-	$	-	$	-	$	2,215,625
Conversion of preferred stock into common stock	$	-	$	-	$	-	$	19,724,839

See notes to financial statements.

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Smart Online, Inc.

Notes to Financial Statements - Unaudited

1. Summary of Business and Significant Accounting Policies

Basis of Presentation-The accompanying balance sheet as of June 30, 2005 and the statements of operations and cash flows for the three months and six months ended June 30, 2005 and 2004 are unaudited. These statements should be read in conjunction with the audited financial statements and related notes, together with management's discussion and analysis of financial position and results of operations, contained in the Company's Form 10-K for the year ended December 31, 2004.

The financial statements have been prepared in accordance with accounting principles generally accepted in the United States, or U.S. GAAP. In the opinion of the Company's management, the unaudited statements in the Form 10-Q include all adjustments necessary for the fair presentation of the Company's statement of financial position as of June 30, 2005, its results of operations and its cash flows for the three months and six months ended June 30, 2005 and 2004. The results for the three months and six months ended June 30, 2005 are not necessarily indicative of the results to be expected for the fiscal year ending December 31, 2005.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As such, they do not include adjustments relating to the recoverability of recorded asset amounts and classification of recorded assets and liabilities. The Company had accumulated losses of approximately $38 million at June 30, 2005 and will be required to make significant expenditures in connection with continuing development and marketing efforts along with general and administrative expenses. The Company's ability to continue its operations is dependant upon its raising of capital through equity financing in order to meet its working needs.

These conditions raise substantial doubt about the Company's ability to continue as a going concern, and, if substantial additional funding is not acquired or alternative sources developed, management will be required to curtail its operations.

The Company needs to raise additional capital by the sale of its equity securities or other financing avenues. Management believes that actions presently being taken to obtain additional funding provides the additional opportunity for the Company to continue as a going concern.

Description of Business **-**Smart Online, Inc. (the "Company" or "Smart Online") was incorporated in the State of Delaware in 1993. Smart Online develops and markets Internet-delivered Software-as-Service (SaS) software applications and data resources to start, run, protect and grow small businesses (one to fifty employees). Smart Online's subscribers access Smart Online's products through the portal at www.SmartOnline.com directly and through the web sites of private label syndication partners that include major companies and financial institutions.

Fiscal Year **-**The fiscal year ends December 31. References to fiscal 2005, for example, refer to the fiscal year ending December 31, 2005.

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 from those estimates.

Segments -The Company operates in one segment.

Revenue Recognition- The Company recognizes revenue in accordance with accounting standards for software and service companies including United States Securities and Exchange Commission ("SEC"), Staff Accounting Bulletin No. 104 "Revenue Recognition" ("SAB 104"), the Emerging Issues Task Force Issue No. 00-21 "Revenue Arrangements with Multiple Deliverables" ("EITF 00-21"),and related interpretations including American Institute of Certified Public Accountants ("AICPA") Technical Practice Aids. We also utilize interpretative guidance from regulatory and accounting bodies, which include, but are not limited to, the SEC, the AICPA, the Financial Accounting Standards Board ("FASB"), and various professional organizations.

We recognize revenue when all of the following conditions are satisfied: (1) there is persuasive evidence of an arrangement; (2) the service has been provided to the customer; (3) the collection of our fees is probable; and (4) the amount of fees to be paid by the customer is fixed or determinable. EITF 00-21 states that revenue arrangements with multiple deliverables should be divided into separate units of accounting if the deliverables in the arrangement meet the following criteria: (1) the delivered item has value to the customer on a standalone basis; (2) there is objective and reliable evidence of the fair value of the undelivered item; and (3) if the arrangement includes a general right of return relative to the delivered item, deliver or performance of the undelivered item is considered probable and substantially in control of the vendor. Smart Online's syndication and integration agreements typically include multiple deliverables including the grant of a non-exclusive license to distribute, use and access the Smart Online platform, fees for the integration of content into the Smart Online platform, maintenance and hosting fees, documentation and training, and technical support and customer support fees. Smart Online cannot establish fair value of the individual revenue deliverables based on objective and reliable evidence because the Company does not have a long, consistent history of standard syndication and integration contractual arrangements, there have only been a few contracts that have continued past the initial contractual term, the Company does not have any contracts in which these elements have been sold as stand-alone items, and there is no third-party evidence of fair value for products or services that are interchangeable and comparable to Smart Online's products and services. As such, Smart Online can not allocate revenue to the individual deliverables and must record all revenues received as a single unit of accounting as further described below. Additionally, Smart Online has evaluated the timing and substantive nature of the performance obligations associated with the multiple deliverables noted above, including the determination that the remaining obligations are essential to the on-going usability and functionality of the delivered products, and determined that revenue should be recognized over the life of the contracts due to such factors as the length of time over which the remaining obligations will be performed, the complex nature of integrating and maintaining customer content with Smart Online's platform, which services are unavailable from other vendors, and the timing of payment of a portion of the contract price such as monthly hosting payments.

Syndication fees consist primarily of fees charged to syndication partners to create and maintain a customized private-label site and ongoing support, maintenance and customer service. The syndication agreements typically include an advance fee and monthly hosting fees. We generally invoice our customers in annual or monthly installments and typical payment terms provide that our customers pay us within 30 days of invoice. Amounts that have been invoiced are recorded in accounts receivable and in deferred revenue and the revenue is recognized ratably over the specified lives of the contracts, commencing on the date the site goes on-line. In general, we collect our billings in advance of the service period. The hosting fees are typically billed on a monthly basis. Our contracts and support contracts are non-cancelable, though they typically provide for early termination upon a material breach by either party that is not cured in a timely manner. We continue to evaluate and adjust the length of these amortization periods as we gain more experience with implementation schedules and contract cancellations. Should the contract terminate earlier than its term then we recognize the remaining deferred revenue upon termination. At present, Smart Online has insufficient historical data to determine if the relationship with its existing customers will extend beyond the initial term with the customer continuing to benefit from the advance fee. If Smart Online determines that existing and/or future contracts are expected to extend beyond the initial term whereby the customer continuing to benefit from the advance fee, Smart Online would extend the revenue recognition period accordingly to include the extended term. Based on that experience, it is possible that, in the future, the estimates of customer lives may change and, in such event, the period over which such syndication revenues are amortized would be adjusted. Any such change in specified contract lives would affect our future results of operations. Additionally, the syndication contracts typically include revenue sharing arrangements whereby syndication partners typically charge their customers a monthly fee to access the private-label site. In most cases, the syndication agreement provides for Smart Online to receive a percentage of these fees. Fees derived from such revenue sharing arrangements are recorded when earned. To date such revenue sharing fees have been negligible.

Integration fees consist primarily of fees charged to integration partners to integrate their products into the Smart Online syndication platform. Integrating third-party content and products has been a key component of Smart Online's strategy to continuously expand and enhance the platform offered to its syndication partners and its own customer base. We generally invoice our customers in advance of the service period in annual or monthly installments and typical payment terms provide that our customers pay us within 30 days of invoice. Amounts that have been invoiced are recorded in accounts receivable and in deferred revenue and the revenue is recognized ratably over the specified lives of the contracts, commencing on the date the site goes on-line. We continue to evaluate and adjust the length of these amortization periods as we gain more experience with implementation schedules and contract cancellations. At present, Smart Online has insufficient historical data to determine if the relationship with its existing customers will extend beyond the initial term with the customer continuing to benefit from the advance fee. If Smart Online determines that existing and/or future contracts are expected to extend beyond the initial term whereby the customer continues to benefit from the advance fee, Smart Online would extend the revenue recognition period accordingly to include the extended term. Our contracts and support contracts are non-cancelable, though they provide for early termination upon a material breach by either party that is not cured in a timely manner. Should the contract terminate earlier than its term then we recognize the remaining deferred revenue upon termination. Based on that experience, it is possible that, in the future, the estimates of customer lives may change and, in such event, the period over which such syndication revenues are amortized would be adjusted. Any such change in specified contract lives would affect our future results of operations. Additionally, integration agreements typically include an upfront fee and a revenue sharing component. Fees derived from such revenue sharing arrangements are recorded when earned. To date such revenue sharing fees have been negligible.

Both syndication and integration fees are recognized on a monthly basis over the life of the contract, although a significant portion of the fee from integration is received upfront. Our contracts and support contracts are non-cancelable, though customers typically have the right to terminate their contracts for cause if we fail to perform. We generally invoice our customers in annual or monthly installments and typical payment terms provide that our customers pay us within 30 days of invoice. Amounts that have been invoiced are recorded in accounts receivable and in deferred revenue or revenue depending on whether the revenue recognition criteria have been met. In general, we collect our billings in advance of the service period. Online marketing, which consists of marketing services provided to our integration and syndication partners have in the past generated additional revenue. In addition, certain users have requested that Smart Online implement online marketing initiatives for them, such as promoting their products through Google or Overture Services. Online marketing has not been a material source of past income. We intend to seek an increase in the level of online marketing services in the future.

Web Services revenues are comprised of e-commerce sales directly to end-users, hosting and maintenance fees, e-commerce website design fees and online loan origination fees. E-commerce sales are made either on a subscription or a la carte basis. Subscription, which is access to most Smart Online offerings, is payable in advance on a monthly basis and is targeted at small companies or divisions of large companies. We will seek to grow our monthly subscription volume over the next 24 months as new versions of Smart Online's platforms (OneBiz Conductor[SM]) are released.

Additionally, Smart Online receives a portion of third-party sales of products and services through revenue sharing arrangements, which involves a split of realized revenues. Hosting and maintenance fees are charged for supporting and maintaining the private-label portal and providing customer and technical support directly to our syndication partner's users and are recognized on a monthly basis. E-commerce website design fees which are charged for building and maintaining corporate websites or to add the capability for e-commerce transactions are recognized over the life of the project. We have discontinued our third-party arrangement for online web design. We expect to resume this service after a new partner is under contract. Online loan origination fees are charged to provide users online financing options by which Smart Online receives payments for loan or credit provided. We intend to become more aggressive about promoting this line item in the future.

Subscription revenue is recognized ratably over the subscription period (usually one year). Third-party premium products are shared with integration partners.

OEM revenues are recorded based on the greater of actual sales or contractual minimum guaranteed royalty payments. Smart Online records the minimum guaranteed royalties monthly and receives payment of the royalties on a quarterly basis, 30 days in arrears. To the extent actual royalties exceed the minimum guaranteed royalties, the excess is recorded in the quarter Smart Online receives notification of such additional royalties.

Barter Transactions- Barter revenue relates to syndication and integration services provided by Smart Online to business customers in exchange for advertising in the customers' trade magazines and on their Web sites. Barter expenses reflect the expense offset to barter revenue. The amount of barter revenue and expense is recorded at the estimated fair value of the services received or the services provided, whichever is more objectively determinable, in the month the services and advertising are exchanged. Smart Online applies APB 29, Accounting for Non-Monetary Transactions, the provisions of EITF 93-11, "Accounting for Barter Transactions Involving Barter Credits" and EITF 99-13 "Accounting for Advertising Barter Transactions" and, accordingly, recognizes barter revenues only to the extent that Smart Online has similar cash transactions within a period not to exceed six months prior to the date of the barter transaction. To date, the amount of barter revenue to be recognized has been more objectively determinable based on integration and syndication services provided rather than based upon the value of advertising received. For revenue from integration and syndication services provided for cash to be considered similar to the integration and syndication services provided in barter transactions, the services rendered must have been in the same media and similar term as the barter transaction. Further, the quantity or volume of integration or syndication revenue received in a qualifying past cash transaction can only evidence the fair value of an equivalent quantity or volume of integration or syndication revenue received in subsequent barter transactions. In other words, a past cash transaction can only support the recognition of revenue on integration and syndication contracts transactions up to the dollar amount of the cash transactions. When the cash transaction has been used to support an equivalent quantity and dollar amount of barter revenue, that transaction cannot serve as evidence of fair value for any other barter transaction. Once the value of the barter revenue has been determined, Smart Online follows the same revenue recognition principals as it applies to cash transactions with unearned revenues being deferred as described more fully above. At the time the barter revenue is recorded, an offsetting pre-paid barter advertising asset is recorded on Smart Online’s balance sheet. This pre-paid barter advertising asset is amortized to expense as advertising services are received such as when an advertisement runs in a magazine. Where more than one deliverable exists, such as when the barter partner is to provide advertising in four issues of a magazine, the expense is recognized pro-rata as the advertising deliverable is provided. Barter revenues totaled $160,477 and $5,000 for the three months ended June 30, 2005 and 2004, respectively. Barter revenues totaled $268,142 and $8,333 for the six months ended June 30, 2005 and 2004, respectively.

Cash and Cash Equivalents- All highly liquid investments with an original maturity of three months or less are considered to be cash equivalents.

Marketable Securities- Management determines the appropriate classification of investments in marketable securities at the time of purchase in accordance with Statement of Financial Accounting Standards No. 115. *Accounting for Certain Investments in Debt and Equity Securities* and reevaluates such determination at each balance sheet date. Securities, which are classified as available for sale at December 31, 2004, are carried at fair value, with the unrealized gains and losses, net of tax, reported as a separate component of stockholders' equity. Fair value is determined based on quoted market rates. There were no unrealized gains or losses at December 31, 2004. Realized gains and losses and declines in value judged to be other-than-temporary on securities available for sale are included as a component of interest income. The cost of securities sold is based on the specific-identification method. Interest on securities classified as available for sale is also included as a component of interest income.

Software Development Costs- Smart Online has not capitalized any direct or allocated overhead associated with the development of software products prior to general release. SFAS No. 86, *Accounting for the Costs of Software to be Sold, Leased or Otherwise Marketed*, requires capitalization of certain software development costs subsequent to the establishment of technological feasibility. Based on the Company's product development process, technological feasibility is established upon completion of a working model. Costs related to software development incurred between completion of the working model and the point at which the product is ready for general release have been insignificant.

Impairment of Long Lived Assets- Long-lived assets and certain identifiable intangibles are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell.

Property and Equipment- Property and equipment are stated at cost and are depreciated over their estimated useful lives, using the straight-line method as follows:

Office equipment	5 years
Furniture and fixtures	7 years
Computer software	3 years
Computer equipment	3 years
Automobiles	5 years

Intangible Assets- Intangible assets consists primarily of trademarks and are being amortized over their estimated useful lives.

Fair Values- The fair values of cash equivalents, accounts receivable, accounts payable, accrued liabilities, and notes payable approximate the carrying values due to the short period of time to maturity.

Accretion of Redemption Value of Redeemable Preferred Stock- The Company accreted the redemption value of redeemable preferred stock ratably over the minimum period such stock was outstanding. In addition, accrued but unpaid dividends were recorded to increase the carrying value of the redeemable preferred stock to the redemption value at maturity.

Advertising Costs- Smart Online expenses all advertising costs as they are incurred. The amount charged to expense during the three months ended June 30, 2005 and 2004 were $53,518 and $65,007, respectively. The amount charged to expense during the six months ended June 30, 2005 and 2004 were $189,852 and $54,482, respectively. The 2004 period reflects a credit related to prior advertising activities. These advertising costs included $46,250 and $41,250 of barter advertising expense for the three months ended June 30, 2005 and 2004, respectively, and $181,250 and $41,250 for the six-months ended June 30, 2005 and 2004, respectively.

Net Loss per Share-Basic loss per share is computed using the weighted-average number of common shares outstanding during the periods. Diluted 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 redeemable preferred stock, stock options and warrants that are computed using the treasury stock method. The Company excluded shares issueable upon the exercise of redeemable preferred stock, stock options and warrants from the calculation of common equivalent shares as the impact was anti-dilutive.

Stock-Based Compensation- Smart Online accounts for its stock-based compensation plans in accordance with the intrinsic value provisions of Accounting Principles Board Opinion (“APB”) No. 25, “Accounting for Stock Issued to Employees.” Stock Options are generally granted at prices equal to the fair value of Smart Online's common stock on the grant dates. Accordingly, Smart Online did not record any compensation expense in the accompanying financial statements for its stock-based compensation plans. Had compensation expense been recognized consistent with the fair value provisions of SFAS No. 123, "Accounting for Stock-Based Compensation," Smart Online's net loss attributed to common stockholders and net loss attributed to common stockholders per share for the quarters ended June 30, 2005 and 2004 would have been changed to the pro forma amounts indicated below:

	Three Months Ended		Six Months Ended	
	June 30, 2005 (Restated)	**June 30, 2004**	**June 30, 2005** (Restated)	**June 30, 2004**
Net loss attributed to common stockholders:				
As reported	$ (860,819)	$ (692,786)	$ (1,154,961)	$ (6,733,250)
Add: Compensation cost recorded at intrinsic value	-	-	-	161,000
Less: Compensation cost using the fair value method	(62,352)	(113,658)	(96,404)	(382,483)
Pro forma	$ (923,171)	$ (806,444)	$ (1,251,365)	$ (6,954,733)

	Three months ended		**Six months ended**	
	June 30, 2005	**June 30, 2004**	**June 30, 2005**	**June 30, 2004**
Reported net loss attributed to common stockholders:				
Basic and diluted	$ (0.07)	$ (0.06)	$ (0.10)	$ (0.75)
Pro forma net loss per share:				
Basic and diluted	$ (0.07)	$ (0.08)	$ (0.10)	$ (0.77)

The fair value of option grants under Smart Online's plan and other stock option issuances during the quarter and six months ended June 30, 2005 and 2004 were estimated using the Black-Scholes option-pricing model with the following weighted-average assumptions:

	Three Months Ended		**Six Months Ended**	
	June 30, 2005	**June 30, 2004**	**June 30, 2005**	**June 30, 2004**
Dividend yield	0. 00%	0. 00%	0. 00%	0. 00%
Expected volatility	33.06%	0.00%	0.00 - 33.06%	0.00%
Risk free interest rate	4.24%	4.23%	4..23%	4.23%
Expected lives (years)	9.2	5.0	9.1	5.0

New Accounting Standards

In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment" ("SFAS 123(R)"). SFAS 123(R), a revision of SFAS 123, "Accounting for Stock-Based Compensation", supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees", and amends SFAS No. 95, "Statement of Cash Flows." SFAS 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. SFAS 123(R) is effective for the beginning of the annual period beginning after June 15, 2005. Therefore the Company plans to adopt SFAS 123(R) on January 1, 2006. The Company is currently assessing the impact of this prospective change in accounting and believes that it will not have a material and adverse impact on the Company's reported results of operations.

2. Balance Sheets Accounts

Marketable Securities

At December 31, 2004, marketable securities consisted of the following:

	Amortized Cost	Fair Value
Municipal bonds - redeemed February 2005	$ 395,000	$ 395,000

Smart Online did not hold any marketable securities on June 30, 2005.

Receivables

Smart Online evaluates the need for an allowance for doubtful accounts based on specifically identified amounts that management believes to be uncollectible. Management also records an additional allowance based on certain percentages of its receivables over 90 days old, which are determined based on historical experience and management's assessment of the general financial conditions affecting its customer base. If actual collections experience changes, revisions to the allowance may be required. Based upon the aforementioned criteria, management has determined that no provision for uncollectible accounts is required as of June 30, 2005 and December 31, 2004.

Property and Equipment

Property and equipment consists of the following at:

	June 30, 2005	December 31, 2004
Office equipment	$ 30,897	$ 16,187
Furniture and fixtures	7,125	7,125
Computer software	420,656	393,629
Computer equipment	710,041	663,723
Automobiles	29,504	29,504
	1,198,223	1,110,168
Less accumulated depreciation	(1,056,623)	(1,034,532)
Property and equipment, net	$ 141,600	$ 75,636

Depreciation expense for the three months ended June 30, 2005 and 2004 was $13,155 and $10,104, respectively. Depreciation expense for the six months ended June 30, 2005 and 2004 was $11,093 and $10,104, respectively.

Deferred Compensation

Certain officers of Smart Online deferred a portion of their compensation, including commissions and interest charges on previously earned but unpaid compensation, from the second quarter of 2001 until September, 2003. In October 2003, these salary deferrals plus interest were converted to promissory notes (the "2003 Notes") in the aggregate amount of $1,049,765. These notes were payable on or before May 31, 2004 and bore interest at a rate of 15% per annum. During the fourth quarter of 2003 and the first quarter of 2004, these officers deferred an additional $141,771. Additionally, during this period $50,135 of the original notes payable were repaid. In April 2004, the holders of the 2003 Notes agreed to exchange the existing notes for new promissory notes payable on or before December 31, 2005. The principal amount of the new notes, $1,141,401, included the unpaid principal from the original notes plus the subsequent deferrals. Subsequently during 2004, $160,904 was repaid against the successor notes and an additional $2,302 of compensation was deferred. The successor notes bore interest at a rate of 15% per annum through June 1, 2004 at which time the holders voluntarily reduced the rate to 8% per annum. On April 30, 2004, the 2004 Notes were extended until May 31, 2005, but later during 2004 the officers entered into standstill agreements not to demand payment until June 30, 2006. The standstill agreement was again amended on December 22, 2004, to provide that demand for payment could be made upon the earlier of June 30, 2006 or the closing after January 1, 2005 of a financing with gross proceeds to Smart Online of $2,000,000 or more. After Smart Online raised $2,500,000 from a sale of securities to a foreign investor in February 2005, Smart Online paid in full the $949,777 of deferred compensation, plus all accrued interest of $154,288, and cancelled the related promissory notes to these officers.

3. Stockholders' Equity (Deficit)

Common Stock

During February and March 2005, Smart Online sold 580,000 shares of common stock resulting in gross proceeds of $2.9 million to foreign investors in sales exempt under Regulation S. A portion of those funds were used to repay deferred compensation, including interest thereon, as more fully discussed in Note 2. In connection with this financing, Smart Online incurred stock issuance costs of $290,000. In connection with this financing, Smart Online issued to one of the investors a warrant to purchase 50,000 shares of common stock in consideration for the investor agreeing to certain restrictions on its ability to sell the shares. These warrants have an exercise price of $5 per share and terminate on January 1, 2007. During March 2005, Smart Online raised an additional $125,000 in gross proceeds from the sale of 25,000 shares of common stock at $5.00 per share in a private placement.

In connection with the aforementioned private placement conducted during March 2005, Smart Online and the investors executed registration rights agreements. One of these registration rights agreements requires Smart Online to pay investors 0.5% of their investment for each thirty-day period after April 30, 2005 in which Smart Online failed to file a registration statement registering shares sold in the private placement, which amount is prorated for partial 30-day periods. During the second quarter of 2005, the Company accrued $5,338 as a dividend to the investor.

Warrants

During February 2005, a consulting firm that was issued 350,000 warrants in November 2003 acquired 50,000 shares of Smart Online's Common Stock as a result of the cashless exercise of warrants. Warrants to purchase 67,568 shares of Common Stock were cancelled in this cashless exercise. The fair market value of Smart Online's Common Stock at the time of exercise was $5.00. During May 2005, this same consulting firm acquired 48,617 shares of Smart Online's Common Stock as a result of the cashless exercise of warrants. Warrants to purchase 62,432 shares of Common Stock were cancelled in this cashless exercise. The fair market value of Smart Online's Common Stock at the time of exercise was $5.875. At June 30, 2005, 220,000 of the warrants issued in November 2003 were still outstanding.

Stock Option Plans

Smart Online maintains three equity compensation plans.

The following is a summary of the status of the plan and stock option activity:

	Shares		Weighted Average Exercise Price
BALANCE, December 31, 2004	1,768,900	$	2.78
Granted	307,500		5.31
Exercised	(16,500)		3.50
Forfeited	(350,500)	$	1.82
BALANCE, June 30, 2005	1,709,400	$	4.69

The following table summarizes information about stock options outstanding at June 30, 2005:

				Currently Exercisable	
Exercise Price	Number of Shares Outstanding	Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
$ 1.30 - $ 1.43	670,000	3.5	$ 1.40	670,000	$ 1.40
$ 3.50	497,500	8.8	$ 3.50	186,730	$ 3.50
$ 5.00	493,900	5.5	$ 5.00	234,400	$ 5.00
$ 7.00	48,000	9.9	$ 7.00	-	$ 7.00
$ 1.30 - $ 7.00	1,709,400	5.8	$ 3.21	1,091,130	$ 2.53

Dividends

Smart Online has not paid any cash dividends through June 30, 2005.

4. Major Customers and Concentration of Credit Risk

Smart Online derives a significant portion of its revenues from certain customer relationships. The following is a summary of customers that represent greater than ten percent of total revenues:

		3 Months Ended June 30, 2005	
		Revenues	% of Total Revenues
Customer A	Integration/Barter	$ 82,500	20.3%
Customer B	Integration	50,000	12.3%
Customer C	Integration	51,183	12.6%
Customer D	Syndication/Barter	46,250	11.4%
Others	Various	176,183	43.4%
Total		$ 406,116	100.0%

		3 Months Ended June 30, 2004	
		Revenues	% of Total Revenues
Customer E	Integration	$ 82,513	35.0%
Customer F	Integration	25,000	10.1%
Customer G	Integration	25,000	10.1%
Others	Various	103,332	43.8%
Total		$ 235,845	100.0%

		6 Months Ended June 30, 2005	
		Revenues	% of Total Revenues
Customer A	Integration/Barter	$ 123,750	18.8%
Customer B	Integration	75,000	11.4%
Customer D	Syndication/Barter	80,938	12.3%
Others	Various	379,666	57.5%
Total		$ 659,354	100.0%

		6 Months Ended June 30, 2004	
		Revenues	% of Total Revenues
Customer E	Integration		