SMART ONLINE INC
Form 424B3
November 14, 2007

Filed pursuant to 424(b)(3)
Registration No. 333-141853

PROSPECTUS SUPPLEMENT NO. 6
TO PROSPECTUS DATED JULY 31, 2007
(as supplemented by Prospectus Supplement No. 1 dated August 21, 2007 and
Prospectus Supplement No. 2 dated September 17, 2007, and
Prospectus Supplement No. 3 dated September 24, 2007,
Prospectus Supplement No. 4 dated October 3, 2007, and
Prospectus Supplement No. 5 dated October 22, 2007)

SMART ONLINE, INC.
8,707,051
SHARES OF COMMON STOCK

This prospectus supplement supplements our prospectus dated July 31, 2007 as previously supplemented, which we generally refer to as the prospectus, relating to the resale of up to 8,707,051 shares of our common stock by the selling security holders named in this prospectus and the person(s) to whom such security holders may transfer their shares. These shares consist of:

- 7,051,136 currently outstanding shares; and
- 1,655,915 shares issuable upon exercise of outstanding warrants held by the selling security holders.

The selling security holders named in this prospectus are offering all of the shares of common stock offered through this prospectus. No shares are being offered by us.

This prospectus supplement should be read in conjunction with, and may not be delivered or utilized without, the prospectus. This prospectus supplement is qualified in its entirety by reference to the prospectus, except to the extent that the information in this prospectus supplement supersedes the information contained in the prospectus.

This prospectus supplement includes the attached Quarterly Report on Form 10-Q for the third quarter of 2007, filed with the Securities and Exchange Commission, or the SEC, on November 14, 2007.

NEITHER THE SEC NOR ANY STATE SECURITIES COMMISSION HAS APPROVED OR DISAPPROVED THESE SECURITIES OR PASSED UPON THE ADEQUACY OR ACCURACY OF THIS PROSPECTUS SUPPLEMENT. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

The date of this prospectus supplement is November 14, 2007.

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2007

OR

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

Commission File Number: 001-32634

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

Delaware **(State or other jurisdiction of incorporation or organization)**	**95-4439334** **(I.R.S. Employer Identification No.)**
2530 Meridian Parkway, 2nd Floor **Durham, North Carolina** **(Address of principal executive offices)**	**27713** **(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: Yesx Noo

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

Large Accelerated Filer o   Accelerated Filer o   Non-accelerated Filer 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 November 12, 2007, there were approximately 18,010,000 shares of the registrant's common stock outstanding.

Smart Online, Inc.

PART I. FINANCIAL INFORMATION
1. Financial Statements

SMART ONLINE, INC.
CONSOLIDATED BALANCE SHEETS

	September 30, 2007 (unaudited)		December 31, 2006	
Assets				
CURRENT ASSETS:				
Cash and Cash Equivalents	$	2,228,027	$	326,905
Restricted Cash (See Note 5)		250,000		250,000
Accounts Receivable, Net		964,264		247,618
Current Portion of Note Receivable		50,000		-
Prepaid Expenses		119,109		100,967
Deferred Financing Costs (See Note 5)		414,220		-
Total Current Assets	$	4,025,620	$	925,490
PROPERTY AND EQUIPMENT, Net	$	187,195	$	180,360
LONG TERM PORTION OF NOTE RECEIVABLE		230,000		-
INTANGIBLE ASSETS, Net		3,036,419		3,617,477
GOODWILL		2,696,642		2,696,642
OTHER ASSETS		75,311		13,040
TOTAL ASSETS	$	10,251,187	$	7,433,009
Liabilities and Stockholders' Equity				
CURRENT LIABILITIES:				
Accounts Payable	$	720,845	$	850,730
Accrued Registration Rights Penalty		-		465,358
Current Portion of Notes Payable (See Note 6)		3,187,346		2,839,631
Deferred Revenue (See Note 5)		475,099		313,774
Accrued Liabilities (See Note 5)		629,997		301,266
Total Current Liabilities	$	5,013,287	$	4,770,759
LONG-TERM LIABILITIES:				
Long-Term Portion of Notes Payable (See Note 6)	$	165,863	$	825,000
Deferred Revenue		259,534		11,252
Total Long-Term Liabilities		425,397		836,252
Total Liabilities	$	5,438,684	$	5,607,011
COMMITMENTS AND CONTINGENCIES				
STOCKHOLDERS' EQUITY:				
Common Stock, $.001 Par Value, 45,000,000 Shares Authorized, Shares Issued and Outstanding:				
September 30, 2007 - 18,009,564; December 31, 2006 - 15,379,030		18,009		15,379
Additional Paid-in Capital		66,231,024		59,159,919
Accumulated Deficit		(61,436,530)		(57,349,300)
Total Stockholders' Equity		4,812,503		1,825,998
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$	10,251,187	$	7,433,009

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

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

	Three Months Ended		Nine Months Ended	
	September 30, 2007	September 30, 2006	September 30, 2007	September 30, 2006
REVENUES:				
Integration Fees	$ -	$ 6,250	$ 5,000	$ 182,660
Syndication Fees	15,000	57,352	45,000	183,619
Subscription Fees (See Note 3)	830,660	429,426	2,040,243	1,476,194
Professional Services Fees	378,068	242,177	984,548	601,200
License Fees	200,000	-	480,000	450,000
Other Revenues	5,467	14,001	20,720	54,312
Total Revenues	$ 1,429,195	$ 749,206	$ 3,575,511	$ 2,947,985
COST OF REVENUES	$ 168,035	$ 31,311	$ 355,942	$ 212,515
GROSS PROFIT	$ 1,261,160	$ 717,895	$ 3,219,569	$ 2,735,470
OPERATING EXPENSES:				
General and Administrative	1,398,170	1,208,044	3,567,385	4,844,464
Sales and Marketing	635,201	135,027	1,563,653	666,940
Research and Development	636,780	455,997	1,908,644	1,279,198
Total Operating Expenses	$ 2,670,151	$ 1,799,068	$ 7,039,682	$ 6,790,602
LOSS FROM CONTINUING OPERATIONS	(1,408,991)	(1,081,173)	(3,820,113)	(4,055,132)
OTHER INCOME (EXPENSE):				
Interest Expense, Net	(139,124)	(51,746)	(400,910)	(190,802)
Takeback of Investor Relations Shares	-	1,562,500	-	3,125,000
Legal Reserve and Debt Forgiveness, Net	(39,477)	-	(34,877)	144,351
Writeoff of Investment	-	-	-	(25,000)
Other Income	24,866	-	168,672	-
Total Other Income (Expense)	$ (153,735)	$ 1,510,754	(267,115)	3,053,549
NET INCOME (LOSS) FROM CONTINUING OPERATIONS	(1,562,726)	429,581	(4,087,228)	(1,001,583)
DISCONTINUED OPERATIONS				
Loss of Operations of Smart CRM, net of tax	-	(2,329,429)	-	(2,525,563)
NET LOSS attributed to common stockholders	$ (1,562,726)	(1,899,848)	$ (4,087,228)	$ (3,527,146)
NET LOSS PER SHARE:				
Continuing Operations				
Basic and Fully Diluted	$ (0.09)	$ 0.03	$ (0.24)	$ (0.07)

Discontinued Operations				
Basic and Fully Diluted	$ -	$ (0.15)	$ -	$ (0.17)
Net Loss Attributed to Common Stockholders				
Basic	$ (0.09)	(0.13)	(0.24)	(0.23)
Fully Diluted	(0.09)	(0.12)	(0.24)	(0.23)
SHARES USED IN COMPUTING NET LOSS PER SHARE				
Basic	17,292,639	15,127,510	17,002,827	15,077,583
Fully Diluted	17,292,639	15,387,110	17,002,827	15,077,583

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

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

	Nine Months Ended September 30, 2007	Nine Months Ended September 30, 2006
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net Loss	$ (4,087,228)	$ (1,001,583)
Adjustments to reconcile Net Loss to Net Cash used in Operating Activities:		
Depreciation and Amortization	631,267	530,969
Amortization of Deferred Financing Costs	320,083	-
Takeback of Investor Relation Shares	-	(3,125,000)
Stock Option Related Compensation Expense	574,343	622,442
Writeoff of Investment	-	25,000
Registration Rights Penalty	(320,632)	345,870
Gain on Debt Forgiveness	(215,123)	(144,351)
Changes in Assets and Liabilities:		
Accounts Receivable	(716,154)	215,569
Prepaid Expenses	(18,634)	97,074
Other Assets	(32,271)	129
Deferred Revenue	410,179	(309,460)
Accounts Payable	85,290	379,431
Accrued and Other Expenses	329,643	102,402
Net cash from operations of discontinued operations	-	212,199
Net Cash used in Operating Activities	$ (3,039,237)	$ (2,049,309)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of Furniture and Equipment	(86,549)	(7,362)
Purchase of Tradename	(2,033)	-
Net cash from investing activities of discontinued operations	-	431,076
Net Cash provided by (used in) Investing Activities	$ (88,582)	$ 423,714
CASH FLOWS FROM FINANCING ACTIVITIES:		
Repayments on Notes Payable	(1,784,272)	(1,460,333)
Debt Borrowings	1,472,850	-
Notes Receivable	(280,000)	-
Advances to Smart CRM	-	(744,918)
Advances from Smart CRM	-	1,308,340
Restricted Cash	-	(102,409)
Issuance of Common Stock	5,748,607	2,522,100
Expenses Related to Form S-1 Filing	(128,244)	-
Net cash from financing activities of discontinued operations	-	(651,364)
Net Cash provided by Financing Activities	$ 5,028,941	$ 871,416
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	$ 1,901,122	$ (754,179)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	$ 326,905	$ 1,427,489
CASH AND CASH EQUIVALENTS OF DISCONTINUED OPERATIONS, BEGINNING OF PERIOD	-	7,477
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 2,228,027	$ 680,787
Supplemental Disclosures:		
Cash Paid During the Period for Interest:	$ 247,400	$ ` 154,288

Cash Payment for Interest by Discontinued Operations	-	41,875
Cash Paid for Taxes	-	-
Shares Issued in Settlement of Registration Rights Penalties	144,351	-

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

Smart Online, Inc.
Consolidated Financial Statements - Unaudited

1. Summary of Business and Significant Accounting Policies

Description of Business - Smart Online, Inc. (the "Company") was incorporated in the State of Delaware in 1993. The Company develops and markets Internet-delivered Software-as-a-Service ("SaaS") software applications and data resources to help start and run small businesses. Subscribers access the Company's products through the websites of its private label syndication partners, and its portal at www.onebiz.com. Corporate information on the Company can be found at www.smartonline.com.

Basis of Presentation- The accompanying balance sheet as of September 30, 2007 and the statements of operations for the three months and nine months ended September 30, 2007 and 2006 and the statements of cash flows for the nine months ended September 30, 2007 and 2006 are unaudited. The balance sheet as of December 31, 2006 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 position and results of operations, contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2006 filed with the Securities and Exchange Commission (the "SEC") on March 30, 2007 (the "2006 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 September 30, 2007, and its results of operations for the three months and nine months ended September 30, 2007 and September 30, 2006 and the statements of cash flows for the nine months ended September 30, 2007 and 2006. The results for the three months and nine months ended September 30, 2007 are not necessarily indicative of the results to be expected for the fiscal year ending December 31, 2007.

The Company continues to incur development expenses to enhance and expand its products by focusing on establishing its Internet-delivered SaaS applications and data resources. All allocable expenses to establish the technical feasibility of the software have been recorded as research and development expense. The ability of the Company to successfully develop and market its products is dependent upon certain factors, including the timing and success of any new services and products, the progress of research and development efforts, results of operations, the status of competitive services and products, and the timing and success of potential strategic alliances or potential opportunities to acquire technologies or assets.

Significant Accounting Policies - In the opinion of the Company's management, the significant accounting policies used for the three months and nine months ended September 30, 2007 are consistent with those used for the years ended December 31, 2006, 2005 and 2004. Accordingly, please refer to the 2006 Annual Report for our significant accounting policies.

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

Revenue Recognition - The Company derives revenue from the license of software platforms along with the sale of associated maintenance, consulting, and application development services. The arrangement may include delivery in multiple-element arrangements if the customer purchases a combination of products and/or services. The Company uses the residual method pursuant to American Institute of Certified Public Accountants ("AICPA") Statement of Position 97-2, *Software Revenue Recognition* ("SOP 97-2"), as amended. This method allows the Company to recognize revenue for a delivered element when such element has vendor specific objective evidence ("VSOE") of the fair value of the delivered element. If VSOE cannot be determined or maintained for an element, it could impact revenues as all or a portion of the revenue from the multiple-element arrangement may need to be deferred.

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

The amount of revenue to be recognized from development and consulting services is typically based on the amount of work performed within a given period. Revenue recognition is typically 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. Changes in estimates of progress to completion and costs to complete are accounted for as cumulative catch-up adjustments.

Under SOP 97-2, provided the arrangement does not require significant development, modification or customization, revenue is recognized when all of the following criteria have been met:

1. persuasive evidence of an arrangement exists
2. delivery has occurred
3. the fee is fixed or determinable
4. collectability is probable

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

Fiscal Year - The Company's fiscal year ends December 31. References to fiscal 2006, for example, refer to the fiscal year ending December 31, 2006.

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.

Software Development Costs - The Company has not capitalized any direct or allocated overhead associated with the development of software products prior to general release. Statement of Financial Accounting Standard (“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 historically 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.

Advertising Costs - The Company expenses all advertising costs as they are incurred. The amounts charged to sales and marketing expense during the third quarter of 2007 and 2006 were $11,133 and $104, respectively. The amounts charged to sales and marketing expense during the first nine months of 2007 and 2006 were $26,802 and $42,419, respectively. There were no barter advertising expenses for the three months ending September 30, 2007 and September 30, 2006, respectively, and $0 and $37,915 for the nine months ended September 30, 2007 and September 30, 2006, respectively.

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

Stock-Based Compensation - In December 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 123 (revised 2004), *Share-Based Payment* ("SFAS No. 123R"), which replaces SFAS No. 123, *Accounting for Stock-Based Compensation* ("SFAS No. 123"), and supersedes Accounting Principles Board ("APB") Opinion No. 25, *Accounting for Stock Issued to Employees* ("APB No. 25"). SFAS No. 123R requires all share-based payments, including grants of employee stock options and restricted stock, to be recognized in the financial statements based on their fair values. Under SFAS No. 123R, public companies are required to measure the costs of services received in exchange for stock options, restricted stock and similar awards based on the grant date fair value of the awards and recognize this cost in the income statement over the period during which an award recipient is permitted to provide service in exchange for the award. The pro forma disclosures previously permitted under SFAS No. 123 are no longer an alternative to financial statement recognition.

The Company maintains stock-based compensation arrangements under which employees, consultants and directors may be awarded grants of unrestricted and restricted stock. Effective January 1, 2006, the Company adopted SFAS No. 123R using the Modified Prospective Approach. Under the Modified Prospective Approach, the amount of compensation cost recognized includes: (i) compensation cost for all share-based payments granted prior to, but not yet vested as of, January 1, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123 and (ii) compensation cost for all share-based payments that will be granted subsequent to January 1, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123R. Upon adoption, the Company recognizes the stock-based compensation of previously granted share-based awards and new share-based awards under the straight-line method over the requisite service period. Total stock-based compensation expense recognized under SFAS No. 123R was approximately $194,325 and $574,344 for the three months and nine months ended September 30, 2007, respectively. Total stock-based compensation expense recognized under SFAS No. 123R was approximately $173,428 and $622,442 for the three months and nine months ended September 30, 2006, respectively. No stock-based compensation was capitalized in the consolidated financial statements.

The fair value of option grants under the Company's 2004 Equity Compensation Plan (the “2004 Plan”) and other stock options outstanding during the three months and nine months ended September 30, 2007 and September 30, 2006 was estimated using the Black-Scholes option-pricing model with the following weighted-average assumptions:

	Three Months Ended		**Nine Months Ended**	
	September 30, 2007	**September 30, 2006**	**September 30, 2007**	**September 30, 2006**
Dividend yield	0.0%	0. 00%	0.0%	0. 00%
Expected volatility	150%	48.6%	150%	150%
Risk free interest rate	4.59%	4.64%	4.59%	4.64%
Expected lives (years)	5	5	5	5

The expected lives of the options represents the estimated period of time until exercise or forfeiture and is based on historical experience of similar awards. Expected volatility is based on the historical volatility of the Company’s common stock over a period of time. The risk free interest rate is based on the published yield available on U.S. treasury issues with an equivalent term remaining equal to the expected life of the option.

Compensation expense is recognized only for option grants expected to vest. The Company estimates forfeitures at the date of grant based on historical experience and future expectation.

The following is a summary of the stock option activity for the nine months ended September 30, 2007:

	Shares	**Weighted Average Exercise Price**
BALANCE, December 31, 2006	2,360,100	$ 5.33
Granted	20,000	$ 2.80
Forfeited	160,800	$ 4.49
Exercised	20,000	$ 1.30
BALANCE, September 30, 2007	2,199,300	$ 5.40

Recently Issued Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* ("SFAS No. 157"). SFAS No. 157 defines fair value, establishes a framework for measuring fair value in U.S. GAAP, and expands disclosures about fair value measurements. SFAS No. 157 applies under other accounting pronouncements that require or permit fair value measurements, the FASB having previously concluded in those accounting pronouncements that fair value is a relevant measurement attribute. Accordingly, SFAS No. 157 does not require any new fair value measurements. However, for some entities, the application of SFAS No. 157 will change current practices. SFAS No. 157 is effective for financial statements for fiscal years beginning after November 15, 2007. Earlier application is permitted provided that the reporting entity has not yet issued financial statements for that fiscal year. Management does not believe that the adoption of SFAS No. 157 will have a material impact on the Company's results of operations or financial condition once adopted.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities - Including an amendment of FASB Statement No. 115* ("SFAS No. 159"). SFAS No. 159 provides companies with an option to measure, at specified election dates, many financial instruments and certain other items at fair value that are not currently measured at fair value. A company that adopts SFAS No. 159 will report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. SFAS No. 159 also establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. Management does not believe that the adoption of SFAS No. 159 will have a material impact on the Company's results of operations or financial condition once adopted.

2. PRESENTATION OF SUBSIDIARIES

As more fully detailed in the 2006 Annual Report, the Company completed two acquisitions in October 2005. On October 4, 2005, the Company purchased substantially all of the assets of Computility, Inc. (“Computility”). In consideration for the purchased assets, the Company issued the seller 484,213 shares of the Company's common stock and assumed certain liabilities of Computility totaling approximately $1.9 million. The shares were valued at $7.30 per share, which was the median trading price on the acquisition date. The total purchase price, including liabilities assumed, was approximately $5.8 million including approximately $228,000 of acquisition fees. The Company operated this business under the name Smart CRM, Inc. (d/b/a Computility) (“Smart CRM”).

On October 18, 2005, the Company completed its purchase of all of the capital stock of iMart Incorporated (“iMart”), a Michigan based company providing multi-channel electronic commerce systems. The Company issued 205,767 shares of its common stock to iMart's stockholders and agreed to pay iMart's stockholders approximately $3,462,000 in cash installments. This cash amount was payable in four equal payments of $432,866 on the first business day of each of January 2006, April 2006, July 2006 and October 2006. The final installment payment of approximately $1.7 million was payable in January 2007. As of January 2007, the entire purchase price was paid in full. The shares were valued at $8.825 per share, which was the median trading price on the acquisition date. The total purchase price for all of the outstanding iMart shares was approximately $5.3 million including approximately $339,000 of acquisition fees. The Company operates this subsidiary as Smart Commerce, Inc. (d/b/a iMart) (“Smart Commerce”).

Upon the Company's successful integration of the sales force automation and customer relationship management (“SFA/CRM”) application into its OneBiz[SM] platform, management deemed the remaining operations of Smart CRM, specifically consulting and network management, to be non-strategic to ongoing operations. On September 29, 2006, the Company, Smart CRM and Alliance Technologies, Inc. ("Alliance") executed and delivered an Asset Purchase Agreement pursuant to which Alliance acquired substantially all of the assets of Smart CRM. In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, the Company has reported the operating results for Smart CRM as discontinued operations. For the three months and nine months ended September 30, 2006, the revenues associated with the discontinued operations were $462,468 and $1,497,002, respectively. For the three months and nine months ended September 30, 2006, the net losses associated with the discontinued operations were $(2,329,429) and $(2,525,563), respectively. Because the sale had been completed in 2006, the 2007 periods contain no results of discontinued operations.

3. SUBSCRIPTION REVENUE

Effective January 1, 2007, a major customer executed a letter of clarification which more clearly defined the roles and responsibilities of each party. Individual Business Owners (“IBOs”) associated with this customer are provided e-commerce, domain name and email services. In exchange for marketing these services to its IBOs, the customer is paid a marketing fee. At the inception of the business relationship, it was agreed that the customer would collect the gross service fee from the IBOs, and the customer would retain its marketing fee and remit the net remaining cash to the Company. Because the roles and responsibilities of each party were vaguely defined in the past, revenue was recorded only on the net cash received. Following the execution of the letter of clarification and in accordance with Emerging Issues Task Force (“EITF”) 99-19, *Reporting Revenue Gross as a Principal versus Net as an Agent,* this revenue is now recorded as the gross amount paid by the IBO and a sales and marketing expense is recorded for the marketing services rendered by the customer. Ultimately, the effect on net income is nil; however, subscription revenue and sales and marketing expense are effectively and appropriately grossed up. Because the new accounting method was triggered by a clarification to the existing agreement and not by a change from one accepted accounting method to another, the 2006 subscription revenue was not retroactively adjusted as would be required by SFAS No. 154, *Accounting Changes and Error Corrections - a replacement of APB Opinion No. 20 and FASB Statement No. 3*. For the three months and nine months ended September 30, 2007, this accounting method resulted in approximately $203,000 and $691,000, respectively, of additional subscription revenue and a corresponding charge to sales and marketing expense.

4. INDUSTRY SEGMENT INFORMATION

SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information* (“SFAS No. 131”), establishes standards for the way in which public companies disclose certain information about operating segments in their financial reports. Consistent with SFAS No. 131, the Company has defined two reportable segments, described below, based on factors such as geography, how the Company manages its operations and how its chief operating decision maker views results.

Smart Commerce revenue is generally composed of subscription fees, professional services fees and licensing fees related to domain name subscriptions, e-commerce or networking consulting or networking maintenance agreements.

The Smart Online segment generates revenue from the development and distribution of internet-delivered SaaS small business applications through a variety of subscription, licensing, integration and syndication channels.

The Company includes costs such as corporate general and administrative expenses and share-based compensation expenses that are not allocated to specific segments in the Smart Online segment, which includes the parent or corporate segment.

The following table shows the Company's financial results by reportable segment for the three months ended September 30, 2007:

	Smart Online, Inc.	Smart Commerce, Inc.	Consolidated
REVENUES:			
Syndication Fees	15,000	-	15,000
Subscription Fees	13,892	816,768	830,660
Professional Services Fees	-	378,068	378,068
License Fees	-	200,000	200,000
Other Revenues	1,117	4,350	5,467
Total Revenues	$ 30,009	$ 1,399,186	$ 1,429,195
COST OF REVENUES	$ 60,748	$ 107,287	$ 168,035
OPERATING EXPENSES	$ 1,756,889	$ 913,262	$ 2,670,151
OPERATING INCOME (LOSS)	$ (1,787,628)	$ 378,637	$ (1,408,991)
OTHER INCOME (EXPENSE)	$ (126,424)	$ (27,311)	$ (153,735)
NET INCOME/(LOSS) BEFORE INCOME TAXES	$ (1,914,052)	$ 351,326	$ (1,562,726)
TOTAL ASSETS	$ 6,564,696	$ 3,686,492	$ 10,251,187

The following table shows the Company's financial results by reportable segment for the nine months ended September 30, 2007:

	Smart Online, Inc.	Smart Commerce, Inc.	Consolidated
REVENUES:			
Integration Fees	$ 5,000	$ -	$ 5,000
Syndication Fees	45,000	-	45,000
Subscription Fees	41,426	1,998,817	2,040,243
Professional Services Fees	-	984,548	984,548
License Fees	280,000	200,000	480,000
Other Revenues	6,802	13,918	20,720
Total Revenues	$ 378,228	$ 3,197,283	$ 3,575,511
COST OF REVENUES	$ 109,522	$ 246,420	$ 355,942
OPERATING EXPENSES	$ 4,743,036	$ 2,296,646	$ 7,039,682

OPERATING INCOME (LOSS)	$	(4,474,330)	$	654,217	$	(3,820,113)
OTHER INCOME (EXPENSE)	$	(168,106)	$	(99,009)	$	(267,115)
NET INCOME/(LOSS) BEFORE INCOME TAXES	$	(4,642,436)	$	555,208	$	(4,087,228)
TOTAL ASSETS	$	6,564,696	$	3,686,492	$	10,251,187

5. ASSETS & LIABILITIES

Accounts Receivable, Net

The Company 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 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 on these criteria, management has recorded an allowance for doubtful accounts of approximately $65,000 and $65,000 as of September 30, 2007 and December 31, 2006, respectively.

Restricted Cash

Under the terms of a promissory note between Smart Commerce and Fifth Third Bank, $250,000 on deposit at Fifth Third Bank serves as loan collateral and is restricted. Such restricted cash is scheduled to be released from the restrictions in three equal installments of approximately $83,000, on June 30, 2007, December 31, 2007 and June 30, 2008, if the Company meets certain debt covenants regarding operating metrics for Smart Commerce. Those operating metrics relate to Smart Commerce’s actual results of operations as compared to certain projections provided to Fifth Third Bank at the inception of the loan. The metrics for the June 30, 2007 release were not met, and therefore, no cash has yet been released.

Deferred Financing Costs

In order to secure a modification to a line of credit with Wachovia Bank, NA (“Wachovia”) (see Note 6 - Notes Payable), Atlas Capital, S.A. (“Atlas”) provided the Company with a modified letter of credit. In exchange for the modified letter of credit, the Company issued Atlas a warrant to purchase 444,444 shares of common stock at $2.70 per share (see Note 7 - Stockholders' Equity). The fair value of that warrant was $734,303 as measured using the Black-Scholes option-pricing model at the time the warrant was issued. Such amount was recorded as deferred financing costs and is being amortized to interest expense in the amount of $37,657 per month over the remaining period of the modified line of credit, which is scheduled to expire in August 2008. As of September 30, 2007, the deferred financing costs that will be amortized to interest expense over the next twelve months, or $414,220, were classified as current assets.

Accrued Liabilities

At December 31, 2006, the Company had accrued liabilities totaling $301,266. This amount consisted primarily of $107,333 of liability accrued related to the development of the Company’s custom accounting application, $56,997 related to its internal investigation conducted during 2006 and $25,000 accrued liability related to a lawsuit against the Company for legal fees incurred by an independent director in connection with the suspension of trading of the Company’s securities. At September 30, 2007, total accrued liabilities increased to $629,997. This amount reflects the addition of $300,000 of additional accrued liability as a reserve for the current litigation involving the Company.

Deferred Revenue

At December 31, 2006, deferred revenue consisted of the short-term and long-term portion of cash received related to one or two year subscriptions for domain names and/or email accounts. At September 30, 2007, deferred revenue consisted of the same domain name and e-mail types of deferred revenue in the amount of $254,633. In addition, at September 30, 2007, the Company had deferred $480,000 of perpetual licensing revenue related to two customers that did not meet all the criteria of SOP 97-2. Such deferred revenue will be recognized as cash is received or collectability becomes probable.

6. NOTES PAYABLE

As of September 30, 2007, the Company had notes payable totaling $3,353,209. The detail of these notes is as follows:

Note Description	Short-Term Portion	Long-Term Portion	TOTAL	Maturity	Rate
Wachovia Credit Line	$ 2,052,000	-	$ 2,052,000	Aug `08	Libor + 0.9%
Fifth Third Loan	$ 900,000	150,000	1,050,000	Nov `08	Prime + 1.5%
Ailco Financial	6,987	15,863	22,850	June '10	18%
Acquisition Fee (iMart)	209,177	-	209,177	Oct '07	8%
Acquisition Fee (Computility)	19,182	-	19,182	Mar '07	8%
TOTAL	$ 3,187,346	$ 165,863	$ 3,353,209		

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On January 24, 2007, the Company entered into an amendment to its line of credit with Wachovia. The amendment resulted in an increase in the line of credit from $1.3 million to $2.5 million. The pay-off date for the line of credit was also extended from August 1, 2007 to August 1, 2008. Interest accrues on the unpaid principal balance at the LIBOR Market Index Rate plus 0.9%. The line of credit is secured by the Company's deposit account at Wachovia and an irrevocable standby letter of credit in the amount of $2,500,000 issued by HSBC Private Bank (Suisse) S.A. with Atlas as account party. As of September 30, 2007, the Company has drawn down approximately $2.1 million on the line of credit.

7. STOCKHOLDERS' EQUITY

Common Stock and Warrants

During the nine months ended September 30, 2007, a total of 159,500 shares of restricted stock were issued. A total of 55,000 shares of restricted stock were issued to the Company’s independent directors in accordance with the Company’s board compensation policy. The restrictions on such shares lapse with respect to the number of shares equal to 25% of the total securities issued over the subsequent four quarters provided that the director remains on the Board of Directors at the time each quarter commences. A total of 25,000 shares of restricted stock were issued to the newly appointed Chief Operating Officer, with the restrictions on such shares lapsing with respect to the number of shares equal to 12.5% of the total securities issued over the subsequent eight quarters, provided that at the time each quarter commences, the officer is still employed as an officer of Company. Finally, a total of 79,500 shares of restricted stock were issued to various employees, one of whom is an officer. Restrictions lapse as to one-third of these shares upon grant, with restrictions lapsing on the remaining shares over the next two years provided the respective employee remains employed by the Company.

In a transaction that closed on February 21, 2007, the Company sold an aggregate of 2,352,941 shares of its common stock to two new investors (the “Investors”). The private placement shares were sold at $2.55 per share pursuant to a Securities Purchase Agreement (the “SPA”) between the Company and each of the Investors. The aggregate gross proceeds to the Company were $6 million, and the Company has incurred issuance costs of approximately $637,000 as of September 30, 2007. Under the SPA, the Company issued the Investors 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, if at all, by February 21, 2010.

The Company and each of the Investors also entered into a Registration Rights Agreement (the “Investor RRA”) whereby the Company had an obligation to register the shares for resale by the Investors by filing a registration statement within 30 days of the closing of the private placement, and to have the registration statement declared effective 60 days after actual filing, or 90 days after actual filing if the SEC reviewed the registration statement. If a registration statement was not timely filed or declared effective by the date set forth in the Investor RRA, the Company would have been obligated to pay a cash penalty of 1% of the purchase price on the day after the filing or declaration of effectiveness was due, and 0.5% of the purchase price per every 30-day period thereafter, to be prorated for partial periods, until the Company fulfilled these obligations. Under no circumstances could the aggregate penalty for late registration or effectiveness exceed 10% of the aggregate purchase price. Under the terms of the Investor RRA, the Company could not offer for sale or sell any securities until May 22, 2007, subject to certain limited exceptions, unless, in the opinion of the Company's counsel, such offer or sale did not jeopardize the availability of exemptions from the registration and qualification requirements under applicable securities laws with respect to this placement. On March 28, 2007, the Company entered into an amendment to the Investor RRA with each Investor to extend the registration filing obligation date by an additional eleven calendar days. On April 3, 2007, the Company filed the registration statement within the extended filing obligation period, thereby avoiding the first potential penalty. Effective July 2, 2007, the Company entered into another amendment to the Investor RRA to extend the registration effectiveness obligation date to July 31, 2007. On July 31, 2007, the SEC declared the registration statement effective. Accordingly, the Company met all of its requirements under the amended Investor RRA and no penalties were incurred.

As part of the commission paid to Canaccord Adams Inc. (“CA”), the Company's placement agent in the transaction described above, 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. CA and the Company also entered into a Registration Rights Agreement (the “CA RRA”). Under the CA RRA, the shares issuable upon exercise of the warrant were required to be included on the same registration statement the Company was obligated to file under the Investor RRA described above, but CA was not entitled to any penalties for late registration or effectiveness.

As incentive to modify a letter of credit relating to the Wachovia line of credit (see Note 6 - 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 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. If the warrant is exercised in full, it will result in gross proceeds to the Company of approximately $1,200,000.

On March 29, 2007, the Company issued 55,666 shares of its common stock to certain investors as registration penalties for its failure to timely file a registration statement covering shares owned by those investors as required pursuant to amendments to registration rights agreements between such investors and the Company. On July 20, 2007, the Company issued 27,427 additional shares as registration penalties to certain investors who did not enter into amendments to certain registration rights agreements.

On July 30, 2007, certain of the Company's affiliates entered into lock-up agreements covering a portion of their shares (the "Lock-Up Agreements"). These agreements restrict the sale of 1,296,623 shares of the Company's common stock. Under the terms of these Lock-Up Agreements, these affiliates cannot sell, pledge, grant or otherwise transfer the shares subject to the agreement for one year following July 31, 2007. After one year, 2.5% of these shares per quarter are released from these restrictions on a pro rata basis among these affiliates. All remaining shares will be released from the Lock-Up Agreements on July 31, 2009. These Lock-Up Agreements will otherwise terminate at the following times: (A) if the Registration Statement on Form S-1 filed by the Company and declared effective on July 31, 2007 (the "Registration Statement") is terminated, the earlier of (i) the date of termination if no shares were sold, or (ii) the date any proceeds received from public investors are placed in the mail for return; (B) the date the Company's common stock is listed on a national securities exchange, or (C) 30 days following the date the persons signing these Lock-Up Agreements are no longer affiliates.

Equity Compensation Plans

On April 11, 2007, the Company entered into a stock option agreement for the purchase of up to 20,000 shares of the Company's common stock at an exercise price of $2.80 per share with an independent director. Under the terms of the option agreement, this option vests in equal quarterly increments on February 16, 2007, May 16, 2007, August 16, 2007, and November 16, 2007 if this director is serving as a member of the Company's Board of Directors on such dates. These dates were selected so that all shares will have vested by the first anniversary of this director's appointment to the Board. In the event of a change of control or reorganization of the Company (both as defined in the option agreement), the option vests as to all shares on the date of such event.

In June 2007, the Company limited the issuance of shares of its common stock reserved under the 2004 Plan to awards of restricted or unrestricted stock. Also in June 2007, the non-interested members of the Company's Board of Directors approved an offer for certain holders of outstanding options with an exercise price of $2.50 per share or greater, including such options held by the Company's named executive officers and directors, to exchange the outstanding options for a certain number of shares of restricted stock. In this offer, the Company intends to divide the outstanding options into classes based on the exercise price and the remaining expected life of the option and to use the Black-Scholes option-pricing model in its determination of the exchange ratios for the several classes of eligible options. The Company targets using exchange ratios such that the eligible options surrendered for cancellation would exceed the number of shares of restricted stock that would be received in exchange for such options. The exchange offer has not commenced and will not commence until certain actions are taken by the Company, including the filing of a tender offer statement and offer to exchange on Schedule TO with the SEC.

The following table summarizes information about stock options outstanding at September 30, 2007:

				Currently Exercisable	
Exercise Price	**Number of Shares Outstanding**	**Average Remaining Contractual Life (Years)**	**Weighted Average Exercise Price**	**Number of Shares**	**Weighted Average Exercise Price**
From $1.30 to $1.43	575,000	1.3	$ 1.41	575,000	$ 1.41
From $2.50 to $3.50	432,500	7.0	$ 3.34	284,708	$ 3.44
$5.00	211,600	8	$ 5.00	196,600	$ 5.00
$7.00	150,000	8.3	$ 7.00	50,000	$ 7.00
From $8.61 to $9.00	570,000	7.9	$ 8.71	200,700	$ 8.68
From $9.60 to $9.82	260,200	0.7	$ 9.82	210,080	$ 9.82

Dividends

The Company has not paid any cash dividends through September 30, 2007.

8. MAJOR CUSTOMERS AND CONCENTRATION OF CREDIT RISK

The Company 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 for their respective time periods:

		Three Months Ended September 30, 2007	
		Revenues	% of Total Revenues
Customer A	License Fees	$ 218,330	15%
Customer B	Subscriptions	$ 425,778	30%
Customer C	Professional Service Fees	$ 327,937	23%
Others	Various	$ 457,150	32%
Total		$ 1,429,19529	100%

		Three Months Ended September 30, 2006	
		Revenues	% of Total Revenues
Customer C	Professional Service Fees	$ 185,935	25%
Customer B	Subscription	$ 352,553	47%
Others	Various	$ 210,718	28%
Total		$ 749,206	100%

		Nine Months Ended September 30, 2007	
		Revenues	% of Total Revenues
Customer C	Professional Service Fees	$ 754,493	21%
Customer B	Subscription	$ 1,562,319	44%
Others	Various	$ 1,258,699	35%
Total		$ 3,575,511	100%

		Nine Months Ended September 30, 2006	
		Revenues	% of Total Revenues
Customer B	Professional Services	$ 848,217	29%
Customer C	Subscription	$ 1,365,826	46%
Others	Various	$ 733,942	25%
Total		$ 2,947,985	100%

As of September 30, 2007, the Company had three customers that accounted for 18%, 19% and 34% of net receivables, respectively. As of September 30, 2006, the Company had three customers that accounted for 11%, 29% and 50% of net receivables, respectively.

9. COMMITMENTS AND CONTINGENCIES

Please refer to Part I, Item 3 of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2006 for a description of material legal proceedings, including the proceedings discussed below.

Securities and Exchange Commission Litigation. As previously disclosed in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2006, the SEC temporarily suspended the trading of the Company's securities on January 17, 2006 and advised the Company that it was conducting a non-public investigation. On September 11, 2007, the Company was informed that Dennis Michael Nouri, its then serving President, Chief Executive Officer, and a director, had been charged in a criminal complaint that alleges federal securities fraud and conspiracy to commit fraud. The Company is not named in the criminal complaint. The U.S. government filed the complaint under seal on August 1, 2007 in the U.S. District Court for the Southern District of New York. Also named as defendants in the criminal complaint are Reeza Eric Nouri, a former manager of the Company, and Ruben Serrano, Anthony Martin, James Doolan, and Alain Lustig, brokers alleged to have participated with the Nouris in the alleged fraud. The criminal complaint alleges that the defendants, directly and indirectly, used manipulative and deceptive devices in violation of Sections 2 and 371 of Title 18 of the U.S. Code, Sections 10(b) and 32 of the Securities Exchange Act of 1934, as amended ("the Exchange Act"), and Rule 10b-5 promulgated under the Exchange Act ("Rule 10b-5"). On November 8, 2007, as part of this on-going action, the U.S. government filed a grand jury indictment against Dennis Michael Nouri, Reeza Nouri, Reuben Serrano and Alain Lustig in the U.S. District Court for the Southern District of New York. The grand jury indictment charges these defendants with conspiracy to commit securities fraud in violation of Sections 78j(b) and 78 ff of Title 17 of the U.S. Code and Rule 10b-5, wire fraud in violation of Sections 1343 and 1346 of Title 18 of the U.S. Code and commercial bribery in violation of Section 1952(a)(3) of Title 18 of the U.S. Code and Sections 180.00 and 180.03 of the New York State Penal Law. Under the grand jury indictment, the U.S. government is seeking forfeiture from these defendants of all property, real and personal, that constitutes or is derived from proceeds traceable to the commission of the alleged securities fraud offenses.

On September 11, 2007, the SEC filed a civil action against the Company and the defendants named in the criminal complaint in the U.S. District Court for the Southern District of New York. The SEC complaint alleged that the defendants in this civil action, either directly or indirectly, engaged in transactions, acts, practices, and courses of business which constitute violations of Section 17(a) of the Securities Act of 1933, as amended ("the Securities Act"), Section 10(b) of the Exchange Act, and Rule 10b-5. The SEC complaint sought to permanently enjoin each of the civil defendants from committing future violations of the foregoing federal securities laws. The SEC complaint also requested that each of the defendants, excluding the Company, be required to disgorge his ill-gotten gains and pay civil penalties. The SEC complaint further sought an order permanently barring Michael Nouri from serving as an officer or director of a public company. The SEC complaint did not seek any fines or other monetary penalties against the Company. On September 28, 2007, the Company agreed, without admission of any liability, to the entry of a consent judgment against it which permanently enjoins it from further violations of the antifraud provisions of the federal securities laws, specifically Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5. No fines or other monetary sanctions were levied against the Company. The consent judgment settles the SEC complaint against the Company and was entered by the court on October 2, 2007. The litigation is continuing against the other defendants.

Gooden v. Smart Online, Inc. 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, and Jesup & Lamont Securities Corp. 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 asserts violations of federal securities laws, including violations of Section 10(b) of the Exchange Act and Rule 10b-5. The complaint is based on the matters alleged in the SEC complaint described above and asserts that the defendants participated 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 requests 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.

Nouri v. Smart Online, Inc. On October 17, 2007, Henry Nouri, the Company's former Executive Vice President, filed a civil action against the Company in the General Court of Justice, Superior Court Division, in Orange County, North Carolina. The complaint alleges that the Company had no "cause" to terminate Mr. Nouri's employment and that it breached Mr. Nouri's employment agreement by notifying him that his employment was terminated for cause, by failing to itemize the cause for the termination, and by failing to pay him benefits to which he would have been entitled had his employment been terminated without "cause." The complaint seeks unspecified compensatory damages, including interest, a declaratory judgment that no cause existed for the termination of Mr. Nouri's employment and that Mr. Nouri is entitled to the benefits provided under his employment agreement for a termination without "cause," and costs and expenses.

At this time, the Company is not able to determine the likely outcome of the legal matters described above, nor can it estimate its potential financial exposure. The Company's management has made an initial estimate based upon its knowledge, experience and input from legal counsel, and the Company has accrued approximately $300,000 of additional legal reserves. Such reserves will be adjusted in future periods as more information becomes available.

10. SUBSEQUENT EVENTS

On November 14, 2007, in an initial closing, the Company sold $3.3 million aggregate principal amount of secured subordinated convertible notes due November 14, 2010. In addition, the noteholders have committed to purchase on a pro rata basis up to $5.2 million aggregate principal of secured subordinated notes upon approval and call by the Company's Board of Directors in future closings. The Company is obligated to pay interest on the notes at an annualized rate of 8% payable in quarterly installments commencing on February 14, 2008. The Company does not have the ability to prepay the notes without approval of at least a majority of the principal amount of the notes then outstanding.

On the earlier of the maturity date of November 14, 2010 or a merger, acquisition, sale of all or substantially all of the Company's assets or capital stock or similar transaction, each noteholder in its sole discretion shall have the option to:

- convert the principal then outstanding on its note into shares of the Company's common stock, or
- demand immediate repayment in cash of the note, including any accrued and unpaid interest.

If a noteholder elects to convert its note under these circumstances, the conversion price for notes:

- issued in the initial closing on November 14, 2007 shall be a 20% premium above the average of the closing bid and asked prices of shares of the Company's common stock quoted in the Over-The-Counter Market Summary averaged over five trading days prior to November 14, 2007; and
- issued in any additional closings shall be the lesser of a 20% premium above the average of the closing bid and asked prices of shares of the Company's common stock quoted in the Over-The-Counter Market Summary (or, if the Company's shares are traded on the Nasdaq StockMarket or another exchange, the closing price of shares of the Company's common stock quoted on such exchange) averaged over five trading days prior to the respective additional closing date.

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

The notes and the common stock into which they may be converted have not been registered under the Securities Act or the securities laws of any other jurisdiction. As a result, offers and sales of the notes were made pursuant to Regulation D of the Securities Act and only made to accredited investors that were the Company's existing stockholders. The investors include, among others, (i) The Blueline Fund, who originally recommended Philippe Pouponnot, one of the Company's directors, for appointment to the Company's Board of Directors, (ii) Atlas Capital, S.A., who originally recommended Shlomo Elia, another one of the Company's directors, for appointment to the Board of Directors, and (iii) William Furr, who is the father of Thomas Furr, one of the Company's directors and executive officers.

In addition, 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.

On November 6, 2007, Canaccord Adams Inc. agreed to waive any rights it held under its January 2007 engagement letter with the Company that it may have with respect to the convertible note offering, including the right to receive any fees in connection with the offering.

2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Information set forth in this Quarterly Report on Form 10-Q contains various forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, or the Securities Act, and Section 21E of the Securities Exchange Act of 1934, or the Exchange Act. Forward-looking statements consist of, among other things, trend analyses, statements regarding future events, future financial performance, our plan to build our business and the related expenses, our anticipated growth, trends in our business, the effect of foreign currency exchange rate and 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 below, under "Risk Factors" and elsewhere in this report, for factors that may cause actual results to be different than those expressed in these forward-looking statements. Except as required by law, we *undertake no obligation to revise or update publicly any forward-looking statements for any reason.*

Overview

We develop and market Internet-delivered Software-as-a-Service, or SaaS, software applications and data resources for small businesses. We reach small businesses through (1) syndication arrangements with other companies that private label our software applications through their corporate web sites and (2) our own website at www.onebiz.com. Our syndication relationships provide a cost and time effective way to market our products and services to the small business sector. We also provide solutions to companies developing customized IT applications through the licensing of one of our platforms.

We currently operate our company in two segments. Those segments are our core operations, or the Smart Online segment, and the operations of our wholly-owned subsidiary Smart Commerce, Inc., or the Smart Commerce segment. The Smart Online segment generates revenues from the development and distribution of Internet-delivered SaaS small business applications through a variety of subscription, licensing, integration and syndication channels. The Smart Commerce segment generally generates revenue from subscription fees, professional services fees, and licensing fees related to domain name subscriptions, e-commerce or networking consulting or networking maintenance agreements. We include costs such as corporate general and administrative expenses and share-based compensation expenses that are not allocated to specific segments in the Smart Online segment.

Sources of Revenue

We derive revenues from the following sources:

- Subscription fees - monthly fees charged to end-users for access to our SaaS applications.
- License fees – fees charged for licensing of platforms or applications. Licenses may be perpetual or for a specific term.
- Integration fees - fees charged to partners to integrate their products into our syndication platform.
- Syndication fees
  - fees charged to syndication partners to create a customized private-label site.
  - barter revenue derived from syndication agreements with media companies.
- Professional services fees - fees related to consulting services which complement our other products and applications.
- Other revenues - revenues generated from non-core activities such as sales of shrink-wrapped products, original equipment manufacturer, or OEM, contracts and miscellaneous other revenues.

Our current primary focus is to target established companies that have both a substantial base of small business customers as well as a recognizable and trusted brand name. We are also seeking to establish partnerships with smaller companies with a specific vertical expertise catering to the small business customer base that we view as more ready to adopt new technologies. Our goal is to enter into partnerships with these companies whereby they private label our products and offer them to their base of small business customers. We believe the combination of the magnitude of their customer bases and their trusted brand names and recognition will help drive our subscription volume. In addition, we are targeting larger or developing enterprises that are developing a customized application delivery system or IT solution that might utilize our platforms as a solution. Such enterprises might wish to use our platform(s) as the framework into which they will integrate their own or other third-party applications, or they might wish to use all or some of our existing applications. Such solutions generally would generate licensing revenue and potentially subscription revenue for us if the customer desires that our applications be made a part of their solution.

Subscription revenues consist of sales of subscriptions directly to end-users, or to others for distribution to end-users, hosting and maintenance fees, and e-commerce website design fees. Subscription sales are made either on a subscription or on a “for fee” basis. Subscriptions, which include access to most of our offerings, are payable in advance on a monthly basis and are typically paid via credit card of the individual end-user or the aggregating entity. We offer new subscribers a limited free use period and notify such free users that we will terminate access it they fail to become paid subscribers within a certain period of time. We expect lower net subscription fees from subscribers at the private label syndication websites of our partners than from our main portal since our syndication agreements require us to share revenue generated from syndication sites with each respective partner. In the first nine months of 2007, 98% of our subscription revenue was generated by our Smart Commerce segment, and the remaining 2% by our Smart Online segment. As of September 30, 2007, we had an aggregate of approximately 13,500 subscribers: approximately 13,100 through our Smart Commerce segment and 400 through our Smart Online segment.

Licensing revenue consists of perpetual or term license agreements for the use of the Smart Online platform, the Smart Commerce platform or any of our applications. Perpetual license revenue is typically recorded in the period the license is sold and meets the requirements of American Institute of Certified Public Accountants Statement of Position 97-2, *Software Revenue Recognition*, or SOP 97-2; specifically, that there is evidence of an arrangement, the product has been delivered, the fee is fixed and determinable, and collection is reasonably assured. The revenue associated with term licenses is typically recorded over the period of the license. In the first nine months of 2007, 58% of our licensing revenue was generated by our Smart Online segment and 42% by our Smart Commerce segment.

When appropriate, we charge our partners a fee for private-labeling our website in their own customized interface (i.e., in the “look and feel” of our partners' sites). This fee is based on the extent of the modifications required as well as the revenue sharing ratio that has been negotiated between us and our partner. If a fee is charged for the production of the website and the modifications, it is recorded as syndication revenue.

In certain instances, we have integrated products offered by other companies into our products or websites. This integration approach is a means for the integration partner to generate additional traffic to its own website or revenue for its own product while expanding the range of our products and services. Such revenue is recorded as integration revenue. Our integration contracts also provide for us to receive a percentage of revenue generated by our partner. Such revenues have been immaterial during the nine months ended September 30, 2007.

Both syndication and integration fees are recognized on a monthly basis over the life of the contract, although a significant portion of integration fees is received upfront. Our contracts and support contracts are generally non-cancelable, though customers typically have the right to terminate their contracts for cause if we fail to perform. We generally invoice our paying syndication or integration partners in annual or monthly installments, and typical payment terms provide that they pay us within 30 days of invoice. Invoiced amounts are recorded as accounts receivable and in deferred revenue or revenue depending on whether the appropriate revenue recognition criteria have been met. In general, we collect our billings in advance of the service period. As we shift our focus to increasing subscription revenue, which we deem to have the greatest potential for future revenue growth, we have seen a decrease in syndication and integration revenue through the first nine months of 2007, and we expect this decrease to continue through the remainder of the fiscal year. In the first nine months of 2007, 100% of our syndication and integration revenue was generated by our Smart Online segment.

Professional services fees are fees generated from consulting services. For example, a partner may request that we re-design its website to better accommodate our products or to improve its own website traffic. Such fees are typically billed on a time and material basis and are recognized as revenue when these services are performed and the customer is invoiced. In the nine months of 2007, 100% of our professional services revenue was generated by our Smart Commerce segment.

Other revenues consist primarily of non-core revenue sources such as traditional shrink-wrap software sales and miscellaneous web services. It also includes OEM revenue generated through sales of our applications bundled with products offered by manufacturers such as Dell, Gateway and CompUSA. Revenues from OEM arrangements are reported and paid to us on a quarterly basis. In the first nine months of 2007, 33% of our other revenues were generated by our Smart Online segment and the remaining 67% were generated by our Smart Commerce segment.

Cost of Revenues

Cost of revenues is primarily composed of salaries associated with maintaining and supporting integration and syndication partners and the cost of external hosting facilities associated with maintaining and supporting integration and syndication partners. Historically, we have not capitalized any costs associated with the development of our products and platforms. Statement of Financial Accounting Standards, or SFAS, No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*, or SFAS No. 86, requires capitalization of certain software development costs subsequent to the establishment of technological feasibility. Based on our 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.

Operating Expenses

In previous years, our efforts primarily focused on basic product development and integration. In the fourth quarter of 2006, we shifted our focus to increasing subscription revenue while concentrating our development efforts on enhancements and customization of our proprietary platforms and applications. In the early part of 2007, we also began to focus on licensing our platform products and applications. As of September 30, 2007, we had 56 employees. Most employees perform multiple functions.

Research and Development. Historically, we have not capitalized any costs associated with the development of our products and platforms. SFAS No. 86 requires capitalization of certain software development costs subsequent to the establishment of technological feasibility. Because any such costs that would be capitalized following the establishment of technological feasibility would immediately be written off due to uncertain realizability, all such costs have been recorded as research and development costs and expensed as incurred. Because of our proprietary, 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 enables us to have relatively low research and development expenses as compared to traditional enterprise software business models. We expect that in the future, research and development expenses will increase substantially in absolute dollars, but decrease as a percentage of total revenue, as we hire additional personnel in both segments to enhance and customize our platforms and applications.

Sales and Marketing. Historically, we spent limited funds on marketing, advertising, and public relations. Our business model of partnering with established companies with extensive small business customer bases allows us to leverage the marketing dollars spent by our partners rather than requiring us to incur such costs. We do not conduct any significant direct marketing or advertising programs. Our sales and marketing costs have increased significantly in 2007 due to the addition of several sales personnel. As we begin to grow the number of subscribers to our products, we expect sales and marketing expense to increase due to the percentages of revenue we may be required to pay to partners as marketing fees.

General and Administrative. General and administrative expenses consist of salaries and related expenses for executive, finance and accounting, legal, human resources, and information technology personnel, professional fees, and other corporate expenses, including facilities costs. We anticipate general and administrative expenses will increase as we add personnel and incur additional professional fees and insurance costs related to the growth of our business and to our operations as a public company. Non-recurring general and administrative expenses increased significantly in 2006 as a result of the suspension of trading of our securities by the Securities and Exchange Commission, or the SEC, the related SEC investigation, and the internal investigation of matters relating to that suspension. Our expenses related to these matters decreased to an immaterial amount in the fourth quarter of 2006 and first half of 2007. Due to legal matters in which we are involved, as more fully described in Part II, Item 1, "Legal Proceedings" of this report, legal fees increased significantly in the third quarter of 2007, and we expect those increased costs to continue through the first half of 2008. We also expect to incur additional material costs in 2007 and 2008 as we take the necessary steps to comply with Section 404 of the Sarbanes-Oxley Act of 2002.

Stock-Based Expenses. Our operating expenses include stock-based expenses related to stock awards, options 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 SFAS No. 123 (revised 2004), *Share-Based Payment*, or SFAS No. 123R, 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 addition, 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 and do not anticipate any further stock option awards to be granted under the 2004 Plan.

Critical Accounting Policies and Estimates

Our discussion and analysis of financial condition and results of operations is based upon our consolidated 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 re-evaluate our critical accounting policies and estimates, including those related to revenue recognition, provision for doubtful accounts and sales returns, 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. Management has consistently applied the same critical accounting policies and estimates which are fully described in our Annual Report on Form 10-K for the year ended December 31, 2006.

Effective January 1, 2007, a major customer executed a letter of clarification which more clearly defined the roles and responsibilities of each party. Individual Business Owners, or IBOs, associated with this customer are provided e-commerce, domain name and email services. In exchange for marketing these services to its IBOs, the customer is paid a marketing fee. At the inception of the business relationship, it was agreed that the customer would collect the gross service fee from the IBOs, and the customer would retain its marketing fee and remit the net remaining cash to us. Because the roles and responsibilities of each party were vaguely defined in the past, revenue was recorded only on the net cash received. Following the execution of the letter of clarification and in accordance with Emerging Issues Task Force, or EITF, 99-19, *Reporting Revenue Gross as a Principal versus Net as an Agent*, this revenue is now recorded as the gross amount paid by the IBO and a sales and marketing expense for the marketing services rendered by the customer. Ultimately, the effect on net income is nil; however, subscription revenue and sales and marketing expense are effectively and appropriately recognized on a gross basis. Because the new accounting method was triggered by a clarification to the existing agreement and not by a change from one accepted accounting method to another, the 2006 subscription revenue was not retroactively adjusted as would be required by SFAS No. 154, *Accounting Changes and Error Corrections - a replacement of APB Opinion No. 20 and FASB Statement No. 3*, or SFAS No. 154. For the three months and nine months ended September 30, 2007, this accounting method resulted in approximately $203,000 and $691,000, respectively, of additional subscription revenue and a corresponding charge to sales and marketing expense.

We derive revenue from the licensing of software platforms along with the sale of associated maintenance, consulting, and application development services. The arrangement may include delivery in multiple-element arrangements if the customer purchases a combination of products and/or services. We use the residual method pursuant to SOP 97-2. 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 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 us 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.

The amount of revenue to be recognized from development and consulting services is typically based on estimates involving total costs to complete, the stage of completion and the amount of work performed in a given period. The assumptions and estimates made to determine total costs and stage of completion may affect the timing of revenue recognition. Changes in estimates of progress to completion and costs to complete are accounted for as cumulative catch-up adjustments.

Under SOP 97-2, provided the arrangement does not require significant development, modification or customization, revenue is recognized when all of the following criteria have been met:

1. persuasive evidence of an arrangement exists
2. delivery has occurred
3. the fee is fixed or determinable
4. collectability is probable

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

We are currently facing legal actions from stockholders as well as a former employee, some of which relate to the charges filed against our former Chief Executive Officer described in Part II, Item 1, “Legal Proceedings” in this report. At this time, we are not able to determine the likely outcome of these legal matters, nor can we estimate our potential financial exposure. Management has made an initial estimate based upon its knowledge, experience and input from legal counsel, and we have accrued approximately $300,000 of additional legal reserves. Such reserves will be adjusted in future periods as more information becomes available.

Overview of Results of Operations for the Three Months Ended September 30, 2007 and September 30, 2006

	Three Months Ended September 30, 2007	**Three Months Ended September 30, 2006**
REVENUES:		
Integration Fees	$ -	$ 6,250
Syndication Fees	15,000	57,352
Subscription Fees	830,660	429,426
Professional Services Fees	378,068	242,177
License Fees	200,000	-
Other Revenues	5,467	14,001
Total Revenues	1,429,195	749,206
COST OF REVENUES	168,035	31,311
GROSS PROFIT	1,261,160	717,895
OPERATING EXPENSES:		
General and Administrative	1,398,170	1,208,044
Sales and Marketing	635,201	135,027
Research and Development	636,780	455,997
Total Operating Expenses	2,670,151	1,799,068
LOSS FROM CONTINUING OPERATIONS	(1,408,991)	(1,081,173)
OTHER INCOME (EXPENSE):		
Interest Expense, Net	(139,124)	(51,746)

Takeback of Investor Relations Shares		-		1,562,500
Legal Reserve and Debt Forgiveness, Net		(39,477)		-
Other Income		24,866		-
Total Other Income (Expense)		(153,735)		1,510,754
NET INCOME (LOSS) FROM CONTINUING OPERATIONS		(1,562,726)		429,581
DISCONTINUED OPERATIONS				
Loss of Operations of Smart CRM, net of tax		-		(2,329,429)
NET LOSS				
Net loss attributed to common stockholders	$	(1,562,726)	$	(1,899,848)
NET LOSS PER SHARE:				
Continuing Operations				
Basic and Fully Diluted	$	(0.09)		0.03
Discontinued Operations				
Basic and Fully Diluted	$	-		(0.15)
Net Loss Attributed to Common Stockholders				
Basic	$	(0.09)		(0.13)
Fully Diluted		(0.09)		(0.12)
SHARES USED IN COMPUTING NET LOSS PER SHARE				
Basic		17,292,639		15,127,510
Fully Diluted		17,292,639		15,387,110

The following table shows our consolidated statements of operations data expressed as a percentage of revenue for the periods indicated:

	Three Months Ended September 30, 2007	**Three Months Ended September 30, 2006**
REVENUES:		
Integration Fees	0%	1%
Syndication Fees	1%	8%
Subscription Fees	58%	57%
Professional Services Fees	26%	32%
License Fees	14%	0%
Other Revenues	1%	2%
Total revenues	100%	100%
COST OF REVENUES	12%	4%
GROSS PROFIT	88%	96%
OPERATING EXPENSES:		
General and Administrative	98%	161%
Sales and Marketing	44%	18%
Research and Development	45%	61%
Total Operating Expenses	187%	240%
LOSS FROM OPERATIONS	(99)%	(144)%
OTHER INCOME (EXPENSE):		
Interest Income (Expense), net	(10)%	(7)%
Other Income	2%	0%
Takeback of Investor Relations Shares	0%	209%
Legal Reserve and Debt Forgiveness, Net	(3)%	0%
DISCONTINUED OPERATIONS		
Loss of Operations of Smart CRM, net of tax	0%	(311)%
NET INCOME(LOSS)	(109)%	(254)%

Overview of Results of Operations of the Three Months Ended September 30, 2007

Total revenues were $1,429,000 for the third quarter of 2007 compared to $749,000 for the third quarter of 2006, representing an increase of $680,000, or 91%. Gross profit increased $543,000, or 76%, to $1,261,000 from $718,000. Operating expenses increased $871,000, or 48%, to $2,670,000 from $1,799,000. Loss from continuing operations grew to $1,409,000 from $1,081,000, an increase of $328,000, or 30%, while net loss from continuing operations grew to $1,563,000 from a gain of $430,000, an increase in loss of $1,993,000. Net loss attributed to common stockholders for the three months ended September 30, 2007 decreased $337,000, or 18%, to $1,563,000 from $1,900,000. The net loss for the third quarter of 2006 included other non-cash income of $1,562,500 related to the takeback of certain investor relations shares. Net loss attributed to common stockholders for the third quarter of 2007 decreased $337,000, or 18%, to $1,563,000 from $1,900,000.

Comparison of the Results of Operations for the Three Months Ended September 30, 2007 and September 30, 2006

Revenues

Total revenues were $1,429,000 for the third quarter of 2007 compared to $749,000 for the third quarter of 2006 representing an increase of $680,000, or 91%. This increase is primarily attributable to increases in revenue from license fees of $200,000, subscription fees of $402,000 and professional services fees of $136,000, which were offset by decreases in integration revenue of $6,000, syndication fees of $42,000 and other revenues of $9,000.

Revenues from license fees increased to $200,000 for the third quarter of 2007 from $0 for the third quarter of 2006 and represented 14% of our consolidated revenue for the third quarter of 2007. This increase is attributable to a $400,000 platform license sale in our Smart Commerce segment in the second quarter of 2007. Such revenue was deferred based on collectability issues. In the third quarter of 2007, we received a payment of $200,000 related to that platform license and the cash received was recognized as revenue in the third quarter of 2007 in accordance with SOP 97-2.

Subscription revenues increased $402,000, or 94%, to $831,000 for the third quarter of 2007 from $429,000 for the third quarter of 2006. This increase was due to approximately $203,000 of additional revenue recorded in the third quarter of 2007 due to our adoption of gross revenue reporting. As discussed above, certain subscription revenues that were recorded net for the third quarter of 2006 were recorded as gross for the third quarter of 2007. Because the new accounting method was triggered by a clarification to an existing agreement and not by a change from one accepted accounting method to another, the 2006 subscription revenues were not retroactively adjusted as would be required by SFAS No. 154. Therefore, subscription revenues for the third quarter of 2007 are not recorded in the same manner as subscription revenues for the third quarter of 2006. If revenue from this customer had been recognized on a net basis (making it comparable to the third quarter of 2006), subscription revenues for the third quarter of 2007 would have been approximately $628,000, as compared to approximately $429,000 in the same period of 2006, an increase of approximately $199,000, or 46%. The remaining increase was the result of two new customers in our Smart Commerce segment, one of which launched in June 2007 and the other in July 2007.

Revenues from professional services fees, all of which are derived from our Smart Commerce segment, increased $136,000, or 56%, to $378,000 for the third quarter of 2007 from $242,000 for the third quarter of 2006. This increase was attributable to the addition of one new customer as well as additional services being provided to one existing customer.

Integration revenues decreased $6,250, or 100%, to $0 for the third quarter of 2007 as compared to $6,250 for the same period in 2006. The third quarters of 2007 and 2006 also included $0 and $5,000, respectively, of revenue derived from barter transactions. Almost all integration contract revenue was recognized by the end of 2006 and we have entered into no new integration agreements. As we shift our focus to growing subscription and license revenue, we have not sought any new or additional integration partners.

Syndication revenues decreased $42,000, or 74%, to $15,000 for the third quarter of 2007 from $57,000 for the third quarter of 2006. This decrease primarily is due to a change in our strategy regarding syndication fees. In the past, we sought and received syndication fees as part of our contracts with partners to set up private label websites. Currently, as part of our efforts to increase the number of subscribers to our services through these partnerships, we are no longer seeking contracts which include such syndication fees and are focusing on increasing subscription revenues from end subscribers. The $15,000 of recognized syndication revenues in the third quarter of 2007 relates to a monthly hosting fee in the amount of $5,000 from one syndication partner.

Other revenues decreased $9,000, or 64%, to $5,000 for the third quarter of 2007 as compared to $14,000 for the same period in 2006. This revenue is generated from non-core activities such as sales of shrink-wrapped products, OEM contracts and miscellaneous other revenues.

Cost of Revenues

Cost of revenues increased $137,000, or 442%, to $168,000 in the third quarter of 2007 from $31,000 in the third quarter of 2006, primarily as a result of increased hosting costs at our Smart Commerce segment related to hosting for additional customers, which resulted in an increase in cost of revenues of approximately $70,000. There was approximately $65,000 of additional expense incurred in the third quarter of 2007 at the Smart Online segment as compared to the third quarter of 2006 related to the addition of several employees in our call center providing customer service which are categorized as cost of revenues.

Operating Expenses

Operating expenses increased $871,000, or 48%, to $2,670,000 for the third quarter of 2007 from $1,799,000 during the third quarter of 2006. This increase is primarily due to an increase in general and administrative expenses of approximately $190,000, an increase in research and development expenses of approximately $181,000, and an increase in sales and marketing expense of approximately $500,000.

General and Administrative - General and administrative expenses increased by $190,000, or 16%, to $1,398,000 for the third quarter of 2007 from $1,208,000 for the third quarter of 2006. This increase was primarily due to certain increases in expenses at the Smart Online segment. There was an increase in wages and associated taxes of approximately $73,000 related to the hiring of a new Chief Operating Officer as well as the appointment of an interim Chief Executive Officer. Compensation expense required by SFAS No. 123R increased by $21,000 from the prior period as there have been several grants of restricted stock which had portions vest in the third quarter of 2007. Legal and professional fees increased by approximately $150,000 over the corresponding period in 2006 due to the legal fees incurred in connection with the legal proceedings brought during the third quarter of 2007 against us, our former executive officer and a former employee. Rent for the period increased approximately $16,000 over the preceding period as a result of a rent increase at the North Carolina corporate office and the addition of a sales office in Iowa, which was subsequently closed in September 2007. Board compensation increased by approximately $14,000 due to the addition of independent directors between September 30, 2006 and 2007. Investor relations expense increased approximately $15,000 as we retained consultants to assist with our analysis of returning to a national market and address blue sky issues related to the registration statement we filed in April 2007. These additions were offset by a reduction of approximately $116,000 of registration rights penalties as we successfully filed a registration statement in 2007 terminating such penalties. In the third quarter of 2006, we paid a commission of $55,000 to a related party in connection with the sale of our Smart CRM segment. There was no corresponding charge in 2007. At the Smart Commerce segment, credit card transaction fees increased by approximately $23,000 in the third quarter of 2007 compared to the third quarter of 2006 as we launched several new customer websites which generated revenue along with associated credit card processing fees.

We are currently disputing our insurance carrier's refusal to cover certain legal expenses related to our securities litigation matters. We contend that these legal expenses should be reimbursed by our insurance carrier. Because the outcome of this dispute is unclear, we have expensed all legal costs incurred with respect to the SEC matters and our internal investigation, and we will account for any insurance reimbursement, should there be any, in the period such amounts are reimbursed.

Sales and Marketing - Sales and marketing expense increased to $635,000 in the third quarter of 2007 from $135,000 in the third quarter of 2006, an increase of $500,000, or 370%. As detailed in the Revenues section above, in the Smart Commerce segment, there was approximately $203,000 of additional revenue recorded in the third quarter of 2007 due to our adoption of gross revenue reporting. A corresponding increase in sales and marketing expense of $203,000 was recorded in association with the new gross accounting method. In addition, the two new customers created revenue share expense in the amount of approximately $215,000 for the third quarter of 2007, for which there was no corresponding expense in the third quarter of 2006. At the Smart Online segment, there was an increase in sales and marketing wages of approximately $38,000 as we had expanded our sales force in both our North Carolina and Iowa offices earlier in 2007. The Iowa office was subsequently closed in September of 2007 as part of our internal restructuring. During the second quarter of 2007, a former employee became a sales consultant, which generated consulting expense of approximately $23,000 in the third quarter of 2007 for which there was no corresponding expense in the third quarter of 2006. That consulting contract was terminated in November of 2007.

Research and Development - Research and development expense increased to $637,000 in the third quarter of 2007 from $456,000 in the third quarter of 2006, an increase of approximately $181,000, or 40%. This increase is due primarily to increased wages, payroll taxes and commission expenses from the Smart Online segment of approximately $178,000 as we added research and development personnel. We expect research and development expenses to increase during the last quarter of 2007 as a result of anticipated hiring of additional research and development personnel for both the Smart Online and Smart Commerce segments to enhance and customize our platforms and applications and launch additional private label sites.

Other Income (Expense)

We incurred net interest expense of $139,000 during the third quarter of 2007 compared to $52,000 during the third quarter of 2006, an increase of approximately $87,000, or 169%. Interest expense increased as a direct result of the notes payable to Fifth Third Bank related to the refinance of the debt to the sellers of iMart Incorporated, or iMart. The Fifth Third Bank note was originated in the fourth quarter of 2006, so there was no corresponding interest expense in the third quarter of 2006. The monthly interest on that note has been approximately $11,000 per month but decreases each month as our outstanding principal balance is reduced. Additionally, interest expense of approximately $33,000 was incurred during the third quarter of 2007 on our revolving line of credit with Wachovia Bank, NA, or Wachovia. We earned interest income of $35,000 during the third quarter of 2007 on money market account deposits compared to $3,000 earned for the same period in 2006. The third quarter 2007 interest income increase was attributable to the interest earned on the cash proceeds of the February 2007 private placement described in Note 7, “Stockholders’ Equity,” to the consolidated financial statements in this report.

We realized a gain of $211,000 during the third quarter of 2007 from negotiated and contractual releases of outstanding liabilities compared to $0 gain from debt forgiveness in the third quarter of 2006. During the third quarter of 2007, we recorded reserves of approximately $300,000 for legal expenses and losses we might incur as a result of the litigation we are facing.

Overview of Results of Operation for the Nine Months Ended September 30, 2007 and 2006

	Nine Months Ended September 30, 2007	Nine Months Ended September 30, 2006
REVENUES:		
Integration Fees	$ 5,000	$ 182,660
Syndication Fees	45,000	183,619
Subscription Fees	2,040,243	