SMART ONLINE INC
Form 10-K
April 01, 2013

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

FORM 10-K

(Mark One)

þ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2012

or

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from __________ to __________

Commission file number 001-32634

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

Delaware (State or other jurisdiction of incorporation or organization)	95-4439334 (I.R.S. Employer Identification No.)
4505 Emperor Blvd., Ste. 320 Durham, North Carolina (Address of principal executive offices)	27703 (Zip Code)

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

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
N/A	N/A

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, $0.001 par value
(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. Yes ¨ No þ

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes þ No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

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

Large accelerated filer	o	Accelerated filer	o
Non-accelerated filer (Do not check if a smaller reporting company)	o	Smaller reporting company	þ

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

The aggregate market value of common stock held by non-affiliates of the registrant as of June 29, 2012 was approximately $27,528,678 (based on the closing sale price of $1.50 per share).

The number of shares of the registrant's Common Stock, $0.001 par value per share, outstanding as of March 21, 2013 was 18,352,542.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive Information Statement to be delivered to stockholders in connection with the Annual Meeting of Stockholders planned to be held on June 13, 2013 are incorporated by reference into Part III.

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PART I

Special Note Regarding Forward-Looking Statements

Information set forth in this Annual Report on Form 10-K contains various forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, or the Securities Act, and Section 21E of the Securities Exchange Act of 1934, or the Exchange Act, and other laws. Forward-looking statements consist of, among other things, trend analyses, statements regarding future events, future financial performance, our plan to build our business and the related expenses, our anticipated growth, trends in our business, the effect of interest rate fluctuations on our business, the potential impact of current or future litigation and government investigations, the potential availability of tax assets in the future and related matters, and the sufficiency of our capital resources, all of which are based on current expectations, estimates, and forecasts, and the beliefs and assumptions of our management. Words such as "expect," "anticipate," "project," "intend," "plan," "estimate," variations of such words, and similar expressions also are intended to identify such forward-looking statements. These forward-looking statements are subject to risks, uncertainties, and assumptions that are difficult to predict. Therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. Readers are directed to risks and uncertainties identified under Part I, Item 1A, "Risk Factors," and elsewhere in this report for factors that may cause actual results to be different than those expressed in these forward-looking statements. Except as required by law, we undertake no obligation to revise or update publicly any forward-looking statements for any reason.

ITEM 1. BUSINESS

General

In this Annual Report on Form 10-K, we refer to Smart Online, Inc. as “Smart Online,” the “Company,” “us,” “we,” and “our.” Smart Online was incorporated in Delaware in August 1993 and became a public company through a self-registration in February 2005. Smart Online’s common stock trades on the OTC Bulletin Board, or the OTCBB, under the symbol “SOLN”.

We develop and market a full range of mobile application software products and services that are delivered via a Software-as-a-Service, or SaaS, model. We also provide website and mobile consulting services to businesses and not-for-profit organizations.

The Company maintains a website for corporate information located at www.MobileSmith.com.

History

During the early stages of our development, we offered application-specific software using the “shrink-wrapped” method of distribution of diskettes and CD-ROMs, primarily through large office supply retailers. In 2000, we undertook a significant shift in our business strategy by moving away from the development and sale of shrink-wrapped software products and began developing SaaS applications for sale over the Internet.

Unlike the shrink-wrapped distribution method that requires the end user to install, configure, and maintain hardware, software, and network services internally to support the software applications, or the ASP (Active Server Pages) model that permits access to the software resident on a server by a user from one dedicated PC, our proprietary multi-tenant SaaS applications allow small businesses to subscribe and access those applications via a browser from any PC on an as-needed basis, with no installation or maintenance required by the end user.

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In 2010, we focused on the use of our e-commerce technology knowledge in the not-for-profit industry by introducing the Loyalty Clicks product, now renamed as SmartOnCause. The strategy of the e-commerce marketing was to provide funding sources for not-for-profit organizations while creating revenue for our Company. We reduced our emphasis on the SmartOnCause during 2011 as we found that charitable organizations did not embrace the product for their fund raising efforts.

Due to the current changes in technology, we recognized that smart phones are the primary communications device purchased today and therefore our technical team developed SmartOn™ Mobile– custom-developed, cross-platform smartphone applications and specific tools that provide businesses with the ability to better engage and assist their customers in leveraging innovative smartphone technology to perform specific business functions and online marketing. SmartOn™ Mobile was rebranded as MobileSmith™ in the first quarter of 2013.

Principal Products and Services

Our principal products and services include:

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

Our SaaS applications are designed to allow end users to access and work on information securely from any location where an Internet browser can be accessed.

Our mobile solutions are designed to enable secure data and content distribution and two-way exchange from any location using mobile devices running iOS and Android operating systems. Our technology enables us to deliver mobile applications that resolve a variety of business problems and provide robust and innovative mobile service architecture and infrastructure; cutting-edge push messaging, integrated newsfeeds and geo-location services.

We also provide services that are designed to complement our product offerings and allow us to create custom business solutions that fit our channel partners' needs (channel partners are organizations that cooperate with our Company to market and sell our products and services.) These services include mobile strategy consulting, graphic design, custom mobile software development, and mobile applications marketing.

Mode of Operations

Software-as-a-Service Model – We follow the SaaS model for delivering our products and services to end users. The on-demand SaaS model developed using multi-tenant architecture enables end users to visit a website and use the SaaS applications, all via a web browser, with no installation, no special information technology knowledge, and no maintenance. The SaaS application is transformed into a service that can be used anytime and anywhere by the end user. Multi-tenant SaaS applications also permit us to add needed functionality to our applications in one location for the benefit of all end users. This capability allows us to provide upgrades universally.

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Integration and Sharing – Our SaaS applications have the capability to allow secure sharing of information (with selectivity and control options) among members of an organization. Each company that subscribes to our SaaS applications can have multiple members or employees who share information with one another. Information entered by one employee can be shared and modified by one or more other employees who have the appropriate access authority.

Target Market and Sales Channels

Our main focus is to enable organizations to get to market quickly with mobile applications as part of an integrated marketing strategy, using our flagship MobileSmith™ platform. The current market is focusing on two ways of delivering mobile apps: 1) limited template-based applications and 2) time consuming and expensive custom development projects, either internal or outsourced. The unique nature of our platform allows organizations of any size, regardless if they wish to deliver one application or a catalog of applications, to take control over the development of these apps within the creative parts of the organization where the needs are identified. This control would not limit them to a template nor would it require the use of developers. We find that these needs are the highest among organizations that have a high business to consumer component and want to deliver their brand via the mobile application space but do so in a more cost effective and time efficient manner. Our market approach is to sell directly to organizations that have mobile marketing needs, as well as to cultivate reseller relationships with potential viable partners in this space. In addition, where these needs are complex and the target customers are not able to develop their own strategy, to provide consulting engagements to help organizations define and deliver on their mobile strategy.

Principal Customers

In 2012, we had two major customers as our major sources of revenue (approximately 69%).

On October 11, 2012, the Company terminated its Web Services Agreement dated October 11, 2010, or the Web Services Agreement, with UR Association, or URA, one of its principal customers. The Company terminated the Web Services Agreement at the contract termination date because it no longer intended to provide the specialized type of services required by URA. The Company did not incur any material termination penalties as a result of its termination of the Web Services Agreement.

Research and Development

During 2010 and 2011, we continued the development work of SaaS applications for the not-for profit segment of the marketplace and in 2011 began the work that led to the MobileSmith™ platform. During 2012, we focused on the delivery of mobile applications through our MobileSmith™ platform, which allows our customers to better communicate with their members, customers and constituents without reinventing the Application each time they need to make changes.

Our research and development costs were approximately $541,605 and $375,000 in 2012 and 2011, respectively. We have not engaged in any customer-sponsored research and development.

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Competition

The market for mobile applications and small-business software applications in both the traditional and SaaS environments is highly competitive and subject to rapid changes in technology and delivery. The direct competition we face depends on the software application within our platforms and the delivery model capabilities of our competitors.

We have two primary categories of competitors: large companies that offer a wide range of products for small- to medium-size businesses, and companies that offer only one or two software products that compete with our product offering. Our principal direct competition is a number of very large vendors of SaaS applications for small businesses that sell many products similar to ours. These competitors include, but are not limited to, IBM, Microsoft, Oracle, NetSuite, Intuit, SAP, and Google.

Companies that offer only one or two products that compete with our suite of mobile SaaS applications include: Kony, Simplicate, Appcelerator, BiznessApps, EachScape and Verivo.

Although we believe we offer highly competitive services and software, many of our competitors do or may have greater resources and a larger number of total customers for their products and services. In addition, a number of our competitors already sell certain products to our current and potential customers, as well as to systems integrators and other vendors and service providers. These competitors may be able to respond more quickly to new or emerging technologies and changes in customer requirements, or to devote greater resources to the development, promotion, and sale of their products, than we can. It is also possible that new competitors or alliances among competitors or other third parties may emerge and rapidly acquire market share. Increased competition may result in price reductions, reduced gross margins, and change in market share, any of which could adversely impact our revenue and profitability targets and timetables.

On each competitive front, we seek to compete against these larger and better-financed companies primarily by offering a specialized mobile SaaS platform that is useful to businesses. To meet our business objectives, we will need to continue to develop high quality and competitively priced new application blocks for our mobile SaaS platform. If we are unable to do so, our revenue and profitability targets and timetables could be adversely impacted.

To compete effectively in the SaaS market, we leverage our marketing resources and business customer relationships to sell our mobile SaaS platform and applications by offering innovative and cost-effective products and services.

Intellectual Property

Our success depends, in part, upon our proprietary technology, processes, trade secrets, and other proprietary information and our ability to protect this information from unauthorized disclosure and use. We rely on a combination of patents, copyright, trade secret, and trademark laws, confidentiality procedures, contractual provisions, and other similar measures to protect our proprietary information. We do not own any issued patents but we do have patent applications pending for our MobileSmith™ product, including “Development Platform for Mobile Applications, Design Canvas and Software n Builder” at this time, the US Patent Office has acknowledge receipt of the filings and we continue to document our technology. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy or design around certain aspects of our SaaS offerings or to obtain and use information that we regard as proprietary, and third parties may attempt to develop similar technology independently. In addition, the laws of some foreign countries do not protect our proprietary rights to the same extent as do the laws of the United States, and we expect that it will become more difficult to monitor use of our products if we develop an international presence.

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We have registered copyrights, trademarks, and registered service marks on several products and data services. These include, but are not limited to MobileSmith™®, Smart Online®, loyaltyclicks®, appcycle®, appcanvas®, appforge®, appoffice®, OneBiz®, and OneDomain®.

As part of our efforts to protect our proprietary information, we enter into license agreements with our customers and nondisclosure agreements with our employees, consultants, and corporate partners. These agreements generally contain restrictions on disclosure, use, and transfer of our proprietary information for a period of three years. We also employ various physical and technological security measures to protect our software source codes, technology, and other proprietary information.

Employees

As of December 31, 2012, we had 25 full-time employees and 2 part-time employees. No employees are known by us to be represented by a collective bargaining agreement, and we have never experienced a strike or similar work stoppage.

Executive Officers of the Company

Our current executive officers are the following:

Robert Brinson
Chief Executive Officer since September, 2012. Mr. Brinson was appointed by the Board of Directors at the September 2012 meeting after serving as a member of the Board of Directors and technology consultant since September 2011, during which time he served as the Chair of the Company's Innovation Committee.
From 2005 to 2007, Mr. Brinson was a board member and Chief Technology Officer of IntelliScience Corporation, a developer of intelligent multi-model image analysis systems and software. In 2007, he became a board member and Chief Technology Officer of IP Tank, LLC. Mr. Brinson is currently the Chief Visionary Officer of Apokalyyis, Inc., a developer of advanced data analysis for national defense and healthcare industry, and serves on their board. He serves as Chief Technology Officer of Affirm ID, LLC. Mr. Brinson serves as Chief Technology Officer of IISSEE, LLC., a company specializing in local search solutions, and serves as their board.

Thaddeus Shalek
Chief Financial Officer since August 2009.
Mr. Shalek was the CFO of Lindell Investments, Inc., a closely held national real estate development company in Tampa, Florida from June 2006 until April 2008, the CEO and CFO of Vertical Health Solutions, Inc., Oldsmar, Florida form October 2004 to June 2006 and the owner and president of Shalek & Associates, CPA's Inc., a Certified Public Accounting firm in Cleveland, Ohio providing accounting, tax and consulting services to small and medium sized businesses from 1984 through December 2004. Mr. Shalek worked as an auditor and tax manager with Coopers & Lybrand (now PricewaterhouseCoopers) and currently teaches accounting and entrepreneurial finance, on a part-time basis, at the University of North Carolina at Greensboro. He was an adjunct instructor of business, accounting and taxation at Cuyahoga Community College of Cleveland, Ohio. Mr. Shalek earned his BSBA from John Carroll University, Cleveland, Ohio and his MBA from The University of Tampa. Mr. Shalek has served on numerous charitable and business boards throughout his career. Mr. Shalek announced his resignation from his positions with our Company, effective as of 6:00 PM on April 1, 2013.

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Available Information

Our corporate information is accessible through our main web portal at www.MobileSmith.com. We are not including the information contained on our website as a part of, or incorporating it by reference into, this Annual Report on Form 10-K. Although we endeavor to keep our website current and accurate, there can be no guarantees that the information on our website is up to date or correct. We make available, free of charge, access to all reports filed with the U.S. Securities and Exchange Commission, or SEC, including our Annual Reports on Form 10-K, our Quarterly Reports on Form 10-Q, our Current Reports on Form 8-K, and amendments to these reports, filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act, as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC. These reports may be accessed by following the link under "About Us - Investor Relations" on our website.

ITEM 1A. RISK FACTORS

We operate in a dynamic and rapidly changing business environment that involves substantial risk and uncertainty, and these risks may change over time. The following discussion addresses some of the risks and uncertainties that could cause, or contribute to causing, actual results to differ materially from expectations. In evaluating our business, you should pay particular attention to the descriptions of risks and uncertainties described below. These risks and uncertainties are not the only ones we face. Additional risks and uncertainties not presently known to us, which we currently deem immaterial, or that are similar to those faced by other companies in our industry or business in general, may also affect our business. If any of the risks described below actually occur, our business, financial condition, or results of operations could be materially and adversely affected.

Historically, we have operated at a loss, and we continue to do so.

We have had recurring losses from operations and continue to have negative cash flows. If we do not become cash flow positive through additional financing or growth, we may have to cease operations and liquidate our business. Our working capital, which is dependent on our convertible note financing facility, should fund our operations for the next 2 to 3 months. As of March 21, 2013, we have approximately $1.34 million available through our convertible note financing facility. The Board of Directors of the Company is currently negotiating with the noteholders under the convertible note financing facility, or the Noteholders, to increase the convertible note financing facility by an additional $5 million. Factors such as the commercial success of our existing services and products, the timing and success of any new services and products, the progress of our research and development efforts, our results of operations, the status of competitive services and products, the timing and success of potential strategic alliances or potential opportunities to acquire technologies or assets, and expenses may require us to seek additional funding sooner than we expect. If we fail to raise sufficient financing, we will not be able to implement our business plan and may not be able to sustain our business.

In addition, our current primary credit facilities consist of the IDB Credit Facility with a due date of May 31, 2013 and the convertible note financing with a maturity date on November 14, 2016. Should we be unable to repay the principal then due from operations or from new or renegotiated capital funding sources, we may not be able to sustain our business. As of March 21, 2013, we have $5.0 million outstanding on our credit facility with IDB Bank and approximately $21.96 million aggregate principal amount of convertible secured subordinated notes, or the Notes, outstanding. We are currently working with IDB to extend our IDB Credit Facility for an additional one-year period with similar terms as those currently in place. We believe that we will be successful in our efforts.

If we are unsuccessful in renegotiating the IDB Credit Fcility, all Notes would become due.

Our independent registered public accounting firm indicates that it has substantial doubts that we can continue as a going concern. Our independent registered public accounting firm’s opinion may negatively affect our ability to raise additional funds, among other things. If we fail to raise sufficient capital, we will not be able to implement our business plan, we may have to liquidate our business, and you may lose your investment.

Cherry Bekaert, LLP, our independent registered public accounting firm has expressed substantial doubt in its report included with this Annual Report on Form 10-K about our ability to continue as a going concern given our recurring losses from operations and deficiencies in working capital and equity, which are described in the first risk factor above. This opinion could materially limit our ability to raise additional funds by issuing new debt or equity securities or otherwise. If we fail to raise sufficient capital, we will not be able to implement our business plan, we may have to liquidate our business, and you may lose your investment. You should consider our independent registered public accounting firm’s comments when determining if an investment in us is suitable.

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Current economic uncertainties in the global economy could adversely impact our growth, results of operations, and our ability to forecast future business.

Since 2008 there has been a downturn in the global economy, slower economic activity, decreased consumer confidence, reduced corporate profits and capital spending, adverse business conditions, and liquidity concerns. These conditions make it difficult for our customers and us to accurately forecast and plan future business activities, and they could cause our customers to slow or defer spending on our products and services, which would delay and lengthen sales cycles, or change their willingness to enter into longer-term licensing and support arrangements with us. Furthermore, during challenging economic times our customers may face issues gaining timely access to sufficient credit, which could result in an impairment of their ability to make timely payments to us. If that were to occur, we may be required to increase our allowance for doubtful accounts and our results would be negatively impacted.

We may also face difficulties in obtaining additional credit or renewing existing credit at favorable terms, or at all, which could impact our ability to fund our operations or to meet debt repayment requirements as they come due.

We cannot predict the timing, strength, or duration of any economic slowdown or subsequent economic recovery. If the downturn in the general economy or markets in which we operate persists or worsens from present levels, our business, financial condition, and results of operations could be materially and adversely affected.

Until recently, we relied on our two major customers for most of our revenues. In the fourth quarter of 2012, we lost one of these major customers. The loss of the remaining major customer will have an adverse effect on our business.

Our two major customers accounted for approximately 69% of our revenues for the year ended December 31, 2012. In October 2012, we terminated our Web Services Agreement with URA one of the major customers, because we no longer intended to provide the specialized type of services required by URA. As a result, we currently have one remaining major customer. The loss of this customer or a reduction in its levels of business will adversely affect our business, operating results and financial condition.

Our online business model is vulnerable and is subject to cyber crime.

On June 28, 2012, our internal corporate network was compromised and portions of our proprietary products were intentionally deleted from the network and most back-up devices. The Company engaged professional security information technology specialists to remediate the problem and contacted the government agencies that oversee cyber crime. While it appears that no individual customer information was addressed or stolen, this occurrence could have destroyed our foundation. Appropriate steps were taken to recover large portions of the data and the development team recovered the system, but we cannot assure that a similar problem will not occur in the future. We were asked not to make the occurrence known until now due to the ongoing investigation into the matter by the government agencies; accordingly, in the future, if another incidence were to occur we may be subject to restriction on our disclosure.

Our business is dependent upon the development and market acceptance of our applications.

Our future financial performance and revenue growth will depend, in part, upon the successful development, integration, introduction, and customer acceptance of our software applications. Thereafter, other new products, whether developed or acquired, and enhanced versions of our existing applications will be critically important to our business. Our business could be harmed if we lose one of our two major customers or fail to deliver timely enhancements to our current and future solutions that our customers desire. We also must continually modify and enhance our services and products to keep pace with market demands regarding hardware and software platforms, database technology, information security, and electronic commerce technical standards. Our business could be harmed if we fail to achieve the improved performance that customers want with respect to our current and future product offerings. There can be no assurance that our products will achieve widespread market penetration or that we will derive significant revenues from the sale or licensing of our platforms or applications.

We have not yet demonstrated that we have a successful business model.

We have invested significantly in infrastructure, operations, and strategic relationships to support our mobile SaaS platform model, which represents a significant departure from the delivery strategies that we and other software vendors have traditionally employed. To maintain positive margins for our small-business services, our revenues will need to continue to grow more rapidly than the cost of such revenues. We anticipate that our future financial performance and revenue growth will depend, in large part, upon our Internet-based SaaS business model, mobile phone platform and the results of our sales efforts to reach agreements with marketing partners with small-business customer bases, but this business model may become ineffective due to forces beyond our control that we do not currently anticipate. Although we currently have various agreements and continue to enter into new agreements, our success depends in part on the ultimate success of our marketing partners and referral partners and their ability to market our products and services successfully. Our partners are not obligated to provide potential customers to us and may have difficulty retaining customers within certain markets that we serve. In addition, some of these third parties have entered, and may continue to enter, into strategic relationships with our competitors. Further, many of our strategic partners have multiple strategic relationships, and they may not regard us as significant for their businesses. Our strategic partners may terminate their respective relationships with us, pursue other partnerships or relationships, or attempt to develop or acquire products or services that compete with our products or services. Our strategic partners also may interfere with our ability to enter into other desirable strategic relationships. If we are unable to maintain our existing strategic relationships or enter into additional strategic relationships, we will have to devote substantially more resources to the distribution, sales, and marketing of our products and services.

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In addition, our end users currently do not sign long-term contracts. They have no obligation to renew their subscriptions for our services after the expiration of their initial subscription period and, in fact, they have often elected not to do so. Our end users also may renew for a lower-priced edition of our services or for fewer users. These factors make it difficult to accurately predict customer renewal rates. Our customers' renewal rates may decline or fluctuate as a result of a number of factors, including when we begin charging for our services, their dissatisfaction with our services, and their capability to continue their operations and spending levels. If our customers do not renew their subscriptions for our services or we are not able to increase the number of subscribers, our revenue may decline and our business will suffer.

Failure to comply with the provisions of our debt financing arrangements could have a material adverse effect on us.

Our IDB Credit Facility is secured by an irrevocable standby letter of credit issued by UBS Private Bank, with Atlas Capital SA, or Atlas, as account party. Our secured subordinated convertible notes are secured by a first priority lien on all of our unencumbered assets.

If an event of default occurs under our debt financing arrangements and remains uncured, then the lender could foreclose on the assets securing the debt. If that were to occur, it would have a substantial adverse effect on our business. In addition, making the principal and interest payments on these debt arrangements may drain our financial resources or cause other material harm to our business.

If our security measures are breached and unauthorized access is obtained to our customers' data or our data, our service may be perceived as not being secure, customers may curtail or stop using our service, and we may incur significant legal and financial exposure and liabilities.

Our service involves the storage and transmission of customers' proprietary information. If our security measures are breached as a result of third-party action, employee error, malfeasance or otherwise and, as a result, unauthorized access is obtained to our customers' data or our data, our reputation could be damaged, our business may suffer, and we could incur significant liability. In addition, third parties may attempt to fraudulently induce employees or customers to disclose sensitive information such as user names, passwords, or other information in order to gain access to our customers' data or our data, which could result in significant legal and financial exposure and a loss of confidence in the security of our service that would harm our future business prospects. Because the techniques used to obtain unauthorized access, or to sabotage systems, change frequently and generally are not recognized until launched against a target, we may be unable to anticipate these techniques or to implement adequate preventative measures. If an actual or perceived breach of our security occurs, the market perception of the effectiveness of our security measures could be harmed and we could lose sales and customers.

The SEC and criminal actions brought against certain former employees, and related stockholder and other lawsuits have damaged our business, and they could damage our business in the future.

An SEC lawsuit and criminal actions filed against a former officer and a former employee, and the class action lawsuit filed against us and certain current and former officers, directors, and employees, Mary Jane Beauregard v. Smart Online, Inc., et al., or the Class Action, filed in the United States District Court for the Middle District of North Carolina, or the District Court, have harmed our business in many ways and may cause further harm in the future. Since the initiation of these actions, our ability to raise financing from new investors on favorable terms has suffered due to the lack of liquidity of our stock, the questions raised by these actions, and the resulting drop in the price of our common stock. As a result, we may not raise sufficient financing, if necessary, in the future. Dennis Michael Nouri, Reza Eric Nouri, former officer and a former employee of the Company were found guilty in July 2009. On June 18, 2010, the Company entered into a Settlement Agreement, or the Settlement Agreement, with Dennis Michael Nouri, Reza Eric Nouri, Henry Nouri and Ronna Loprete Nouri, collectively, the Nouri Parties, in settlement of claims filed by the Nouri Parties against the Company in the Court of Chancery of the State of Delaware for advancement of legal expenses and indemnification. The Settlement Agreement provided for the payment by the Company of up to $1,400,000 for the benefit of the Parties. These funds have all been paid.

We are required to issue 1,475,000 shares of our common stock to the Class Action class in connection with the Company's Class Action lawsuit settlement approved by the District Court on July 1, 2011 (see Note 7, "Commitments and Contingencies – Legal Proceedings"). These shares have not been issued as of March 21, 2013.

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Legal and other fees related to these and other actions described in Item 3 have also reduced our available cash for operations. We make no assurance that we will not continue to experience additional harm as a result of these matters. The time spent by our management team and directors dealing with issues related to these actions detracts, and despite the tentative settlement of the Class Action continue to detract, from the time they spend on our operations, including strategy development and implementation. These actions, more fully described in Part II, Item 8, Note 7, “Commitments and Contingencies – Legal Proceedings” in this Annual Report on Form 10-K, also have harmed our reputation in the business community, jeopardized our relationships with vendors and customers, and decreased our ability to attract qualified personnel, especially given the media coverage of these events.

Compliance with regulations governing public company corporate governance and reporting is uncertain and expensive.

As a public company, we have incurred and will continue to incur significant legal, accounting, and other expenses that we did not incur as a private company. We incur costs associated with our public company reporting requirements and with corporate governance and disclosure requirements, including requirements under the Sarbanes-Oxley Act of 2002, or Sarbanes-Oxley, and rules implemented by the SEC. We expect these rules and regulations to increase our legal and financial compliance costs and to make some activities more time consuming and costly.

We currently are required to comply with the requirements of Section 404 of Sarbanes-Oxley involving management’s assessment of our internal control over financial reporting. To comply with this requirement, we are evaluating and testing our internal controls, and where necessary, taking remedial actions, to allow management to report on our internal control over financial reporting. As a result, we have incurred and will continue to incur expenses and diversion of management’s time and attention from the daily operations of the business, which may increase our operating expenses and impair our ability to achieve profitability.

Officers, directors, and principal stockholders control us. This might lead them to make decisions that do not align with interests of minority stockholders.

Our principal stockholders beneficially own or control a large percentage of our outstanding common stock. Certain of these principal stockholders hold convertible Notes, which may be exercised or converted into additional shares of our common stock under certain conditions. The convertible noteholders have designated a bond representative to act as their agent. We have agreed that the bond representative shall be granted access to our facilities and personnel during normal business hours, shall have the right to attend all meetings of our Board of Directors and its committees, and shall receive all materials provided to our Board of Directors or any committee of our Board. In addition, so long as the notes are outstanding, we have agreed that we will not take certain material corporate actions without approval of the bond representative.

Our principal stockholders, acting together, would have the ability to control substantially all matters submitted to our stockholders for approval (including the election and removal of directors and any merger, consolidation, or sale of all or substantially all of our assets) and to control our management and affairs. Accordingly, this concentration of ownership may have the effect of delaying, deferring, or preventing a change in control of us; impeding a merger, consolidation, takeover, or other business combination involving us; or discouraging a potential acquirer from making a tender offer or otherwise attempting to obtain control of us, which in turn could materially and adversely affect the market price of our common stock.

Any issuance of shares of our common stock in the future could have a dilutive effect on the value of our existing stockholders’ shares.

We may issue shares of our common stock or other securities in the future for a variety of reasons. Upon maturity of their convertible Notes, our convertible noteholders may elect to convert all, a part of, or none of their Notes into shares of our common stock at a floating conversion price.

If we raise additional funds through the issuance of equity securities or debt convertible into equity securities, the percentage of stock ownership by our existing stockholders would be reduced. In addition, such securities could have rights, preferences, and privileges senior to those of our current stockholders, which could substantially decrease the value of our securities owned by them. Depending on the share price we are able to obtain, we may have to sell a significant number of shares in order to raise the necessary amount of capital. Our stockholders may experience dilution in the value of their shares as a result.

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Our securities may be subject to “penny stock” rules, which could adversely affect our stock price and make it more difficult for our stockholders to resell their stock.

The SEC has adopted rules that regulate broker-dealer practices in connection with transactions in penny stocks. Penny stocks are generally equity securities with a price of less than $5.00 per share (other than securities registered on certain national securities exchanges or quotation systems, provided that reports with respect to transactions in such securities are provided by the exchange or quotation system pursuant to an effective transaction reporting plan approved by the SEC).

The penny stock rules require a broker-dealer, prior to a transaction in a penny stock not otherwise exempt from those rules, to deliver a standardized risk disclosure document prescribed by the SEC and certain other information related to the penny stock, the broker-dealer compensation in the transaction, and the other penny stocks in the customer’s account.

In addition, the penny stock rules require that, prior to a transaction in a penny stock not otherwise exempt from those rules, the broker-dealer must make a special written determination that the penny stock is a suitable investment for the purchaser and receive the purchaser’s written acknowledgment of the receipt of a risk disclosure statement, a written agreement related to transactions involving penny stocks, and a signed and dated copy of a written suitability statement. These disclosure requirements could have the effect of reducing the trading activity in the secondary market for our stock because it will be subject to these penny stock rules. Therefore, stockholders may have difficulty selling those securities.

The executive management team is critical to the execution of our business plan, and the frequency of management turnover has been disruptive to the success of the business.

Our executive management team has experienced significant changes in the last five years, including the resignation of our former Chief Executive Officer in December 2008, our former interim Chief Executive Officers in May 2009 and November 2009 and the resignation of our former Chief Financial Officer in May 2009, among others. In 2012, our former Chief Operating Officer resigned and in March 2013, our Chief Financial Officer announced his resignation, effective as of 6:00 PM on April 1, 2013.   If we cannot attract and retain qualified personnel and integrate new members of our executive management team effectively into our business, then our business and financial results may suffer. In addition, all of our executive team works at the same location, which could make us vulnerable to the loss of our entire team in the event of a natural or other disaster. We do not maintain key man insurance policies on any of our employees.

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ITEM 1B. UNRESOLVED STAFF COMMENTS

Not applicable.

ITEM 2. PROPERTIES

Our corporate headquarters and research and development facility is located in Durham, North Carolina near Research Triangle Park and consists of approximately 9,837 square feet of office space held under a prepaid sublease that expires on November 15, 2013. We believe that the space available in our facility is adequate to meet our current needs. We are currently considering relocating to a new facility at the expiration of our lease.

ITEM 3. LEGAL PROCEEDINGS

Not applicable.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

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PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock is quoted on the OTCBB under the symbol "SOLN." The following table sets forth the range of high and low sales prices of our common stock quoted on the OTCBB for the quarterly periods indicated. These quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not necessarily represent actual transactions.

	High	Low
Year Ended December 31, 2011:		
First Quarter	$ 1.45	$ 1.01
Second Quarter	$ 1.38	$ 0.51
Third Quarter	$ 1.40	$ 0.80
Fourth Quarter	$ 1.40	$ 0.55
Year Ended December 31, 2012:		
First Quarter	$ 1.49	$ 0.50
Second Quarter	$ 1.55	$ 0.90
Third Quarter	$ 1.50	$ 1.02
Fourth Quarter	$ 1.40	$ 1.20

At March 21, 2012, there were 176 holders of record of our common stock.

We have never declared or paid any cash dividends on our common stock and do not intend to declare or pay dividends for the foreseeable future. As long as our convertible notes are outstanding, we must receive approval from the agent designated by the noteholders in order to pay any dividend on our capital stock.

During the fourth quarter of 2012, none of our securities registered under Section 12 of the Exchange Act were repurchased by or on behalf of us or any affiliated purchaser.

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ITEM 6. SELECTED FINANCIAL DATA

Not applicable.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Executive Summary

The following discussion is designed to provide a better understanding of our financial statements, including a brief discussion of our business and products, key factors that impacted our performance, and a summary of our operating results. This executive summary, including the remarks on page 20, should be read in conjunction with the more detailed discussion and analysis of our financial condition and results of operations in this Item 7 Item 1A, "Risk Factors" and our financial statements and the notes thereto included in Item 8, "Financial Statements and Supplementary Data."

Overview

We develop and market a full range of mobile application software products and services that are delivered via a SaaS model. We also provide website and mobile consulting services to not-for-profit organizations and businesses.

Sources of Revenue

We derive revenues from the following sources:

Subscription fees – monthly fees charged to customers for access to our SaaS applications

Professional service fees – fees related to consulting services, some of which complement our other products and applications

License fees – fees charged for perpetual or term licensing of platforms or applications

Hosting fees – fees charged for providing network accessibility for our customers using our customized platforms

Other revenues – revenues generated from non-core activities such as merchant processing fees; original equipment manufacturer, or OEM, contracts; and miscellaneous other revenues

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Subscription fees primarily consist of sales of subscriptions to end users. We make subscription sales either on a subscription or on a “for fee” basis. Subscriptions are generally payable on a monthly basis. In the past, we recognized all subscription revenue on a gross basis and in accordance with our policy to periodically review our accounting policies we recognized that certain contracts require the reporting of subscription revenue on a gross basis and others on a net basis according to United States Generally Accepted Accounting Principles or US GAAP. On that basis, we continue to report subscription revenue from certain contracts on a gross basis and others on a net basis, where applicable. The net effect of this reclassification of expenses only impacts gross revenue and certain gross expenses; it does not change the net income. We discuss this matter in more depth in Note 2 to the financial statements.

We generate professional service fees from our consulting services. For example, a customer may request that we design/build an application to better accommodate products or to improve its own mobile application. We bill professional service fees on a time and material basis or as a fixed fee in some cases.

Cost of Revenues

Cost of revenues primarily is composed of salaries associated with maintaining and supporting customers, the cost of domain name and e-mail registrations, and the cost of external facilities where our applications and our customers’ customized applications are hosted.

Operating Expenses

During 2012 and 2011, our business initiatives included increasing license fee revenue and professional services revenue, making organizational improvements, concentrating our development efforts for our mobile platform and applications, and shifting our strategic focus to the sales and marketing of our products. We also provided services for our subscription fee customers and focused our efforts on improving our current technology.

General and Administrative – General and administrative expenses are composed primarily of costs associated with our executive, finance and accounting, legal, human resources, and information technology personnel and consist of salaries and related compensation costs; professional services (such as outside legal counsel fees, audit, and other compliance costs); depreciation and amortization; facilities and insurance costs; and travel and other costs.

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Sales and Marketing – Sales and marketing expenses are composed primarily of costs associated with our sales and marketing activities and consist of salaries and related compensation costs of our sales and marketing personnel, travel and other costs, and marketing and advertising expenses. In the past, we spent limited funds on marketing, advertising, and public relations, particularly due to our prior business model of partnering with established companies with extensive small-business customer bases. As we execute our current sales and marketing strategy to market our platform products, we expect associated costs to increase in 2013 due to targeting new partnerships, development of channel partner enablement programs, participation in multiple tradeshows, advertising campaigns, additional sales and marketing personnel, and the various percentages of revenues we may be required to pay to future partners as marketing fees.

Research and Development – Research and development expenses include costs associated with the development of new products, enhancements of existing products, and general technology research. These costs are composed primarily of salaries and related compensation costs of our research and development personnel as well as outside consultant costs.

Accounting standards require capitalization of certain software development costs subsequent to the establishment of technological feasibility, with costs incurred prior to this time expensed as research and development. Technological feasibility is established when all planning, designing, coding, and testing activities that are necessary to establish that the product can be produced to meet its design specifications have been completed. At the end of the third quarter of 2011, our technical team achieved technological feasibility for our MobileSmith™ platform product and continues to develop features and applications. As a result, we capitalized a portion of the costs incurred during the fourth quarter of 2011 and during 2012 into capitalized software in our balance sheet at December 31, 2012. In the past, we had not developed detailed design plans for our SaaS applications, and the costs incurred between the completion of a working model of these applications and the point at which the products were ready for general release had been insignificant and as a result of low revenue generated by the sale of the prior applications that did not support the net realizable value of any capitalized costs, we continued the expensing of underlying costs as research and development.

Stock-Based Expenses – Our operating expenses include stock-based expenses related to options, restricted stock awards, and warrants issued to employees and non-employees. These charges have been significant and are reflected in our historical financial results and will continue to result in material costs on a prospective basis as long as a significant number of options are outstanding. The following table identifies recent outstanding grants of options:

Date of Grant	Grantee	Title	Number of Options	Initial Vesting Date	Expense	
					2012	2011
February 1, 2010	Robert Dieterle	VP & General Manager	75,000	February 1, 2011	$11,761	$10,660
October 21, 2010	Employees	Various	68,000	January 15, 2011	$7,474	$9,371
August 1, 2011	Employees	Various	8,400	November 1, 2011	$987	$163
September 14, 2011	Robert M. Brinson	Board Member	20,000	December 15, 2011	$14,103	$1,163
April 1, 2012	Employees	Various	5,000	July 1, 2012	$294	-
May 15, 2012	Employees	Various	12,500	August 15, 2012	$248	-
June 13, 2012			75,000		$1,188	-

	Robert W. Hancock	Vice President of Sales		September 13, 2012		
September 11, 2012	Robert M. Brinson	Chief Executive Officer	75,000	December 11, 2012	$3,334	-

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During the second quarter of 2011, we issued 10,000 restricted shares of stock to Mr. Shlomo Elia for his services as a member of the Board of Directors as a result $13,850 of expense was recognized in 2011. There were no shares of restricted stock canceled during 2012 due to terminations and payment of employee tax obligations resulting from share vesting. At December 31, 2012, there was $159,485 of unvested expense yet to be recorded related to all stock options outstanding.

Critical Accounting Policies and Estimates

Our discussion and analysis of financial condition and results of operations are based upon our financial statements, which we prepared in accordance with US GAAP. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues, and expenses and related disclosures of contingent assets and liabilities. “Critical accounting policies and estimates” are defined as those most important to the financial statement presentation and that require the most difficult, subjective, or complex judgments. We base our estimates on historical experience and on various other factors that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Under different assumptions and/or conditions, actual results of operations may materially differ. We periodically reevaluate our critical accounting policies and estimates, including those related to revenue recognition, provision for doubtful accounts, expected lives of customer relationships, useful lives of intangible assets and property and equipment, provision for income taxes, valuation of deferred tax assets and liabilities, and contingencies and litigation reserves. We believe the following critical accounting policies involve the most significant judgments and estimates used in the preparation of our financial statements.

Revenue Recognition – We derive revenue primarily from subscription fees charged to customers accessing our SaaS applications; professional service fees, consisting primarily of consulting; the perpetual or term licensing of software platforms or applications; and hosting and maintenance services.

In accordance with Financial Accounting Standard Board or FASB and SEC Staff Accounting guidance on revenue recognition the Company considers revenue earned and realizable when: (a) persuasive evidence of the sales arrangement exists, (b) the arrangement fee is fixed or determinable, (c) service delivery or performance has occurred, (d) customer acceptance has been received, if contractually required, and (e) collectability of the arrangement fee is probable. The Company typically uses signed contractual agreements as persuasive evidence of a sales arrangement. We apply the provisions of the relevant FASB accounting pronouncements when making estimates or assumptions related to transactions involving the license of software where the software deliverables are considered more than inconsequential to the other elements in the arrangement. For contracts that contain multiple deliverables, we analyze the revenue arrangements when making estimates or assumptions in accordance with the appropriate authoritative guidance, which provides criteria governing how to determine whether goods or services that are delivered separately in a bundled sales arrangement should be considered as separate units of accounting for the purpose of revenue recognition. Deliverables are accounted for separately if they meet all of the following criteria: (a) the delivered item has value to the customer on a stand-alone basis; (b) there is objective and reliable evidence of the fair value of the undelivered items; and (c) if the arrangement includes a general right of return relative to the delivered items, the delivery or performance of the undelivered items is probable and substantially controlled by the Company.

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

We account for consulting, website design fees and application development services separately from the license of associated software platforms when these services have value to the customer and there is objective and reliable evidence of fair value of each deliverable. When accounted for separately, we recognize revenue as the services are rendered for time and material contracts, and when milestones are achieved and accepted by the customer for fixed price or long-term contracts. The majority of our consulting service contracts are on a time and material basis, and we typically bill our customers monthly based upon standard professional service rates.

Application development services are typically fixed price and of a longer term. As such, we account for them as long-term construction contracts that require us to recognize revenue based on estimates involving total costs to complete and the stage of completion. Our assumptions and estimates made to determine the total costs and stage of completion may affect the timing of revenue recognition, with changes in estimates of progress to completion and costs to complete accounted for as cumulative catch-up adjustments. If the criteria for revenue recognition on construction-type contracts are not met, we capitalize the associated costs of such projects and include them in costs in excess of billings on the balance sheet until such time that we are permitted to recognize revenue.

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Subscription fees primarily consist of sales of subscriptions to end users. We make subscription sales either on a subscription or on a "for fee" basis. Subscriptions are generally payable on a monthly basis. We have a revenue-share arrangement with marketing partners in order to encourage them to market our products and services to their customers. We accrue any payments received in advance of the subscription period as deferred revenue and amortize them over the subscription period. In accordance with our policy to periodically review our accounting policies we determined that certain contracts require the reporting of subscription revenue on a gross basis and others on a net basis according to US GAAP. On that basis, we continue to report subscription revenue from certain contracts on a gross basis and others on a net basis, when applicable.

Because our customers generally do not have the contractual right to take possession of the software we license or market at any time, we recognize revenue on hosting and maintenance fees as we provide the services in accordance with US GAAP.

Provision for Doubtful Accounts – We maintain an allowance for doubtful accounts for estimated losses resulting from the inability, failure, or refusal of our customers to make required payments. We evaluate the need for an allowance for doubtful accounts based on specifically identified amounts that we believe to be potentially uncollectible. Although we believe that our allowances are adequate, if the financial conditions of our customers deteriorate, resulting in an impairment of their ability to make payments, or if we underestimate the allowances required, additional allowances may be necessary, which will result in increased expense in the period in which such determination is made.

Impairment of Long-Lived Assets – We record our long-lived assets, such as intangibles, property and equipment, at cost. Management tests for the impairment of goodwill and other indefinite lived assets annually. Management evaluates other long-lived assets whenever events and circumstances indicate that the value may be impaired. There was no impairment in 2012 or 2011.

Capitalized Software Development Costs - Accounting standards require capitalization of certain software development costs subsequent to the establishment of technological feasibility, with costs incurred prior to this time expensed as research and development. Technological feasibility is established when all planning, designing, coding, and testing activities that are necessary to establish that the product can be produced to meet its design specifications have been completed. At the end of the third quarter of 2011, our technical team achieved technological feasibility for our MobileSmith™ platform product and the team continues to develop features and applications. As a result, we capitalized a portion of the costs incurred during the fourth quarter of 2011 into capitalized software in our balance sheet at December 31, 2012. In the past, we had not developed detailed design plans for our SaaS applications, and the costs incurred between the completion of a working model of these applications and the point at which the products were ready for general release had been insignificant and as a result of low revenue generated by the sale of the prior applications that did not support the net realizable value of any capitalized costs, we continued the expensing of underlying costs as research and development. Capitalized software development costs are amortized over a seven-year period after the launch of the MobileSmith™ Platform on February 28, 2012.

Income Taxes – We are required to estimate our income taxes in each of the jurisdictions in which we operate. This involves estimating our current tax liabilities in each jurisdiction, including the impact, if any, of additional taxes resulting from tax examinations, as well as making judgments regarding our ability to realize our deferred tax assets. Such judgments can involve complex issues and may require an extended period to resolve. In the event we determine that we will not be able to realize all or part of our net deferred tax assets, we would make an adjustment in the period we make such determination. We recorded no income tax expense in 2012 and 2011, as we have experienced significant operating losses to date. If utilized, we may apply the benefit of our total net operating loss carryforwards to reduce future tax expense. Since our utilization of these deferred tax assets is dependent on future profits, which are not assured, we have recorded a valuation allowance equal to the net deferred tax assets. These carryforwards would also be subject to limitations, as prescribed by applicable tax laws. As a result of prior equity financings and the equity issued in conjunction with certain acquisitions, we have incurred ownership changes, as defined by applicable tax laws. Accordingly, our use of the acquired net operating loss carryforwards may be limited. Further, to the extent that any single-year loss is not utilized to the full amount of the limitation, such unused loss is carried over to subsequent years until the earlier of its utilization or the expiration of the relevant carryforward period.

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2012 Summary

The following is a summary of key financial results and certain non-financial results achieved for the year ended December 31, 2012:

Our total revenues for the year were $480,000, an increase from 2011 of $13,000, or 3%. This overall increase in revenues was primarily attributable to net increases in license fees, hosting fees, and professional service fees offset by a reduction in subscription fees and other revenue.

Our gross profit for the year was $94,000, an increase of $317,000 from the 2011 loss of $223,000. This increase was primarily attributable to reduction in costs of revenues due to the cost-effectiveness of our MobileSmith™ platform and an increase in total revenues for 2012.

Operating expenses for the year were $2.5 million, an increase from 2011 of $0.7 million, or 36%. A significant portion of this increase was a due to the growth of $302,000 in the amount of sales and marketing expenses, an increase in general and administrative expenses of $237,000 and a net increase in research and development expenses of $166,000 in 2012.

Our loss from operations for the year was $2.4 million, an increase from 2011 of $360,000, or 17%. Net loss per basic and fully diluted share was $0.24 in 2012 compared to $0.19 in 2011.

Cash and cash equivalents at December 31, 2012 were $190,000 compared to $236,000 at December 31, 2011. The primary reason for this decrease is that in 2012, we paid significant accounts payable and increased accounts receivable.

Business Outlook

We believe that the current economic recession will spawn a record number of new, highly fragmented and underserved small businesses seeking low-cost tools and applications to help them operate. We also believe that trade organizations and other membership- or subscription-driven agencies and companies will recognize an increased need for customer retention and will look for new and innovative ways to achieve this. Both of these events could increase our ability to obtain new channel partners and end-user businesses in 2013. However, we also believe that competition for mobile business solutions will increase. We anticipate focusing on the following key areas, among others, during 2013 in response to these opportunities and competitive environment:

Investment in technology, product development, and infrastructure. We have shifted our focus toward the rapid growth of our MobileSmith™ platform and how smartphones and tablets can be utilized in business and non-profit organizations. Specifically, our MobileSmith™ platform is modular and multi-tenant (where a single instance of the software runs on a server, providing service to multiple organizations) with popular pre-built mobile functionality modules that allows us the flexibility too quickly and efficiently package unique and innovative branded solutions for each client and deploy to each of the smartphone's application stores for easy distribution to the client's constituents.

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Investment in marketing. In 2012 and 2011, we shifted our focus from development to sales and marketing of our MobileSmith™ platform product. We expect to increase this effort in 2013 through public relations, attendance at trade shows, print and electronic advertisements, e-mail marketing, white-paper placement, webcasts, blogging, and paid search, among other tactics.

Expansion of our sales channels. We intend to expand our sales force and channel partner relationships to reach more end users.

Continuation of operating improvements. We continue to streamline our operations in an effort to reduce cash burn, reach profitability, and improve efficiencies. We will continue to focus on this critical area in 2013 by questioning current practices, closely scrutinizing actual-to-budget variances to identify deviations early, and realigning the business as required to meet the needs of our operations.

Results of Operations

The following table sets forth certain statements of operations data for the periods indicated:

	2012		2011	
	Dollars	% of Revenue	Dollars	% of Revenue
Total revenues	$ 480,122	100.00%	$ 467,308	100.00%
Cost of revenues	385,747	80.34	690,438	147.75
Gross (loss) profit	94,375	19.66	(223,130)	(47.75)
Operating expenses	2,538,641	528.75	1,860,808	398.20
Loss from operations	(2,444,266)	(509.09)	(2,083,938)	(445.95)
Other expense, net	(1,954,499)	(407.08)	(1,455,872)	(311.54)
Net loss	$ (4,398,765)	(916.18)%	$ (3,539,810)	(757.49)%
Net loss per common share	$ (0.24)		$ (0.19)	

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Revenues

Revenues for 2012 and 2011 comprise the following:

	Years Ended December 31,		Year-Over-Year Change	
	2012	2011	Dollars	Percent
Subscription fees	$ 260,752	$ 363,040	$ (102,288)	(28.18)%
Professional service fees	50,122	1,067	49,055	4,597.49 %
License fees	93,833	-	93,833	100.00%
Hosting fees	1,296	216	1,080	500.00%
Other revenue	74,119	102,985	(28,866)	(28.03)%
Total revenues	$ 480,122	$ 467,308	$ 12,814	2.74 %

Revenues increased 3% to $480,000 in 2012 from $467,000 in 2011. Our overall increase in revenues was the result of increased professional service, licensing fees and hosting fees offset by a decrease in subscription fees. Select items are discussed in detail below.

Subscription Fees

Revenues from subscription fees for 2012 and 2011 are as follows:

	Years Ended December 31,		Year-Over-Year Change	
	2012	2011	Dollars	Percent
Subscription fees	$ 260,752	$ 363,040	$ (102,288)	(28.18)%
Percent of total revenues	54.31%	77.69%		

Revenue from subscription fees decreased 28% to $261,000 in 2012 from $363,000 in 2011. This decrease is primarily attributable to the Company's decision to terminate our relationship with a direct-selling organization.

Professional Service Fees

Revenues from professional service fees for 2012 and 2011 are as follows:

	Years Ended December 31,		Year-Over-Year Change	
	2012	2011	Dollars	Percent
Professional service fees	$ 50,122	$ 1,067	$ 49,055	4,597.49%
Percent of total revenues	10.44%	0.23%		

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Revenue from professional service fees increased to $50,000 in 2012 from $1,000 in 2011. This increase was due to requests from customers for additional project consulting services related to the MobileSmith™ platform product.

License Fees

Revenues from license fees for 2012 and 2011 are as follows:

	Years Ended December 31,		Year-Over-Year Change	
	2012	2011	Dollars	Percent
License fees	$ 93,833	$ -	$ 93,833	100.0%
Percent of total revenues	20.00%	0.00%		

Revenue from license fees increased 100% to $94,000 in 2012 from $0 in 2011. These revenues are the results of new customers licensing our MobileSmith™ platform product in 2012.

Hosting Fees

Revenues from hosting fees for 2012 and 2011 are as follows:

	Years Ended December 31,		Year-Over-Year Change	
	2012	2011	Dollars	Percent
Hosting fees	$ 1,296	$ 216	$ 1,080	500.00%
Percent of total revenues	0.27%	0.05%		

Hosting fees for 2012 increased to $1,296 from $216 in 2011as we provide customers with hosting services in conjunction with our MobileSmith™ platform product.

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Other Revenue

Revenues from other sources for 2012 and 2011 are as follows:

	Years Ended December 31,		Year-Over-Year Change	
	2012	2011	Dollars	Percent
Other revenue	$ 74,119	$ 102,985	$ (28,866)	(28.03