

SMART & FINAL INC/DE
Form DEF 14A
April 20, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

SCHEDULE 14A

Proxy Statement Pursuant to Section 14(a)

of the Securities Exchange Act of 1934

(Amendment No.)

Filed by the Registrant

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Check the appropriate box:

Preliminary Proxy Statement

Definitive Proxy Statement

Definitive Additional Materials

Soliciting Material Pursuant to §240.14a-12

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SMART & FINAL INC.

(Name of Registrant as Specified In Its Charter)

(Name of Person(s) Filing Proxy Statement, if other than the Registrant)

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(3) Filing Party:

(4) Date Filed:

SMART & FINAL INC.

600 Citadel Drive

Commerce, California 90040

NOTICE OF ANNUAL MEETING OF STOCKHOLDERS

May 20, 2005

TO THE STOCKHOLDERS:

The Annual Meeting of Stockholders of Smart & Final Inc. will be held at our corporate headquarters, 600 Citadel Drive, Commerce, California 90040, on Friday, May 20, 2005, at 2:00 p.m., local time, for the purpose of considering and voting upon:

1. the election of eight directors, each for a term of one year;
2. the approval of our Long-Term Equity Compensation Plan for Non-Employee Directors, which will allow us to grant our non-employee directors a maximum of 375,000 shares in the form of stock options, stock appreciation rights, restricted stock or restricted stock units; and
3. the transaction of any other business that is properly presented before the Annual Meeting or any adjournment or postponement thereof.

All holders of shares of our common stock, as of the close of business on March 24, 2005, are entitled to receive notice of, and to vote at, the Annual Meeting or any adjournment or postponement thereof.

WE REQUEST THAT YOU SIGN, DATE AND RETURN THE ENCLOSED PROXY CARD IN THE ENCLOSED POSTAGE-PAID ENVELOPE, WHETHER YOU PLAN TO ATTEND THE ANNUAL MEETING OR NOT, SO THAT AS MANY SHARES OF OUR COMMON STOCK AS POSSIBLE WILL BE REPRESENTED AT THE ANNUAL MEETING.

DONALD G. ALVARADO

Secretary

Commerce, California

April 20, 2005

SMART & FINAL INC.

600 Citadel Drive

Commerce, California 90040

PROXY STATEMENT

GENERAL

We are providing these proxy materials in connection with the solicitation of proxies by our Board of Directors, or Board, to be voted at our 2005 Annual Meeting of Stockholders, or Annual Meeting. You are cordially invited to attend the Annual Meeting, which will be held on Friday, May 20, 2005, at 2:00 p.m., local time, at our corporate headquarters, located at 600 Citadel Drive, Commerce, California 90040. The approximate mailing date of this proxy statement, notice and the accompanying proxy is April 20, 2005. (Throughout this proxy statement, we refer to Smart & Final Inc. and its subsidiaries collectively as the Company, we, our and us.)

Proxy Information

We will vote the shares of our common stock represented by a properly signed proxy that we receive before or at the Annual Meeting in accordance with the specifications made on the proxy. Proxies that we receive with no specification will be voted, as recommended by our Board, to: (i) elect the eight nominees for director named in this proxy statement; and (ii) approve our Long-Term Equity Compensation Plan for Non-Employee Directors, as described herein.

You may revoke your proxy at any time before it is voted at the Annual Meeting. You may revoke your proxy by giving written notice of such revocation to the Secretary at our corporate headquarters, located at 600 Citadel Drive, Commerce, California 90040. You may also give notice by filing a properly executed proxy bearing a later date or by voting in person at the Annual Meeting.

Under the rules of the New York Stock Exchange, Inc., or NYSE, if you hold your shares through a bank or broker, your broker is permitted to vote your shares for the election of directors even when your broker does not receive instructions from you.

Record Date and Voting

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If you are a stockholder of record at the close of business on March 24, 2005, you are entitled to one vote, for each share of our common stock you hold, on each matter submitted to a vote of stockholders. As of March 24, 2005, there were 30,970,833 shares of our common stock, par value \$0.01 per share, outstanding.

Holders of a majority of the voting interest of our common stock, present in person or by proxy, will constitute a quorum for the holding of the Annual Meeting for the election of directors. The inspectors of election we appoint will tabulate the votes cast in person or by proxy at the Annual Meeting. The inspectors of election will treat abstentions as shares that are present and entitled to vote for purposes of determining the presence of a quorum, but as unvoted for purposes of determining the approval of any matter submitted to the stockholders for a vote. If a broker indicates on the proxy that it does not have discretionary authority as to certain shares to vote on a particular matter, those shares will not be considered as present and entitled to vote by the inspectors of election with respect to that matter.

You may either vote for or withhold your vote for each of the directors identified below. The eight director nominees receiving the greatest number of votes will be elected to our Board. If you mark your vote withheld or you do not vote in the election (including abstentions and broker non-votes), this will have no impact on the election of directors, because these votes will not be included in the total number of votes present at the Annual Meeting.

On the proposal to approve our Long-Term Equity Compensation Plan for Non-Employee Directors, votes may be cast for or against, or may be withheld from voting on this proposal. The affirmative vote of a majority of all outstanding shares of our common stock entitled to vote at the Annual Meeting will be required for approval of the Smart & Final Inc. Long-Term Equity Compensation Plan for Non-Employee Directors. Abstentions and brokers' non-votes are counted in determining the number of votes present at the meeting, and therefore will have the same effect as a vote against this proposal.

ITEM 1 ELECTION OF DIRECTORS

At last year's Annual Meeting of stockholders held on May 19, 2004, the proposal to declassify our Board and to provide for a one year term of service for each director beginning in 2005 was approved. At the Board meeting held on February 15, 2005, one of our directors affiliated with Casino Guichard-Perrachon, S.A., a publicly traded French joint stock limited liability company, which together with its affiliates own 57.1% of our common stock (Casino Guichard-Perrachon, S.A. and its affiliates are referred to throughout this proxy statement collectively as Groupe Casino), represented he was acting for all of the Groupe Casino affiliated directors and that Groupe Casino wanted to reduce the size of our Board from eleven members to eight members, as allowed under our Amended and Restated Bylaws. The stated reasons were to increase the efficient operation of the Board and to reduce costs by reducing the aggregate fees and expenses paid to members of our Board. This reduction of the size of our Board was to be effective as of the election of our directors at the Annual Meeting. The Groupe Casino director said that in order to accomplish the reduction in the size of our Board, one non-independent director, Mr. Couvreur, and two independent directors, Messrs. Gold and Plaskett, would not be nominated to stand for re-election at the Annual Meeting.

Thereafter, on March 22, 2005, Groupe Casino informed us of its intention to nominate two persons who had not previously served on our Board, to serve as replacements for its two remaining current representatives on our Board. Groupe Casino recommended Messrs. Pascal Announ and Thierry Bourgeron for election to our Board in place of current Board members, Messrs. Bouchut and Hernu. The Corporate Governance Committee reviewed the biographies and either the Committee, or an individual member of the Committee to which the task was delegated, interviewed the new nominees proposed by Groupe Casino. The Board authorized, by unanimous written consent, the nomination of Messrs. Announ and Bourgeron for election to our Board at the Annual Meeting.

The Board proposed that, at our Annual Meeting the eight individuals listed below be elected to hold office until the 2006 Annual Meeting of Stockholders and until their successors have been duly elected and qualified. Six of the nominees listed below are currently serving on our Board; and two nominees, Messrs. Announ and Bourgeron have not previously served on our Board. Additionally, Mr. Watson was appointed to serve on the Board and the Audit Committee in May 2004; this is the first time he will be standing for election to our Board.

Unless properly instructed otherwise, the proxy holders intend to vote for the election of all eight nominees. It is not anticipated that any of the nominees will decline or be unable to serve as a director. However, if that should occur, the proxy holders will vote the proxies in their discretion for any nominee designated by our present Board.

The following table sets forth, as of March 31, 2005, information concerning each person nominated for election as a director:

Nominees

<u>Name</u>	<u>Age</u>	<u>Director Since</u>
<i>Pascal Announ</i>	40	Not applicable

Mr. Announ has served as director of finance for Groupe Casino from 1998 to the present, with responsibility for corporate finance activities, treasury operations, and risk management. Since joining Groupe Casino in 1990, he has held senior financial positions including treasurer from 1995 to 1998. Prior to his employment with Groupe Casino, Mr. Announ was a strategic planning consultant for the consulting firms of Telesis from 1988 to 1989, and Mars & Co. from 1989 to 1990. Since 2003 Mr. Announ has been chairman of the board and a director of Banque du Groupe Casino, a French consumer credit bank whose majority owner is Groupe Casino. Since 1999, Mr. Announ has also been a director of Slivarente (Sicav), an investment fund managed by Calyon (the French corporate and investment banking subsidiary of Crédit Agricole S.A.).

<i>Thierry Bourgeron</i>	51	Not applicable
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Mr. Bourgeron has served as executive vice president of human resources and communication for Groupe Casino from 1999 to the present. Prior to joining Groupe Casino, from 1994 to 1999 he was the vice president of human resources for Rhône Poulenc Agrochimie in Lyon, France and a member of the executive committee of its parent corporation, Rhône-Poulenc, S.A., an international, diversified chemical company (now Aventis S.A.). From 1992 to 1994, he was employed with DRH International de Rhône Poulenc Inc., an affiliate of Rhône-Poulenc located in Princeton, New Jersey. Earlier he held positions in the human resource department of Rhône-Poulenc and its affiliates, beginning in 1984.

<i>Timm F. Crull</i>	74	1994
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Mr. Crull has served as a director on our Board since 1994. Currently, Mr. Crull serves on our Audit Committee and is Chairman of our Compensation Committee. From 1991 until his retirement in 1994, Mr. Crull was Chairman of the Board and Chief Executive Officer of Nestlé USA, Inc., a food and related products company. From 1983 to the beginning of 1990, Mr. Crull also held the position of Chairman of the Board and President of Carnation Company, a food and related products company.

<i>David J. McLaughlin</i>	68	1990
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Mr. McLaughlin has served as a director on our Board since 1990. Currently, Mr. McLaughlin serves on our Audit and Compensation Committees. Since 1987, Mr. McLaughlin has been a director of Scientific Atlanta, Inc., a communications and instrumentation products company, and since 1994, he has served as a director of Troy Biosciences Incorporated, a biotechnology company. From 2000 to 2001, Mr. McLaughlin served as the Vice Chairman of Troy Biosciences Incorporated. He also served as President and Chief Executive Officer of Troy Biosciences Incorporated from 1996 to 1999. Since January 2000, Mr. McLaughlin has been the President and Chief Executive Officer of Pentacle Press LLC, a publishing and research company.

<u>Name</u>	<u>Age</u>	<u>Director Since</u>
<i>Joël-André Ornstein</i>	50	1999

Mr. Ornstein has served as a director on our Board since 1999. Since 1989, Mr. Ornstein has been Senior Adviser to the Chairman and Chief Executive Officer of Euris, S.A., or Euris, a Paris-based investment holding company controlled by Mr. Jean-Charles Naouri. Mr. Naouri is a French citizen whose principal business is making corporate investments and who owns through holding entities, a controlling interest in Groupe Casino, who in turn owns a controlling interest in us. Mr. Ornstein is also Chairman and Chief Executive Officer of Euristates, Inc., the U.S. based subsidiary of Euris. He is also a director of Euris and Euristates, Inc.

<i>Ross E. Roeder</i>	67	1984
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Mr. Roeder has served as a director on our Board since 1984. He is currently Chairman of our Board and Chairman of the Corporate Governance Committee. Mr. Roeder became our Chairman, President and Chief Executive Officer in January 1999. In September 2003, when Mr. Snollaerts became our President, Mr. Roeder continued to serve as our Chief Executive Officer until May 19, 2004, when he became our non-executive Chairman. Prior to his appointment as Chairman and Chief Executive Officer, Mr. Roeder was Chairman of our Audit Committee and a member of our Compensation Committee. Mr. Roeder became Chairman of our Corporate Governance Committee in early 1999 and is a member of the boards of directors of our principal subsidiaries. Until 1998, Mr. Roeder was Chairman of Morgan-Kaufman Publishers, Inc., a publisher of computer science text and reference books, where he was also a director from 1986 to 1998. Since 1997, Mr. Roeder has served as a director of Chico's FAS, Inc., a retail women's store company, where he also serves on its corporate governance committee, compensation and benefits committee and audit committee. From 1995 to 2002, Mr. Roeder served as a director of Gulf West Banks, Inc. which in 2002, was acquired by The South Financial Group. Mr. Roeder is currently serving as a director of Mercantile Bank, a subsidiary of The South Financial Group. (For a further discussion of Mr. Roeder's employment agreement with us, see Executive Compensation *Roeder Employment Agreement* below.)

<i>Etienne Snollaerts</i>	49	1998
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Mr. Snollaerts has served as a director on our Board since 1998. Currently, Mr. Snollaerts serves on our Corporate Governance Committee. In September 2003, Mr. Snollaerts was named our President and Chief Operating Officer and on May 19, 2004 became our Chief Executive Officer. Prior to joining our executive group, he was the Deputy General Manager and Director of the supply chain within Groupe Casino and was responsible for supervising Groupe Casino's investment in us. From 1998 to 2000, Mr. Snollaerts was in charge of the international activities of Groupe Casino, which included operations in ten countries. He has been associated with Groupe Casino since 1985 and served as Director of Purchasing and Logistics and as Director of Retail Distributions, Store Operations and Information Systems. Before 1985, Mr. Snollaerts was a management consultant with Alexander Proudfoot Company, now Management Consulting Group PLC. (For a further discussion of Mr. Snollaerts' employment agreement with us, see Executive Compensation *Snollaerts Employment Agreement* below.)

<u>Name</u>	<u>Age</u>	<u>Director Since</u>
<i>Stephen E. Watson</i>	60	2004

On May 19, 2004, Mr. Watson was appointed to our Board and also appointed to serve on our Audit Committee. From 1997 to 2002 when he retired, Mr. Watson was President and Chief Executive Officer of Gander Mountain, L.L.C., a privately held retailer of outdoor recreational equipment and clothing. Previously, he held various executive officer positions with Target Corporation and its predecessors. He joined Target Corporation in 1972 and headed merchandising for its department store division until becoming the division's Chairman and Chief Executive Officer in 1985. He continued in that role until his retirement from the company in 1996 and additionally held the position of President and director of Target Corporation from 1991 to 1996. Mr. Watson also serves on the boards of directors of Shopko Stores Inc., a chain of retail stores specializing in discount merchandise; Retek Inc., a leading provider of software services and solutions to the retail industry; and Walker Art Center, a Minneapolis-based multidisciplinary arts organization.

Vote Required and Recommendation of the Board. You may either vote for or withhold your vote for each of the directors identified above. The eight director nominees receiving the greatest number of votes will be elected to our Board. If you mark your vote withheld or you do not vote in the election (including abstentions and broker non-votes), this will have no impact on the election of directors, because these votes will not be included in the total number of votes present at the Annual Meeting.

THE BOARD UNANIMOUSLY RECOMMENDS THAT STOCKHOLDERS VOTE FOR THE ELECTION OF EACH OF THE NOMINEES IDENTIFIED ABOVE.

CORPORATE GOVERNANCE

Governance Guidelines

We have in place long-standing policies and practices of good corporate governance. During fiscal 2004, our Board adopted Guidelines for Corporate Governance that outline the responsibilities of the Board, as well as qualifications for directors to serve on the Board. We have a Code of Ethics that was amended in February 2005, to ensure compliance with the Sarbanes-Oxley Act of 2002 and the listing standards of the NYSE. Our Code of Ethics applies to our Chief Executive Officer, our Chief Financial Officer and our Chief Accounting Officer, as well as to other employees of our company, and complies with the requirements imposed by the Sarbanes-Oxley Act of 2002 and the rules issued thereunder for codes of conduct applicable to such officers. Our Board has reviewed and will continue to evaluate its role and responsibilities with respect to the new legislative and other governance requirements. All of our corporate governance materials, including our Code of Ethics, our Guidelines for Corporate Governance and all of our committee charters are available for public viewing on our Internet web site at <http://www.smartandfinal.com>, Investor Information, under the Governance tab. In addition, interested persons can obtain a copy of any of these materials by writing to, Corporate Secretary, Smart & Final Inc., 600 Citadel Drive, Commerce, California 90040.

Director Independence and Controlled Company Exemption

Our Board is currently composed of 11 directors, five of whom are independent under the NYSE listing standards. Our Chief Executive Officer is the only member of management currently serving as a director. For purposes of determining independence, we have adopted the following standards for director independence in compliance with the listing standards of the NYSE:

No director qualifies as independent unless the Board affirmatively determines that the director has no material relationship with us or any of our subsidiaries (directly or as a partner, stockholder or officer of an organization that has a relationship with us or any of our subsidiaries);

A director who is an employee or whose immediate family member is an executive officer of the Company or any of our subsidiaries is not independent until three years after the end of such employment relationship;

A director who receives, or whose immediate family member receives, more than \$100,000 per year in direct compensation from us or any of our subsidiaries, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service), is not independent until three years after he or she ceases to receive more than \$100,000 per year in such compensation;

A director who is affiliated with or employed by, or whose immediate family member is affiliated with or employed in a professional capacity by, Ernst & Young LLP, our present external auditor; Arthur Andersen, our former external auditor; or a present or former internal auditor of the Company or any of our subsidiaries is not independent until three years after the end of the affiliation or the employment or auditing relationship;

A director who is employed, or whose immediate family member is employed, as an executive officer of another company where any of our present executives or any of our subsidiaries present executives serve on that company's compensation committee is not independent until three years after the end of such service or employment relationship;

A director who is an executive officer or an employee, or whose immediate family member is an executive officer, of a company that makes payments to, or receives payments from, us or any of our subsidiaries for property or services in an amount which, in any single fiscal year, exceeds the greater of \$1 million, or 2% of such other company's consolidated gross revenues, is not independent until three years after falling below such threshold; and

A director who is an employee or representative of a significant supplier of any Company business unit or legal entity is not independent unless we entered into our relationship with the supplier as a result of competitive purchasing practices.

The Board determined that Messrs. Crull, Gold, McLaughlin, Plaskett and Watson meet the aforementioned independence standards and that Messrs. Bouchut, Couvreur, Hernu, Ornstein, Roeder and Snollaerts do not meet the aforementioned independence standards. Messrs. Bouchut, Couvreur, and Hernu do not meet the independence standards because they are employees of Groupe Casino. Mr. Ornstein does not meet the independence standards because he is employed by Euris, S.A., which indirectly owns a controlling interest in Groupe Casino. (For a further discussion of Groupe Casino and its relationship to us, see Compensation Committee Interlocks and Insider Participation *Relationship between Smart & Final Inc. and Casino USA* below.) Mr. Roeder does not meet the aforementioned independence standards because he served as our Chief Executive Officer until May 2004. Mr. Snollaerts does not meet the independence standards because he is our current Chief Executive Officer.

If Messrs. Announ and Bourgeron are elected to the Board at the May 2005 Annual Meeting, it is anticipated that they will not meet the independence standards because they are both currently employees of Groupe Casino.

Section 303A.00 of the NYSE listing standards, to which we are subject, defines a Controlled Company as a company of which more than 50% of the voting power is held by an individual, a group or another company. We are a Controlled Company because 57.1% of our common stock is owned by Groupe Casino. As a Controlled Company, we are exempt from the NYSE requirement that we have a majority of independent directors, and from the requirements that our Corporate Governance Committee and Compensation Committee be composed entirely of independent directors. Pursuant to such exemption, our Board does not consist of a majority of independent directors, and our Corporate Governance and Compensation Committees are not composed solely of independent directors. (For a further discussion of the composition of our Corporate Governance Committee and our Compensation Committee, see Corporate Governance *Committees of the Board and Attendance at Meetings* below.)

Committees of the Board and Attendance at Meetings

We have established three standing committees of our Board, an Audit Committee, a Compensation Committee and a Corporate Governance Committee. Each of these committees reports to the full Board and the activities of each committee are therefore generally subject to the approval of the Board.

Audit Committee

The Audit Committee is currently comprised of Messrs. Plaskett (as Chairman), Crull, McLaughlin and Watson. At the May 2004 Board meeting, Mr. Watson was appointed to the Board and our Audit Committee. The Audit Committee operates under a written charter adopted by our Board. During fiscal 2004, our Board re-examined the Audit Committee's composition and confirmed that all members of the Audit Committee are independent within the meaning of the NYSE's listing standards. In addition, the Board determined that Mr. Plaskett, the Audit Committee chair, meets the U.S. Securities and Exchange Commission's, or SEC's, definition of an audit committee financial expert. Because our current Chairman is not a nominee for re-election to our Board, at the next regularly scheduled Board meeting after our Annual Meeting, the Board intends to appoint a new Chairman of the Audit Committee.

During fiscal 2004, there were four regular meetings and six telephonic meetings of the Audit Committee.

Corporate Governance Committee

The Corporate Governance Committee is currently comprised of Messrs. Roeder (as Chairman), Couvreur, Plaskett and Snollaerts. The Corporate Governance Committee operates under a written charter adopted by our Board. Of the current members of the Corporate Governance Committee, only Mr. Plaskett is independent of management. However, because we are a Controlled Company under the NYSE listing standards, our Corporate Governance Committee is not subject to the independence requirements set forth in the NYSE listing standards. (For a further discussion regarding the independence standards to which we are subject, see Corporate Governance *Director Independence and Controlled Company Exemption* above.)

Messrs. Couvreur and Plaskett are currently serving on our Corporate Governance Committee, but are not nominees for re-election. Therefore, at the next regularly scheduled Board meeting after our Annual Meeting, the Board intends to appoint additional director(s) to serve on the Corporate Governance Committee.

During fiscal 2004, there were four regular meetings and two telephonic meetings of the Corporate Governance Committee.

Compensation Committee

The Compensation Committee is currently comprised of Messrs. Crull (as Chairman), Couvreur, Gold, McLaughlin and Plaskett. Mr. Couvreur was appointed to the Compensation Committee effective September 2004. The Compensation Committee operates under a written charter

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adopted by our Board. The current members of our Compensation Committee, with the exception of Mr. Couvreur, are independent directors. However, because we are a Controlled Company under the NYSE listing standards, we are not required to have a Compensation Committee composed entirely of independent directors. (For a further discussion regarding the independence standards to which we are subject, see Corporate Governance *Director Independence and Controlled Company Exemption* above.) Of the five directors that are not nominees for re-election, three directors, Messrs. Couvreur, Gold and Plaskett, are members of our Compensation Committee. Thus, at the next regularly scheduled Board meeting after our Annual Meeting, the Board intends to appoint additional director(s) to serve on the Compensation Committee.

During fiscal 2004, there were four regular meetings of the Compensation Committee.

Board Attendance

During fiscal 2004, our Board held five regular meetings. Each director, with the exception of Mr. Bouchut, attended at least 75% of the aggregate of (a) the total number of Board meetings and (b) the total number of committee meetings held by all committees of the Board on which such director served. We encourage our directors to attend the Annual Meeting. At the 2004 Annual Meeting of Stockholders, four of our 11 directors attended.

Communications with the Board of Directors

Stockholders who wish to communicate with members of the Board, including the independent directors individually or as a group, may send correspondence to them in care of Corporate Secretary, Smart & Final Inc., 600 Citadel Drive, Commerce, California 90040.

Report of the Audit Committee

The Audit Committee adopted a written charter in April 2001, which was revised and approved by our Board in December 2003 and again in February 2005. The most recent revised and approved Charter of the Audit Committee, or the Charter, is attached hereto as Appendix A. The Charter complies with the requirements of the SEC and the NYSE listing standards. The Audit Committee will continue to regularly review and assess the Charter to ensure continued compliance with these requirements. The Charter is also available for public viewing, on our Internet web site at <http://www.smartandfinal.com>, Investor Information, under the Governance tab. In addition, interested persons can obtain a copy of the Charter by writing to, Corporate Secretary, Smart & Final Inc., 600 Citadel Drive, Commerce, California 90040.

The functions of the Audit Committee include, among other things:

Oversight of our financial reporting process, compliance with legal and regulatory requirements, and our assessment, evaluation and reporting on the effectiveness of the Company's internal control over financial reporting pursuant to the requirements of Section 404 of the Sarbanes-Oxley Act of 2002;

Engagement of independent auditors and approval of auditor fees;

Review with the independent auditors of the scope and the planning of the annual examination of the Company's consolidated financial statements and internal control over financial reporting;

Review of the audited consolidated financial statements and reports on internal control over financial reporting with management and the independent auditors;

Review of the findings and recommendations of the independent and internal auditors, and management's response to the recommendations of the auditors;

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Oversight of the independence and performance of internal and external auditors; and

Preparation of the Audit Committee Report.

During fiscal 2004, the Board examined the Audit Committee's composition and confirmed that each member of the Audit Committee is an independent director based on the NYSE listing standards, the SEC's independence requirements, and the Company's Governance Guidelines. In addition, the Board has determined that all members of the Audit Committee are financially literate and that Mr. Plaskett, the Chair of the Audit Committee, is a financial expert as defined by the SEC's rules and the NYSE listing standards.

The Audit Committee has reviewed and discussed with management of the Company and Ernst & Young LLP (E&Y), the Company's independent auditing firm, the audited consolidated financial statements of the Company as of January 2, 2005 and for the fiscal year then ended (the Audited Financial Statements). The Audit Committee has also reviewed and discussed with management of the Company and E&Y (i) management's report on internal control over financial reporting as of January 2, 2005 and (ii) E&Y's audit report on management's assessment of the effectiveness of internal control over financial reporting as of January 2, 2005. In addition, the Audit Committee has discussed with E&Y the matters required to be discussed by the Statement on Auditing Standards No. 61 (*Communication with Audit Committees; Codification of Statements on Auditing Standards AU § 380*).

The Audit Committee received and reviewed the written disclosures and the letter from E&Y required by Independence Standards Board Standard No. 1 (*Independence Discussions with Audit Committees*). The Audit Committee has discussed with E&Y its independence from the Company. The Audit Committee additionally discussed with management of the Company and E&Y such other matters and received such assurances from them as it deemed appropriate.

Management is responsible for the Company's internal controls and the financial reporting process. The Audit Committee has reviewed the Company's programs aimed at strengthening the effectiveness of the Company's internal audit and disclosure control structure. The Audit Committee monitors the scope and adequacy of the Company's internal auditing program, reviewing staffing levels and steps taken to implement improvements to internal procedures and controls. Management is responsible for performing an assessment and evaluation of the Company's internal control over financial reporting and issuing a report on the effectiveness thereof. E&Y is responsible for performing an independent audit of the Company's financial statements and internal control over financial reporting in accordance with generally accepted auditing standards of the United States and issuing reports thereon. The Audit Committee's responsibility is to monitor and oversee these processes.

Based on the above-described reviews and discussions and a review of the report of E&Y with respect to the Audited Financial Statements, and relying thereon, the Audit Committee recommended to the Company's Board the inclusion of the Audited Financial Statements in the Company's Annual Report on Form 10-K for the fiscal year ended January 2, 2005.

AUDIT COMMITTEE

Thomas G. Plaskett, Chairman

Timm F. Crull

David J. McLaughlin

Stephen E. Watson

Report of the Corporate Governance Committee

The Corporate Governance Committee adopted a written charter, or the Charter, which was amended in February 2004 in compliance with the requirements of the Sarbanes-Oxley Act of 2002 and NYSE listing standards. The Charter will be reviewed and reassessed regularly to ensure continued compliance with these requirements. The Charter is available for public viewing, on our Internet web site at <http://www.smartandfinal.com>, Investor Information, under the Governance tab. In addition, interested persons can obtain a copy of the Corporate Governance Charter by writing to, Corporate Secretary, Smart & Final Inc., 600 Citadel Drive, Commerce, California 90040.

Because we have elected to be treated as a Controlled Company, our Corporate Governance Committee is not subject to the independence requirements set forth in the NYSE listing standards. Section 303A.00 of the NYSE listing standards defines a Controlled Company as a company of which more than 50% of the voting power is held by an individual, a group or another company. We are a Controlled Company because 57.1% of our common stock is owned by Groupe Casino. As a Controlled Company, we are exempt from the NYSE requirement that we have a majority of independent directors, and from the requirement that the Corporate Governance Committee be composed entirely of independent directors. Pursuant to such exemption, the Corporate Governance Committee is not composed solely of independent directors.

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The functions of the Corporate Governance Committee include, among other things:

Seeking out, evaluating and recommending to our Board qualified candidates for nomination as directors on our Board;

Considering other matters pertaining to the size and composition of our Board and its committees;

Giving appropriate consideration to qualified individuals recommended by stockholders for nomination as directors, provided that such recommendations are accompanied by information sufficient to enable the Corporate Governance Committee to evaluate the qualifications of such individuals;

Responsibility for developing and recommending to our Board the corporate governance principles under which we operate; and

Making awards under our Non-Employee Director Stock Plan to members of the Board.

In considering individuals for nomination as directors, the Corporate Governance Committee typically solicits recommendations from its current directors and is authorized to engage third party advisors, including search firms, to assist in the identification and evaluation of candidates. For 2005, the Corporate Governance Committee, or an individual member to whom the task was delegated by the Committee, conducted interviews of the potential nominees for election as directors to our Board and reviewed the biographies of each such candidate. The Corporate Governance Committee agreed to the nominees proposed by the Groupe Casino directors. The Board ratified the nominees listed in the Proxy Statement. (For further information about these nominees, see Item 1 Election of Directors above.)

In evaluating potential candidates, the Corporate Governance Committee may consider such factors as it deems appropriate. These factors may include judgment, skill, diversity, integrity, experience with businesses and other organizations of comparable size, the interplay of the candidate's experience with the experience of other Board members and the extent to which the candidate would be a desirable addition to the Board and any committees of the Board. While the Corporate Governance Committee has not established any specific minimum qualifications for director nominees, the Corporate Governance Committee believes that demonstrated leadership, as well as significant years of service, in an area of endeavor such as business, law, public service, related industry or academia, is a desirable qualification for service as a director of the Company.

Any stockholder may make recommendations to the Corporate Governance Committee for membership on the Board by sending a written statement of the qualifications of the recommended individual to, Corporate Secretary, Smart & Final Inc., 600 Citadel Drive, Commerce, California 90040. Such recommendations should be received no later than 60 days before the anniversary of last year's Annual Meeting, nor no earlier than 90 days before the anniversary of last year's Annual Meeting. In accordance with Article III, Section 2 of our Amended and Restated Bylaws, certain criteria must be included with the stockholder's notice. Our Amended and Restated Bylaws were attached as Appendix B to our Proxy Statement filed with the SEC on April 16, 2004 and may be accessed through our Internet web site at <http://www.smartandfinal.com>, Investor Information, under the SEC tab. The Corporate Governance Committee will evaluate candidates recommended by stockholders on the same basis as they evaluate other candidates, including the following criteria:

Directors should be of the highest ethical character and share values that reflect positively on themselves and the Company;

Directors should have reputations, both personal and professional, consistent with the image and reputation of the Company; and

Directors should be highly accomplished in their respective fields, with superior credentials and recognition.

The fact that a proposed director nominee meets all of the above criteria will not obligate the Corporate Governance Committee to recommend the candidate to the Board, and will not obligate the Board to nominate or recommend the candidate for director in our proxy materials.

CORPORATE GOVERNANCE COMMITTEE

Ross E. Roeder, Chairman

Christian P. Couvreur

Thomas G. Plaskett

Etienne Snollaerts

Report of the Compensation Committee

The Compensation Committee operates under a written charter adopted by our Board. The Charter of the Compensation Committee, or the Charter, complies with the requirements of the SEC and the NYSE listing standards. The Charter will be reviewed and reassessed regularly to ensure continued compliance with these requirements. The Charter is available for public viewing on our Internet web site at <http://www.smartandfinal.com>, Investor Information, under the Governance tab. In addition, interested persons can obtain a copy of the Charter by writing to, Corporate Secretary, Smart & Final Inc., 600 Citadel Drive, Commerce, California 90040.

Because we have elected to be treated as a Controlled Company, our Compensation Committee is not subject to the independence requirements set forth in the NYSE listing standards. Section 303A.00 of the NYSE listing standards defines a Controlled Company as a company of which more than 50% of the voting power is held by an individual, a group or another company. We are a Controlled Company because 57.1% of our common stock is owned by Groupe Casino. As a Controlled Company, we are exempt from the NYSE requirement that we have a majority of independent directors, and from the requirement that the Compensation Committee be composed entirely of independent directors. Pursuant to such exemption, the Compensation Committee is not composed solely of independent directors.

The functions of the Compensation Committee include, among other things:

Approving salary practices and base salary amounts for our executive personnel;

Approving the structure of and determining awards under the annual incentive bonus plan for our executive officers and under our Long-Term Equity Compensation Plan; and

Approving the strategy and structure of our other employee plans and benefits, and making recommendations to our Board with respect to base salary and incentive compensation for our Chief Executive Officer.

The Compensation Committee's basic philosophy is to provide competitive levels of compensation to motivate, retain and attract management. This philosophy includes providing incentives linked to the Company's financial performance, enhanced stockholder value and personal performance. This philosophy applies to compensation for all of our management, including our Chief Executive Officer.

Executive Compensation

Generally, compensation for our executives consists of a base salary, an annual incentive bonus and an opportunity to receive stock options, stock appreciation rights or other performance-based compensation under our Long-Term Equity Compensation Plan.

Chief Executive Officer Compensation. The Compensation Committee has established a formal process for evaluating the Chief Executive Officer's performance. This process generally begins at the last scheduled Compensation Committee meeting of the fiscal year. This meeting is typically held in late November or early December. Since May 2004, Mr. Snollaerts has been the Company's Chief Executive Officer. Mr. Snollaerts' employment agreement establishes a minimum base salary of \$650,000. If our Board awards annual bonuses to our executive officers, then Mr. Snollaerts is entitled to a bonus commensurate to our other similarly situated executives. Mr. Snollaerts' target for his annual bonus is no less than 100% and no greater than 200% of his base salary for the year. (For a further discussion of Mr. Snollaerts' employment agreement with us, see *Executive Compensation Snollaerts Employment Agreement* below.)

Base Salaries. Base salaries for executive officers are reviewed annually. Executive salaries are designed to be competitive with salaries paid at other companies of comparable size and complexity in the retail and wholesale food distribution business. These salaries are also designed to be competitive with salaries paid in

other comparable businesses including, for example, certain non-food, multi-unit retail companies. The Compensation Committee uses these companies for comparative purposes because it believes that the Company competes with these companies in attracting and maintaining management. The Compensation Committee collects information on these companies from published industry surveys and from competitors proxy statements. It is the policy of the Compensation Committee to adjust salaries in a way that recognizes executive performance and responsibilities and enables us to attract and retain highly qualified executives. In fiscal 2004, executive base salaries (other than for the Chief Executive Officer) were increased an average of 5.69%, ranging from 3.57% to 8.33%, consistent with the Compensation Committee's policy objectives, and were at median levels among comparison companies.

Annual Incentive Bonus Plan. The Compensation Committee believes that the annual incentive bonus plan is an integral part of the overall compensation package offered to executive officers. The Compensation Committee specifically approves bonus amounts for executive officers. The Compensation Committee also determines the bonus amount for the Chief Executive Officer, consistent with the terms of his employment agreement. (See *Chief Executive Officer Compensation* above.) During fiscal 2000, the Compensation Committee decided to link the annual incentive bonus plan to specific financial objectives as a means of encouraging improvements in financial performance. These objectives range from our total financial performance, which is the only objective for determining the bonus awarded to our Chief Executive Officer, to performance of particular operating units. The objectives also include individual targets to help reach certain tactical objectives. In fiscal 2004, the bonuses awarded to executives, depending on the person's position, were based upon financial objectives and tactical objectives. These objectives were tied to our overall performance at the corporate, regional and divisional levels, as well as to specified personal objectives.

We determine actual bonus amounts after the fiscal year end. At that time, the Chief Executive Officer meets with the Compensation Committee to review the performance of executive officers (other than his performance) and presents his recommendations for their actual bonus amounts. For fiscal 2004, the Compensation Committee determined that management had met their financial profit objectives for continuing operations and as a result, approved the recommendations of the Chief Executive Officer for bonus awards. Actual bonuses to executive officers (other than the Chief Executive Officer, whose bonus was pursuant to his employment agreement) averaged approximately 68.3% of base salary and ranged from approximately 52.6% to 86%. (For a further discussion of compensation matters, see *Executive Compensation* below).

Director Compensation

During fiscal 2004, both cash payments and shares of our common stock were used to compensate each of our non-employee directors. Effective 2004, our non-employee directors were paid an annual cash fee of \$20,000. This annual fee is paid in quarterly installments in advance at the beginning of each calendar quarter. Our non-employee directors also received \$1,500 in cash for each Board meeting and each committee meeting attended, whether attendance was in person or telephonically. In addition, the Chairman of the Audit Committee, Mr. Plaskett, received an additional payment of \$10,000 per year and the Chairman of the Compensation Committee, Mr. Crull, received an additional payment of \$5,000 per year. The Chairman of our Corporate Governance Committee is also entitled to receive an additional payment of \$5,000 per year. During fiscal 2004, Mr. Roeder served as the Chairman of our Corporate Governance Committee, but he was not entitled to receive compensation for acting as the Chairman because he was our employee during fiscal 2004. We also reimburse our directors for the expenses they incur in attending meetings in person. Our directors that are also our employees are not compensated for their service as members of our Board or any committee of the Board.

In addition to the cash payments described above, our non-employee directors that are also not employed by Groupe Casino receive equity compensation under our Amended and Restated Non-Employee Director Stock Plan, or our 1996 Non-Employee Director Stock Plan. However, our 1996 Non-Employee Director Stock Plan expired on February 22, 2005, and thus in this proxy statement we are submitting for stockholder approval, a new Smart & Final Inc. Long-Term Equity Compensation Plan for Non-Employee Directors, a complete copy of which is attached hereto as Appendix B.

Under our 1996 Non-Employee Director Stock Plan, eligible directors received an automatic award of common stock on May 1st of each year valued at approximately \$20,000 on the date of the award. Each eligible director who was serving as a director on the award date received these shares. For purposes of our 1996 Non-Employee Director Stock Plan, an eligible non-employee director was an individual who, for at least three years prior to becoming a director: (i) was not our employee; and (ii) was not an employee of Groupe Casino. For the May 1, 2004 grant, Messrs. Crull, Gold, McLaughlin, and Plaskett were all eligible non-employee directors under the 1996 Non-Employee Director Stock Plan. Each of these individuals received 1,680 shares of common stock. Each share award is comprised of that number of shares equal to the quotient of \$20,000 divided by the fair market value of a share on the award date as defined in the 1996 Non-Employee Director Stock Plan. Cash is paid in lieu of fractional shares. Our directors must hold the shares awarded for at least six months after the award date. On May 18, 2004, the Board awarded Mr. Watson an initial grant of 22,500 stock options upon joining the Board and Messrs. Crull, Gold, McLaughlin, and Plaskett received a grant of 4,000 options.

At the July 2002 Annual Meeting, our stockholders approved an amendment to the 1996 Non-Employee Director Stock Plan, which provided that the number of shares available under the plan would increase each year by the number of shares from the 1996 Non-Employee Director Stock Plan that have been exercised and/or vested. In fiscal 2004, 66,000 stock options were exercised under the 1996 Non-Employee Director Stock Plan and it had 70,000 shares available for grant at the end of fiscal 2004. The 1996 Non-Employee Director Stock Plan expired on February 22, 2005 and no awards of shares were made under it in 2005. At the end of fiscal 2004, there were 239,000 unexercised options outstanding that have been granted to non-employee directors. Of these options, 38,500 will expire if not exercised on or before May 18, 2014; 36,000 will expire if not exercised on or before May 22, 2013; 72,000 will expire if not exercised on or before February 18, 2013; 20,000 will expire if not exercised on or before May 1, 2010; 22,500 will expire if not exercised on or before May 11, 2009; and 50,000 will expire if not exercised on or before May 4, 2009.

We also have a Stock Incentive Plan, as amended, or Incentive Plan, which expired in June 2001 as to new grants. Our Board had a policy in place to the effect that any elected or appointed non-employee director serving prior to 1998 would receive an automatic grant of options to purchase 22,500 shares of our common stock under such Incentive Plan as of the date of initial appointment or election. The options were nonqualified stock options and had exercise prices equal to the fair market value of our common stock at the date of grant. In addition, these options have an exercise term of ten years after the date of grant and are subject to early termination in the event the option holder ceases to be a director, becomes permanently disabled or dies. One-third of these options become exercisable two years after the date of grant and each year thereafter, so that 100% would be exercisable four years after the date of grant. There are 40,000 unexercised options outstanding that have been granted to non-employee directors under our Incentive Plan. Of these options, 17,500 will expire if not exercised on or before June 18, 2006; and 22,500 will expire if not exercised on or before May 4, 2010.

We also have a Directors Deferred Compensation Plan, or Deferred Plan. This Deferred Plan allows our non-employee directors to defer on a pre-tax basis up to 100% of their cash fees (with a minimum annual deferral of \$2,500), as well as any shares of our common stock received as compensation for services as a director. Participation in the Deferred Plan is voluntary on an annual basis. Deferrals of cash amounts are credited to a special bookkeeping account in the non-employee director's name, and earnings on deferrals are indexed to certain investment fund options. Deferrals of shares of our common stock are held within the Deferred Plan, for the benefit of the deferring director's account and are not redeemable for cash. We pay all benefits and costs from our general assets. We have created a non-qualified grantor trust whose assets will be used to pay benefits and defray expenses; however, the assets of the trust are subject to the claims of our general creditors in the event of our insolvency or bankruptcy. In general, participants will receive benefits under the Deferred Plan after retirement. Benefits are paid in one lump-sum payment or a stream of five, ten or fifteen annual payments, depending on a director's pre-elected payment option. The Deferred Plan permits limited withdrawals prior to retirement. The Deferred Plan also provides additional death benefits in the event of death prior to retirement. During fiscal 2004, three directors participated in the Deferred Plan.

Compensation Plans

Stock Incentive Plan. The Incentive Plan authorized the issuance of options covering up to 2,450,000 shares of our common stock. The Incentive Plan expired in June 2001 as to new grants. Accordingly, no awards of stock were made under the Incentive Plan during fiscal 2004. As of March 31, 2005, there were 210,063 unexercised options outstanding under the Incentive Plan. These options will expire at varying dates on or before February 20, 2011, if not exercised before that date.

Long-Term Equity Compensation Plan. Under guidelines set by the Compensation Committee, incentive-based compensation constitutes a greater portion of executives' potential long-term pay. A portion of this incentive-based compensation is made through stock-based awards under the Long-Term Equity Compensation Plan. The primary objectives of this plan are to optimize our profitability and growth through incentives. These incentives are designed to be consistent with our goals, and to link the personal interests of plan participants to those of our stockholders.

At the May 2001 Annual Meeting, the stockholders approved an amendment to the Long-Term Equity Compensation Plan increasing the stock-based awards allowed under this plan from 2,470,000 shares to 3,600,000 shares of our common stock. The stockholders also extended the Long-Term Equity Compensation Plan's expiration date from December 31, 2006 to December 31, 2010. At the July 2002 Annual Meeting, the stockholders approved an amendment and restatement of the Long-Term Equity Compensation Plan that increased the stock-based awards allowed under this plan from 3,600,000 shares to 5,100,000 shares of our common stock. The amendment also provided that the number of shares available under the Long-Term Equity Compensation Plan would increase each year by the number of shares that were exercised and/or expired. In fiscal 2004, an additional 591,646 shares became available under the Long-Term Equity Compensation Plan based on the exercises of common stock and the vesting of restricted shares. These shares will be added back into the plan on May 30, 2005. At the end of fiscal 2004, the total stock-based awards available for grant under the Long-Term Equity Compensation Plan were 542,358 shares.

Certain Other Benefits. We provide health, welfare and pension benefits to the Company's executive officers. These benefits are also generally available to all of the Company's full-time employees. In addition, we provide certain perquisites to our executive officers including, depending upon the executive officer, reimbursement of tax preparation and/or financial planning expenses, club dues, moving expenses, car allowances, a supplemental executive retirement plan, life insurance policies, long-term disability plans and executive medical coverage.

Other Matters. The Compensation Committee has reviewed the compensation plans with regard to the deductibility limitation contained in Section 162(m) of the Internal Revenue Code of 1986, as amended, or the Code. The Compensation Committee has decided at present not to alter the compensation plans to comply with the deductibility requirements of Section 162(m) of the Code. The Compensation Committee will continue to review the issue and monitor whether the compensation plans should be amended in the future to meet the deductibility requirements of the Code. Our Long-Term Equity Compensation Plan provides that at all times when Code Section 162(m) is applicable, all awards granted under that plan shall comply with the requirements of Section 162(m) of the Code. However, the Compensation Committee may determine that such compliance is not desired with respect to any particular award.

COMPENSATION COMMITTEE

Timm F. Crull, Chairman

James S. Gold

David J. McLaughlin

Thomas G. Plaskett

Executive Officers

The following table sets forth, as of March 31, 2005, the names, ages and titles of our executive officers and the officers of our subsidiaries, Smart & Final Stores Corporation, or Smart & Final Stores, American Foodservice Distributors, Inc., or American Foodservice Distributors, and Port Stockton Food Distributors, Inc. dba Smart & Final Foodservice Distributors, or Smart & Final Foodservice:

<u>Name</u>	<u>Age</u>	<u>Title</u>
Etienne Snollaerts	49	Chief Executive Officer and President of Smart & Final Inc., Smart & Final Stores, and American Foodservice Distributors; Chairman of the Board and Chief Executive Officer of Smart & Final Foodservice.
Donald G. Alvarado	50	Senior Vice President, General Counsel and Secretary of Smart & Final Inc. and Smart & Final Stores; Senior Vice President and Secretary of American Foodservice Distributors and Smart & Final Foodservice.
André Delolmo	53	Senior Vice President of Operations for Smart & Final Inc. and Smart & Final Stores.
Zeke Duge	58	Senior Vice President and Chief Information Officer of Smart & Final Stores.
Richard A. Link	50	Vice President and Controller of Smart & Final Inc. and Vice President and Chief Accounting Officer of Smart & Final Stores.
Norah Morley	53	Senior Vice President, Marketing of Smart & Final Stores.
Suzanne Mullins	52	Senior Vice President of Store Operations of Smart & Final Stores.
Richard N. Phegley	49	Senior Vice President and Chief Financial Officer of Smart & Final Inc. and Smart & Final Stores, American Foodservice Distributors, and Smart & Final Foodservice.
Timothy M. Snee	51	Senior Vice President, Buying of Smart & Final Stores.
Jeff D. Whynot	48	Senior Vice President, Human Resources of Smart & Final Inc. and Smart & Final Stores.
John M. Willis	59	President, Cash & Carry division of Smart & Final Stores.

Our executive officers are appointed by our Board and serve at our Board's discretion.

Etienne Snollaerts. See ITEM 1 Election of Directors above.

Donald G. Alvarado. Mr. Alvarado was named Senior Vice President, General Counsel of Smart & Final Inc. and Smart & Final Stores in September 1996. Mr. Alvarado also serves as our Secretary and the Secretary of American Foodservice Distributors, Smart & Final Foodservice and Smart & Final Stores. From 1997 to 1999, Mr. Alvarado was also Senior Vice President Law/Development. From 1991 until September 1996, he served as our Vice President, General Counsel and Secretary. Mr. Alvarado joined us in 1987 as our Assistant General Counsel and was appointed our Secretary in 1989. He has been Secretary of Smart & Final Stores since 1990. From 1989 to January 1994, Mr. Alvarado was also Assistant Secretary of Casino USA, the U.S.-based subsidiary of Groupe Casino, and of Casino Realty, Inc., its former wholly-owned subsidiary. In September 2003, Mr. Alvarado was appointed as the Secretary of Casino USA.

André Delolmo. Mr. Delolmo was appointed Senior Vice President of Operations for Smart & Final Stores in December 2002 and in May 2004, he was appointed Senior Vice P>3,743

OPERATING EXPENSES:

Sales and marketing					214,428	206,287	766,881	599,638
Research and development					195,660	40,363	585,876	73,625
General and administrative	317,049	427,398	1,081,558	968,749	Loss on disposal of fixed assets	72,016	-	110,952
Total operating expenses					799,153	674,048	2,545,267	1,642,012
LOSS FROM OPERATIONS					(817,766)	(689,619)	(2,713,899)	(1,638,269)

OTHER (EXPENSE):

Interest expense, net	(611,082)	(428,726)	(1,592,780)	(1,203,037)	Gain on legal settlements and insurance claims	51,030	3,713	56,265	3,815
Loss on debt extinguishment						-	-	(21,793,055)	-
Change in market value of settlement related financial instrument						147,500	-	147,500	(442,500)
Total other expense					(412,552)	(425,013)	(23,182,070)	(1,641,722)	
LOSS FROM CONTINUING OPERATIONS					(1,230,318)	(1,114,632)	(25,895,969)	(3,279,991)	

DISCONTINUED OPERATIONS

Income (loss) from discontinued operations					(14,941)	46,207	(14,778)	110,726
Impairment of assets of discontinued operations								(14,654)

NET LOSS

\$ (1,245,259) \$(1,068,425) \$ (25,925,401) \$(3,169,265)

NET LOSS PER COMMON SHARE:

Basic and fully diluted from continuing operations \$ (0.07) \$(0.06) \$ (1.41) \$(0.18)

Basic and fully diluted from discontinued operations \$(0.00) \$0.00 \$(0.00) \$0.01

WEIGHTED-AVERAGE NUMBER OF SHARES USED IN COMPUTING NET LOSS PER COMMON

SHARE:

Basic and fully diluted 18,352,542 18,352,542 18,352,542 18,352,542

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

MOBILESMITH, INC.
CONDENSED STATEMENTS OF CASH FLOWS
(unaudited)

	Nine Months Ended	
	September 30, 2013	September 30, 2012
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	\$(25,925,401)	\$(3,169,265)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	113,308	76,425
Loss on disposal of fixed assets	125,606	-
Non cash amortization of debt discount	72,364	-
Equity-based compensation	35,624	26,109
Loss on debt extinguishment	21,793,055	-
Changes in assets and liabilities:		
Accounts receivable	(42,849)	(91,408)
Contracts receivable		(6,200)
Prepaid expenses	31,339	(85,706)
Other assets	(34,424)	(168)
Accounts payable	(146,169)	92,351
Deferred revenue	55,206	217,806
Accrued and other expenses	155,708	394,385
Net cash used in operating activities	(3,766,633)	(2,545,671)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(21,834)	(25,530)
Purchase of software license	-	(75,000)
Capitalized patent development costs	(14,440)	(17,248)
Capitalized software	(287,628)	(749,160)
Net cash used in investing activities	(323,902)	(866,938)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Restricted cash used to pay IDB interest expense	135,566	152,904
Deposit of cash to IDB restricted account	(202,886)	(281,341)
Proceeds from debt borrowings	4,375,000	3,639,253
Repayments of debt borrowings	(38,858)	(12,172)
Net cash provided by financing activities	4,268,822	3,498,644
NET DECREASE IN CASH AND CASH EQUIVALENTS	178,287	86,035
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	58,458	165,139
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$236,745	\$251,174
Supplemental disclosures of cash flow information:		
Cash paid during the period for interest	\$1,525,682	\$748,778
Non-cash investing and financing activities:		
Financed purchase of office furniture	\$40,000	\$-

Recorded debt discount associated with beneficial conversion feature	\$1,334,804	\$-
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The accompanying notes are an integral part of these financial statements.

MOBILESMITH, INC.
CONDENSED STATEMENT OF STOCKHOLDERS' DEFICIT
FOR THE PERIOD ENDED SEPTEMBER 30, 2013

	Common Stock		Additional Paid-In Capital	Accumulated Deficit	Totals
	Shares	Par Value			
BALANCES, DECEMBER 31, 2012	18,352,542	\$ 18,353	\$ 67,157,841	\$ (94,336,465)	\$ (27,160,271)
Equity-based compensation			12,181		12,181
Net loss				(1,427,804)	(1,427,804)
BALANCES, MARCH 31, 2013	18,352,542	18,353	67,170,022	(95,764,269)	(28,575,894)
Equity-based compensation			11,917		11,917
Beneficial conversion feature recorded as a result of June 27, 2013 debt modification			22,218,055		22,218,055
Net loss				(23,252,338)	(23,252,338)
BALANCES, JUNE 30, 2013	18,352,542	18,353	89,399,994	(119,016,607)	(29,598,260)
Equity-based compensation			11,526		11,526
Beneficial conversion feature recorded as a result of issuance of convertible debt			909,804		909,804
Net loss				(1,245,259)	(1,245,259)
BALANCES, SEPTEMBER 30, 2013	18,352,542	\$ 18,353	\$ 90,321,324	\$ (120,261,866)	\$ (29,922,189)

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

MOBILESMITH, INC.
NOTES TO CONDENSED FINANCIAL STATEMENTS
For the Quarterly Period Ended September 30, 2013
(unaudited)

1. DESCRIPTION OF BUSINESS AND BASIS OF PRESENTATION

MobileSmith, Inc. (the “Company”) was incorporated as Smart Online, Inc. in the State of Delaware in 1993. The Company changed its name to MobileSmith, Inc. effective July 1, 2013. The Company develops and markets software products and services tailored to users of mobile devices. The Company’s flagship product is The MobileSmith™ Platform. The MobileSmith™ Platform is an innovative, patents pending mobile app development platform that enables organizations to rapidly create, deploy, and manage custom, native smartphone apps deliverable across iOS and Android mobile platforms.

The Company’s principal products and services include:

Licensing of our SaaS (“Software as a Service”) Mobile App Development Platform to our customers who design and build their own apps;

Custom mobile application design and development services provided by the Company;

Mobile application marketing services;

Mobile strategy implementation consulting; and

Cloud-based software hosting and management services.

The Company prepared the accompanying unaudited Condensed Financial Statements pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”). Pursuant to these rules and regulations, we have condensed or omitted certain information and footnote disclosures we normally include in our annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”). In management’s opinion, we have made all adjustments (consisting only of normal, recurring adjustments, except as otherwise indicated) necessary to fairly present our financial position, results of operations, cash flows and stockholder deficit as of September 30, 2013. Our interim period operating results do not necessarily indicate the results that may be expected for any other interim period or for the full fiscal year. These financial statements and accompanying notes should be read in conjunction with the audited financial statements and notes thereto in our Annual Report on Form 10-K for the fiscal year ended December 31, 2012, as amended, on file with the SEC (our “Annual Report”).

There have been no material changes to our significant accounting policies as compared to the significant accounting policies described in our Annual Report.

The accompanying financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. During the nine months ended September 30, 2013 and 2012, the Company incurred net losses as well as negative cash flows and had deficiencies in working capital. These factors indicate that the Company may be unable to continue as a going concern.

Certain prior year balances were reclassified in connection with the presentation of discontinued operations of legacy domain hosting operations and the presentation of debt balances as of September 30, 2013.

2. BALANCE SHEET ACCOUNTS

Capitalized software consists of the following:

	September 30, 2013	December 31, 2012
Capitalized software	\$ 952,139	\$ 672,359
Less accumulated amortization	(133,752)	(53,802)
Capitalized software, net	\$ 818,387	\$ 618,557

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Office furniture and equipment:

During the quarter ended September 30, 2013, the Company finalized its plans to move to a new office location. During the nine month period then ended the Company purchased \$21,834 of new equipment and tradeshow furniture, in addition to purchasing \$40,000 of new office furniture, which was financed.

As a result of the office move, the Company disposed of \$125,606 of certain undepreciated assets which were not moved to the new location.

Financial instruments:

The fair value of the financial liability related to issuance of 1,475,000 shares of our common stock, par value \$0.001 per share (the "Common Stock"), resulting from the settlement of the Class Action lawsuit on July 1, 2011 was \$1,917,500 and \$2,065,000 at September 30, 2013 and December 31, 2012, respectively.

The Company recognized a gain of \$147,500 and a loss of \$442,500 in relation to the change in value of the financial liability during the nine-month periods ended September 30, 2013 and 2012, respectively.

3. DEBT

The table below summarizes the Company's debt at September 30, 2013 and December 31, 2012:

Note Description	September 30, 2013	December 31, 2012	Maturity	Rate	
IDB Bank	\$5,000,000	\$5,000,000	May-14	4.0	%
Insurance premium note	-	23,987	Jun-13	6.9	%
Capital lease obligations - Noteholder lease	136,893	150,072	Aug-19	8.0	%
Capital lease obligations - Office furniture	38,310	-	Sep-18	9.8	%
Convertible notes - Related parties	14,557,051	14,557,051	Nov-16	8.0	%
Convertible notes, net of discount	9,055,509	5,942,949	Nov-16	8.0	%
Total debt	28,787,763	25,674,059			
Less: current portion of long term debt					
Capital lease obligations	25,142	17,754			
IDB Bank	5,000,000	5,000,000			
Insurance premium note	-	23,987			
Total current portion of long term debt	5,025,142	5,041,741			
Debt - long term	\$23,762,621	\$20,632,318			

Convertible Notes

On June 26, 2013, the Company entered into the Sixth Amendment and Agreement to Join as a Party to Convertible Secured Subordinated Note Purchase Agreement, Fourth Amendment to Convertible Secured Subordinated Promissory Notes and Fifth Amendment and Agreement to Join as a Party to Registration Rights Agreement (the "Sixth Amendment"), with the holders of a majority of the aggregate outstanding principal amount of the Convertible Secured Subordinated Promissory Notes (the "Notes"), issued by the Company under the Convertible Secured

Subordinated Note Purchase Agreement, dated November 14, 2007, as amended (as so amended, the “Note Purchase Agreement”), and an additional purchaser of the Notes, Grasford Investments Ltd (“Grasford”) (together, the “Noteholders”). The modification to our convertible instrument applied to \$23,075,000 of Notes outstanding as of the date of modification and to all future Notes. As amended by the Sixth Amendment, the convertible instrument has the following characteristics:

a maturity date of November 16, 2016;

an interest rate of 8% per year;

optional conversion at a Noteholders’ request;

the borrowing commitment was increased by \$10 million to \$33.3 million;

a conversion price that is the greater of (i) 80% of the lowest closing price of the Common Stock in the twelve-month period immediately preceding the date of conversion or (ii) \$0.50; and

if at the time any particular requested conversion the Company does not have the number of authorized shares of Common Stock sufficient to allow for such particular conversion, the Noteholders may request that the Company call a special meeting of the stockholders specifically for the purpose of increasing the number of the authorized shares of Common Stock to cover the remaining portion of the Notes outstanding.

The modification of the Note Purchase Agreement was accounted for as debt extinguishment. The total value of the convertible instrument immediately after the modification was determined to be \$44,868,055, of which \$21,793,055 was allocated to the intrinsic value of the embedded conversion feature of the instrument immediately after the modification (beneficial conversion feature) in accordance with ASC 470 "Debt" and recorded as part of additional paid-in capital.

The difference between the fair value of the new convertible instrument and the carrying value of the old convertible notes in the amount of \$21,793,055 was recognized as loss on extinguishment of debt in the statement of operations.

Subsequent to modification and through September 30, 2013 the Company sold \$1,800,000 in additional Notes to Union Bancaire Privée ("UBP") under the amended Note Purchase Agreement at conversion prices ranging between \$0.72 and \$0.82 on the date of sale. The Company recorded a beneficial conversion feature of \$1,334,804 and corresponding debt discount, which will be amortized into interest expense through the maturity of the Notes.

During the nine-month period ended September 30, 2013, the Company sold Notes to UBP totaling \$4,375,000 (including the \$1,800,000 in Notes described above) under the same terms as previously-sold Notes under the convertible instrument.

Fair Value of Modified Convertible Notes

The modified convertible debt instrument was recorded at fair value of \$44,868,055. The Company used a binomial model to determine the fair value of the instrument. The binomial model method uses significant unobservable inputs and falls within Level III measurement method under Fair Value Hierarchy under ASC 820 "Fair Value Measurements"

The significant unobservable inputs and information used to develop those inputs include the following:

volatility of stock price was determined to be 47% and was based on the volatility of the Company's stock price as quoted on the Over-the-Counter Bulletin Board (the "OTCBB") for the period of 3.4 years, which approximates the period remaining until maturity of the convertible instrument;

the risk free rate of 1.41%;

the credit spread over the risk free rate was determined to be approximately 20%, which was derived from a combination of the credit spread of CCC rated bonds with added premium for lack of marketability of the convertible instrument;

the nodes of the binomial model were extended for 3 years, which approximates the time period until maturity of the convertible instrument; and

the conversion ratio varied from approximately 1.39 to .56 shares per dollar, depending on the node of the conversion tree. The conversion ratio varied due to projected change in value of the stock driven by historical volatility of 47%.

IDB Credit Facility

On June 28, 2013, the Company extended its secured credit facility (the "IDB Credit Facility"), with Israel Discount Bank of New York ("IDB"), as lender, effective as of May 31, 2013, for an additional one-year period for the \$5,000,000 already outstanding, and we maintain \$250,000 in a Restricted Cash Account held at IDB for future interest payments. All other terms remained unchanged. To date, the Company has borrowed \$5,000,000 under the

IDB Credit Facility. Borrowings under the IDB Credit Facility are guaranteed by Atlas Capital SA (“Atlas”), a majority Noteholder and a related party, and further secured by an extended irrevocable standby letter of credit issued by UBS Private Bank (“UBS”) with an expiration date of November 30, 2015.

4. COMMITMENTS AND CONTINGENCIES

Aggregate future lease commitments

The Company leases computers, office equipment and office furniture under capital lease agreements that expire through August 2019. Total amounts financed under these capital leases were \$175,203 and \$150,072 at September 30, 2013 and December 31, 2012, respectively. These obligations are included within the Company’s total debt.

The table below summarizes Company's future obligations under its capital leases:

Year:

2013	\$9,818
2014	39,259
2015	39,259
2016	39,259
2017	39,259
Thereafter	53,601
	220,455
Less amount representing interest	(45,252)
Capital lease obligations	\$175,203

The Company rents its office space pursuant to a lease that expires on November 15, 2013.

On July 29, 2013, the Company signed a sixty-five month lease for new office space in Raleigh, North Carolina, effective October 30, 2013. The landlord built the space to the Company's specifications and provided the Company with five months free rent, as an incentive. Rent expense will be recognized over the entire sixty-five month term of the lease on a straight-line basis. The lease contains an option to renew for two three-year terms. Monthly rent is approximately \$13,000 per month.

In addition, on July 17, 2013, the Company leased a vehicle for a period of thirty-six months with monthly payments of \$300. The vehicle is mostly used for transporting equipment to and from tradeshow that often take place within reasonable driving distance from the Company's office.

The table below summarizes the Company's future obligations under the new office and vehicle leases:

Year:

2013	\$897
2014	119,775
2015	162,528
2016	165,678
2017	167,786
Thereafter	216,500
Total	\$833,164

Legal Proceedings

The Company may be subject to legal proceedings and litigation arising in the ordinary course of business, including, but not limited to, certain pending patent and privacy matters, including class action lawsuits, as well as inquiries investigations, audits and other regulatory proceedings.

The Company will record a liability when it believes that it is both probable that a loss has been incurred and the amount can be reasonably estimated. The Company periodically evaluates developments in its legal matters that could affect the amount of liability that it has previously accrued, if any, and makes adjustments as appropriate. Significant judgment is required to determine both the likelihood of there being, and the estimated amount of, a loss related to such matters, and the Company's judgment may be incorrect. The outcome of any proceeding is not determinable in

advance. Until the final resolution of any such matters that the Company may be required to accrue for, there may be an exposure to loss in excess of the amount accrued, and such amounts could be material.

On June 18, 2010, the Company entered into a Stipulation and Agreement of Settlement (the "Stipulation") with the lead plaintiff in the securities class action involving the Company in the case captioned Mary Jane Beauregard vs. Smart Online, Inc., et al., filed in the District Court (the "Class Action"). The Stipulation provides for the settlement of the Class Action on the terms described below. The District Court issued an order preliminarily approving the settlement on January 13, 2011. The final settlement hearing was held on May 11, 2011. As of the date of this report, the 1,475,000 shares of Common Stock had not been issued and, according to GAAP, the Company now carries the obligation as a financial instrument on its balance sheet.

The Stipulation provides for the certification of a class consisting of all persons who purchased the Company's publicly traded securities between May 2, 2005 and September 28, 2007, inclusive. As per the terms of the Stipulation, the settlement class has received total consideration of a cash payment of \$350,000 made by the Company, and a cash payment of \$112,500 made by Maxim Group. In addition, Henry Nouri is required to transfer 25,000 shares of Company Common Stock to the settlement class and the Company is required to issue 1,475,000 shares of Company Common Stock to the class. Under the terms of the Stipulation, counsel for the settlement class may sell some or all of the Common Stock received in the settlement before distribution to the class, subject to the limitation that it cannot sell more than 10,000 shares in one day or 50,000 shares in 30 calendar days. Subject to the terms of the Stipulation, we paid the lead plaintiff \$75,000 on July 14, 2010, \$100,000 on September 15, 2010, \$100,000 on December 14, 2010 and \$75,000 on March 14, 2011. On July 1, 2011, the District Court issued the Final Judgment and Order of Partial Dismissal with Prejudice in the Class Action case. The Court approved the Stipulation and directed the terms of how the Stipulation should be consummated. On July 1, 2011, the Company recorded the Class Action obligation as a financial instrument liability.

On January 13, 2011 (the "Effective Date"), the District Court issued the Order Preliminarily Approving Settlement and Providing Notice. Based upon the Settlement Agreement and the January 13, 2011 District Court Order Preliminarily Approving Settlement and Providing Notice, we paid for the benefit of Dennis Michael Nouri, Reza Eric Nouri, Henry Nouri and Ronna Loprete Nouri, collectively, the Nouri Parties, a total of \$1,332,773 between January 2011 and February 2012. The Company was ordered by a court of proper jurisdiction to withhold \$67,227 for future payment of adjudicated debt owed by the Nouri Parties'. Under the terms of the Settlement Agreement, to the extent the Nouri Parties' legal costs are less than \$300,000, the Company is owed the difference. The Settlement Agreement also provides for the exchange of mutual releases by the parties.

5. EQUITY COMPENSATION

The following is a summary of the stock option activity for the nine-months period ended September 30, 2013:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic value
Outstanding, December 31, 2012	450,900	\$2.02		
Cancelled	(164,900)	1.53		
Issued	249,370	1.62		
Outstanding, September 30, 2013	535,370	\$1.96	5.2	24,300
Vested and exercisable, September 30, 2013	191,750	\$2.76	4.9	17,825

Aggregate intrinsic value represents the difference between the closing stock price at September 30, 2013 of the Company's Common Stock and the exercise price of outstanding, in-the-money options. The Company's closing stock

price as reported on the OTCBB as of September 30, 2013 was \$1.30.

At September 30, 2013, there remains \$329,219 of unvested expense yet to be recorded related to all options outstanding.

6. MAJOR CUSTOMERS AND CONCENTRATION

During the nine-month period ended September 30, 2013, two major customers accounted for 27% of total revenues. For the nine-month period ended September 30, 2012, six major customers accounted for 82% of total revenues.

7. DISCONTINUED OPERATIONS

In May 2013, the Company's management agreed to discontinue the Company's legacy business of domain hosting and e-commerce effective as of July 31, 2013. Results of legacy operations are presented as discontinued operations in the Condensed Statements of Operations. The Company has impaired all remaining assets associated with the legacy business, which included a number of servers, and recorded an impairment charge in the amount of approximately \$15,000. Remaining liabilities of \$6,600 include deferred revenue for the recently renewed subscriptions.

8. SUBSEQUENT EVENTS

Subsequent to September 30, 2013, the Company sold four Notes totaling \$840,000 to UBP on the same terms as previously sold Notes. The Notes will mature on November 14, 2016.

Effective November 1, 2013, Atlas transferred all of its interest in the Notes to Grasford Investments, Ltd. ("Grasford"). Grasford is an entity controlled by Avy Lugassy, beneficial owner of both Company equity and the Notes interests formerly held by Atlas. As a result of the transaction, Avy Lugassy continues to control those interests through control of Grasford in the same manner that he used to control the same interests through control of Atlas.

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

Information set forth in this Quarterly Report on Form 10-Q 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 and other laws. 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 potential impact of current or future litigation and government investigations, our ability to continue as a going concern, and the sufficiency of our capital resources including funds available under our existing credit facility, the funds available under our Note facility and the future sales of Notes, all of which are based on current expectations, estimates, and forecasts, and the beliefs and assumptions of our management. Words such as “expect,” “anticipate,” “project,” “intend,” “plan,” “estimate,” variations of such words, and similar expressions also are intended to identify such forward-looking statements. These forward-looking statements are subject to risks, uncertainties, and assumptions that are difficult to predict. Therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. Readers are directed to risks and uncertainties identified under Part I, Item 1A, “Risk Factors,” in our Annual Report and our subsequent periodic reports filed with the Securities and Exchange Commission, or SEC, for factors that may cause actual results to be different than those expressed in these forward-looking statements. Except as required by law, we undertake no obligation to revise or update publicly any forward-looking statements for any reason.

The following discussion is designed to provide a better understanding of our unaudited financial statements, including a brief discussion of our business and products, key factors that impacted our performance, and a summary of our operating results. The following discussion should be read in conjunction with the unaudited condensed financial statements and the notes thereto included in Part I, Item 1 of this Quarterly Report on Form 10-Q, and the financial statements and notes thereto and Management's Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report. Historical results and percentage relationships among any amounts in the financial statements are not necessarily indicative of trends in operating results for any future periods.

Overview

We develop and market software products and services tailored to users of mobile devices. Our flagship product is our MobileSmith™ Platform, which allows our customers to quickly design, build and manage native iOS and Android apps without having developer skills or experience. We use a SaaS business model – the customers acquire access to our platform through user license agreements and are able to obtain total control of mobile app production. Our business model allows for creation and management of any desired number of apps by our customers for a monthly license fee.

We also provide consulting services, which include assistance with design and implementation of mobile strategy and/or the development of mobile apps.

We believe that the do-it-yourself model for creation and management of apps will become a cost effective solution for enterprise clients who have an ever increasing need to interact with their customers and employees through mobile devices. Single apps may reach their limits of usability very quickly, if made complex. Our platform offers an ability to create multiple, customized non-template apps with designated functionalities and specific designs without incurring additional costs.

Our market penetration strategy focuses on three distinct sectors:

Government:

We believe that our platform has a unique capability to service various structures within federal, state and local governments, as government structure is highly segmented by function and territory. In addition, our platform can be safely placed behind the firewalls of individual departments, where data security is a primary concern. Replicating our platform and placing it behind a secure firewall would allow an organization to create and manage multiple mobile apps with targeted functionality for targeted audiences without going outside of the secure firewall.

Healthcare clients:

Healthcare organizations, such as hospitals and healthcare networks are akin to government in their departmental segmentation and territorial reach. Additionally, healthcare companies are subject to increased regulation as a result of Affordable Care Act and may be subject to penalties for delivering inefficient care under new Medicare provisions. Hospitals increasingly turn to portfolios of apps to increase efficiency and remain competitive: outpatient care apps, wellness apps, physician referral apps, appointment apps, discharge apps and others. We believe that our platform has a significant competitive advantage in the healthcare space due to the ability to deliver a variety of targeted mobile solutions cost effectively.

Enterprise clients:

The third sector combines all other large and multi-national enterprise clients, where large-scale customization based on functionality or territory is of the highest value, and other contributors as time to market, technology reach, and ease of use play important roles. These target clients may include large food chain, media and PR companies, software solutions providers, hardware manufacturers, mortgage brokers and real estate franchises.

Continuous Upgrades of our MobileSmith™ Platform

During the nine-month period ended September 30, 2013, we invested approximately \$324,000 in equipment, upgrades to the functionality of the platform and development of related patents. The main upgrades to the platform included:

Release of MobileSmith™ 3.0 platform, which includes improvements to the user interface and streamlined workflow;

Release of iPad AppCanvas™ on July 19, 2013. With this release our platform can produce native iPad apps with the same ease and agility as the iPhone and Android phone apps. Tablets are currently driving mobile app usage and MobileSmith™ became one of the first SaaS app platforms to accommodate this trend;

Introduction of Enterprise App Versioning (EAV), which allows for more structured ways of app version development and release to internal and public app stores. EAV also allows managing of multiple live app versions without forcing users to download a new version of an app; and

In September of 2013, we added Device Content Management (DCM) functionality, which allows customer's data to be easily integrated in our platform. DCM allows for development of apps that use content from existing databases. DCM enabled apps are not only able to receive push updates from the servers, but can also push data updates back to the servers. DCM functionality significantly increases the range and sophistication of apps that can be built on our platform.

Discontinued Operations of Domain Management and E-Commerce Business.

During the second quarter of 2013, we adopted a plan to completely discontinue our domain hosting and e-commerce operations in order to focus on our core mobile platform business and related services. In July 2013, we executed the plan and are now completely out of the business of domain hosting and e-commerce operations which were gradually on the decline over the past two years. We do not expect our exit to have any substantial impact on our operations and cash flows. We recorded a loss on impairment of assets used in discontinued operations of \$14,654 for the nine months ended September 30, 2013. The assets included a number of servers and switches that were used for domain hosting operations.

Liquidity and Capital Resources

We have not yet achieved positive cash flows from operations, and our main source of funds for our operations is the sale of additional Notes. We must continue to rely on this source until we are able to generate sufficient cash from revenues to fund our operations. We believe that anticipated cash flows from operations, and additional issuances of Notes, together with cash on hand, will provide sufficient funds to finance our operations at least for the next 12 to 18 months, depending on our ability to achieve strategic goals outlined in our annual operating budget approved by our board of directors, or the Board. Changes in our operating plans, lower than anticipated sales, increased expenses, or other events may cause us to seek additional equity or debt financing in future periods. There can be no guarantee that financing will be available on acceptable terms or at all. Additional equity and convertible debt financing could be dilutive to the holders of our Common Stock, and additional debt financing, if available, could impose greater cash payment obligations and more covenants and operating restrictions. The distribution of the Class Action settlement shares will cause current stockholders to be further diluted due to the issuance of an additional 1,475,000 shares of Common Stock pursuant to the terms of the agreement.

On June 26, 2013, we entered into the Sixth Amendment with the Noteholders. The debt modification affected both currently outstanding convertible debt and issuances made subsequently. The modification was a condition for which

the parties to the Note Purchase Agreement would agree to increase the ceiling for the amount of Notes authorized to be issued. As a result of the modification, the Noteholders agreed to increase the amount of Notes authorized to be issued in subsequent closings of the sale of Notes by \$10,000,000, from \$23,300,000 to \$33,300,000. The commitment is non-binding. As of November 14, 2013, we had \$7,385,000 available under the convertible instrument.

The modification resulted in a significant reduction in the conversion price on all outstanding and future Notes issued under the Note Purchase Agreement. Immediately after the modification, the holders of \$23,075,000 of Notes were allowed to convert at a 20% discount to the lowest price of the our Common Stock during the previous twelve month period as quoted on the OTCBB or, \$0.72, into 32,048,611 shares, which resulted in a significant increase in intrinsic value for the holders of the Notes to \$21,793,055, and a significant potential dilution of our current stockholders. However, it is unlikely that this value can be realized by the holders of the Notes, if converted, due to fact that our stock is thinly traded.

During the nine-month period ended September 30, 2013, we sold thirteen Notes to UBP totaling \$4,375,000, under the same terms as previously-sold Notes under the convertible instrument.

During the nine-month period ended September 30, 2013, we used in operations approximately \$3,766,633, of which \$1,398,956 or 37% was used to pay interest on our outstanding convertible debt.

Our unrestricted cash on hand was \$236,745 at September 30, 2013, compared to \$58,458 at December 31, 2012. When compared to December 31, 2012, our accumulated deficit increased by the amount of our nine-month loss of \$25,895,969 and was \$120,261,866 at September 30, 2013. Included in the net loss for the period was \$21,793,055 of loss on modification of debt, which was accounted for as a debt extinguishment.

Under the IDB Credit Facility, we borrowed \$5,000,000. The terms of the IDB Note called for the repayment of the principal amount on May 31, 2013. On June 28, 2013, we extended our IDB Credit Facility, effective as of May 31, 2013, or an additional one-year period for the \$5,000,000 already outstanding, and we maintain \$250,000 in a Restricted Cash Account held at IDB for future interest payments. All other terms remain the same. Borrowings under the IDB Credit Facility are guaranteed by Atlas, a majority Noteholder and a related party until November 11, 2013, and further secured by an extended irrevocable standby letter of credit issued by UBS with expiration date of November 30, 2015.

Further information concerning the Notes and the IDB Credit Facility is reported in Note 3 to the Financial Statements above.

Going Concern

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

Results of Operations for the Three-Months Ended September 30, 2013 and September 30, 2012

Revenue

During the three-month period ended September 30, 2013, our total revenue increased to \$102,326, from \$29,405 for the comparable period in the prior year, or 248%.

During the three-month period ended September 30, 2013, we continued revenue growth associated with the licensing of its MobileSmith™ platform and related service revenue.

Cost of Revenue

During the three-month period ended September 30, 2013, cost of revenue increased to \$120,939, from \$44,976 for the three-month period ended September 30, 2012, or an increase of approximately \$76,000. The increase is mostly attributable to the following changes:

the cost of professional services that include consulting and training was approximately \$64,000, compared to zero during the same period of last year; and

outsourced hosting fees associated with the MobileSmith™ platform were approximately \$21,000, compared to \$9,000 during the same period of last year.

Sales and Marketing

During the three-month period ended September 30, 2013, sales and marketing expenses increased from \$206,287 for the three-month period ended September 30, 2012, to \$214,428, or 4%. There were no significant changes in our sales force or related activities between the two periods. Marketing salaries decreased by \$24,000 as the composition of our marketing team changed, offset by an increase in advertising and tradeshow activities of \$32,000.

Research and Development

During the three-month period ended September 30, 2013, research and development expenses increased from \$40,363 for the three-month period ended September 30, 2012, to \$195,660. Research and development expenses fluctuate based on the stage of development and functionality of the platform and various app blocks. During the three-month period ended September 30, 2012, significant costs associated with our platform were capitalized, as the core of our MobileSmith™ platform was being enhanced. During the three-month period ended September 30, 2013, the development efforts were focused on new individual app blocks, which individually require separate research and development activities. As such, a higher proportion of costs are related to design as opposed to production of the

individual app blocks. Our software capitalization criteria are described in further detail in our Annual Report. In addition to the change in timing of capitalization of research and development expenses, we expanded our development team in 2013, which resulted in an increase in payroll related expenses of approximately \$67,000.

General and Administrative

During the three-month period ended September 30, 2013, our general and administrative expenses decreased from \$427,398 for the three-month period ended September 30, 2012, to \$317,049 or 26%. The decrease is predominantly attributable to:

the absence of breach related expenses in the third quarter of 2013 as compared to the third quarter of 2012. Such expenses amounted to approximately \$52,000 for the three month period ended September 30, 2012;

the decrease in legal fees of approximately \$27,000; and

the decrease in board member fees of approximately \$23,000.

Results of Operations for the Nine-Months Ended September 30, 2013 and September 30, 2012

Revenue

During the nine-month period ended September 30, 2013, our total revenue increased from \$94,328 for the nine-month period ended September 30, 2012, to \$227,534, or 141%, as we continued revenue growth associated with licensing of our MobileSmith™ platform and related service revenue.

Cost of Revenue

During the nine-month period ended September 30, 2013, cost of revenue increased from \$90,585 for the nine-month period ended September 30, 2012 to \$396,166 when compared to the same period last year, an increase of \$305,581.

The increase is mostly attributable to the following:

the cost of developers servicing the platform and its components was approximately \$65,000 compared to approximately \$10,000 during the same period of last year;

the cost of professional services that include consulting and training amounted to approximately \$165,663 compared to zero during the same period of last year;

the amortization of capitalized software included in cost of revenue was approximately \$96,000 compared to \$62,000 for the same period of last year; and

outsourced hosting fees associated with the MobileSmith™ platform were approximately \$53,000 compared to \$30,000 during the same period of last year.

Sales and Marketing

During the nine-month period ended September 30, 2013, sales and marketing expenses increased from \$599,638 for the nine-month period ended September 30, 2012, to \$766,881, or 28%. The increase is attributable mostly to:

an increase in sales team payroll costs of approximately \$72,000;

an increased presence at tradeshows, which resulted in an increase in related expenses of approximately \$40,000; and

an increase in costs associated with advertising and promotion of the our platform of approximately \$41,000.

Research and Development

During the nine-month period ended September 30, 2013, research and development expenses increased from \$73,625 for the nine-month period ended September 30, 2012, to \$585,876. Research and development expenses fluctuate based on the stage of development and functionality of the platform and various app blocks. During the nine-month period ended September 30, 2012, significant costs associated with our platform were capitalized, as the core of our MobileSmith™ platform was being enhanced. During the nine-month period ended September 30, 2013, the development efforts were focused on new individual app blocks, which individually require separate research and development activities. As such, a higher proportion of costs are related to design as opposed to production of the individual app blocks. Our software capitalization criteria are described in detail in our Annual Report. In addition to

the change in timing of the capitalization of research and development expenses, we expanded our development team in 2013, which resulted in an increase in payroll related expenses of approximately \$190,000.

General and Administrative

During the nine-month period ended September 30, 2013, our general and administrative expenses increased from \$968,749 for the nine-month period ended September 30, 2012, to \$1,081,558 or 12%. The increase is predominantly attributable to the following:

additional legal, consulting and other professional fees resulting from the compromise of our internal corporate network in June 2012. During the nine-month period ended September 30, 2013, we continued to incur such expenses, which totaled approximately \$73,000;

increase in rent of approximately \$18,000;

increase of \$71,000 in executive compensation; and

an absence of a \$30,000 gain related to the recovery of receivable balance previously written off. This balance was included in general and administrative expense for the nine month period ended September 30, 2012; offset by decreases in IT related expenses of \$38,000 and Board member compensation fees of \$33,000 due to a decrease in the number of Board members.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not applicable.

ITEM 4. CONTROLS AND PROCEDURES

Our management, with the participation of our Chief Executive Officer has evaluated the effectiveness of our disclosure controls and procedures for the three month period ended September 30, 2013. The term “disclosure controls and procedures,” as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC’s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company’s management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, as ours are designed to do, and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of September 30, 2013, our disclosure controls and procedures were effective at the reasonable assurance level.

There has been no change to our internal control over financial reporting, as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act, during the three months ended September 30, 2013 that has materially affected, or that is reasonably likely to materially affect, our internal control over financial reporting.

PART II – OTHER INFORMATION

ITEM 5. OTHER INFORMATION

As discussed elsewhere in this Quarterly Report on Form 10-Q, on November 11, 2013, Atlas transferred all \$13.826 million in aggregate principal amount of its Notes of the Company to Grasford, a British Virgin Islands company which is owned and controlled by Avy Lugassy, effective as of November 1, 2013. As a holder of the Notes, Grasford has the option to convert all or a portion of the principal amount of its Notes into Common Stock of the Company immediately upon Grasford's request. In addition to the Notes, Grasford owns 7,330,269 shares of the Company's Common Stock.

As a result of Atlas's transfer of the Notes to Grasford, if Grasford were to convert its Notes, it would own, and Mr. Lugassy would indirectly beneficially own, approximately 59.9% of the issued and outstanding Common Stock of the Company following such conversion. The Company has not received any notice of conversion by Grasford or Mr. Lugassy.

Except for the Notes, there were no arrangements or understandings among Mr. Lugassy and Grasford or their respective associates with respect to the election of directors or other matters. There are no arrangements known to the Company, the operation of which may, at a subsequent date, result in a change in control.

On November 13, 2013, the Company sold an additional Note in the principal amount of \$320,000, or the New Note, to a current noteholder upon substantially the same terms and conditions as the Company's previously issued notes, or the Existing Notes, the terms of which are as described in Item 1 and Exhibit 4.1 of the Company's Quarterly Reports on Form 10-Q filed with the Securities and Exchange Commission on November 14, 2007 and November 12, 2008, under Item 2.03 of the Company's Current Reports on Forms 8-K filed on November 21, 2008 and February 25, 2009, under Item 1.01 of the Company's Current Report on Form 8-K filed on March 8, 2010, under Item 1.01 of the Company's Current Report on Form 8-K filed on June 19, 2012 and under Item 1.01 of the Company's Current Report on Form 8-K filed on July 2, 2013, which descriptions are incorporated herein by reference. The Company is obligated to pay interest on the New Note at an annualized rate of 8% payable in quarterly installments commencing February 13, 2014. As with the Existing Notes, the Company is not permitted to prepay the New Note without approval of the holders of at least a majority of the aggregate principal amount of the Notes then outstanding.

The Company plans to use the proceeds to meet ongoing working capital and capital spending requirements.

The sale of the New Note was made pursuant to an exemption from registration in reliance on Section 4(a)(2) of the Securities Act of 1933, as amended.

ITEM 6. EXHIBITS

The following exhibits are being filed or furnished herewith and are numbered in accordance with Item 601 of Regulation S-K:

EXHIBIT INDEX

ExhibitDescription
No.

- 3.1 Amended and Restated Certificate of Incorporation, dated January 4, 2005, as amended to date (incorporated herein by reference to Exhibit 3.1 to our Quarterly Report on Form 10-Q, as filed with the SEC on August 14, 2013)
- 3.2 Seventh Amended and Restated Bylaws, effective July 1, 2013 (incorporated herein by reference to Exhibit 3.3 to our Quarterly Report on Form 10-Q, as filed with the SEC on August 14, 2013)
- 10.1 Partner Agreement, dated May 24, 2013, by and between Smart Online, Inc. and Jon Campbell (Filed herewith)
- 31.1 Certification of Principal Executive Officer Pursuant to Rule 13a-14(a) (Filed herewith)
- 31.2 Certification of Principal Executive Officer Pursuant to Rule 13a-14(a) (Filed herewith)
- 32.1 Certification of Principal Executive Officer Pursuant to 18 U.S.C. Section 1350 (Furnished herewith)
- 32.2 Certification of Principal Financial Officer Pursuant to 18 U.S.C. Section 1350 (Furnished herewith)
- 101.1 The following materials from the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2013, formatted in XBRL (eXtensible Business Reporting Language): (i) the Condensed Balance Sheets, (ii) the Condensed Statements of Operations, (iii) the Condensed Statements of Cash Flows, (iv) the Statement of Stockholders' Deficit and (v) related notes to these financial statements, tagged as blocks of text and in detail (Filed herewith)

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

MOBILESMITH, INC.

November 25, 2013

By:/s/ Amir Elbaz
Amir Elbaz
Chief Executive Officer

November 25, 2013

By:/s/ Gleb Mikhailov
Gleb Mikhailov
Chief Financial Officer

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