SMART ONLINE INC
Form DEF 14C
May 08, 2013

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

SCHEDULE 14C INFORMATION

Information Statement Pursuant to Section 14(c) of the Securities Exchange Act of 1934 (Amendment No.)

Check the appropriate box:

o Preliminary Information Statement

o Confidential, for Use of the Commission Only (as permitted by Rule 14c- 5(d)(2))

þ Definitive Information Statement

SMART ONLINE, INC.
(Name of Registrant as Specified in Its Charter)

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SMART ONLINE, INC.
4505 Emperor Boulevard
Suite 320
Durham, North Carolina 27703

NOTICE OF ANNUAL MEETING OF STOCKHOLDERS

TO BE HELD JUNE 17, 2013

You are cordially invited to attend the Annual Meeting of Stockholders of Smart Online, Inc., which will be held on Monday, June 17, 2013, at 11:00 a.m. local time, in the Board Room at the offices of the corporation at 4505 Emperor Boulevard, Suite 320, Durham, North Carolina 27703. Stockholders will be asked to consider and vote upon the following matters at the meeting, which are described in the accompanying information statement:

1. The election of three directors, each to serve for a term of one year or until his successor shall have been duly elected and qualified;

2. To amend our certificate of incorporation and change our name from Smart Online, Inc. to MobileSmith, Inc.;

3. To consider and approve by a nonbinding advisory vote, the compensation of our named executive officers as described in the accompanying information statement;

4. To recommend, by a nonbinding advisory vote, the frequency (every one, two or three years) of future advisory votes of stockholders on the compensation of our named executive officers;

5. The ratification of the appointment of Cherry Bekaert LLP as our independent registered public accounting firm for the fiscal year ending December 31, 2013; and

6. The transaction of such other business as may be properly brought before the meeting.

Stockholders of record at the close of business on April 22, 2013 are entitled to notice of and to vote at the annual meeting and any and all adjournments or postponements thereof.

We are not soliciting proxies for this annual meeting. However, all stockholders are welcome to attend the meeting and vote in person.

By Order of the Board of Directors

/s/ Amir Elbaz
Amir Elbaz
Chairman of the Board

Durham, North Carolina
May 8, 2013

SMART ONLINE, INC.

2013 ANNUAL MEETING OF STOCKHOLDERS

11:00 A.M. EDT, JUNE 17, 2013

INFORMATION STATEMENT

WE ARE NOT ASKING YOU FOR A PROXY AND YOU ARE
REQUESTED NOT TO SEND US A PROXY

This Information Statement contains information related to the Company's 2013 annual meeting of stockholders to be held at the Company's corporate offices, 4505 Emperor Boulevard Suite 320, Durham North Carolina 27703 at 11:00 A.M., Eastern Daylight Time, on June 17, 2013 and at any adjournments or postponements thereof. The approximate date that this Information Statement, the preceding Notice of Annual Meeting and the Company's Annual Report to Stockholders for the fiscal year ended December 31, 2012, or the Annual Report, are first being made available to stockholders is May 8, 2013. We are making this Information Statement available to our stockholders for use at the annual meeting. You should review this Information Statement in conjunction with the Company's Annual Report.

GENERAL INFORMATION

Meeting Information

The annual meeting of stockholders of Smart Online, Inc. or Smart Online, the Company, we, our or us, will be held at the Company's corporate offices 4505 Emperor Boulevard, Suite 320, Durham, NC 27703 beginning at 11:00 A.M., Eastern Daylight Time, on June 17, 2013.

The proposals scheduled to be voted on are: (1) to elect three (3) directors for one-year terms; (2) to amend the Certificate of Incorporation of the Company and to change its name from Smart Online, Inc. to MobileSmith, Inc.; (3) to approve by a nonbinding advisory vote, the compensation of our named executive officers; (4) to recommend, by a nonbinding advisory vote, the frequency at which our stockholders will be asked to hold a nonbinding, advisory vote on the compensation of our named executive officers; and (5) to ratify the appointment of Cherry Bekaert LLP, or Cherry Bekaert, as the Company's independent registered public accounting firm for the fiscal year ending December 31, 2013. Our Board of Directors, or the Board, recommends that you vote "FOR" each of the nominees to the Board described in Proposal No. 1; "FOR" the amendment of the Company's Certificate of Incorporation to effectuate a name change of the Company from Smart Online, Inc. to MobileSmith, Inc., as described in Proposal No. 2; "FOR" the approval of the compensation of our named executive officers, as described in Proposal No. 3; EVERY "THREE YEARS" for the frequency at which our stockholders will be asked to hold a nonbinding, advisory vote on the compensation of our named executive officers, as described in Proposal No. 4; and "FOR" the ratification of the selection of Cherry Bekaert as our independent registered public accounting firm for the fiscal year ending December 31, 2013, as described in Proposal No. 5.

Who May Vote

You are entitled to vote in person at the annual meeting if you owned shares of our common stock as of the close of business (5:00 p.m.) on April 22, 2013, the record date of the annual meeting. On the record date, 18,352,542 shares of our common stock were issued and outstanding and held by 175 holders of record. Holders on the record date of our common stock which is (1) held directly in your name as the stockholder of record or (2) held for you as the beneficial owner through a stockbroker, bank or other nominee, are entitled to one vote per share at the annual meeting.

WE ARE NOT ASKING YOU FOR A PROXY AND YOU ARE REQUESTED NOT TO SEND US A PROXY

How To Vote

Holders of record may vote in person at the meeting by ballot. If your shares are not held of record in your name, you must obtain a proxy from the record holder, usually a broker or other nominee, in order to vote in person at the meeting.

Quorum

The presence at the annual meeting, in person or by proxy, of the holders of a majority of the shares of our common stock outstanding on the record date will constitute a quorum. Abstentions are counted as present for the purpose of determining the presence of a quorum. A broker who holds shares in nominee or “street name” for a customer who is the beneficial owner of those shares may be prohibited from voting those shares in person on any proposal to be voted on at the annual meeting without specific instructions from such customer with respect to such proposal.

Votes Needed

Proposal 1: Election of Directors. The affirmative vote of a plurality of the votes cast at the annual meeting is required for the election of each of the three director nominees. You may vote “FOR” one or more director nominees or you may withhold your vote as to one or more director nominees. A properly executed ballot marked “withhold” as to the election of one or more director nominees will not be counted with respect to the director or directors indicated, although it will be counted for purposes of determining whether there is a quorum. Stockholders do not have the right to cumulate their votes for directors. No New York Stock Exchange (NYSE) member broker who is the record holder of shares on behalf of a beneficial owner (the customer) can vote shares at the meeting with respect to the election of directors unless the broker receives instructions from the beneficial owner. These “broker non-votes” will not impact the results of the election, but will be counted for purposes of determining whether there is a quorum.

Proposal 2: Amendment to Certificate of Incorporation to Effectuate a Name Change from Smart Online, Inc. to MobileSmith, Inc. The affirmative “FOR” vote of the holders of a majority of all shares casting votes in person or by proxy at the annual meeting is required to amend the Certificate of Incorporation of the Company to change our name from Smart Online, Inc. to MobileSmith, Inc. You may vote “FOR” or “AGAINST” this proposal or abstain from voting. A properly executed ballot marked “abstain” with respect to this proposal will not be counted, although it will be counted for purposes of determining whether there is a quorum. Since abstentions are not considered votes cast, they will have no effect on the outcome of this proposal. NYSE member brokers have discretion to vote on behalf of beneficial owners with respect to this proposal; as a result, there will be no “broker non-votes” on this item.

Proposal 3: Advisory Vote on the Compensation of our Named Executive Officers. The affirmative “FOR” vote of the holders of a majority of all shares casting votes in person or by proxy at the annual meeting is required for the approval of the compensation of our named executive officers. You may vote “FOR” or “AGAINST” this proposal or abstain from voting. A properly executed ballot marked “abstain” with respect to this proposal will not be counted, although it will be counted for purposes of determining whether there is a quorum. Since abstentions are not considered votes cast, they will have no effect on the outcome of this proposal. No NYSE member broker who is the record holder of shares on behalf of a beneficial owner (the customer) can vote shares at the meeting with respect to the advisory vote on executive compensation unless the broker receives instructions from the beneficial owner. These “broker non-votes” will not impact the results of the vote on executive compensation, but will be counted for purposes of determining whether there is a quorum.

Proposal 4: Advisory Vote on the Frequency of the Advisory Vote on Compensation of our Named Executive Officers. The choice of frequency that receives the highest number of votes will be considered as the frequency that our stockholders are recommending for us to hold a non-binding, advisory vote on the compensation of our named executive officers. You may vote for “EVERY ONE YEAR,” “EVERY TWO YEARS,” OR “EVERY THREE YEARS” or abstain from voting on this proposal. A properly executed ballot marked “abstain” with respect to this proposal will not be counted, although it will be counted for purposes of determining whether there is a quorum. No NYSE member broker who is the record holder of shares on behalf of a beneficial owner (the customer) can vote shares at the meeting with respect to the vote on the frequency of votes on executive compensation unless the broker receives instructions from the beneficial owner. These “broker non-votes” will not impact the results of the vote on the recommendation of frequency, but will be counted for purposes of determining whether there is a quorum.

Proposal 5: Ratification of the Appointment of the Independent Registered Public Accounting Firm. The affirmative "FOR" vote of the holders of a majority of all shares casting votes in person or by proxy at the annual meeting is required to ratify the appointment of Cherry Bekaert as our independent registered public accounting firm for the fiscal year ending December 31, 2013. You may vote "FOR" or "AGAINST" this proposal or abstain from voting. A properly executed ballot marked "abstain" with respect to this proposal will not be counted, although it will be counted for purposes of determining whether there is a quorum. Since abstentions are not considered votes cast, they will have no effect on the outcome of this proposal. NYSE member brokers have discretion to vote on behalf of beneficial owners with respect to this proposal; as a result, there will be no "broker non-votes" on this item.

As of the record date, our directors and executive officers and their affiliates owned and were entitled to vote approximately 82,500 shares of our common stock. All of these persons have indicated they and their affiliates will vote their shares in favor of: the three director nominees as described in Proposal No. 1; the amendment of the Company's Certificate of Incorporation to effectuate a name change of the Company from Smart Online, Inc. to MobileSmith, Inc., as described in Proposal No. 2; the approval of the compensation of our named executive officers, as described in Proposal No. 3; EVERY "THREE YEARS" for the frequency at which our stockholders will be asked to hold a nonbinding, advisory vote on the compensation of our named executive officers, as described in Proposal No. 4; and the ratification of the selection of Cherry Bekaert as our independent registered public accounting firm for the fiscal year ending December 31, 2013, as described in Proposal No. 5.

Other Matters

The Board does not know of any other matter that will be presented for your consideration at the annual meeting other than the five proposals described herein.

PROPOSAL NO. 1

ELECTION OF DIRECTORS

At the annual meeting, three nominees will be elected as directors. Our Board currently consists of five members, three of whom are standing for re-election at the annual meeting. The directors elected at the annual meeting will serve until the next annual meeting of stockholders and until their respective successors are duly elected and qualified.

Our Board, based on the recommendation of the nominating and governance committee, has nominated each of Shlomo Elia, Amir Elbaz, and Ronen Shviki to stand for re-election at the annual meeting.

The bylaws of the Company provide that the number of directors on the Board will be no more than nine. We had three directors at the beginning of fiscal year 2011. In September 2011, we expanded the size of the Board to four directors and nominated our fourth director. In February 2013, we expanded the size of the Board to five directors and nominated our fifth director. Two of the current five members of the board of directors have notified the Company that they do not intend to run for re-election. We are therefore only proposing to elect three directors for fiscal year 2013. The three nominees that receive the most votes will be appointed to serve on our Board for the next year. You cannot vote for a greater number of persons than the number of nominees named. All three of the persons nominated for election to the Board at the annual meeting are currently serving as directors of the Company. The Company is not aware of any nominee who will be unable or will decline to serve as a director. If a nominee becomes unable or declines to serve, votes may be cast for a substitute nominee, if any, designated by the Board. The term of office of each person elected as a director will continue until the later of the next annual meeting of stockholders or until such time as his or her successor has been duly elected and qualified, or until his prior death, resignation or removal.

The following table lists the nominees for election and information about each director nominee:

Name	Age	Principal Occupation and Background
Shlomo Elia	70	Director. Mr. Elia has served on the Company's Board since November 2006 and was originally recommended for appointment to the Board by Atlas Capital, SA, or Atlas, one of the Company's stockholders and lenders. Mr. Elia is currently a director and Chairman of the Board of NETZ Holding Ltd., a public Israeli company. Mr. Elia is the founder and a Director of 3Pen Ltd., 3Pen, a private holding company focusing on business opportunities in Internet infrastructure and telecommunications. Prior to founding 3Pen in 1999, Mr. Elia held several senior positions in the Israeli Defense Forces, I.D.F., including the post of the Military Governor of the West-Bank (1982-1984) and Commander of the Liaison Unit for South Lebanon (1984-1985). During his service, among other activities, General Elia was engaged for a year as a Research Fellow in the Institute of International Strategic Affairs at UCLA. Since his retirement from the I.D.F., he has been involved in communication projects in Nigeria and West Africa and construction projects in Romania. Among his civilian activities, Mr. Elia was Chairman of the National Tourist Board in Israel and currently is Chairman of 3Pen Technologies Ltd. and co-chairman of the Israeli Soldiers Welfare Association. Mr. Elia holds a B.A. in Modern History of the Middle-East from Tel Aviv University. We believe Mr. Elia's international business expertise and significant management experience will provide constructive insight and perspective to our Board and management.
Amir Elbaz	36	Director. Mr. Elbaz has served on the Company's Board since January 2010 and as the Chairman of the Board since November 2012. Mr. Elbaz currently serves as the Company's Chief Executive Officer since May 1, 2013 and as Chief Executive Officer of two other companies in the technology and media sectors. Mr. Elbaz also advises technology and renewable energy companies on business strategy, restructuring and business development initiatives. Mr. Elbaz served as the Executive Vice President & Chief Financial Officer of Lithium Technology Corporation until November 2008. Mr. Elbaz joined LTC in 2006 to oversee finances and marketing, as well as business development. Prior to joining LTC, Mr. Elbaz served as a Senior Associate of Arch Hill Capital NV, a Dutch venture firm, from 2005-2006. During 2004 and most of 2005, Mr. Elbaz served as Vice President of Corporate Finance at Yorkville Advisors, where Mr. Elbaz sourced, structured and managed investments in more than a dozen public and private companies. Prior to joining Yorkville Advisors, Mr. Elbaz served for several years as an analyst with the Economic Department in the Procurement Mission of the Israeli Ministry of Defense in New York City. In that capacity, Mr. Elbaz co-headed multi-million dollar negotiations with first tier technology companies, and was in charge of the financial aspects of the day-to-day operations. Mr. Elbaz holds a B.A. from the University of Haifa, Israel, and an MBA in Finance & Investments from Bernard Baruch College, CUNY, New York. Following his MBA graduation, Mr. Elbaz was elected to the International Honorary Finance Society of Beta Gamma Sigma. We believe Mr. Elbaz's significant experience in the technology sector, coupled with his extensive financial and economic background provide invaluable insight with respect to our business and technologies.
Ronen Shviki	44	Director. Mr. Shviki has served on the Company's Board since February 2013. Since January 2013, Mr. Shviki has served as the Vice President for Business Development of Mendelssohn

	Ltd., an Israeli distribution company. Prior to this, Mr. Shviki served in the Israel Defense Forces as a Colonel in the Army branch. Mr. Shviki holds a B.A. in Business Administration from Interdisciplinary Center Herzliya and an LLB from Interdisciplinary Center Herzliya. We believe Mr. Shviki's extensive marketing and management experience, in addition to his knowledge of the international marketplace, contributes to the strategic composition of the Board.

Our Board unanimously recommends that you vote "FOR" the election of each of the director nominees named above.

PROPOSAL NO. 2

AMENDMENT TO CERTIFICATE OF INCORPORATION TO EFFECTUATE A NAME CHANGE FROM SMART ONLINE, INC. TO MOBILESMITH, INC.

At the annual meeting, the stockholders will be asked to approve the filing of an amendment to the Company's Certificate of Incorporation to effectuate a name change of the Company from Smart Online, Inc. to MobileSmith, Inc.

The filing of an amendment to the Company's Certificate of Incorporation which is required to effectuate the change of the Company's name from Smart Online, Inc. to MobileSmith, Inc. was recommended by a majority of the Board and approved by a Board resolution dated April 22, 2013.

The management and the Board believe that the name change to MobileSmith, Inc. would be in the best interest of the Company and better and more accurately depict the Company's current focus on the use of mobile devices in business and government organizations. It would also present an improved and consistent brand-image and appeal.

Our Board unanimously recommends that you vote "FOR" the amendment of the Certificate of Incorporation and name change described above.

PROPOSAL NO. 3

ADVISORY VOTE ON THE COMPENSATION OF OUR NAMED EXECUTIVE OFFICERS

In accordance with the requirements of Section 14A of the Securities Exchange Act of 1934, as amended, or the Exchange Act, (which was added by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010) and related rules of the U.S. Securities and Exchange Commission, or the SEC, we are including a separate proposal subject to stockholder vote to approve, on a non-binding, advisory basis, the compensation of those of our executive officers listed in the Summary Compensation Table appearing elsewhere in this Information Statement, or our named executive officers, as disclosed in this Information Statement pursuant to Item 402 of Regulation S-K. To learn more about our executive compensation, see "Executive Compensation" elsewhere in this Information Statement.

The vote on this proposal is not intended to address any specific element of compensation; rather, the vote relates to the compensation of our named executive officers, as described in this Information Statement in accordance with the compensation disclosure rules of the SEC. To the extent there is any significant vote against our named executive officer compensation as disclosed in this information statement, the compensation committee of our Board, or the Compensation Committee, will evaluate whether any actions are necessary to address the concerns of stockholders.

Based on the above, we request that you indicate your support for our executive compensation by voting in favor of the following resolution:

"RESOLVED, that the Company's stockholders approve, on a non-binding, advisory basis, the compensation of the Company's named executive officers as described in this Information Statement, including the "Executive Compensation" section, the compensation tables and the other narrative compensation disclosures."

The opportunity to vote on this Proposal No. 3 is required pursuant to Section 14A of the Exchange Act. However, as an advisory vote, the vote on Proposal No. 3 is not binding upon us and serves only as a recommendation to our Board. Nonetheless, the Compensation Committee, which is responsible for designing and administering our executive compensation program, and the Board value the opinions expressed by stockholders, and will consider the outcome of the vote when making future compensation decisions for our named executive officers.

Our Board unanimously recommends that you vote "FOR" the approval of the compensation of our named executive officers, as disclosed in this Information Statement.

PROPOSAL NO. 4

ADVISORY VOTE ON THE FREQUENCY OF THE ADVISORY VOTE ON COMPENSATION OF OUR NAMED EXECUTIVE OFFICERS

In accordance with the requirements of Section 14A of the Exchange Act and related rules of the SEC, we are including a separate proposal subject to stockholder vote to recommend, on a non-binding, advisory basis, whether a non-binding, advisory stockholder vote to approve the compensation of our named executive officers (that is, a vote similar to the non-binding, advisory vote in Proposal No. 3 above) should occur every one, two or three years.

By voting with respect to this Proposal No. 4, stockholders may indicate whether they would prefer that we conduct future advisory votes on our named executive officer compensation once every one, two, or three years. Stockholders also may, if they so wish, abstain from casting a vote on this proposal.

The Board has considered the frequency of the advisory vote on the compensation of our named executive officers that it should recommend. After considering the benefits and consequences of each alternative for the frequency of submitting the advisory vote on the compensation of our named executive officers to stockholders, the Board recommends submitting the advisory vote on the compensation of our named executive officers to our stockholders every three years.

In determining to recommend that stockholders vote for a frequency of once every three years, the Board considered how an advisory vote at this frequency will provide our stockholders with sufficient time to evaluate the effectiveness of our overall compensation philosophy, policies and practices in the context of our long-term business results for the corresponding period, while avoiding over-emphasis on short term variations in compensation and business results. An advisory vote occurring once every three years will also permit our stockholders to observe and evaluate the impact of any changes to our executive compensation policies and practices which have occurred since the last advisory vote on executive compensation, including changes made in response to the outcome of a prior advisory vote on executive compensation. We will continue to engage with our stockholders regarding our executive compensation program during the period between advisory votes on executive compensation.

For the above reasons, the Board recommends that you vote to hold a non-binding, advisory vote on the compensation of our named executive officers every three years. Your vote, however, is not to approve or disapprove the Board’s recommendation.

When voting on this proposal, you have four choices: you may elect that we hold an advisory vote on the compensation of our named executive officers every year, every two years or every three years, or you may abstain from voting. If you properly complete your ballot and fail to indicate your preference or abstention, your shares will be voted to select every three years as the frequency with which our stockholders will be asked to hold a non-binding, advisory vote on the compensation of our named executive officers.

The choice of frequency that receives the highest number of votes will be considered as the frequency that our stockholders are recommending for us to hold a non-binding, advisory vote on the compensation of our named executive officers. The Board will consider the outcome of the vote when making future decisions on executive compensation. However, as an advisory vote, the vote on this Proposal No. 4 is not binding upon us, and the Board may decide that it is in the best interests of our stockholders and the Company to hold an advisory vote on executive compensation more or less frequently than the alternative approved by our stockholders. Our Board has not yet determined the frequency with which we will hold the stockholder advisory vote on named executive officer compensation required by Section 14A of the Exchange Act or when the next such stockholder advisory vote on named executive officer compensation will occur.

Our Board unanimously recommends vote to hold an advisory vote on the compensation of our named executive officers EVERY "THREE YEARS".

PROPOSAL NO. 5

RATIFICATION OF APPOINTMENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Cherry Bekaert has acted as our independent registered public accounting firm to audit the consolidated financial statements of the Company for the fiscal year ended December 31, 2012. Cherry Bekaert has served the Company as its independent registered public accounting firm and independent auditors since April 2009. Representatives of Cherry Bekaert are not expected to be present at the annual meeting, but will be available to respond to appropriate questions and make any necessary statements, if required, at the meeting via conference call.

Although the appointment of Cherry Bekaert as independent registered public accounting firm is not required to be submitted to a vote by stockholders, the Board believes it appropriate, as a matter of policy, to request that the stockholders ratify the appointment. If stockholder ratification (by the affirmative vote of a majority of the shares of common stock present in person or represented by proxy at the annual meeting) is not received, the Audit Committee of the Board will reconsider the appointment. Even if the selection of Cherry Bekaert is ratified, the Audit Committee of the Board may, in its discretion, appoint a different firm at any time during the year if the Audit Committee feels that such a change would be in the best interests of the Company and its stockholders.

The Board recommends stockholders vote “FOR” the ratification of Cherry Bekaert as the Company’s independent registered public accounting firm for the fiscal year ending December 31, 2013.

Executive Officers

The Company’s executive officers are appointed by its Board to hold office until their successors are appointed. The following table lists the Company’s current executive officers:

Name	Age	Position
Amir Elbaz	36	Chief Executive Officer and Chairman of the Board
Gleb Mikhailov	33	Chief Financial Officer

Information regarding Mr. Elbaz is described above under PROPOSAL NO. 1 — ELECTION OF DIRECTORS, above.

Gleb Mikhailov, Chief Financial Officer

Chief Financial Officer since April 2013. From January 2013 to March 2013, Mr. Mikhailov served as the Manager of Financial Reporting and SEC Consulting in the SEC Solutions Group of Citrin Cooperman, LLP, an accounting firm providing business solutions and accounting services to middle market companies. From 2005 until 2012, Mr. Mikhailov was employed by EisnerAmper LLP, a full-service advisory and public accounting firm, in its Private Business Services Group and Audit and Assurance Group. He was a Manager at EisnerAmper LLP since 2010. Mr. Mikhailov holds a B.A. in Accounting from Rutgers, The State University of New Jersey and an M.B.A. from Rutgers Business School. Mr. Mikhailov holds a CPA license issued by the State of New Jersey.

Code of Ethics

The Company has adopted a Code of Ethics applicable to its executives, including the principal executive officer, principal financial officer, and principal accounting officer, as defined by applicable rules of the SEC. It is publicly available on the Company’s website at www.mobilesmith.com. If the Company makes any amendments to the Code of Ethics other than technical, administrative, or other non-substantive amendments, or grants any waivers, including implicit waivers, from a provision of the Code of Ethics to the Company's Chief Executive Officer, Chief Financial Officer, or certain other finance executives, the Company will disclose the nature of the amendment or waiver, its effective date, and to whom it applies on the Company's website at www.mobilesmith.com.

Board Composition and Independence of Directors

The size of the Board is currently fixed at five members; however, only three persons have been nominated for election at the annual meeting. The Board believes that the current number of directors is appropriate at this time; however, the Board will consider adding additional members who can bring additional skills and professional connections that can benefit the Company.

The Company's stock is currently quoted on the OTC Bulletin Board, or OTCBB. The OTCBB does not have rules regarding director independence. Accordingly, we determined that the NASDAQ Stock Market, or Nasdaq, independence requirements are an appropriate standard to determine director independence.

The position of Chairman of the Board is currently held by Amir Elbaz, who is also the Company's principal executive officer, effective as of May 1, 2013. Robert M. Brinson, Jr. served as our principal executive officer from September 2012 through April 30, 2013. Nasdaq listing requirements mandate that a majority of the members of a listed company's board of directors be "independent directors" as defined under Nasdaq Stock Market Rule 5605. The Board has determined that two of the present directors — Messrs. Elia and Shviki — are "independent directors" within the meaning of Nasdaq Marketplace Rules. Messrs. Elia, Elbaz and Shviki are standing for re-election, and Mr. Elbaz has been appointed Chief Executive Officer as of May 1, 2013. Assuming all three nominees are elected at the annual meeting, two of the three directors — Messrs. Elia and Shviki — will be "independent directors" within the meaning of the Nasdaq Marketplace Rules. Mr Elbaz will not be an "independent director" within the meaning of the Nasdaq Marketplace Rules, but the Board will have a majority of "independent directors" after the annual meeting. The Board believes this current leadership structure provides effective and clear leadership for the Company; however, the Company is currently looking at new leadership structure models in light of the resignation of Mr. Brinson as Chief Executive Officer and the appointment of Mr. Elbaz, the current Chairman of the Board, as Chief Executive Officer, effective as of May 1, 2013.

Risk Oversight

While our management is responsible for assessing and managing risks to the Company, the Board takes an active role, as a whole and also at the committee level, in overseeing the material risks facing the Company, including operational, financial, legal and regulatory and strategic and reputational risks. Risks are considered in virtually every business decision and as part of the Company's overall business strategy. Our board committees also regularly engage in risk assessment as a part of their regular function. The Board discusses with management the Company's major financial risk exposures and the steps management has taken to monitor and control such exposures. The Board is also responsible for overseeing the management of risks relating to the Company's executive compensation plans and arrangements. Further, the Board manages risks associated with corporate governance, including risks associated with the independence of the board and reviews risks associated with potential conflicts of interest affecting directors and executive officers of the Company. These risk oversight responsibilities had previously been carried out by committees of our Board that reported to the full Board. Due to the expected decrease in the size of the Board from five to three members, the Board dissolved each of the Audit Committee, Compensation Committee and Corpororate Governance and Nominating Committee, and assumed the responsibilities of each in May 2013.

The Board regularly engages in discussion of financial, legal, technological, economic and other risks. Because overseeing risk is an ongoing process that is inherent in the Company's strategic decisions, our Board discusses risk throughout the year at other meetings in relation to specific proposed actions. Additionally, our Board exercises its risk oversight function in approving new product research and development projects, large marketing engagements, the annual budget and quarterly forecasts and in reviewing the Company's long-range strategic and financial plans with management.

Attendance at Meetings

The Board held five meetings during the fiscal year ended December 31, 2012. Each incumbent director attended or participated in at least 75% of the aggregate of (1) the number of meetings of the Board held in fiscal year 2012 during the period he served as a director and (2) the number of meetings of committees on which he served that were held during his period of his service as a director.

The Company’s policy is that it expects all directors that are seeking re-election to attend each annual meeting of stockholders, absent good reason. All incumbent directors who held their positions during 2012 and are seeking re-election attended the annual meeting of stockholders in 2012.

Standing Committees

Until May 2013, the Company’s Board had three standing committees: the Audit Committee, the Compensation Committee, and the Corporate Governance and Nominating Committee. Because these committees have been dissolved, there are no longer applicable committee charters.

Audit Committee. Due to the expected decrease in the size of the Board from five to three members, the Board dissolved the Audit Committee and assumed its responsibilities in May 2013.

Compensation Committee. The Compensation Committee was established by the Company’s Board for the purpose of assisting it in discharging its duties with respect to (1) the formulation, implementation, review, and modification of the compensation of the Company’s officers and directors and (2) the preparation of the annual report on executive compensation for inclusion in the Company’s annual proxy or information statement, if required. The Compensation Committee’s duties, which will now be performed by the full Board, included, among other things, setting the compensation for officers and directors, making recommendations with respect to incentive compensation plans and equity-based compensation plans, approving grants of stock options and other awards under the Company’s 2004 Equity Compensation Plan, and administering the Company’s defined benefit and defined contribution plans, if any.

In fulfilling its responsibilities, the Compensation Committee was entitled to delegate any or all of its responsibilities to a subcommittee of the Compensation Committee, to the extent consistent with applicable law, the Company’s certificate of incorporation, bylaws, corporate governance guidelines, and rules of any exchange or market on which the securities of the Company are then traded if compliance with such rules is required to begin or continue trading.

As part of its review and establishment of the performance criteria and compensation of officers and directors of the Company, the Compensation Committee was required to separately meet at least annually with the Company’s Chief Executive Officer, the principal human resources executive and compliance officer, and with any other corporate officers as the Compensation Committee deems appropriate. However, the Compensation Committee also met regularly without such officers present, and in all cases such officers could not be present at the meetings at which their performance and compensation was being discussed and determined. The Compensation Committee could consult with the Chief Executive Officer regarding compensation of the other officers of the Company. The Compensation Committee did not engage any compensation consultant to determine or recommend the amount or form of executive and director compensation. The Compensation Committee met one time during 2012.

Due to the expected decrease in the size of the Board from five to three members, the Board dissolved the Compensation Committee and assumed its responsibilities in May 2013.

Corporate Governance and Nominating Committee and Procedures for Director Nominations. The Corporate Governance and Nominating Committee was established by the Board for the purpose of assisting it in discharging its duties with respect to (1) the identification of individuals qualified to become directors and the selection or recommendation of candidates for directorships to be filled by the Board or the stockholders, and (2) the development, maintenance, and recommendation of a set of corporate governance principles applicable to the Company, and the periodic review of such principles. The Corporate Governance and Nominating Committee did not meet during 2012; the Board as a whole met to discuss issues relating to the Company’s corporate governance and nominations.

The Corporate Governance and Nominating Committee was, and the Board currently is, responsible for identifying and selecting or recommending qualified candidates for membership on the Board. In identifying candidates, the Committee took into account such factors as it considers appropriate, which may include (a) knowledge in the technology industry generally, and Software-as-a-Service specifically, (b) experience in the areas of accounting and finance, (c) mature business judgment, (d) the candidate’s management, leadership, and business strategy experience, (e) the candidate’s ability to manage a crisis, and (f) the candidate’s knowledge of proper corporate governance.

The Corporate Governance and Nominating Committee was responsible for evaluating suggestions concerning possible candidates for election to the Board submitted to the Company, including those submitted by Board members (including self-nominations) and stockholders. All candidates, including those submitted by stockholders, will be evaluated by the Board on the same basis as other candidates using the Board membership criteria described above and in accordance with applicable procedures. The Board believes that the minimum qualifications for serving as a Company director are that a candidate demonstrate, by significant accomplishment in his or her field, an ability to make a meaningful contribution to the Board’s oversight of the Company’s business and affairs and have an impeccable record and reputation for honest and ethical conduct in his or her professional and personal activities. Qualifications for consideration as a director nominee may vary according to the particular areas of expertise being sought as a complement to the existing Board composition.

Once candidates have been identified, the Board will determine whether such candidates meet the minimum qualifications for director nominees and will recommend qualified nominees to the Board. In accordance with the Company’s bylaws, proposed nominees must tender, prior to nomination, an irrevocable, conditional letter of resignation that would be effective upon such person being charged with a felony or equivalent offense under the laws of any jurisdiction. The full Board will then approve qualified nominees for appointment or election to the Board. The three nominees for election at the meeting were recommended by and approved by the Board.

While the Board currently has no policy with respect to which it considers diversity in identifying nominees for director, one of our directors has a strong business development and marketing background and another of our directors has a background in accounting, finance, and management. We believe that the backgrounds and skills of our directors bring a diverse range of experience, opinion and perspectives to the Board. Details of each nominee's strengths are identified in the biographical presentation under PROPOSAL NO. 1 — ELECTION OF DIRECTORS, above.

Due to the expected decrease in the size of the Board from five to three members, the Board dissolved the Corporate Governance and Nominating Committee and assumed its responsibilities in May 2013.

Any stockholder desiring to present a nomination for consideration by the Board prior to the 2014 Annual Meeting of Stockholders must do so in accordance with the Company's bylaws. See "Stockholder Proposals for the 2014 Annual Meeting" below.

Section 16(a) Beneficial Ownership Reporting Compliance

The members of the Company's Board, its executive officers, and persons who hold more than 10% of its outstanding common stock are subject to the reporting requirements of Section 16(a) of the Exchange Act, which requires them to file reports with respect to their ownership of the Company's common stock and their transactions in such common stock. Based upon the Company's review of the Section 16(a) reports in its records for fiscal year 2012 transactions in the Company's common stock, the Company believes that all reporting requirements under Section 16(a) for fiscal year 2012 were met in a timely manner by its directors, executive officers, and greater than 10% beneficial owners, except that a Form 4 filed by Atlas on October 18, 2012 was filed one business day late.

Certain Relationships and Related Transactions

IDB Credit Facility. On December 6, 2010, the Company entered into (i) a $6,500,000 Promissory Note, or the IDB Note, as borrower, and (ii) a Letter Agreement for a $6,500,000 Term Loan Facility, each with Israel Discount Bank of New York, or IDB, as lender, and together, the IDB Credit Facility.

The total of all amounts borrowed under the initial IDB Credit Facility had to be drawn by June 10, 2011. The Company borrowed $5,000,000 during the initial term of the loan, which was originally due May 31, 2012. On May 31, 2012, the Company extended its IDB Credit Facility for an additional one-year period for the $5,000,000 already outstanding, and the Company deposited $250,000 in a restricted cash account held at IDB for future interest payments. The balance in the restricted account as of December 31, 2012 was $131,103 due to the payment of interest as stipulated in the IDB Credit Facility documents. All other terms remain the same. Our IDB Credit Facility is secured by an irrevocable standby letter of credit issued by UBS Private Bank with Atlas as account party.

Atlas. Until February 7, 2013, Atlas was a beneficial owner of 40% of the common stock of the Company, and the holder of a majority of the aggregate outstanding principal amount, or the Requisite Percentage Holder, of the Notes under the Convertible Secured Subordinated Note Purchase Agreement, dated November 14, 2007, as amended, or the Note Purchase Agreement, between the Company and the convertible noteholders, under which the Company is entitled to elect to sell to the convertible noteholders, and the convertible noteholders are obligated to buy, Notes. On February 7, 2013, Mr. Avy Lugassy, a principal with Atlas, and the beneficial owner of 7,330,269 shares of common stock of the Company, which shares represent approximately 40% of the Company's outstanding voting securities, transferred such shares from Atlas to Grasford Investments Ltd., a British Virgin Islands company, or Grasford, which is owned and controlled by Mr. Lugassy. Atlas remains the holder of a majority of the aggregate outstanding principal amount of the Company's Notes. The terms of the Note Purchase Agreement and the Notes are described in "Sale of Convertible Notes to Certain Affiliates" below.

Sale Leaseback of Company Equipment with Noteholders. On September 4, 2009, the Company entered into a sale-leaseback agreement with the current holders of the Notes. The noteholders paid a market rate cost of $200,000 through the reduction of current outstanding debt under such Notes in exchange for all of the Company's office furniture, equipment and computers. The noteholders then leased all furniture, equipment and computers back to the Company over a ten (10) year period. The purchase price of $200,000 represented the fair market value of the equipment based on an independent appraisal of the equipment by Dynamic Office Services and Coastal Computers, which are not affiliated with the Company.

Sale of Convertible Notes to Certain Affiliates. As of May 8, 2013, the Company had $22.7 million of Convertible Notes outstanding, of which Atlas, an affiliated party, held $14.0 million. The Notes sold to Atlas during 2012 are as follows:

Date of Purchase	Amount of Convertible Note	Interest Rate		Original Maturity Date
January 5, 2012	$350,000	8	%	11/14/2016
February 10, 2012	$350,000	8	%	11/14/2016
April 2, 2012	$350,000	8	%	11/14/2016
May 25, 2012	$200,000	8	%	11/14/2016
October 15, 2012	$200,000	8	%	11/14/2016

On the earlier of the maturity date of November 14, 2016 or a merger or acquisition or other transaction pursuant to which our existing stockholders hold less than 50% of the surviving entity, or the sale of all or substantially all of our assets, or similar transaction, or event of default, each noteholder in its sole discretion shall have the option to:

convert the principal then outstanding on its Notes into shares of our common stock, or

receive immediate repayment in cash of the Notes, including any accrued and unpaid interest.

If a noteholder elects to convert its notes under the circumstances, the conversion price will be the lowest "applicable conversion price" determined for each Note. The "applicable conversion price" for each Note shall be calculated by multiplying 120% by the lowest of

the average of the high and low prices of the Company's common stock on the OTCBB averaged over the five trading days prior to the closing date of the issuance of such Note,

if the Company's common stock is not traded on the Over-The-Counter market, the closing price of the common stock reported on the Nasdaq National Market or the principal exchange on which the common stock is listed, averaged over the five trading days prior to the closing date of the issuance of such Note, or

the closing price of the Company's common stock on the OTCBB, the Nasdaq National Market, or the principal exchange on which the common stock is listed, as applicable, on the trading day immediately preceding the date such Note is converted,

in each case as adjusted for stock splits, dividends or combinations, recapitalizations, or similar events.

We are obligated to pay interest on the Notes at an annualized rate of 8% payable in quarterly installments commencing three months after the purchase date of the Notes. We are not permitted to prepay the Notes without approval of the holders of at least a majority of the principal amount of the Notes then outstanding.

Payment of the Notes will be automatically accelerated if we enter voluntary or involuntary bankruptcy or insolvency proceedings.

The noteholders of the Notes include, among others, Atlas, an affiliate that originally recommended Shlomo Elia, one of our current directors, for appointment to the Board. The noteholders have designated Doron Roethler as bond representative to act as their agent. So long as the Notes are outstanding, the Company has agreed that it will not take certain actions without approval of the bond representative. Crystal Management Ltd., which owns $750,000 aggregate principal amount of Notes, is owned by Doron Roethler, the former Chairman of the Board and former Interim Chief Executive Officer and who currently serves as the noteholders' bond representative.

If we propose to file a registration statement to register any of our common stock under the Securities Act of 1934, as amended, in connection with the public offering of such securities solely for cash, subject to certain limitations, we must give each noteholder who has converted its Notes into common stock the opportunity to include such shares of converted common stock in the registration. We have agreed to bear the expenses for any of these registrations, exclusive of any stock transfer taxes, underwriting discounts, and commissions.

EXECUTIVE COMPENSATION

Summary of Cash and Certain Other Compensation

The following table shows the annual and long-term compensation, for the fiscal years indicated, of the individual who served as the Company's Chief Executive Officer and Chief Financial Officer (together, referred to as "the named executive officers") during fiscal years 2011 and 2012.

Summary Compensation Table

Name and Principal Position	Year	Salary ($)	Option Awards ($) (1)	All Other Compensation ($)	Total ($)
Dror Zoreff	2011		$ 11,564(3)	$ 60,000	$ 60,000
Interim President and	2012		$ -	$ 50,000	$ 50,000
Chief Executive Officer (2)					
Robert Brinson, Jr.	2011			$ 39,720	$ 39,720
Chief Executive Officer (6)	2012			$ 83,040	$ 83,040
Thaddeus J. Shalek	2011	$ 109,200	$ 2,698(5)	$ 2,184	$ 114,079
Chief Financial Officer (4)	2012	$ 109,200	$ 2,698(5)	$ -	$ 111,898

(1) Amounts do not reflect compensation actually received by the named executive officer. Instead, the amounts represent the amount of compensation cost recognized in fiscal years 2011 and 2012, as applicable, in accordance with United States Generally Accepted Accounting Principles or US GAAP, disregarding any adjustments for forfeiture assumptions. For a discussion of the assumptions used to value these awards, see Note 2 to the Company's consolidated financial statements included in its Annual Report on Form 10-K, as amended.

(2) Mr. Zoreff served as the Chairman of the Board from May 2009 until November 2012, and as the Company's Interim President and Chief Executive Officer from November 2009 until September 2012. As Chairman of the Board, Mr. Zoreff received $5,000 per month. He did not otherwise receive a salary in fiscal years 2011 and 2012.

(3) On March 26, 2010, Mr. Zoreff was granted a nonqualified stock option to purchase 30,000 shares of common stock of the Company, subject to vesting at the rate of twenty-five percent (25%) for each quarter after the date of grant. The stock option is now fully exercisable.

(4) Mr. Shalek served as the Company's Interim Chief Financial Officer from August 2009 until September 2010, at which time he was promoted to Chief Financial Officer of the Company. Mr. Shalek resigned from his positions with the Company, including as Chief Financial Officer, effective as of April 1, 2013.

(5) On October 21, 2010, Mr. Shalek was granted a nonqualified stock option to purchase 15,000 shares of common stock of the Company, subject to vesting at the rate of

twenty-five percent (25%) on each anniversary date, beginning on January 1, 2011. As of December 31, 2012, only fifty percent (50%) of the options were vested.

(6) During 2011, Mr. Brinson served as a member of the Company's Board of Directors and received $39,720 in compensation paid through Mr. Brinson's consulting firm pursuant to a services agreement between the consulting firm and the Company. Effective September 11, 2012, Mr. Brinson was appointed Chief Executive Officer. During 2012, Mr. Brinson received total compensation of $83,040 paid through Mr. Brinson's consulting firm. Mr. Brinson resigned from his role as Chief Executive Officer, effective as of April 30, 2013. He continues to serve as a strategic advisor of the Company in 2013.

Outstanding Equity Awards

The following table provides information about outstanding equity awards held by the named executive officers as of December 31, 2012.

Outstanding Equity Awards at 2012 Fiscal Year-End

Name	Option Awards Number of securities underlying unexercised options (#) Exercisable	Number of Securities underlying unexercised Options (#) Unexercisable	Option exercise price ($/Sh)	Option expiration date
Dror Zoreff	15,000	-	$ 3.25	9/19/2018
	30,000	-	$ 1.14	3/25/2020
Robert M. Brinson, Jr.	20,000	-	$ 1.35	9/15/2021
	-	75,000	$ 1.45	9/11/2022
Thaddeus J. Shalek	11,250	3,750	$ 1.10	10/20/2020

Termination and Change in Control Arrangements

The Company currently has no arrangements with any of its named executive officers with respect to payments in connection with a termination of their employment or a change in control of the Company.

Compensation of Directors

The following table summarizes the compensation paid to directors for the fiscal year ended December 31, 2012 not covered in the tables above. Mr. Elia did not receive any compensation from us in 2012.

2012 Director Compensation

Name	Fees Earned or Paid in Cash ($)	Stock Awards ($)	Option Awards ($)	All Other Compensation ($)	Total ($)
Amir Elbaz	$ 32,000	$ -	$ -	$ -	$ 32,000

Restricted Stock Agreements. The restricted stock agreements with Mr. Elia provide that upon a “Change in Control,” the lapsing of restrictions on their restricted stock shall accelerate so as to lapse as to all of such shares on the date of such event.

A “Change in Control” shall be deemed to have occurred on the earliest of the following dates:

(i) the date on which any “person” (as such term is used in Sections 13(d) and 14(d) of the Exchange Act), other than: (A) the Company; (B) a trustee or other fiduciary holding securities under an employee benefit plan of the Company; (C) a corporation owned, directly or indirectly, by the stockholders of the Company in substantially the same proportions as their ownership of stock of the Company; or (D) the existing holders of capital stock of the Company as of the effective date hereof or their respective affiliates, is or becomes the “beneficial owner” (as defined in Rule 13d-3 under the Exchange Act), directly or indirectly, of securities of the Company representing more than fifty percent (50%) of the combined voting power of the Company’s then outstanding securities; or

(ii) on the condition that the transaction is consummated, the date the shareholders of the Company approve a definitive agreement or plan for: (A) a merger, share exchange, consolidation or reorganization involving the Company and any other corporation or other entity as a result of which securities representing more than fifty percent (50%) of the combined voting power of the Company or of the surviving or resulting corporation or entity are held in the aggregate by persons different than the persons holding those securities (including their affiliates) immediately prior to such transaction; or (B) an agreement for the sale or disposition by the Company of all or substantially all of the Company’s assets.

Effective March 26, 2010, the Company’s Board adopted a revised compensation policy, or the Revised Policy. Under the Revised Policy, each non-management member of the Board remained entitled to a fee of $1,500 per month. No additional monetary compensation would be received for committee service or for service as the Chairman of the Board or Chairman of the Audit Committee. However, additional monetary compensation may be awarded at the Chairman of the Board’s discretion for any director incurring overnight travel to attend Board meetings or other functions for the benefit of the Company. In addition, the number of shares underlying equity award grants was decreased to either 20,000 shares (30,000 shares for a non-management director who is appointed the Chairman of the Board) for stock option grants or 10,000 shares (15,000 shares for a non-management director who is appointed the Chairman of the Board) for restricted stock awards.

On October 21, 2010, the Board granted 10,000 shares of restricted stock to Shlomo Elia, the transfer restrictions on which lapse quarterly in 25% increments, commencing January 1, 2011. The restricted stock was provided to Mr. Elia on March 31, 2011. These options were fully vested as of December 31, 2012.

On September 14, 2011, the Board granted Robert M. Brinson, Jr. non-qualified stock options to acquire up to 20,000 shares of common stock at an exercise price of $1.35 per share, representing the fair market value on the date of grant. The options vest quarterly in 25% increments, commencing September 14, 2011. These options were fully vested as of December 31, 2012.

On September 11, 2012 the Board granted Robert M. Brinson, Jr. non-qualified stock options to acquire up to 75,000 shares of common stock at an exercise price of $1.45 per share, representing the fair market value on the date of grant. The options vest quarterly in 25% increments, commencing October 1, 2013. None of these options were vested as of December 31, 2012.

Equity Compensation Plans

The following table provides information, as of December 31, 2012, regarding the Company's compensation plans (including individual compensation arrangements) under which the Company is authorized to issue equity securities.

Equity Compensation Plan Information

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)(c))
Equity compensation plans approved by security holders	197,100(1)	$ 2.90	4,542,430(2)
Equity compensation plans not approved by security holders	-	-	
Total	197,100		4,542,430

(1) Consists of shares issuable upon exercise of outstanding options under the Company's 2004 Equity Compensation Plan.

(2) All of the shares remaining for future issuance under the 2004 Equity Compensation Plan are available for issuance as options or restricted stock awards.

OWNERSHIP OF SECURITIES

Principal Stockholders and Share Ownership by Management

The following table sets forth information regarding beneficial ownership of the Company's common stock as of May 6, 2013 by (i) each person who is known by the Company to beneficially own more than 5% of its common stock, (ii) each person who served as a named executive officer of the Company in fiscal year 2012, (iii) each person serving as a director or nominated for election as a director, and (iv) all current executive officers and directors as a group. Except as otherwise indicated by footnote, to the Company's knowledge, the persons named in the table below have sole voting and investment power with respect to all shares of common stock shown as beneficially owned by them.

Beneficial Owner Name and Address (1)	Amount and Nature of Beneficial Ownership (2)	Percent of Class	
Avy Lugassy (3) 126 Chemin des Hauts Crets, 1253 Vandoeuvres, Geneva, Switzerland	7,330,269	39.6	%
Doron Roethler (4) c/o S. Roethler 134 Aluf David Street Ramat Gan 52236 Israel	2,028,028	10.8	%
Shlomo Elia (5)	60,000	*	
Dror Zoreff	47,500	*	
Amir Elbaz	20,000	*	
Ronen Shviki	0	*	
Robert M. Brinson, Jr.	20,000	*	
Thaddeus Shalek	11,250	*	
All officers and directors as a group (5 persons) (6)	172,500	0.9	%

*Less than 1%

(1) Unless otherwise noted, all addresses are in care of the Company at 4505 Emperor Boulevard, Suite 320, Durham, North Carolina 27703.

(2) Based upon 18,523,792 shares of common stock outstanding on May 6, 2013. The number and percentage of shares beneficially owned is determined in accordance with Rule 13d-3 of the Exchange Act, and the information is not necessarily indicative of beneficial ownership for any other purpose. Under such rule, beneficial ownership includes any shares as to which the person has sole or shared voting power or investment power and also any shares that the person has the right to acquire within 60 days of May 6, 2013 through the exercise of any stock options or other rights. Any shares that a person has the right to acquire within 60 days are deemed to be outstanding for the purpose of computing the percentage ownership of such person but are not deemed outstanding for the purpose of computing the percentage ownership of any other person.

(3) Shares held by Grasford Investments Ltd., which is primarily controlled by Mr. Avy Lugassy, principal.

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(4) Includes (i) 1,323,619 shares owned by Greenleaf Ventures Ltd., a British Virgin Islands company, (ii) 121,116 shares owned by Crystal Management Ltd., a company registered in Anguilla, (entities controlled by Mr. Roethler), and (iii) 560,793 shares of common stock owned directly by Doron Roethler, of which 3,750 shares are held pursuant to a restricted stock award as to which restrictions had not lapsed as of May 6, 2013.

(5) Includes 2,500 shares held pursuant to a restricted stock award as to which all restrictions had not lapsed as of May 6, 2013.

(6) For all current executive officers and directors as a group, includes a total of 151,250 shares subject to options exercisable within 60 days of May 6, 2013 and 20,000 shares held pursuant to restricted stock awards as to which restrictions had not lapsed as of May 6, 2013.

Arrangements That May Result in a Change in Control

As described in detail under “Certain Relationships and Related Transactions” above, Mr. Avy Lugassy has certain relationships with the Company that, under certain circumstances, could result in Mr. Avy Lugassy obtaining a majority of the Company’s outstanding common stock in the future. As of May 8, 2013, Mr. Avy Lugassy held 7,330,269 shares of the Company’s common stock through Grasford, which represents approximately 40% of the number of shares issued and outstanding, and continues to purchase the Company’s common stock from time to time. As of May 8, 2013, Atlas holds $13,975,000 aggregate principal amount of the Company’s Notes due November 14, 2016, which are convertible into the Company’s common stock on the earlier of November 14, 2016, certain change in control events, or an event of default. If the notes were converted at the conversion price applicable to the Notes as of May 8, 2013, Atlas would receive approximately 8,698,335 shares upon conversion of the Notes.

REPORT OF THE AUDIT COMMITTEE

The role of the Audit Committee is to assist the Board in its oversight of the quality and integrity of the Company's financial statements, compliance with legal and regulatory requirements, qualification and independence of the Company's independent registered public accounting firm, and performance of internal control over financial reporting. The full responsibilities of the Audit Committee are described in a written charter adopted by the Board, a copy of which is posted on the Company's website at www.mobilesmith.com. The management of the Company is responsible for the preparation, presentation and integrity of the Company's financial statements, the Company's accounting and financial reporting principles, internal controls and procedures designed to assure compliance with accounting standards and applicable laws and regulations. The independent registered public accounting firm is responsible for auditing the Company's financial statements and expressing an opinion as to their conformity with US GAAP.

In the performance of its oversight function, the Audit Committee has reviewed and discussed with management and the independent registered public accounting firm the audited financial statements as of and for the year ended December 31, 2012. The Audit Committee has also discussed with the independent registered public accounting firm the matters required to be discussed by Statement on Auditing Standards No. 61, Communication with Audit Committees, as amended (AICPA, Professional Standards, Vol. 1, AU section 380), as adopted by the Public Company Accounting Oversight Board in Rule 3200T. In addition, the Audit Committee has received the written disclosures and the letter from the independent registered public accounting firm required by applicable requirements of the Public Company Accounting Oversight Board regarding the independent registered public accounting firm's communications with the Audit Committee concerning independence, and has discussed with the independent registered public accounting firm's independence.

The members of the Audit Committee in carrying out their duties are not engaged in the practice of accounting and do not act as auditors. Members of the Audit Committee rely without independent verification on the information provided to them and on the representations made by management and the independent auditors. Accordingly, the Audit Committee's oversight does not provide an independent basis to determine that management has maintained appropriate accounting and financial reporting principles or appropriate internal controls and procedures designed to assure compliance with accounting standards and applicable laws and regulations. The Audit Committee's considerations and discussions referred to above do not assure that the audit of the Company's financial statements has been carried out in accordance with US GAAP, that the financial statements are presented in accordance with US GAAP or that the Company's independent registered public accounting firm are in fact independent.

Based upon the review and discussions described in this report, and subject to the limitations on the role and responsibilities of the Audit Committee referred to above and in the Audit Committee Charter, the Audit Committee recommended to the Board that the audited financial statements be included in the Company's Annual Report on Form 10-K for the year ended December 31, 2012, as amended, for filing with the SEC.

THE AUDIT COMMITTEE*

Amir Elbaz, Chairman
Shlomo Elia
April 22, 2013

* Due to the expected decrease in the size of the Board from five to three members, the Board dissolved the Audit Committee and assumed its responsibilities in May 2013.

Principal Accountant

Cherry Bekaert's report on the financial statements of the Company for each of the fiscal years ended December 31, 2011 and December 31, 2012 did not contain any adverse opinion or disclaimer of opinion, and was not qualified or modified as to uncertainty, audit scope, or accounting principles, except that the reports on the financial statements of the Company for each of the fiscal years ended December 31, 2011 and December 31, 2012 contained an explanatory paragraph expressing substantial doubt about the Company's ability to continue as a going concern.

During the fiscal years ended December 31, 2011 and 2012, neither the Company nor anyone on the Company's behalf consulted with Cherry Bekaert regarding (i) either the application of accounting principles to a specific transaction, either completed or proposed, or the type of audit opinion that might be rendered on the Company's financial statements, and Cherry Bekaert did not provide any written report or oral advice to the Company that Cherry Bekaert concluded was an important factor considered by the Company in reaching a decision as to the accounting, auditing, or financial reporting issue; or (ii) any matter that was either the subject of a "disagreement" (as defined in Item 304(a)(1)(iv) of Regulation S-K) or a "reportable event" (as defined in Item 304(a)(1)(v) of Regulation S-K).

Principal Independent Registered Public Accounting Firm Fees and Services

All audit and permissible non-audit services provided by the Company's independent registered public accounting firm, as well as the fees for such services, must be pre-approved by the Audit Committee. The Audit Committee may delegate to one or more designated members of the Audit Committee the authority to pre-approve audit and permissible non-audit services, provided such pre-approval decisions are reported to the full Audit Committee at a later time. Any pre-approval is generally for the current fiscal year, and any pre-approval is detailed as to the particular service or category of services. All audit and non-audit services provided by the Company's independent registered public accounting firm during fiscal years 2011 and 2012 were pre-approved by or on behalf of the Audit Committee. Due to the expected decrease in the size of the Board from five to three members, the Board dissolved the Audit Committee and assumed its responsibilities in May 2013.

The following table summarizes the fees Cherry Bekaert billed for the last two fiscal years:

	Twelve months ended December 31, 2012	Twelve months ended December 31, 2011
Audit Fees	$ 113,000	$ 79,600
Audit-Related Fees	$ 10,000	None
Tax Fees	None	None
All Other Fees	None	$ 6,500
Total Fees	$ 123,000	$ 86,100

Audit Fees. Aggregate fees billed in 2011 and 2012 for audit services, consisting of the audit of the Company's 2010 and 2011 annual consolidated financial statements, including the reviews of the Company's Quarterly Reports on Form 10-Q filed during 2011, and assistance to the Company with its response to SEC comment letters, were $79,600 and $113,000, respectively.

Audit-Related Fees. There were zero and $10,000 in audit-related fees billed by the principal accountant in fiscal years 2011 and 2012, respectively. Audit-related fees in year 2012 relate to additional IT specialist costs incurred in the audit process due to June 28, 2012 incident of internal corporate network being compromised, as disclosed in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2012.

Tax Fees. The principal independent registered public accounting firm did not provide professional services related to tax compliance, tax advice, and tax planning during fiscal years 2011 and 2012.

All Other Fees. The Company was billed zero fees for technical accounting and tax research by the principal independent registered public accounting firm in fiscal year 2012 and $6,500 in 2011.

OTHER MATTERS

Other Business

Other than the election of directors and the ratification of the appointment of independent registered public accounting firm for the Company, as described in this Information Statement, the Board presently knows of no other business to be conducted at the 2013 Annual Meeting of Stockholders. The Company has not received any notice from a stockholder desiring to present a proposal for consideration at the meeting, including any director nomination. Should any other business properly come before the meeting, stockholders may vote their shares in their discretion.

Stockholder Proposals for the 2014 Annual Meeting

Stockholder proposals can be eligible for inclusion in our 2014 proxy or information statement. Any such stockholder proposals must be submitted, along with proof of ownership of our stock in accordance with Rule 14a-8(b)(2) under the Exchange Act, to our principal executive offices, in care of our Corporate Secretary, Smart Online, Inc., 4505 Emperor Boulevard, Suite 320, Durham, North Carolina 27703. Failure to deliver a proposal by this means may result in it not being deemed timely received. We must receive each such stockholder proposal no later than January 9, 2014 for it to be considered for inclusion in our 2014 proxy or information statement. We strongly encourage any stockholder interested in submitting a proposal to contact our Corporate Secretary in advance of this deadline to discuss the proposal, and stockholders may want to consult knowledgeable counsel with regard to the detailed requirements of applicable securities laws. Submitting a stockholder proposal does not guarantee that we will include it in our proxy or information statement. The Board will review all stockholder proposals.

Alternatively, if a stockholder does not want to submit a proposal for the 2014 annual meeting in our proxy or information statement under Rule 14a-8 under the Exchange Act, or intends to nominate a person as a candidate for election to the Board, the stockholder may submit the proposal or nomination not earlier than ninety (90) days or later than sixty (60) days prior to the first anniversary of the date of the 2013 annual meeting, unless the date of the 2014 annual meeting is advanced by more than thirty (30) days or delayed by more than sixty (60) days from the anniversary of the 2014 annual meeting (other than by adjournment), in which case such proposal or nomination must be submitted no earlier than ninety (90) days prior to the 2014 annual meeting and not later than (a) sixty (60) days prior to such annual meeting or (b) the tenth (10th) day following the calendar day on which public announcement of the date of such meeting is first made by the Company.

For our 2014 annual meeting, we must receive such proposals and nominations no earlier than March 19, 2014 and no later than April 18, 2014. If the date of the 2014 annual meeting is advanced by more than thirty (30) days or delayed by more than sixty (60) days from the anniversary of the 2013 annual meeting (other than by adjournment), the stockholder must submit any such proposal or nomination no earlier than the close of business on the ninetieth (90th) day prior to the 2014 annual meeting and no later than the close of business on the later of the sixtieth (60th) day prior to the 2014 annual meeting or the tenth (10th) day following the day on which public announcement of the date of such meeting is first made. The stockholder’s submission must include certain specified information concerning the proposal or nominee, as the case may be, and information as to the stockholder’s ownership of our stock. We will not entertain any proposals or nominations at the annual meeting that do not meet these requirements.

If the stockholder does not also comply with the requirements of Rule 14a-4(c)(2) under the Exchange Act, we may exercise discretionary voting authority under proxies that we solicit, if any, to vote in accordance with our best judgment on any such stockholder proposal or nomination. To make a submission, stockholders should contact our Corporate Secretary via mail directed to Corporate Secretary, 4505 Emperor Boulevard, Suite 320, Durham, North Carolina 27703. We strongly encourage stockholders to seek advice from knowledgeable counsel before submitting a proposal or a nomination.

Stockholder Communications with Directors

The Board, as a matter of policy, desires to facilitate communications between stockholders and directors to assist the Board in fulfilling its responsibilities to all stockholders. To that end, the Board has established a process for use by stockholders who desire to bring matters to the Board's attention. The process is intended to provide stockholders one means of communicating with directors and is not intended to be exclusive.

Any stockholder who desires to send a communication to members of the Board may submit it either by e-mail addressed to Corporate.Secretary@smartonline.com, or by mail addressed to the attention of Gleb Mikhailov at Smart Online, Inc., 4505 Emperor Boulevard, Suite 320, Durham, North Carolina 27703. All such communications should include the mailing address, telephone number, and e-mail address, if any, of the person submitting the communication. All communications properly submitted under these procedures, except those deemed inappropriate as noted below, will be delivered to all members of the Board periodically, generally in advance of each regularly scheduled Board meeting. The Board has directed that the Secretary not forward communications that (a) are not reasonably related to the business of the Company, (b) concern individual grievances or other interests that are personal to the stockholder submitting the communication and that cannot reasonably be construed to present a matter of concern to stockholders generally, or (c) under community standards, contain offensive, scurrilous, or abusive content or advocate engaging in illegal activities. If the Secretary, in his or her judgment, deems a communication inappropriate under the foregoing criteria, it will be returned to the person who submitted it together with a brief explanation of the reason why it has been deemed inappropriate for delivery.

Availability of Report on Form 10-K

A copy of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2012, as amended (without exhibits), including financial statements, is available at www.mobilesmith.com and www.iproxydirect.com/SOLN. A copy will be furnished without charge to any stockholder whose vote is solicited hereby upon written request directed to the attention of Gleb Mikhailov, Smart Online, Inc., 4505 Emperor Boulevard, Suite 320, Durham, North Carolina 27703. Copies of this information are also available through the following resources:

PHONE:	FAX:	INTERNET:	EMAIL:			
Call toll free 1-866-752-8683	Send this card to 202-521-3464	https://www.iproxydirect.com/SOLN and follow the on-screen instructions.	proxy@iproxydirect.com. Include your Control ID in your email.	$ 6,959	$ 2,793	$ 2,143

	Nine months Ended September 30			
	Pension Plan		Other Benefits	
	2012	2011	2012	2011
Service cost	$ 11,588	$ 8,785	$ 4,121	$ 2,971
Interest cost	11,465	11,012	2,958	2,683
Expected return on plan assets	(8,669)	(6,712)	(1,374)	(1,032)
Recognized net initial APBO (1)	N/A	N/A	207	207
Amortization of prior service cost	4,712	4,740	87	87
Recognized net actuarial loss	6,001	3,051	2,379	1,512
Net periodic benefit cost	$ 25,097	$ 20,876	$ 8,378	$ 6,428

(1) APBO - Accumulated postretirement benefit obligation

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Note 6. Short-term Borrowings

On June 29, 2011, the Company and Cal Water entered into Syndicated Credit Facilities, which provide for unsecured revolving credit facilities of up to an initial aggregate amount of $400 million. The Syndicated Credit Facilities amend, expand, and replace the Company s and its subsidiaries existing credit facilities originally entered into on October 27, 2009. The new credit facilities extended the terms until June 29, 2016, increased the Company s and Cal Water s unsecured revolving lines of credit, and lowered interest rates and fees. The Company and subsidiaries which it designates may borrow up to $100 million under the Company s revolving credit facility. Cal Water may borrow up to $300 million under its revolving credit facility; however, all borrowings need to be repaid within 12-months unless otherwise authorized by the CPUC. The proceeds from the revolving credit facilities may be used for working capital purposes, including the short-term financing of capital projects. The base loan rate may vary from LIBOR plus 72.5 basis points to LIBOR plus 95 basis points, depending on the Company s total capitalization ratio. Likewise, the unused commitment fee may vary from 8 basis points to 12.5 basis points based on the same ratio.

Both short-term unsecured credit agreements contain affirmative and negative covenants and events of default customary for credit facilities of this type including, among other things, limitations and prohibitions relating to additional indebtedness, liens, mergers, and asset sales. Also, these unsecured credit agreements contain financial covenants governing the Company and its subsidiaries consolidated total capitalization ratio and interest coverage ratio. As of September 30, 2012, the Company and Cal Water have met all borrowing covenants for both credit agreements.

As of September 30, 2012 and December 31, 2011, the outstanding borrowings on the Company lines of credit were $60.7 million and $47.1 million, respectively, and there were no outstanding borrowings on the Cal Water lines of credit as of September 30, 2012 and December 31, 2011. For the nine months ended September 30, 2012, the average borrowing rate was 1.7% compared to 2.6% for the same period last year.

Note 7. Income Taxes

The Company accounts for income taxes using the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Measurement of the deferred tax assets and liabilities is at enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the period that includes the enactment date.

The Company s estimated annual effective tax rate was 41.8% and 41.2% for the nine months ended September 30, 2012 and 2011, respectively, excluding discrete items. The Company s actual effective rates for the three months ended September 30, 2012 and 2011 was 26.6% and 41.1%, respectively and reflect the recording of a discrete tax item in 2012. The Company s actual effective rates for the nine months ended September 30, 2012 and 2011 was 32.6% and 38.4%, respectively and reflect the tax effects of discrete items for both years. The Company considers these discrete items as infrequently occurring or unusual.

Effective January 1, 2012, the corporate federal income tax repairs and maintenance deduction for qualified tangible property became mandatory for qualified property placed into service during 2012 and prior years. The new tax regulations require the Company to deduct a significant amount of costs previously capitalized for book and tax purposes. The Company completed its analysis of the federal repairs and maintenance deduction related to 2011 and prior years during the third quarter of 2012. The Company s federal repairs and maintenance deduction for qualified tangible property placed into service during 2011 and prior years was $86.7 million and created a $30.4 million deferred tax liability for the temporary timing difference between book and tax treatments as of September 30, 2012. An estimate for the 2012 federal repairs deduction was not recorded as of September 30, 2012. The 2011 and prior year federal repairs and maintenance deduction eliminated the Company s 2010 and 2011 previously filed federal qualified U.S. production activities deductions (QPAD) and was recorded as an $0.8 million federal income tax expense during the three months ended September 30, 2012. The 2012 federal income tax QPAD deduction is more likely than not to be eliminated and was excluded from the 2012 tax provision. The Company s state repairs deduction for qualified tangible property deductions placed into service during 2011 and prior years was $122.2 million and was recorded as a $7.0 million reduction to state income tax expense during the third quarter ended September 30, 2012. An estimate for the 2012 state repairs deduction was not recorded as of September 30, 2012.

The repairs and maintenance deductions resulted in a federal and state tax net operating loss (NOL). The NOL carry-forward amounts are more likely than not to be recovered and therefore require no valuation allowance. The NOL carry-forward does not begin to expire until 2032.

The California Franchise Tax Board (FTB) is auditing the Company s 2008 and 2009 California income tax returns. It is uncertain when the FTB will complete its audit. The Company believes that the final resolution of the FTB audit will not have a material adverse impact on its financial condition or results of operations. The Company is not under audit by any other jurisdiction.

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Note 8. Regulatory Assets and Liabilities

During 2011, the CPUC issued a decision regarding the $34.2 million of litigation proceeds previously received by Cal Water during 2008 which is being used to replace infrastructure damaged by the gasoline additive Methyl tert-butyl ether (MTBE). The decision requires use of these proceeds for costs incurred as a result of MTBE contamination with any related benefits to be provided to Cal Water customers. Such usage includes transfer of the amount to contributions in aid of construction (CIAC) for remediation or replacement project costs once complete. Usage of the proceeds is reported to the CPUC through an Advice Letter or General Rate Case filing. As of December 31, 2011, $16.7 million of the proceeds was recorded as CIAC. Cal Water did not use any of the proceeds to replace damaged infrastructure during the third quarter of 2012. The remaining balance of $16.3 million at September 30, 2012 is recorded as other long-term liabilities.

During 2011, Cal Water added balancing accounts for its pension plans and conservation program. Both balancing account effective dates were January 1, 2011. The pension plans balancing account is a two-way balancing account that tracks the differences between actual expenses and adopted rate recovery which will result in either a regulatory asset or liability. The conservation program is a one-way balancing account that tracks the differences between actual expenses and adopted rate recovery which may result in a regulatory liability if actual conservation expenses are less than adopted over the three year period ending December 31, 2013. As of September 30, 2012 there was a pension regulatory asset of $1.9 million and a conservation program regulatory liability of $6.6 million compared to a $1.9 million pension regulatory liability and a conservation program regulatory liability of $4.3 million as of December 31, 2011.

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Note 9. Commitment and Contingencies

Commitments

The Company has significant commitments to lease certain office spaces and water systems and to purchase water from water wholesalers. These commitments are described in Form 10-K for the year ended December 31, 2011. As of September 30, 2012, there were no significant changes from December 31, 2011.

Contingencies

Groundwater Contamination

The Company has undertaken litigation against third parties to recover past and future costs related to ground water contamination in our service areas. The cost of litigation is expensed as incurred and any settlement is first offset against such costs. The Commission s general policy requires all proceeds from contamination litigation to be used first to pay transactional expenses, then to make ratepayers whole for water treatment costs to comply with the Commission s water quality standards. The Commission allows for a risk-based consideration of contamination proceeds which exceed the costs of the remediation described above and may result in some sharing of proceeds with the shareholder, determined on a case by case basis. The Commission has authorized various memorandum accounts that allow the Company to track significant litigation costs to request recovery of these costs in future filings and uses of proceeds to comply with Commission s general policy.

Other Legal Matters

From time to time, the Company is involved in various disputes and litigation matters that arise in the ordinary course of business. The status of each significant matter is reviewed and assessed for potential financial exposure. If the potential loss from any claim or legal proceeding is considered probable and the amount of the range of loss can be estimated, a liability is accrued for the estimated loss in accordance with the accounting standards for contingencies. Legal proceedings are subject to uncertainties, and the outcomes are difficult to predict. Because of such uncertainties, accruals are based on the best information available at the time. While the outcome of these disputes and litigation matters cannot be predicted with any certainty, management does not believe when taking into account existing reserves the ultimate resolution of these matters will materially affect the Company s financial position, results of operations, or cash flows.

Note 10. Fair Value of Financial Assets and Liabilities

The accounting guidance for fair value measurements and disclosures provides a single definition of fair value and requires certain disclosures about assets and liabilities measured at fair value. A hierarchal framework for disclosing the observability of the inputs utilized in measuring assets and liabilities at fair value is established by this guidance. The three levels in the hierarchy are as follows:

Level 1 -	Quoted prices are available in active markets for identical assets or liabilities as of the reporting date. The types of assets and liabilities included in Level 1 are highly liquid and actively traded instruments with quoted prices.
Level 2 -	Pricing inputs are other than quoted prices inactive markets, but are either directly or indirectly observable as of the reporting date. The types of assets and liabilities included in Level 2 are typically either comparable to actively traded securities or contracts, or priced with discounted cash flow or option pricing models using highly observable inputs.
Level 3 -	Significant inputs to pricing have little or no observability as of the reporting date. The types of assets and liabilities included in Level 3 are those valued with models requiring significant management judgment or estimation.

Specific valuation methods include the following:

Cash equivalents, accounts receivable and accounts payable carrying amounts approximated the fair value because of the short-term maturity of the instruments.

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Long-term debt fair values were estimated using the published quoted market price, if available, or the discounted cash flow analysis, based on the current rates available using a risk-free rate (a U.S. Treasury securities yield curve) plus a risk premium of 1.19%.

Advances for construction fair values were estimated using broker quotes from companies that frequently purchase these investments.

	September 30, 2012				
		Fair Value			
	Cost	**Level 1**	**Level 2**	**Level 3**	**Total**
Long -term debt, including current maturities	$ 486,137	$	$ 629,572	$	$ 629,572
Advances for construction	188,249		67,175		67,175
Total	$ 674,386	$	$ 696,747	$	$ 696,747

	December 31, 2011				
		Fair Value			
	Cost	**Level 1**	**Level 2**	**Level 3**	**Total**
Long -term debt, including current maturities	$ 488,165	$	$ 625,202	$	$ 625,202
Advances for construction	187,278		69,959		69,959
Total	$ 675,443	$	$ 695,161	$	$ 695,161

Note 11. Condensed Consolidating Financial Statements

On April 17, 2009, Cal Water issued $100 million aggregate principal amount of 5.875% First Mortgage Bonds due 2019, and on November 17, 2010, Cal Water issued $100 million aggregate principal amount of 5.500% First Mortgage Bonds due 2040, all of which are fully and unconditionally guaranteed by the Company.

The following tables present the condensed consolidating balance sheets as of September 30, 2012 and December 31, 2011, the condensed consolidating statements of income for the three and nine months ended September 30, 2012 and 2011 and the condensed consolidating statements of cash flow for the nine months ended September 30, 2012 and 2011 of (i) California Water Service Group, the guarantor of the first mortgage bonds and the parent company; (ii) California Water Service Company, the issuer of the first mortgage bonds and a 100% owned subsidiary of California Water Service Group; and (iii) the other 100% owned subsidiaries of California Water Service Group.

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CALIFORNIA WATER SERVICE GROUP

CONDENSED CONSOLIDATING BALANCE SHEET

As of September 30, 2012

(In thousands)

	Parent Company	Cal Water	All Other Subsidiaries	Consolidating Adjustments	Consolidated
ASSETS					
Utility plant:					
Utility plant	$ 525	$ 1,902,919	$ 169,432	$ (7,197)	$ 2,065,679
Less accumulated depreciation and amortization	(94)	(592,236)	(31,697)	1,474	(622,553)
Net utility plant	431	1,310,683	137,735	(5,723)	1,443,126
Current assets:					
Cash and cash equivalents	1,198	14,439	1,334		16,971
Receivables and unbilled revenue		112,641	4,368		117,009
Receivables from affiliates	21,085	741	78	(21,904)	
Other current assets	81	15,003	1,034		16,118
Total current assets	22,364	142,824	6,814	(21,904)	150,098
Other assets:					
Regulatory assets		331,532	2,468		334,000
Investments in affiliates	493,832			(493,832)	
Long-term affiliate notes receivable	25,692	7,794		(33,486)	
Other assets	858	38,408	9,585	(242)	48,609
Total other assets	520,382	377,734	12,053	(527,560)	382,609
	$ 543,177	$ 1,831,241	$ 156,602	$ (555,187)	$ 1,975,833
CAPITALIZATION AND LIABILITIES					
Capitalization:					
Common stockholders equity	$ 474,936	$ 443,704	$ 55,703	$ (499,407)	$ 474,936
Affiliate long-term debt	7,794		25,692	(33,486)	
Long-term debt, less current maturities		476,260	3,200		479,460
Total capitalization	482,730	919,964	84,595	(532,893)	954,396
Current liabilities:					
Current maturities of long-term debt		5,987	690		6,677
Short-term borrowings	60,675				60,675
Payables to affiliates	50	714	21,140	(21,904)	
Accounts payable		54,562	4,277		58,839
Accrued expenses and other liabilities	301	59,890	3,852		64,043
Total current liabilities	61,026	121,153	29,959	(21,904)	190,234
Unamortized investment tax credits		2,254			2,254
Deferred income taxes, net	(579)	160,880	4,334	(390)	164,245
Pension and postretirement benefits other than pensions		234,432			234,432
Regulatory and other liabilities		78,910	8,127		87,037
Advances for construction		187,360	889		188,249
Contributions in aid of construction		126,288	28,698		154,986
	$ 543,177	$ 1,831,241	$ 156,602	$ (555,187)	$ 1,975,833

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CALIFORNIA WATER SERVICE GROUP

CONDENSED CONSOLIDATING BALANCE SHEET

As of December 31, 2011

(In thousands)

	Parent Company	Cal Water	All Other Subsidiaries	Consolidating Adjustments	Consolidated
ASSETS					
Utility plant:					
Utility plant	$ 324	$ 1,808,568	$ 158,688	$ (7,199)	$ 1,960,381
Less accumulated depreciation and amortization	(51)	(551,345)	(29,251)	1,385	(579,262)
Net utility plant	273	1,257,223	129,437	(5,814)	1,381,119
Current assets:					
Cash and cash equivalents	89	18,475	8,639		27,203
Receivables	158	76,227	(4,797)		71,588
Receivables from affiliates	7,817	3,446	5	(11,268)	
Other current assets		14,225	872		15,097
Total current assets	8,064	112,373	4,719	(11,268)	113,888
Other assets:					
Regulatory assets		317,564	2,334		319,898
Investments in affiliates	466,515			(466,515)	
Long-term affiliate notes receivable	28,921	7,832		(36,753)	
Other assets	1,144	31,662	7,081	(205)	39,682
Total other assets	496,580	357,058	9,415	(503,473)	359,580
	$ 504,917	$ 1,726,654	$ 143,571	$ (520,555)	$ 1,854,587
CAPITALIZATION AND LIABILITIES					
Capitalization:					
Common stockholders equity	$ 449,829	$ 417,810	$ 54,377	$ (472,187)	$ 449,829
Affiliate long-term debt	7,832		28,921	(36,753)	
Long-term debt, less current maturities		477,998	3,634		481,632
Total capitalization	457,661	895,808	86,932	(508,940)	931,461
Current liabilities:					
Current maturities of long-term debt		5,851	682		6,533
Short-term borrowings	47,140				47,140
Payables to affiliates	52	190	11,026	(11,268)	
Accounts payable		47,568	4,010		51,578
Accrued expenses and other liabilities	625	46,462	(547)	84	46,624
Total current liabilities	47,817	100,071	15,171	(11,184)	151,875
Unamortized investment tax credits		2,254			2,254
Deferred income taxes, net	(561)	113,925	3,435	(431)	116,368
Pension and postretirement benefits other than pensions		232,110			232,110
Regulatory and other liabilities		71,034	8,016		79,050
Advances for construction		185,902	1,376		187,278
Contributions in aid of construction		125,550	28,641		154,191
	$ 504,917	$ 1,726,654	$ 143,571	$ (520,555)	$ 1,854,587

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CALIFORNIA WATER SERVICE GROUP

CONDENSED CONSOLIDATING STATEMENT OF INCOME

For the three months ended September 30, 2012

(In thousands)

	Parent Company	Cal Water	All Other Subsidiaries	Consolidating Adjustments	Consolidated
Operating revenue	$	$ 168,680	$ 9,455	$	$ 178,135
Operating expenses:					
Operations:					
Water production costs		63,647	2,842		66,489
Administrative and general		21,639	2,286		23,925
Other operations		16,177	1,607	(126)	17,658
Maintenance		4,238	139		4,377
Depreciation and amortization		13,051	699	(30)	13,720
Income tax (benefit) expense	(150)	9,831	372	334	10,387
Property and other taxes		4,552	666		5,218
Total operating expenses	(150)	133,135	8,611	178	141,774
Net operating income	150	35,545	844	(178)	36,361
Other Income and Expenses:					
Non-regulated revenue	474	3,372	617	(707)	3,756
Non-regulated expense, net		(2,217)	(483)	3	(2,697)
Income tax (expense) on other income and expense	(193)	(469)	(82)	322	(422)
Net other income	281	686	52	(382)	637
Interest:					
Interest expense	368	7,702	535	(581)	8,024
Less: capitalized interest		(505)	(293)		(798)
Net interest expense	368	7,197	242	(581)	7,226
Equity earnings of subsidiaries	29,709			(29,709)	
Net income	$ 29,772	$ 29,034	$ 654	$ (29,688)	$ 29,772

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CALIFORNIA WATER SERVICE GROUP

CONDENSED CONSOLIDATING STATEMENT OF INCOME

For the nine months ended September 30, 2012

(In thousands)

	Parent Company	Cal Water	All Other Subsidiaries	Consolidating Adjustments	Consolidated
Operating revenue	$	$ 413,796	$ 24,640	$	$ 438,436
Operating expenses:					
Operations:					
Water production costs		150,396	7,723		158,119
Administrative and general		62,043	7,067		69,110
Other operations		54,584	5,008	(379)	59,213
Maintenance		14,247	495		14,742
Depreciation and amortization		39,393	2,079	(89)	41,383
Income tax (benefit) expense	(416)	19,094	(198)	997	19,477
Property and other taxes		11,819	1,983		13,802
Total operating expenses	(416)	351,576	24,157	529	375,846
Net operating income	416	62,220	483	(529)	62,590
Other Income and Expenses:					
Non-regulated revenue	1,429	10,867	1,805	(2,158)	11,943
Non-regulated expense, net		(7,072)	(1,422)	3	(8,491)
Income tax (expense) on other income and expense	(582)	(1,545)	(216)	960	(1,383)
Net other income	847	2,250	167	(1,195)	2,069
Interest:					
Interest expense	1,022	22,648	1,594	(1,780)	23,484
Less: capitalized interest		(1,785)	(862)		(2,647)
Net interest expense	1,022	20,863	732	(1,780)	20,837
Equity earnings of subsidiaries	43,581			(43,581)	
Net income (loss)	$ 43,822	$ 43,607	$ (82)	$ (43,525)	$ 43,822

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CALIFORNIA WATER SERVICE GROUP

CONDENSED CONSOLIDATING STATEMENT OF INCOME

For the three months ended September 30, 2011

(In thousands)

	Parent Company	Cal Water	All Other Subsidiaries	Consolidating Adjustments	Consolidated
Operating revenue	$	$ 160,297	$ 8,957	$	$ 169,254
Operating expenses:					
Operations:					
Water production costs		58,913	2,680		61,593
Administrative and general		19,359	2,287		21,646
Other operations		15,746	1,886	(126)	17,506
Maintenance		4,417	234		4,651
Depreciation and amortization		12,110	650	(31)	12,729
Income tax (benefit) expense	(135)	15,659	(24)	381	15,881
Property and other taxes		4,537	633		5,170
Total operating expenses	(135)	130,741	8,346	224	139,176
Net operating income	135	29,556	611	(224)	30,078
Other Income and Expenses:					
Non-regulated revenue	558	3,033	678	(844)	3,425
Non-regulated expense, net		(6,005)	(484)		(6,489)
Income tax (expense) benefit on other income and expense	(227)	1,211	(99)	369	1,254
Net other income (expense)	331	(1,761)	95	(475)	(1,810)
Interest:					
Interest expense	330	7,764	630	(717)	8,007
Less: capitalized interest		(434)	(240)		(674)
Net interest expense	330	7,330	390	(717)	7,333
Equity earnings of subsidiaries	20,799			(20,799)	
Net income	$ 20,935	$ 20,465	$ 316	$ (20,781)	$ 20,935

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CALIFORNIA WATER SERVICE GROUP

CONDENSED CONSOLIDATING STATEMENT OF INCOME

For the nine months ended September 30, 2011

(In thousands)

	Parent Company	Cal Water	All Other Subsidiaries	Consolidating Adjustments	Consolidated
Operating revenue	$	$ 375,851	$ 22,949	$	$ 398,800
Operating expenses:					
Operations:					
Water production costs		131,004	7,292		138,296
Administrative and general		56,582	6,120		62,702
Other operations		42,741	5,518	(380)	47,879
Maintenance		14,567	571		15,138
Depreciation and amortization		35,802	1,981	(93)	37,690
Income tax (benefit) expense	(427)	23,270	(714)	1,149	23,278
Property and other taxes		12,505	1,731		14,236
Total operating expenses	(427)	316,471	22,499	676	339,219
Net operating income	427	59,380	450	(676)	59,581
Other Income and Expenses:					
Non-regulated revenue	1,647	8,760	3,595	(2,505)	11,497
Non-regulated expense, net		(10,815)	(2,607)		(13,422)
Gain on sale of properties		62			62
Income tax (expense) benefit on other income and expense	(671)	812	(476)	1,111	776
Net other income (expense)	976	(1,181)	512	(1,394)	(1,087)
Interest:					
Interest expense	1,047	23,800	1,834	(2,125)	24,556
Less: capitalized interest		(1,298)	(608)		(1,906)
Net interest expense	1,047	22,502	1,226	(2,125)	22,650
Equity earnings of subsidiaries	35,488			(35,488)	
Net income (loss)	$ 35,844	$ 35,697	$ (264)	$ (35,433)	$ 35,844

CALIFORNIA WATER SERVICE GROUP

CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS

For the nine months ended September 30, 2012

(In thousands)

	Parent Company	Cal Water	All Other Subsidiaries	Consolidating Adjustments	Consolidated
Operating activities:					
Net income (loss)	$ 43,822	$ 43,607	$ (82)	$ (43,525)	$ 43,822
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:					
Equity earnings of subsidiaries	(43,581)			43,581	
Dividends received from affiliates	19,785			(19,785)	
Depreciation and amortization		40,604	2,207	(89)	42,722
Change in value of life insurance contracts		(2,244)			(2,244)
Other changes in noncurrent assets and liabilities	1,180	30,928	(3,815)	118	28,411
Changes in operating assets and liabilities:					
Other changes, net	(247)	(10,557)	(2,417)	(85)	(13,306)
Net adjustments	(22,863)	58,731	(4,025)	23,740	55,583
Net cash provided by (used in) operating activities	20,959	102,338	(4,107)	(19,785)	99,405
Investing activities:					
Utility plant expenditures		(88,593)	(11,007)		(99,600)
Purchase of life insurance		(3,199)			(3,199)
Restricted cash and other changes		1,553			1,553
Net changes in affiliate advances	(13,975)	2,708		11,267	
Proceeds from affiliate long-term debt	411	36		(447)	
Net cash (used in) investing activities	(13,564)	(87,495)	(11,007)	10,820	(101,246)
Financing Activities:					
Short-term borrowings	14,535	51,030			65,565
Repayment of short-term borrowings	(1,000)	(51,030)			(52,030)
Net changes in affiliate advances		524	10,743	(11,267)	
Repayment of affiliate long-term borrowings	(36)		(411)	447	
Proceeds from long-term debt			123		123
Repayment of long-term borrowings		(1,573)	(550)		(2,123)
Advances and contributions in aid for construction		5,416	75		5,491
Refunds of advances for construction		(5,575)	(57)		(5,632)
Dividends paid to non-affiliates	(19,785)				(19,785)
Dividends paid to affiliates		(17,671)	(2,114)	19,785	
Issuance of common stock					
Net cash (used in) provided by financing activities	(6,286)	(18,879)	7,809	8,965	(8,391)
Change in cash and cash equivalents	1,109	(4,036)	(7,305)		(10,232)
Cash and cash equivalents at beginning of period	89	18,475	8,639		27,203

Cash and cash equivalents at end of period	$ 1,198	$ 14,439	$ 1,334	$	$ 16,971

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CALIFORNIA WATER SERVICE GROUP

CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS

For the nine months ended September 30, 2011

(In thousands)

	Parent Company	Cal Water	All Other Subsidiaries	Consolidating Adjustments	Consolidated
Operating activities:					
Net income (loss)	$ 35,844	$ 35,697	$ (264)	$ (35,433)	$ 35,844
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:					
Equity earnings of subsidiaries	(35,488)			35,488	
Dividends received from affiliates	19,245			(19,245)	
Depreciation and amortization	37	36,986	2,083	(93)	39,013
Change in value of life insurance contracts		2,829			2,829
Other changes in noncurrent assets and liabilities	(248)	1,264	645		1,661
Changes in operating assets and liabilities:					
Other changes, net	1,460	20,628	(3,748)	37	18,377
Net adjustments	(14,994)	61,707	(1,020)	16,187	61,880
Net cash provided by (used in) operating activities	20,850	97,404	(1,284)	(19,246)	97,724
Investing activities:					
Utility plant expenditures		(72,502)	(17,015)		(89,517)
Purchase of life insurance		(1,744)			(1,744)
Restricted cash and other changes		(50)			(50)
Net changes in affiliate advances	(17,230)	(4,835)		22,065	
Proceeds from affiliate long-term debt	618	34	53	(705)	
Net cash (used in) investing activities	(16,612)	(79,097)	(16,962)	21,360	(91,311)
Financing Activities:					
Short-term borrowings	16,110				16,110
Net changes in affiliate advances			22,157	(22,157)	
Repayment of affiliate long-term borrowings	(87)		(711)	798	
Proceeds from long-term debt			135		135
Repayment of long-term borrowings		(1,225)	(519)		(1,744)
Advances and contributions in aid for construction		5,559	681		6,240
Refunds of advances for construction		(4,429)	(10)		(4,439)
Dividends paid to non-affiliates	(19,245)				(19,245)
Dividends paid to affiliates		(17,183)	(2,062)	19,245	
Issuance of common stock	965				965
Net cash (used in) proved by financing activities	(2,257)	(17,278)	19,671	(2,114)	(1,978)
Change in cash and cash equivalents	1,981	1,029	1,425		4,435
Cash and cash equivalents at beginning of period	188	40,446	1,643		42,277
Cash and cash equivalents at end of period	$ 2,169	$ 41,475	$ 3,068	$	$ 46,712

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Item 2.

MANAGEMENT S DISCUSSION AND ANALYSIS OF

FINANCIAL CONDITION AND RESULTS OF OPERATIONS

(Dollar amounts in thousands, except where otherwise noted and per share amounts)

FORWARD LOOKING STATEMENTS

This quarterly report, including all documents incorporated by reference, contains forward-looking statements within the meaning established by the Private Securities Litigation Reform Act of 1995 (Act). Forward-looking statements in this quarterly report are based on currently available information, expectations, estimates, assumptions and projections, and our management s beliefs, assumptions, judgments and expectations about us, the water utility industry and general economic conditions. These statements are not statements of historical fact. When used in our documents, statements that are not historical in nature, including words like expects, intends, plans, believes, may, estimates, assumes, anticipates, projects, predicts, forecasts, should, seeks, or variations of these words or similar expressions are intended to identify forward-looking statements. The forward-looking statements are not guarantees of future performance. They are based on numerous assumptions that we believe are reasonable, but they are open to a wide range of uncertainties and business risks. Consequently, actual results may vary materially from what is contained in a forward-looking statement.

Factors which may cause actual results to be different than those expected or anticipated include, but are not limited to:

- governmental and regulatory commissions decisions, including decisions on proper disposition of property;
- changes in regulatory commissions policies and procedures;
- the timeliness of regulatory commissions actions concerning rate relief;
- changes in the capital markets and access to sufficient capital on satisfactory terms;
- new legislation;

- changes in accounting valuations and estimates;
- changes in accounting treatment for regulated companies, including adoption of International Financial Reporting Standards, if required;
- electric power interruptions;
- increases in suppliers prices and the availability of supplies including water and power;
- fluctuations in interest rates;
- changes in environmental compliance and water quality requirements;
- litigation that may result in damages or costs not recoverable from third parties;
- acquisitions and the ability to successfully integrate acquired companies;
- the ability to successfully implement business plans;
- civil disturbances or terrorist threats or acts, or apprehension about the possible future occurrences of acts of this type;
- the involvement of the United States in war or other hostilities;
- our ability to attract and retain qualified employees;
- labor relations matters as we negotiate with the unions;

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- federal health care law changes could result in increases to Company health care costs and additional income tax expenses in future years;
- changes in federal and state income tax regulations and treatment of such by regulatory commissions;
- implementation of new information technology systems;
- changes in operations that result in an impairment to acquisition goodwill;
- restrictive covenants in or changes to the credit ratings on current or future debt that could increase financing costs or affect the ability to borrow, make payments on debt, or pay dividends;
- general economic conditions, including changes in customer growth patterns and our ability to collect billed revenue from customers;
- changes in customer water use patterns and the effects of conservation;
- the impact of weather on water sales and operating results;
- the ability to satisfy requirements related to the Sarbanes-Oxley Act and other regulations on internal controls; and
- the risks set forth in Risk Factors included elsewhere in this quarterly report.

In light of these risks, uncertainties and assumptions, investors are cautioned not to place undue reliance on forward-looking statements, which speak only as of the date of this quarterly report or as of the date of any document incorporated by reference in this report, as applicable. When considering forward-looking statements, investors should keep in mind the cautionary statements in this quarterly report and the documents incorporated by reference. We are not under any obligation, and we expressly disclaim any obligation, to update or alter any forward-looking statements, whether as a result of new information, future events or otherwise.

CRITICAL ACCOUNTING POLICIES

We maintain our accounting records in accordance with accounting principles generally accepted in the United States of America (GAAP) and as directed by the regulatory commissions to which we are subject. The process of preparing financial statements in accordance with GAAP requires the use of estimates and assumptions on the part of management. The estimates and assumptions used by management are based on historical experience and our understanding of current facts and circumstances. Management believes that the following accounting policies are critical because they involve a higher degree of complexity and judgment, and can have a material impact on our results of operations and financial condition. These policies and their key characteristics are discussed in detail in the 2011 Form 10-K. They include:

- revenue recognition and the water revenue adjustment mechanism;
- expense balancing and memorandum accounts;
- modified cost balancing accounts;
- regulatory utility accounting;
- income taxes;
- pension benefits;
- workers compensation and other claims;
- goodwill accounting and evaluation for impairment; and
- contingencies

For the three and nine month periods ended September 30, 2012, there were no changes in the methodology for computing critical accounting estimates, no additional accounting estimates met the standards for critical accounting policies, and there were no material changes to the important assumptions underlying the critical accounting estimates.

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RESULTS OF THIRD QUARTER 2012 OPERATIONS COMPARED TO

THIRD QUARTER 2011 OPERATIONS

Amounts in thousands except share data

Overview

Third quarter of 2012 net income was $29.8 million equivalent to $0.71 per diluted common share compared to net income of $20.9 million or $0.50 per diluted common share in the third quarter of 2011. The increase in net income was primarily attributable to rate increases, a nonrecurring income tax benefit of $0.15 per diluted common share, and an unrealized gain on our benefit plan insurance investments.

Operating Revenue

Operating revenue increased $8.9 million or 5% to $178.1 million in the third quarter of 2012. As disclosed in the following table, the increase was primarily due to rate increases.

The factors that primarily impacted the operating revenue for the third quarter of 2012 compared to 2011 are:

Rate increases (includes a 2012 $1.1 million water cost of capital mechanism revenue reduction)	$	8,377
Usage (includes WRAM and MCBA deferral adjustment)		7,492
Net change due to actual versus adopted results, and other		(6,988)
Net operating revenue increase	$	8,881

The net change due to actual versus adopted results, usage, and other in the above table refers primarily to the revenue impact year over year of the change in revenue recognized by the WRAM and MCBA. The WRAM is impacted by changes in consumption patterns from our historical trends as well as an increase in conservation efforts. The MCBA, which records the differences in production costs from the adopted costs, is recorded as an element of revenue as it represents pass through costs which are billed to customers. The MCBA is impacted by changes in total production quantities, the production mix of the source of water, the price paid for purchased water and power, and the amount of pump taxes paid.

The components of the rate increases are listed in the following table:

Purchase water offset increases	$	4,107
Step rate increases		2,781

General rate case (GRC) increases		1,137
Other		352
Total increase in rates	$	8,377

Total Operating Expenses

Total operating expenses were $141.8 million for the third quarter of 2012, versus $139.2 million for the same period in 2011, a 2% increase.

Water production expense consists of purchased water, purchased power, and pump taxes. It represents the largest component of total operating expenses, accounting for approximately 47% of total operating expenses in the third quarter of 2012. Water production expenses increased $4.9 million, or 8%, during the third quarter of 2012 compared to the same period last year due to purchased water and power price increases. These cost increases were partially offset by reductions in customer usage. Our wholly-owned operating subsidiaries, Washington Water, New Mexico Water, and Hawaii Water obtain all of their water supply from wells.

Sources of water as a percent of total water production are listed in the following table:

	Three Months Ended September 30	
	2012	**2011**
Well production	50%	50%
Purchased	44%	45%
Surface	6%	5%
Total	100%	100%

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The components of water production costs are shown in the table below:

	Three Months Ended September 30		
	2012	2011	Change
Purchased water	$ 51,428	$ 47,652	$ 3,776
Purchased power	11,440	10,866	574
Pump taxes	3,621	3,075	546
Total	$ 66,489	$ 61,593	$ 4,896

Purchased water costs increased due to price increases from water wholesalers. Total water production, measured in acre feet, increased 3% during the third quarter of 2012 as compared with the third quarter of 2011 due to an increase in customer usage.

Administrative and general expense and other operations expense increased 6% to $41.6 million. The primary reasons for the increase were increases in employee benefits and wage costs, and conservation program expenses during the third quarter of 2012. At September 30, 2012, there were 1,129 employees and at September 30, 2011, there were 1,141 employees.

Maintenance expenses decreased by 6% to $4.4 million in the third quarter of 2012 compared to $4.7 million in the third quarter of 2011, due to a decrease in main and service repairs. Depreciation and amortization expense increased $1.0 million, or 8%, due to 2011 capital additions.

Federal and state income taxes charged to operating expenses and other income and expenses decreased $3.8 million, from a provision of $14.6 million in the third quarter of 2011 to $10.8 million in the third quarter of 2012. The decrease was due to new corporate tax regulations, effective January 1, 2012, that require the Company to deduct costs previously capitalized for book and tax purposes and resulted in a nonrecurring income tax benefit related to 2011 and prior years which reduced income tax expense $6.2 million during the third quarter of 2012. We expect the effective tax rate to be between 31% and 35% for fiscal year 2012.

Other Income and Expense

Other income, net of income taxes, increased $2.4 million during the third quarter of 2012 mostly due to a $0.6 million unrealized gain on our benefit plan insurance investments during the third quarter of 2012 compared to an unrealized loss of $2.9 million during the third quarter of 2011.

Interest Expense

Total interest expense, net of interest capitalized, decreased $0.1 million to $7.2 million for the third quarter of 2012 compared to the same period last year. This decrease was attributable to lower borrowing costs on the short-term lines of credit and an increase in capitalized interest charged to construction projects.

Company Health Care Benefits

In March 2010, both the federal Patient Protection and Affordable Care Act (P.L. 111-148) and Health Care and Education Reconciliation Act (H.R. 4872) were enacted. We have not determined the impact of this legislation on the Company s health care costs during 2012 and in future years. However, we anticipate that the Company s health care and other costs will increase as a result of the new federal health care laws and based on available information. A new memorandum account was established for Cal Water, effective January 1, 2011, to account for health care cost changes due to federal legislation, as these costs were not included in the 2009 GRC decision.

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RESULTS OF THE NINE MONTHS ENDED SEPTEMBER 2012 COMPARED TO

THE NINE MONTHS ENDED SEPTEMBER 2011 OPERATIONS

Amounts in thousands except per share data

Overview

Net income for the nine-month period ended September 30, 2012, was $43.8 million, or $1.05 per diluted common share compared to net income of $35.8 million or $0.86 per diluted common share for the nine months ended September 30, 2011. The increase in net income is primarily attributable to rate increases, a nonrecurring income tax benefit of $0.15 per diluted common share, and an unrealized gain on our benefit plan insurance investments.

Operating Revenue

Operating revenue increased $39.6 million or 10% to $438.4 million in the nine month period ended September 30, 2012. As disclosed in the following table, the increase was due to increases in usage (includes an additional $11.4 million of net WRAM and MCBA operating revenues that were deferred as of December 31, 2011) and rates.

The factors that impacted the operating revenue for the third quarter of 2012 compared to 2011 are as follows:

Usage (includes WRAM and MCBA deferral adjustment)	$	26,978
Rate increases (includes a 2012 $2.7 million water cost of capital mechanism revenue reduction)		23,278
Net change due to actual versus adopted results and other		(10,620)
Net operating revenue increase	$	39,636

The net change due to actual versus adopted results, usage, and other in the above table refers primarily to the revenue impact year over year of the change in revenue recognized by the WRAM and MCBA. The WRAM is impacted by changes in consumption patterns from our historical trends as well as an increase in conservation efforts. The MCBA, which records the differences in production costs from the adopted costs, is recorded as an element of revenue as it represents pass through costs which are billed to customers. The MCBA is impacted by changes in total production quantities, the production mix of the source of water, the price paid for purchased water and power, and the amount of pump taxes paid.

The components of the rate increases are as follows:

Purchased water offset increases	$	13,870
Step rate increases		6,351
General rate case (GRC) increases		2,090
Other		967
Total increase in rates	$	23,278

Total Operating Expenses

Total operating expenses were $375.8 million for the nine months ended September 30, 2012, versus $339.2 million for the same period in 2011, an 11% increase.

Water production expense consists of purchased water, purchased power and pump taxes. Water production expense represents the largest component of total operating expenses, accounting for approximately 42% of total operating expenses. Water production expenses increased $19.8 million in the nine months ended September 30, 2012, or 14% compared to the same period last year due to increased cost of purchased water and pump taxes. Our wholly-owned operating subsidiaries, Washington Water, New Mexico Water, and Hawaii Water obtain all of their water supply from wells.

Sources of water production as a percent of total water production are listed on the following table:

	Nine Months Ended September 30	
	2012	**2011**
Well production	47%	48%
Purchased	47%	46%
Surface	6%	6%
Total	100%	100%

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The components of water production costs are shown in the table below:

	Nine Months Ended September 30		
	2012	2011	Change
Purchased water	$ 125,218	$ 108,121	$ 17,097
Purchased power	24,577	23,198	1,379
Pump taxes	8,324	6,977	1,347
Total	$ 158,119	$ 138,296	$ 19,823

Purchased water costs increased due to higher prices from wholesalers. Pump taxes were higher due to increased production from wells subject to pump taxes. Total water production, measured in acre feet, increased 5% for the first nine months of 2012 compared to the same period last year due to an increase in customer usage.

Administration and general and other operations expenses were $128.3 million, increasing $17.7 million, or 16%, for the nine months ended September 30, 2012. The increase was primarily attributable to increases in employee benefits and wage costs, and conservation program expenses during the nine months ended September 30, 2012.

Maintenance expense decreased $0.4 million, or 3%, for the nine months ended September 30, 2012, to $14.7 million due to less repairs of mains, water treatment facilities, and wells. Depreciation and amortization expense increased $3.7 million, or 10%, due to 2011 capital additions.

Federal and state income taxes charged to operating expenses and other income and expenses decreased $1.6 million, or 7%, for the nine months ended September 30, 2012. The decrease was due to new tax regulations, effective January 1, 2012, that require the Company to deduct costs previously capitalized for book and tax purposes and resulted in a nonrecurring income tax benefit related to 2011 and prior years which reduced income tax expense $6.2 million during the nine months ended September 30, 2012. We expect the effective tax rate to be between 31% and 35% for fiscal year 2012.

Other Income and Expense

Other income, net of income taxes, was $2.1 million for the nine months ended September 30, 2012, compared to a loss of $1.1 million in the same period last year, which was an increase of $3.2 million. The increase was mostly due to a $2.2 million unrealized gain on our benefit plan insurance investments during the nine months ended September 30, 2012 compared to an unrealized loss of $2.8 million during the same period last year

Interest Expense

Net interest expense decreased $1.8 million to $20.8 million for the nine month period ended September 30, 2012 compared to the nine month period ended September 30, 2011. This decrease was attributable to lower borrowing costs on the short-term lines of credit, the TIRBA balancing account interest charges ending on December 31, 2011, and an increase in capitalized interest charged to construction projects during the first nine months of 2012.

Company Health Care Benefits

In March 2010, both the federal Patient Protection and Affordable Care Act (P.L. 111-148) and Health Care and Education Reconciliation Act (H.R. 4872) were enacted. We have not determined the impact of this legislation on the Company s health care costs during 2012 and in future years. However, we anticipate that the Company s health care and other costs will increase as a result of the new federal health care laws and based on available information. A new memorandum account was established for Cal Water, effective January 1, 2011, to account for health care cost changes due to federal legislation, as these costs were not included in the 2009 GRC decision.

REGULATORY MATTERS

The state regulatory commissions have plenary powers setting rates and operating standards. As such, state commission decisions significantly impact Cal Water s revenues, earnings, and cash flows. The amounts discussed herein are generally annual amounts, unless specifically stated, and the financial impact to recorded revenue is expected to occur over a 12-month period from the effective date of the decision. In California, water utilities are required to make several different types of filings. Most filings result in rate changes that remain in place until the next General Rate Case (GRC). As explained below, surcharges and surcredits are used to recover balancing and memorandum accounts as well as general rate case interim rate catch-up. Surcharges and surcredits are temporary rate changes, which have specific time frames for recovery.

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GRCs, escalation rate increase filings, and offset filings change rates to amounts that will remain in effect until the next GRC. The CPUC follows a rate case plan, which requires Cal Water to file a GRC for each of its regulated operating districts every three years. In a GRC proceeding, the CPUC not only considers the utility s rate setting requests, but may also consider other issues that affect the utility s rates and operations. The CPUC is generally required to issue its GRC decision prior to the first day of the test year or authorize interim rates. In accordance with the rate case plan, the Commission issued a decision on Cal Water s 2009 general rate case filing in the fourth quarter of 2010 with rates effective on January 1, 2011. Cal Water filed its 2012 GRC on July 5, 2012, which will be applicable to all of its California Districts. Any rate change as a result of this filing is expected to be effective on January 1, 2014.

Between GRC filings utilities may file escalation rate increases, which allow the utility to recover cost increases, primarily from inflation and incremental investment, during the second and third years of the rate case cycle. However, escalation rate increases are subject to a weather-normalized earnings test on a district-by-district basis. Under the earnings test, the CPUC may reduce the escalation rate increase if, in the most recent 12-month period, this earnings test reflects earnings in excess of authorized for that district.

In addition, California water utilities are entitled to make offset filings. Offset filings may be filed to adjust revenues for construction projects authorized in GRCs when the plant is placed in service or for rate changes charged to the Company for purchased water, purchased power, and pump taxes (referred to as offsettable expenses). Such rate changes approved in offset filings remain in effect until the next GRC is approved.

The Water Revenue Adjustment Mechanism (WRAM) and Modified Cost Balancing Account (MCBA) are required by the CPUC to encourage Cal Water to promote lower water consumption levels with water conservation programs. In order to maintain revenue neutrality, the CPUC de-coupled Cal Water s revenue requirement from ratepayer usage with the WRAM/MCBA. Under the WRAM/MCBA, Cal Water recovers the full quantity revenue amounts authorized by the CPUC by using advice letter filings for any unbilled quantity revenue amounts or refunds for overcollection, regardless of customer usage volumes.

Surcharge and surcredit advice letters to amortize balances in the WRAM and MCBA accounts are filed between February and April of each year based on the district balances for the last calendar year. Based on current CPUC interpretations, surcharges are generally amortized over 12 or 18 months. The WRAM and MCBA amounts are cumulative, so if they are not amortized in a given calendar year, the balance will be carried forward and included with the following year balance.

2012 Regulatory Activity

Changes in CPUC s Procedures for WRAM Amortization

Cal Water, along with four other investor-owned water utilities filed a joint application to change the amortization periods to 24 months or less. The CPUC issued a proposed decision regarding the amortization periods on March 23, 2012 and a final decision on April 19, 2012. The final decision shortened the amortization for undercollected balances for calendar years 2011, 2012, and 2013. Also, the decision authorized Cal Water to bill and collect all year-end undercollected balances. Cal Water anticipates most of the undercollected balances during calendar years 2011, 2012, and 2013 will be collected using 12 and 18- month amortization periods. The collection periods for calendar year 2014 and future years will be determined during the 2012 GRC.

Remaining Balances from Previously Authorized Balancing Accounts Recoveries/Refunds

Prior to the adoption of the MCBA on July 1, 2008, the CPUC required incremental cost balancing accounts (ICBA) memorandum and balancing accounts. The ICBA refunds and billings will be completed during calendar year 2012. As of September 30, 2012, a $0.7 million regulatory asset and a $0.3 million regulatory liability were recorded for the remaining unbilled or un-refunded balances.

California Cost of Capital Applications

Cal Water, along with the three other large water utilities in California, filed an application with the CPUC in May of 2011 to review its cost of capital for 2012 through 2014. The Company and the other applicants reached a settlement with the Division of Ratepayer Advocates that was approved by the CPUC in Decision D.12.07.009. The decision required Cal Water to adopt a 9.99% return on equity and 53.4% equity capital structure for rate setting purposes. Cal Water filed an advice letter to reflect this lower authorized return, resulting in a revenue decrease of $3.9 million. The decision also continues the Water Cost of Capital

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Mechanism (WCCM), which requires an additional adjustment to equity returns if there is a large change in the Moody AA utility bond index. The WCCM triggered and Cal Water filed a 2013 rate decrease of $3.8 million effective January 1, 2013. The decision also discontinued the Temporary Interest Rate Balancing Account (TIRBA) and required Cal Water to refund the balance of $1.1 million to customers via a 12-month surcredit. Because this proceeding was scheduled to set the authorized rate of return for the Company s investment starting on January 1, 2012 and a decision had not been issued, the CPUC required Cal Water to file an advice letter to establish a Cost of Capital interim rate memorandum account. In August, Cal Water filed an advice letter to amortize this balance. This will result in a refund to customers of $2.5 million over a 12 month period.

2012 California GRC filing

On July 5, 2012, Cal Water filed its 2012 GRC application covering all district and general office revenue requirements. The GRC application requested an increase of $92.7 million or 19.4% in rates for 2014, $17.2 million or 3.0% in rates for 2015 and $16.9 million or 2.9% in rates for 2016. The GRC also asks the CPUC consider a number of special requests. Any rate change as a result of this filing is expected to be effective on January 1, 2014

2009 California GRC Decision

On July 2, 2009, Cal Water filed its 2009 GRC application covering all district and general office revenue requirements. The GRC application requested an increase of $70.6 million or 16.75% in rates for 2011, $24.8 million or 5.04% in rates for 2012 and $24.8 million or 4.79% in rates for 2013. On December 2, 2010, the CPUC issued decision 10-12-017, which approved a settlement between Cal Water, the Division of Ratepayer Advocates, and several intervenors representing the interests of individual district customers. This decision allows for revenue increases of $25.4 million or 5.6% in 2011. Cal Water is also allowed to file for increases of $9.6 million or 2.0% for 2012, and $9.0 million or 2.0% for 2013 subject to adjustment for indexed inflation and contingent upon passing a weather normalized earnings test. This decision also allows for offset increases after construction of 77 large capital projects in various operating districts. Cal Water has filed advice letter for 24 large capital projects completed and in-service during 2009, 2011, and 2012, with construction costs totaling $22.1 million.

In addition, the Company was authorized to make a deviation from its escalation expense and exclude employee health care, retiree health insurance, and conservation expenses from it escalation filings in 2012 and 2013. Instead for these three significant expense items, the CPUC has enumerated fixed three-year budgets for these expenses. It is anticipated that the budgets for these areas will more closely align with the actual expenses now that this change has been initiated.

The CPUC also authorized a Pension Balancing Account to track the difference between authorized pension contributions included in rates and the costs actually incurred. It is anticipated that this account will allow Cal Water to reduce some of the volatility it experiences in regard to the recovery of these costs from customers.

The Company was also authorized to combine the rates and tariffs of the South San Francisco and the Mid Peninsula Districts, located on the San Francisco peninsula, into a single ratemaking area in 2011. This new ratemaking area is known as the Bayshore District. Previously, the two separate districts had been operated out of a combined location.

Due to the transition between a phased rate case and a total company filing, the CPUC delayed the rate cases of 16 Cal Water districts. However, to compensate for this delay, the CPUC authorized interim rates from the authorized effective date under the old rate case plan. The difference between revenue requirements that were effective in the interim period and those calculated based on a final determination in the 2009 general rate case filing totaled $6.7 million and is being recovered as customer surcharges over a three-year period. During 2011, $3.8 million was billed and recorded as revenue. The remaining balance of $2.9 million is expected to be recovered during 2012 and 2013, and will be recorded as revenue when billed. Overcollected amounts from ratepayers will be recorded as regulatory liability during the reporting period in which it occurs. As of September 30, 2012, the overcollected amount of $0.9 million was recorded as a regulatory liability.

In January 2012, Cal Water implemented escalation rate increases in 17 districts. The annual revenue associated with these increases is $8.7 million.

Low Income Ratepayer Assistance Program

Cal Water currently administers a Low Income Ratepayer Assistance Program in accordance with decision D.06-11-053. This program provides qualifying low income customers with a 50% discount on their service charge (up to a maximum of $12 per month). It imposed a surcharge on non-qualifying customers of $0.01 per hundred cubic feet of monthly water consumption for metered customers and between $0.24 and $0.41 per flat rate service per month. Due to a successful enrollment of over 47,000 customers, this account had accumulated an under collection of approximately $7.5 million as of September 30, 2012, and is

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recorded in non-current regulatory assets. During the second quarter of 2012, Cal Water filed a petition to modify D.06-11-053 to 1) increase surcharges to balance program expenses and revenues, 2) amortize the current balance in the program, and 3) establish an annual adjustment mechanism to reduce the potential for large balances in the future. On May 25, 2012, Cal Water and the Division of Ratepayer Advocates (DRA) filed a full settlement of the application with the Commission. The settlement was approved during the month of September 2012 and allows Cal Water to 1) raise its LIRA surcharge on non eligible customers from $0.01 per CCF to $0.06 per CCF to account for more eligible customers participating in the program; 2) adjust surcharges on an annual basis; and 3) put in place a temporary surcharge of $0.0182 to recover the accumulated balance in the program account.

2010 Ka anapali (Hawaii) GRC Filing

On December 30, 2010, Hawaii Water filed its 2010 GRC application for the Ka anapali Service Area. The Hawaii Public Utilities Commission (HPUC) requires a separate rate application for all service areas and uses a limited future test year. The Ka anapali GRC requested additional revenue of $1.5 million or an increase of 38.2% over the prior year. Hawaii Water and the Consumer Advocate of the HPUC reached a tentative settlement on this rate increase. On January 11, 2012, the HPUC issued a Decision and Order approving the stipulated settlement. This resulted in a $1.2 million, or 30.8%, annual revenue increase that was effective March 2012.

2011 Pukalani (Hawaii) GRC Filing

In August 2011, Hawaii Water filed a general rate case for the Pukalani wastewater system requesting $1.3 million in additional annual revenues. Hawaii Water began settlement negotiations with the Consumer Advocate in early 2012. At this time, Hawaii Water cannot determine timing or final amount of rate relief this filing will generate.

2012 Waikoloa (Hawaii) GRC Filings

In August 2012, Hawaii Water filed general rate cases for the Waikoloa water, wastewater, and irrigation systems in Waikoloa Village and Waikoloa Resort requesting $6.3 million additional annual revenues. The Consumer Advocate has not issued any reports on these GRCs and at this time, Hawaii Water cannot determine timing of final amount of rate relief in this filing will generate.

2011 Washington Water GRC Filing

In 2011, Washington Water filed a general rate case for its operations. It requested a $1.7 million, or 21.8%, increase in revenue. On January 26, 2012, the Washington Utilities and Transportation Commission approved a $1.6 million, or 20.0%, increase effective February 2012.

Federal Income Tax Bonus Depreciation

In 2011, Cal Water filed for and received approval to track the benefits from federal income tax accelerated depreciation in a memorandum account due to the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. Additional federal income tax deductions for assets placed in service after September 8, 2010 and before December 31, 2011 was $6.6 million for 2010 and estimated at $10.5 million for 2011. The CPUC will determine the disposition of amounts recorded in the memorandum account in Cal Water s next GRC.

Request for MTBE regulatory treatment

The CPUC in its Decision (D.) 10-10-018 issued rules for treating contamination proceeds generally. Subsequently, the CPUC s D.11-03-043 resolved Cal Water s separate application for treatment of MTBE proceeds by ordering continued tracking of the proceeds and expenditures until litigation and remediation are both complete. The new rules allow Cal Water to file an advice letter to move proceeds from this tracking account into Contributions in Aid of Construction (CIAC) when remediation or replacement projects are complete. Cal Water has completed several such projects totaling $16.7 million. While the advice letters have not been filed for some of these projects, Cal Water believes it is probable the CPUC will treat the invested amounts as CIAC when the advice letters are filed. The Company reclassified $16.7 million from regulatory and other liabilities to CIAC during 2011. Project costs totaling $9.1 million were treated as CIAC in setting rates in the 2009 General Rate Case effective January 1, 2011, so there is no rate impact for this reclassification. For projects not identified in the 2009 General Rate Case, as projects to remediate or replace MTBE-contaminated plant are completed, the Company will book a reclassification from other long-term liabilities to CIAC and adjust rate base during the next GRC. The CPUC s adopted rules would require all contamination proceeds to be used first to pay transactional expenses, then to make ratepayers whole for costs to ensure the water system complies with the CPUC s water quality standards. The rules allow for a risk-based consideration of proceeds which exceed the costs of the remediation

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described above and may result in some sharing of excess, or net proceeds. Because treatment or replacement of Cal Water s MTBE contaminated wells will occur over a number of years, a final disposition of Cal Water s memorandum account will occur at an unknown future date. Cal Water will continue to monitor proceeds and remediation and will report to the CPUC in its next GRC. Because of uncertainty surrounding eventual remediation capital and operating costs and the eventual ratemaking treatment of net proceeds as defined by the CPUC, Cal Water cannot predict the future disposition of its partial MTBE settlement proceeds at this time.

Service Line Insurance Billing

As a consequence of D.07-12-055 which resolved Cal Water s 2006 GRC, Cal Water was required to demonstrate that its non-regulated Extended Service Protection (ESP) business or its successor complies with CPUC rules. Cal Water made an administrative compliance filing in 2008 which was rejected. Cal Water subsequently filed A.08-05-019 requesting Commission confirmation that the interaction between Cal Water, CWS Utility Services, and Home Service USA complied with all applicable rules. During the proceeding, the CPUC established a memorandum account to record Cal Water s revenues and expenses related to the non-regulated service line insurance business. The application is being processed in 2011 and 2012 after the CPUC adopted comprehensive rules for the relationships between regulated utilities and their unregulated affiliates and the rules for offering non-tariffed products and services. These rules went into effect on June 30, 2011 as a result of D.10-10-019. The CPUC s ratepayer advocate testified that Cal Water s customers should receive some of the proceeds from the sale of the non-regulated ESP business as well as other program revenues. While Cal Water challenged these claims and presented its own testimony, the parties were able to reach a settlement on all issues in the case. The proposed settlement, which was filed in October 2011, describes the accounting and revenue sharing applicable to the non-regulated service line business after June 30, 2011 and proposes a monetary settlement of $2.1 million to ratepayers to resolve all issues related to non-regulated service line business activity from 2007 through June 30, 2011. The settlement is still subject to approval by the CPUC. Cal Water anticipates that the CPUC will approve the settlement in the fourth quarter of 2012. A $2.1 million regulatory liability and reduction to revenues was recorded during the third quarter of 2011. The amount is expected to be refunded on ratepayer bills over a 12-month period.

2012 Expense Offset filings

In 2012, Cal Water filed advice letters to offset increased purchased water and pump tax rates in nine of its regulated districts totaling $13.2 million in annual revenue. Expense offsets are dollar-for-dollar increases in revenue to match increased expenses and interact with the WRAM and MCBA mechanisms so that net operating income is not affected by an offset increase.

In May, Cal Water filed an advice letter to recover the cost relating to the expense of hiring 6 additional Cross Connection Control Inspectors. These positions were approved in the 2009 GRC and Cal Water was allowed to file for the recovery of the positions and associated equipment after the positions were hired. The annual revenue increase from this filing is $0.6 million. In the future, Cal Water plans to file advice letters to offset expected increases in purchased water and pump tax charges in some districts. Cal Water cannot predict the exact timing or dollar amount of the changes.

2012 Ratebase Offset filings

In 2012, Cal Water filed advice letters to offset several infrastructure improvement projects in seven districts totaling $2.0 million in annual revenue. For some of these offsets, Cal Water also filed 12 month surcredits to the customers to account for the use of internal labor to complete the flat to meter projects. These surcredits total $1.2 million. Companies are allowed to file rate base offsets to increase revenues for construction projects authorized in GRCs when the plant is placed in service. The project for this filing was authorized in the 2009 GRC. The remaining advice letter projects from the 2009 GRC are scheduled to be completed during 2012 and 2013.

LIQUIDITY

Cash flows from Operations

Cash flow from operations was $99.4 million during the nine months ended September 30, 2012, compared to $97.7 million for the same period of 2011. In general, cash flow from operations is primarily generated by net income, non-cash expense for depreciation and amortization, deferred income taxes, regulatory liabilities, and other current liabilities. Cash generated by operations varies during the year due to customer billings, timing of contributions to our benefit plans, and timing of vendor and tax payments.

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Effective January 1, 2012, the corporate federal income tax repairs and maintenance deduction for qualified tangible property became mandatory for property placed into service during 2012 and prior years. The new tax regulations require the Company to deduct a significant amount of costs previously capitalized for book and tax purposes. The Company s 2011 and prior years repairs and maintenance deduction significantly reduced its 2012 pre-tax earnings for income tax reporting and is estimated to reduce the Company s income tax cash payments approximately $29 million for 2012. It will also allow the Company to recover $5.5 million during 2013 for federal income taxes paid for tax years 2010 and 2011. The cash savings from the new tax deductions will be used to fund capital expenditures.

On April 19, 2012, the CPUC issued a decision to shorten the amortization periods for Cal Water s undercollected net WRAM and MCBA receivable balances for calendar years 2011, 2012, and 2013. This change is estimated to significantly increase cash collections during 2012.

During the nine months ended September 30, 2012, we made contributions of $25.5 million to our pension and retiree health care plans compared to $15.9 million for the same period of 2011.

The water business is seasonal. Billed revenue is lower in the cool, wet winter months when less water is used compared to the warm, dry summer months when water use is highest. This seasonality results in the possible need for short-term borrowings under the bank lines of credit in the event cash is not available to cover operating and capital costs during the winter period. The increase in cash flows during the summer allows short-term borrowings to be paid down. Customer water usage can be lower than normal in years when more than normal precipitation falls in our service areas or temperatures are lower than normal, especially in the summer months. The reduction in water usage reduces cash flows from operations and increases the need for short-term bank borrowings. In addition, short-term borrowings are used to finance capital expenditures until long-term financing is arranged.

Investing Activities

During the nine months ended September 30, 2012 and 2011, we used $99.6 million and $89.5 million, respectively, of cash for both company-funded and developer-funded capital expenditures. For 2012, our capital budget is approximately $100 to $125 million. Annual expenditures fluctuate each year due to the availability of construction resources and our ability to obtain construction permits in a timely manner.

Financing Activities

During the nine months ended September 30, 2012, there were no equity or debt offerings; however, we borrowed $65.6 million on our unsecured revolving credit facilities mostly to finance company-funded capital expenditures.

The undercollected net WRAM and MCBA receivable balances were $52.0 million as of September 30, 2012 and $49.6 million as of December 31, 2011. During the third quarter of 2012, the undercollected net WRAM and MCBA receivable balances decreased $1.7 million from the June 30, 2012 balance of $53.7 million. The decrease was due to cash collections exceeding the growth of net undercollected receivable balances during the third quarter of 2012. Cash collections on the net undercollected receivable balances increased during the third quarter of 2012 because the CPUC authorized Cal Water to bill all year-end net undercollected receivable balances and shortened the amortization periods for most undercollected balances to 18-months or 12-months. The undercollected balances were primarily financed by Cal Water and negatively affected cash flows for the nine months ended September 30, 2012. Cal Water used short-term and long-term financing arrangements to meet operational cash requirements. Interest on the undercollected balances, the interest recoverable from ratepayers, is limited to the current 90-day commercial paper rates which is significantly lower than Cal Water s short and long-term financing rates.

Short-Term and Long-Term Debt

Short-term liquidity is provided by the bank lines of credit described above and by internally generated funds. Long-term financing is accomplished through the use of both debt and equity. As of September 30, 2012, there were short-term borrowings of $60.7 million outstanding on the unsecured revolving line of credit compared to $47.1 million as of December 31, 2011.

Given our ability to access our lines of credit on a daily basis, cash balances are managed to levels required for daily cash needs and excess cash is invested in short-term or cash equivalent instruments. Minimal operating levels of cash are maintained for Washington Water, New Mexico Water, and Hawaii Water.

California Water Service Group and subsidiaries which it designates may borrow up to $100 million under its new short-term credit facility. California Water Service Company may borrow up to $300 million under its new credit facility; however, all borrowings need to be repaid within twelve months unless otherwise authorized by the CPUC.

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Both short-term credit agreements contain affirmative and negative covenants and events of default customary for credit facilities of this type including, among other things, limitations and prohibitions relating to additional indebtedness, liens, mergers, and asset sales. Also, these unsecured credit agreements contain financial covenants governing the Company and its subsidiaries consolidated total capitalization ratio and interest coverage ratio. As of September 30, 2012, we have met all of the covenant requirements and are eligible to use the full amounts of these credit agreements.

Bond principal and other long-term debt payments were $2.1 million during the nine months ended September 30, 2012, compared to $1.7 million during the same period of 2011.

Long-term financing, which includes senior notes, other debt securities, and common stock, has typically been used to replace short-term borrowings and fund capital expenditures. Internally generated funds, after making dividend payments, provide positive cash flow, but have not been at a level to meet the needs of our capital expenditure requirements. Management expects this trend to continue given our capital expenditures plan for the next five years. Some capital expenditures are funded by payments received from developers for contributions in aid of construction or advances for construction. Funds received for contributions in aid of construction are non-refundable, whereas funds classified as advances in construction are refundable. Management believes long-term financing is available to meet our cash flow needs through issuances in both debt and equity instruments.

Dividends

The third quarter common stock dividend of $0.1575 per share was paid on August 17, 2012, compared to a quarterly dividend in the third quarter of 2011 of $0.15375. This was our 270th consecutive, quarterly dividend. Annualized, the 2012 dividend rate is $0.63 per common share, compared to $0.615 in 2011. For the full year 2011, the payout ratio was 68% of net income. On a long-term basis, our goal is to achieve a dividend payout ratio of 60% of net income.

At its October 31, 2012 meeting, the Board declared the fourth quarter dividend of $0.1575 per share payable on November 23, 2012, to stockholders of record on November 12, 2012. This will be our 271st consecutive quarterly dividend.

2012 Financing Plan

Cal Water is currently reviewing its financing needs for the balance of 2012 and 2013. We intend to fund our capital needs in future periods through a relatively balanced approach between long-term debt and equity. The Company and Cal Water have a five-year syndicated unsecured revolving line of credit of $100 million and $300 million, respectively for short-term borrowings. As of September 30, 2012, the Company s availability on its new unsecured revolving line of credit was $60.1 million and Cal Water s availability on its new unsecured revolving line of credit was $300 million.

Book Value and Shareholders

Book value per common share was $11.33 at September 30, 2012 compared to $10.76 at December 31, 2011.

There are approximately 2,353 (not in thousands) stockholders of record of our common stock, as of November 1, 2012.

Utility Plant Expenditures

During the nine months ended September 30, 2012, capital expenditures totaled $99.6 million for company-funded and developer-funded projects. The planned 2012 company-funded capital expenditure budget is approximately $120 to $125 million. The actual amount may vary from the budget number due to timing of actual payments related to current year projects and prior year projects. We do not control third-party-funded capital expenditures and therefore are unable to estimate the amount of such projects for 2012.

At September 30, 2012, construction work in progress was $145.7 million compared to $107.0 million at September 30, 2011. Work in progress includes projects that are under construction but not yet complete and placed in service.

WATER SUPPLY

Our source of supply varies among our operating districts. Certain districts obtain all of their supply from wells; some districts purchase all of their supply from wholesale suppliers; and other districts obtain supply from a combination of wells and wholesale suppliers. A small portion of supply comes from surface sources and is processed through Company-owned water treatment plants. To the best of management s knowledge, we are meeting water quality, environmental, and other regulatory standards for all company-owned systems.

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California s normal weather pattern yields little precipitation between mid-spring and mid-fall. The Washington Water service areas receive precipitation in all seasons, with the heaviest amounts during the winter. New Mexico Water s rainfall is heaviest in the summer monsoon season. Hawaii Water receives precipitation throughout the year, with the largest amounts in the winter months. Water usage in all service areas is highest during the warm and dry summers and declines in the cool winter months. Rain and snow during the winter months replenish underground water aquifers and fill reservoirs, providing the water supply for subsequent delivery to customers. To date, snowpack water content and rainfall accumulation during the 2011 2012 water year is 83% of normal (as of October 1, 2012 per the California Department of Water Resources). Management believes that supply pumped from underground aquifers and purchased from wholesale suppliers will be adequate to meet customer demand during 2012 and beyond. Long-term water supply plans are developed for each of our districts to help assure an adequate water supply under various operating and supply conditions. Some districts have unique challenges in meeting water quality standards, but management believes that supplies will meet current standards using current treatment processes.

CONTRACTUAL OBLIGATIONS

During the nine months ended September 30, 2012, there were no material changes in contractual obligations outside the normal course of business.

Item 3.

QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

We do not hold, trade in or issue derivative financial instruments and therefore are not exposed to risks these instruments present. Our market risk to interest rate exposure is limited because the cost of long-term financing and short-term bank borrowings, including interest costs, is covered in consumer water rates as approved by the commissions. We do not have foreign operations; therefore, we do not have a foreign currency exchange risk. Our business is sensitive to commodity prices and is most affected by changes in purchased water and purchased power costs.

Historically, the CPUC s balancing account or offsetable expense procedures allowed for increases in purchased water and purchased power costs to be passed on to consumers. Traditionally, a significant percentage of our net income and cash flows comes from California regulated operations; therefore the CPUC s actions have a significant impact on our business. See Item 2, Management s Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies -Expense Balancing and Memorandum Accounts and Regulatory Matters .

Item 4.

CONTROLS AND PROCEDURES

(a) Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(c) under the Exchange Act) that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission s rules and forms, and that such information is accumulated and communicated to our management, including our CEO and CFO, as appropriate, to allow for timely decisions regarding required disclosure.

In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Accordingly, our disclosure controls and procedures have been designed to provide reasonable assurance of achieving their objectives.

Our management, with the participation of our CEO and our CFO, evaluated the effectiveness of our disclosure controls and procedures as of September 30, 2012. Based on that evaluation, we concluded that our disclosure controls and procedures were effective at the reasonable assurance level.

(b) Changes to Internal Control Over Financial Reporting

There was no change in our internal control over financial reporting that occurred during the last fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II OTHER INFORMATION

Item 1.

LEGAL PROCEEDINGS

From time to time, the Company is involved in various disputes and litigation matters that arise in the ordinary course of business. The status of each significant matter is reviewed and assessed for potential financial exposure. If the potential loss from any claim or legal proceeding is considered probable and the amount of the range of loss can be estimated, a liability is accrued for the estimated loss in accordance with the accounting standards for contingencies. Legal proceedings are subject to uncertainties, and the outcomes are difficult to predict. Because of such uncertainties, accruals are based on the best information available at the time. While the outcome of these disputes and litigation matters cannot be predicted with any certainty, management does not believe when taking into account existing reserves the ultimate resolution of these matters will materially affect the Company s financial position, results of operations, or cash flows. In the future, we may be involved in disputes and litigation related to a wide range of matters, including employment, construction, environmental issues and operations. Litigation can be time consuming and expensive and could divert management s time and attention from our business. In addition, if we are subject to additional lawsuits or disputes, we might incur significant legal costs and it is uncertain whether we would be able to recover the legal costs from ratepayers or other third parties.

Item 1A.

RISK FACTORS

There have been no material changes to the Company s risk factors set forth in Part I, Item 1A of the Company s Annual Report on Form 10-K for the year-ended December 31, 2011, filed with the SEC on February 29, 2012.

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Item 6.

EXHIBIT INDEX

Exhibit Number	Exhibit Title	Incorporated by Reference Form	File No.	Exhibit No.	Filing Date	Provided Herewith
3.1	Amended & Restated Bylaws	8-K	001-13883	3.1	9/27/2012	
31.1	Chief Executive Officer certification of financial statements pursuant to Section 302 of the Sarbanes- Oxley Act of 2002.					X
31.2	Chief Financial Officer certification of financial statements pursuant to Section 302 of the Sarbanes- Oxley Act of 2002.					X
32	Chief Executive Officer and Chief Financial Officer Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes- Oxley Act of 2002.					X
101.INS	XBRL Instance Document					X
101.SCH	XBRL Taxonomy Extension Schema Document					X
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document					X
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document					X
101.LAB	XBRL Taxonomy Extension Label Linkbase Document					X
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document					X

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SIGNATURES

Pursuant to the requirement 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.

CALIFORNIA WATER SERVICE GROUP
Registrant

November 7, 2012

By: /s/ Thomas F. Smegal
Thomas F. Smegal
Vice President, Chief Financial Officer and Treasurer

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