

Bridgeline Digital, Inc.
Form 10-Q
May 14, 2012

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

Form 10-Q

(Mark One)

QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2012

OR

TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission File Number 333-139298

Bridgeline Digital, Inc.
(Exact name of registrant as specified in its charter)

Delaware
State or other jurisdiction of incorporation or
organization

52-2263942
IRS Employer Identification No.

80 Blanchard Road
Burlington, Massachusetts
(Address of Principal Executive Offices)

01803
(Zip Code)

(781) 376-5555
(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

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 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

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(§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 No

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 definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

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

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

The number of shares of Common Stock par value \$0.001 per share, outstanding as of May 11, 2012 was 12,614,627.

Bridgeline Digital, Inc.

Quarterly Report on Form 10-Q

For the Quarterly Period ended March 31, 2012

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Bridgeline Digital, Inc.

Quarterly Report on Form 10-Q

For the Quarterly Period ended March 31, 2012

Statements contained in this Report on Form 10-Q that are not based on historical facts are “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements may be identified by the use of forward-looking terminology such as “should,” “could,” “may,” “will,” “expect,” “believe,” “estimate,” “anticipate,” “intends,” “continue,” or similar terms or variations of those terms or the negative of those terms. These statements appear in a number of places in this Form 10-Q and include statements regarding the intent, belief or current expectations of Bridgeline Digital, Inc. Forward-looking statements are merely our current predictions of future events. Investors are cautioned that any such forward-looking statements are inherently uncertain, are not guaranties of future performance and involve risks and uncertainties. Actual results may differ materially from our predictions. Important factors that could cause actual results to differ from our predictions include the impact of the weakness in the U.S. and international economies on our business, our inability to manage our future growth effectively or profitably, fluctuations in our revenue and quarterly results, our license renewal rate, the impact of competition and our ability to maintain margins or market share, our ability to maintain our listing on the Nasdaq Capital Market, the limited market for our common stock, the volatility of the market price of our common stock, the performance of our products, our ability to respond to rapidly evolving technology and customer requirements, our ability to protect our proprietary technology, the security of our software, our dependence on our management team and key personnel, our ability to hire and retain future key personnel, our ability to maintain an effective system of internal controls, or risks associated with our contracts with the U.S. federal government. Although we have sought to identify the most significant risks to our business, we cannot predict whether, or to what extent, any of such risks may be realized, nor is there any assurance that we have identified all possible issues which we might face. We assume no obligation to update our forward-looking statements to reflect new information or developments. We urge readers to review carefully the risk factors described in our Annual Report on Form 10-K for the fiscal year ended September 30, 2011 as well as in the other documents that we file with the Securities and Exchange Commission. You can read these documents at www.sec.gov.

Where we say “we,” “us,” “our,” “Company” or “Bridgeline” we mean Bridgeline Digital, Inc.

PART I—FINANCIAL INFORMATION

Item 1. Financial Statements.

BRIDGELINE DIGITAL, INC.
 CONDENSED CONSOLIDATED BALANCE SHEETS
 (Dollars in thousands, except share and per share data)
 (Unaudited)

ASSETS	March 31, 2012	September 30, 2011
Current assets:		
Cash and cash equivalents	\$1,352	\$2,528
Accounts receivable and unbilled receivables, net	3,672	4,274
Prepaid expenses and other current assets	846	494
Total current assets	5,870	7,296
Equipment and improvements, net	3,082	1,779
Intangible assets, net	1,270	1,527
Goodwill	20,809	20,122
Other assets	664	685
Total assets	\$31,695	\$31,409
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$987	\$1,291
Accrued liabilities	937	1,081
Accrued earnouts, current	527	295
Debt, current	1,366	1,750
Capital lease obligations, current	200	216
Deferred revenue	1,206	1,169
Total current liabilities	5,223	5,802
Accrued earnouts, net of current portion	923	772
Debt, net of current portion	3,344	3,017
Capital lease obligations, net of current portion	209	215
Other long term liabilities	1,206	395
Total liabilities	\$10,905	\$10,201
Commitments and contingencies		
Stockholders' equity:		
Preferred stock - \$0.001 par value; 1,000,000 shares authorized; none issued and outstanding	-	-
Common stock - \$0.001 par value; 20,000,000 shares authorized; 12,606,511 and 12,306,207 shares issued and outstanding, respectively	13	12
Additional paid-in capital	38,329	38,083
Accumulated deficit	(17,399)	(16,770)
Accumulated other comprehensive loss	(153)	(117)
Total stockholders' equity	20,790	21,208

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Total liabilities and stockholders' equity	\$31,695	\$31,409
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The accompanying notes are an integral part of these consolidated financial statements.

BRIDGELINE DIGITAL, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Dollars in thousands, except share and per share data)
(Unaudited)

	Three Months Ended March 31,		Six Months Ended March 31,	
	2012	2011	2012	2011
Revenue:				
Web application development services	\$5,441	\$5,381	\$10,749	\$10,924
Managed service hosting	611	501	1,227	968
Subscription and perpetual licenses	620	731	1,213	1,250
Total revenue	6,672	6,613	13,189	13,142
Cost of revenue:				
Web application development services	2,771	2,963	5,626	5,976
Managed service hosting	85	115	191	261
Subscription and perpetual licenses	100	178	220	361
Total cost of revenue	2,956	3,256	6,037	6,598
Gross profit	3,716	3,357	7,152	6,544
Operating expenses:				
Sales and marketing	1,846	1,779	3,561	3,422
General and administrative	1,001	1,022	2,001	1,920
Research and development	480	470	883	852
Depreciation and amortization	435	333	850	681
Impairment of intangible asset	----	----	281	----
Total operating expenses	3,762	3,604	7,576	6,875
Loss from operations	(46)	(247)	(424)	(331)
Interest income (expense), net	(72)	(61)	(136)	(112)
Loss before income taxes	(118)	(308)	(560)	(443)
Provision for income taxes	48	21	69	42
Net loss	\$(166)	\$(329)	\$(629)	\$(485)
Net loss per share:				
Basic and diluted	\$(0.01)	\$(0.03)	\$(0.05)	\$(0.04)
Number of weighted average shares:				
Basic and diluted	12,338,156	12,254,793	12,328,899	12,069,326

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

BRIDGELINE DIGITAL, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Dollars in thousands)
(Unaudited)

	Six Months Ended March 31,	
	2012	2011
Cash flows from operating activities:		
Net loss	\$(629	) \$(485
Adjustments to reconcile net loss to net cash provided by operating activities:		
Amortization of intangible assets	386	398
Impairment of intangible asset	281	-
Depreciation	464	312
Other amortization	90	175
Stock-based compensation	155	187
Contingent earnout liability adjustment	(313) -
Changes in operating assets and liabilities, net of acquisitions:		
Accounts receivable and unbilled receivables	833	(191
Prepaid expenses and other assets	(209	) (308
Accounts payable and accrued liabilities	(745	) (327
Deferred revenue	(134	) 277
Other liabilities	(139	) (18
Total adjustments	669	505
Net cash provided by operating activities	40	20
Cash flows from investing activities:		
Equipment and improvements	(580	) (213
Acquisitions, net of cash acquired	(33) -
Software development capitalization costs	(14) -
Contingent acquisition payments	(261	) (413
Net cash used in investing activities	(888	) (626
Cash flows from financing activities:		
Proceeds from sale of common stock, net of issuance costs	-	857
Proceeds from exercise of employee stock options	20	121
Borrowings from bank line of credit	1,875	4,450
Payments on bank line of credit	(1,849	) (4,625
Payments on acquired debt	(120) -
Payments on subordinated promissory notes	(83	) (42
Principal payments on capital leases	(135	) (82
Net cash (used in)/provided by financing activities	(292	) 679
Effect of exchange rate changes on cash and cash equivalents	(36	) 7
Net (decrease)/increase in cash and cash equivalents	(1,176	) 80
Cash and cash equivalents at beginning of period	2,528	3,045
Cash and cash equivalents at end of period	\$1,352	\$3,125
Supplemental disclosures of cash flow information:		
Cash paid for:		
Interest	\$130	\$110
Income taxes	\$34	\$27
Non cash activities:		

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Equipment purchased under capital leases	\$104	\$573
Equipment and other assets included in accounts payable	\$237	\$50
Accrued contingent consideration (earnouts)	\$600	\$-
Common stock issued in connection with acquisition	\$150	\$-

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

BRIDGELINE DIGITAL, INC.
NOTES TO UNAUDITED INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in thousands, except share and per share data)

1. Description of Business

Overview

Bridgeline Digital is a developer of an award-winning Web Experience Management (WEM) product suite named iAPPS® and award-winning interactive technology solutions that help organizations optimize business processes. Bridgeline's iAPPS product suite combined with its interactive development capabilities assists customers in maximizing revenue, improving customer service and loyalty, enhancing employee knowledge, and reducing operational costs by leveraging web based technologies.

Bridgeline Digital's iAPPS product suite provides solutions that deeply integrate Web Content Management, eCommerce, eMarketing, and web Analytics capabilities within the mission critical website, on-line stores, intranets, extranets, or portals in which they reside; enabling business users to enhance and optimize the value of their web properties. Combined with award-winning interactive development capabilities, Bridgeline helps customers cost-effectively accommodate the changing needs of today's rapidly evolving web properties.

The iAPPS product suite is delivered through a Cloud-based SaaS ("Software as a Service") business model, whose flexible architecture provides customers with state of the art deployment providing maintenance, daily technical operation and support; or via a traditional perpetual licensing business model, in which the iAPPS software resides on a dedicated server in either the customer's facility or Bridgeline's co-managed hosting facility.

In 2012, KMWorld Magazine Editors selected iAPPS one of the 100 Companies That Matter in Knowledge Management and also selected iAPPS as a Trend Setting Product in both 2010 and 2011. iAPPS Content Manager and iAPPS Commerce were selected as finalists for the 2012 Codie Awards for Best Content Management Solution and Best Electronic Commerce Solution, globally. iAPPS Content Manager won the 2010 Codie Award for Best Content Management Solution globally, and was a finalist for the same award in 2011. iAPPS Commerce was also selected as a finalist for the 2011 Codie Award for Best Electronic Commerce Solution, globally. B2B Interactive has selected Bridgeline Digital as one of the Top Interactive Technology companies in the United States in 2009, 2010 and 2011.

Bridgeline's team of Microsoft® Gold Certified developers specialize in end-to-end interactive technology solutions which include digital strategy, user-centered design, web experience development, SharePoint development, rich media development, search engine optimization and web experience hosting management.

Bridgeline Digital was incorporated under the laws of the State of Delaware on August 28, 2000.

Locations

The Company's corporate office is located north of Boston, Massachusetts. The Company maintains regional offices serving the following geographical locations: Atlanta, GA; Baltimore, MD; Boston, MA; Chicago, IL; Denver, CO; New York, NY; Philadelphia, PA; and Tampa, FL. The Company has two wholly-owned subsidiaries, Bridgeline Intelligence Group Inc., located in Maryland and Bridgeline Digital Pvt. Ltd. located in Bangalore, India.

2. Summary of Significant Accounting Policies

Basis of Presentation and Principles of Consolidation

The condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All significant inter-company accounts and transactions have been eliminated.

Unaudited Interim Financial Information

The accompanying interim Condensed Consolidated Balance Sheet as of March 31, 2012, the Condensed Consolidated Statements of Operations for the three and six months ended March 31, 2012 and 2011, respectively, and the Condensed Consolidated Statements of Cash Flows for the six months ended March 31, 2012 and 2011, respectively, are unaudited. The unaudited interim condensed consolidated statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“US GAAP”) and in the opinion of the Company’s management have been prepared on the same basis as the audited consolidated financial statements as of and for the year ended September 30, 2011. These condensed financial statements include all adjustments, consisting of normal recurring adjustments and accruals, necessary for the fair presentation of the Company’s financial position at March 31, 2012 and its results of operations for the three and six months ended March 31, 2012 and 2011, respectively, and its cash flows for the six months ended March 31, 2012 and 2011, respectively. The results for the three and six months ended March 31, 2012 are not necessarily indicative of the results to be expected for the year ending September 30, 2012. The accompanying September 30, 2011 Condensed Consolidated Balance Sheet has been derived from the audited financial statements at that date, but does not include all of the information and footnotes required by US GAAP for complete financial statements.

BRIDGELINE DIGITAL, INC.
NOTES TO UNAUDITED INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in thousands, except share and per share data)

Recent Accounting Pronouncements

In December 2011, the FASB issued the FASB Accounting Standards Update No. 2011-11 “Balance Sheet: Disclosures about Offsetting Assets and Liabilities” (“ASU 2011-11”). This Update requires an entity to disclose information about offsetting and related arrangements to enable users of its financial statements to understand the effect of those arrangements on its financial position. The objective of this disclosure is to facilitate comparison between those entities that prepare their financial statements on the basis of U.S. GAAP and those entities that prepare their financial statements on the basis of IFRS. The amended guidance is effective for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods.

In December 2011, the FASB issued the FASB Accounting Standards Update No. 2011-12 “Comprehensive Income: Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05” (“ASU 2011-12”). This Update is a deferral of the effective date pertaining to reclassification adjustments out of accumulated other comprehensive income in ASU 2011-05. FASB is to going to reassess the costs and benefits of those provisions in ASU 2011-05 related to reclassifications out of accumulated other comprehensive income. Due to the time required to properly make such a reassessment and to evaluate alternative presentation formats, the FASB decided that it is necessary to reinstate the requirements for the presentation of reclassifications out of accumulated other comprehensive income that were in place before the issuance of Update 2011-05.

All other requirements in Update 2011-05 are not affected by this Update, including the requirement to report comprehensive income either in a single continuous financial statement or in two separate but consecutive financial statements. Public entities should apply these requirements for fiscal years, and interim periods within those years, beginning after December 15, 2011.

Management does not believe that any other recently issued, but not yet effective accounting pronouncements, if adopted, would have a material effect on the accompanying consolidated financial statements.

Subsequent Events

The Company evaluated subsequent events through the date of this filing and concluded there were no material subsequent events requiring adjustment to or disclosure in these interim condensed consolidated financial statements.

3. Accounts Receivable and Unbilled Receivables

Accounts receivable and unbilled receivables consists of the following:

	As of March 31, 2012	As of September 30, 2011
Accounts receivable	\$ 3,448	\$ 4,197
Unbilled receivables	409	365
Subtotal	3,857	4,562
Allowance for doubtful accounts	(185)	(288)

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Accounts receivable and unbilled receivables, net	\$	3,672	\$	4,274
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BRIDGELINE DIGITAL, INC.
NOTES TO UNAUDITED INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in thousands, except share and per share data)

4. Acquisitions

Magnetic Corporation

On October 3, 2011, the Company completed the acquisition of Magnetic Corporation (“Magnetic”), a web technology company based in Tampa, Florida. The Company acquired all of the outstanding capital stock of Magnetic for consideration consisting of (i) \$150 thousand in cash and (ii) contingent consideration of up to \$600 thousand in cash and 166,666 shares of Bridgeline Digital common stock, valued at \$150 thousand (\$0.90 per share). The cash consideration was further reduced by \$100 thousand due to the Seller’s inability to meet an agreed upon target for working capital. The contingent consideration is payable quarterly over the 12 consecutive calendar quarters following the acquisition, contingent upon the acquired business achieving certain quarterly revenue and quarterly operating income targets during the period. The contingent common stock has been issued and is being held in escrow pending satisfaction of the applicable targets. To the extent that either the quarterly revenue target or the quarterly operating income target is not met in a particular quarter, the earn-out period will be extended for up to four additional quarters. Magnetic achieved its quarterly revenue and operating income targets for the three months ended December 31, 2011 and March 31, 2012. Magnetic’s operating results are reflected in the Company’s condensed consolidated financial statements as of the acquisition date, which corresponds to the Company’s commencement of fiscal 2012.

The estimated fair value of net assets acquired from the Magnetic acquisition are summarized as follows:

Net assets acquired:	Amount
Cash	\$ 17
Accounts Receivable, net	139
Other Assets	103
Fixed Assets	57
Intangible Assets	410
Goodwill	522
Total Assets	1,248
Current Liabilities	448
Total liabilities assumed	448
Net assets acquired:	\$ 800
Purchase Price:	
Cash Paid	\$ 50
Contingent earnouts - payable in cash	600
Contingent earnouts - payable in common stock	150
	\$ 800

Of the \$410 thousand allocated to intangible assets, \$350 thousand is allocated to customer relationships and \$60 thousand is allocated to non-compete agreements, with an average useful life of five years. These amounts are preliminary and will be adjusted when the formal valuation is completed, which is in progress.

The following unaudited pro forma financial information reflects the combined results of operations for Bridgeline for the six months ended March 31, 2012 and 2011, including certain adjustments, as if the acquisition had occurred on October 1, 2010. This information does not necessarily reflect the results of operations that would have occurred had

the acquisition taken place at the beginning of the period, and is not necessarily indicative of the results which may be obtained in the future.

BRIDGELINE DIGITAL, INC.
NOTES TO UNAUDITED INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in thousands, except share and per share data)

Unaudited Pro forma financial information

(in thousands, except per share data)	Six Months Ended March 31, 2012	Six Months Ended March 31, 2011
Total revenue	\$ 13,189	\$ 14,293
Net loss	\$ (629)	\$ (433)
Net loss per share:		
Basic and diluted	\$ (0.05)	\$ (0.04)
Number of weighted average shares:		
Basic and diluted	12,329	12,069

e.Magination network, LLC.

On July 9, 2010, the Company acquired certain assets and assumed certain liabilities of e.Magination network, LLC, and e.Magination IG (combined "e.Magination"), a Baltimore, Maryland based web application development company. Consideration consisted of (i) \$2.65 million in cash, (ii) contingent consideration of up to \$647 thousand (which reflects a post acquisition adjustment to the purchase price) payable quarterly in cash over 12 quarters beginning with the quarter ending September 30, 2010, with half of the earnout based on the achievement of quarterly revenue of \$1.35 million and half of the earnout based on the achievement of quarterly earnings from operations of \$225 thousand by the Maryland business unit, (iii) additional contingent consideration of up to \$300 thousand (which reflects a post acquisition adjustment to the purchase price) payable quarterly in cash over 12 quarters beginning with the quarter ending September 30, 2010 based on the achievement of quarterly earnings from operations of \$300 thousand by the Maryland business unit, and (iv) contingent consideration of up to \$675 thousand payable quarterly in Bridgeline common stock over four quarters beginning with the quarter ending December 31, 2012, with half of the earnout based on the achievement of quarterly revenue of \$1.35 million and half of the earnout based on the achievement of quarterly earnings from operations of \$225 thousand of the Maryland business unit. The contingent common stock will be held in escrow pending the satisfaction of the applicable earnout targets. To the extent that both the quarterly revenue target and the quarterly earnings from operations target are not met in any particular quarter, both the quarterly cash earnout period and the quarterly common stock earnout period will be extended for up to four additional quarters.

In the three months ended March 31, 2012, the Company recorded a \$313 thousand reduction of contingent earnout liabilities for certain targets that were not achieved. The \$313 thousand is included in General and Administrative Expenses in the Consolidated Statement of Operations. Of the \$313 thousand adjustment, \$144 thousand reduced accrued contingent liabilities and \$169 thousand was consideration payable in stock and allocated to additional paid-in capital.

BRIDGELINE DIGITAL, INC.
NOTES TO UNAUDITED INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in thousands, except share and per share data)

5. Intangible Assets

Changes in the carrying amount of intangible assets are as follows:

	As of March 31, 2012		
	Gross Amount	Accumulated Amortization	Net Amount
Intangible assets:			
Domain and trade names	\$ 26	\$ (26)	\$ -
Customer related	3,747	(2,631)	1,116
Non-compete agreements	697	(543)	154
Acquired software	362	(362)	-
Total intangible assets	\$ 4,832	\$ (3,562)	\$ 1,270

	As of September 30, 2011		
	Gross Amount	Accumulated Amortization	Net Amount
Intangible assets:			
Domain and trade names	\$ 26	\$ (26)	\$ -
Customer related	3,397	(2,032)	1,365
Non-compete agreements	637	(475)	162
Acquired software	362	(362)	-
Total intangible assets	\$ 4,422	\$ (2,895)	\$ 1,527

Total amortization expense related to intangible assets for the three and six months ended March 31, 2012 and 2011 is as follows:

Amortization expense charged to:	Three Months Ended		Six Months Ended	
	March 31,		March 31,	
	2012	2011	2012	2011
Operating expense *	\$191	\$6	\$667	\$30
Cost of revenue	-	184	-	368
Total	\$191	\$190	\$667	\$398

* Included in amortization expense for the six months ended March 31, 2012 was a charge to operations of \$281 thousand for impairment charges related to assets assumed from our fiscal 2010 acquisition of e.Magination and its wholly-owned subsidiary eMagination IG, LLC (now Bridgeline Intelligence Group, Inc.). In the first quarter of fiscal 2012, the Company stopped servicing low margin non-iAPPS opportunities acquired from e.Magination IG, LLC. It was therefore determined that a portion of the customer list was impaired. The impairment charge is included in

operating expenses in the Company's Condensed Consolidated Statements of Operations.

BRIDGELINE DIGITAL, INC.
NOTES TO UNAUDITED INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in thousands, except share and per share data)

6. Goodwill

Changes in the carrying amount of goodwill follows:

	As of March 31, 2012	As of September 30, 2011
Balance at beginning of period	\$ 20,122	\$ 20,036
Acquisitions	522	-
Contingent acquisition payments	165	86
Balance at end of period	\$ 20,809	\$ 20,122

Contingent consideration (“earnouts”) related to acquisitions completed before September 30, 2009 are accounted for as an increase to goodwill at the time such earnouts are paid or earned. Goodwill is tested for impairment annually during the fourth quarter of every year and more frequently if events and circumstances indicate that the asset might be impaired. For the year ended September 30, 2011 the Company’s assessment was that goodwill was not impaired and did not record a goodwill impairment charge.

7. Fair Value of Financial Instruments

The fair value of cash and cash equivalents and trade receivables approximates their carrying values due to their short maturities. The fair value of non-current assets and liabilities approximate their carrying value unless otherwise stated. The fair value of subordinated debt, bank term loans and credit lines also approximate their carrying values.

In accordance with FASB ASC Topic 820, "Fair Value Measurements and Disclosures", the estimated fair values of amounts reported in the consolidated financial statements have been determined using available market information and valuation methodologies, as applicable. Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Entities are required to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value based on the following value hierarchy:

Level 1 Quoted prices in active markets for identical assets or liabilities;

Level 2 Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities; and

Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

BRIDGELINE DIGITAL, INC.
NOTES TO UNAUDITED INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in thousands, except share and per share data)

The following table summarizes the financial liabilities measured at fair value on a recurring basis:

	As of March 31, 2012	As of September 30, 2011
Level 3:		
Contingent earnout liabilities	\$ 1,450	\$ 1,067

The contingent earnout liabilities were recorded at fair value based on valuation models that utilize relevant factors such as estimated probabilities of the acquisitions achieving the performance targets throughout the earnout period.

The following table summarizes the changes in earnout liabilities for the six months ended March 31, 2012.

Balance at September 30, 2011	\$1,067
Contingent earnout liability accruals	788
Contingent earnout liability payments	(261)
Contingent earnout liability valuation adjustment	(144)
Balance at March 31, 2012	\$1,450

8. Debt

In March 2010, the Company entered into an Amended and Restated Loan and Security Agreement SVB (the “Loan Agreement”) with Silicon Valley Bank (“SVB”). The Loan Agreement has a two year term which expires on March 31, 2012. In May 2011, the Company amended its loan arrangement (the “Amendment”) with SVB, extending the maturity date of the line of credit for one year to March 31, 2013. The Amendment also revised certain financial covenants and amended the out of formula borrowings to be structured as a \$2 million term loan and interest on the term loan will be at SVB’s prime rate plus 1.75%. In May 2012, the Company amended its loan agreement (the “2012 Amendment”) with SVB, extending the maturity date of the line of credit for one year to March 31, 2014. The 2012 Amendment also revised certain financial covenants.

Debt consists of the following:

	As of March 31, 2012	As of September 30, 2011
Line of credit borrowings	\$ 2,418	\$ 2,392
Bank term loan	2,000	2,000
Subordinated promissory note	292	375

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Total debt	\$	4,710	\$	4,767
Less current portion	\$	1,366	\$	1,750
Long term debt, net of current portion	\$	3,344	\$	3,017

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BRIDGELINE DIGITAL, INC.
NOTES TO UNAUDITED INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
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9. Other Long Term Liabilities

Deferred Rent

In connection with new leases for the Company's headquarters in Burlington, Massachusetts and a new location in New York, the Company made investments in leasehold improvements at these locations of approximately \$1.4 million, of which the respective landlords funded approximately \$950 thousand. The capitalized leasehold improvements are being amortized over the initial lives of each lease. The improvements funded by the landlords are treated as lease incentives. Accordingly, the funding received from the landlords was recorded as fixed asset additions and a deferred rent liability on the Condensed Consolidated Balance Sheet. The deferred rent liability is being amortized as a reduction of rent expense over the lives of the leases.

10. Shareholder's Equity

Common Stock

In connection with the acquisition of Magnetic Corporation on October 3, 2011, contingent consideration of 166,666 shares of Bridgeline Digital common stock is contingently issuable to the sole stockholder of Magnetic. The contingent consideration is payable quarterly over the 12 consecutive calendar quarters following the acquisition, contingent upon the acquired business achieving certain operating and revenue targets. The common stock has been issued and is being held in escrow pending satisfaction of the applicable earnout targets. For the six months ended March 31, 2012, common shares of 27,777 were earned.

Employee Stock Options

In order to increase employee retention and morale, in October 2011, the Company offered its employees the opportunity to have certain outstanding options modified by (i) reducing the grant exercise price to \$0.67, the fair market value of the common stock as of the modification date and (ii) starting a new three year vesting schedule. The aggregate fair value of the modified options of approximately \$90 thousand was calculated using the difference in value between the original terms and the new terms as of the modification date. The incremental cost of the modified option over the original option will be recognized as additional compensation expense over the new three year vesting period beginning on the date of modification. This opportunity was generally limited to options issued subsequent to the October 2008 repricing described in Note 11 to the Company's Annual Report on Form 10-K for fiscal 2011. Options to purchase a total of 697,667 shares of common stock were exchanged for new grants in the October 28, 2011 repricing.

Employee Stock Purchase Plan

On April 12, 2012, the Company's stockholders approved and adopted the Bridgeline Digital, Inc. 2012 Employee Stock Purchase Plan (the "ESPP"). Under the terms of the ESPP, the Company will grant eligible employees the right to purchase shares of Bridgeline common stock through payroll deductions at a price equal to 85% of the fair market value of Bridgeline common stock on the purchase termination date of defined offering or purchase periods. Each offering period is six months in duration. The ESPP permits the Company to offer up to 300,000 shares of common stock. The maximum number of shares of common stock that may be purchased by all participants in any purchase

period may not exceed 150,000 shares. The first purchase period will be June 2012 through November 2012.

Common Stock Warrants

In July 2007, the Company issued 150,000 warrants to the underwriter's of the Company's initial public offering (the "IPO Warrants") with an original exercise price of \$7.50 per share. In October 2010, 57,000 IPO warrants were cancelled (see below). After adjustments for anti-dilution provisions, the IPO Warrants are exercisable to purchase shares of the Company's common stock at an exercise price of \$7.39. The IPO Warrants are currently exercisable and will expire in July 2012.

On October 21, 2010, the Company issued 50,000 common stock warrants to purchase shares of the Company's common stock to a non-employee consultant as compensation for services rendered. The warrants vest over a one year period and expire on October 15, 2015. Of the warrants issued, 25,000 are exercisable at an exercise price of \$1.00 per share and 25,000 are exercisable at an exercise price of \$2.00 per share.

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On October 29, 2010, the Company issued four year warrants to the placement agent in the Company's private placement. The warrants are exercisable to purchase 64,000 shares of the Company's common stock at a price equal to \$1.45 per share. In return for such warrants, the placement agent agreed to cancel 71,231 warrants issued to the placement agent in April 2006 and 57,000 IPO Warrants.

As of March 31, 2012: (i) IPO Warrants to purchase 93,000 shares at an exercise price of \$7.39 remain outstanding; (ii) placement agent warrants to purchase 64,000 shares at an exercise price of \$1.45 are outstanding; and (iii) warrants issued to a non-employee consultant to purchase 25,000 shares at an exercise price of \$1.00 and 25,000 shares at an exercise price of \$2.00 are outstanding.

Summary of Option and Warrant Activity and Outstanding Shares

	Stock Options		Stock Warrants	
	Options	Weighted Average Exercise Price	Warrants	Weighted Average Exercise Price
Outstanding, September 30, 2011	2,280,204	\$ 1.00	207,000	\$ 4.13
Granted	1,737,667	0.68	—	—
Exercised	(133,638)	0.82	—	—
Forfeited, cancelled or expired	(1,036,330)	1.04	—	—
Outstanding, March 31, 2012	2,847,903	\$ 0.79	207,000	\$ 4.13

11. Comprehensive Income

Comprehensive income includes net (loss) income, as well as other changes in stockholder's equity that result from transactions and economic events other than those with the stockholders.

Comprehensive loss was as follows:

	Three Months Ended March 31,		Six Months Ended March 31,	
	2012	2011	2012	2011
Net loss	\$ (166)	\$ (329)	\$ (629)	\$ (485)
Net change in foreign currency translation adjustment	(30)	5	(36)	7
Comprehensive loss	\$ (196)	\$ (324)	\$ (665)	\$ (478)

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12. Net Loss Per Share

Basic and diluted net loss per share is computed as follows:

(in thousands, except per share data)	Three Months Ended March 31,		Six Months Ended March 31,	
	2012	2011	2012	2011
Net loss	\$(166	) \$(329	) \$(629	) \$(485
Weighted average common shares outstanding - basic	12,338	12,255	12,329	12,069
Effect of dilutive securities (primarily stock options)	-	-	-	-
Weighted average common shares outstanding - diluted	12,338	12,255	12,329	12,069
Net loss per share - basic and diluted	\$(0.01	) \$(0.03	) \$(0.05	) \$(0.04

Basic net income per share is computed by dividing net income available to common shareholders by the weighted average number of common shares outstanding. Diluted net income per share is computed by using the weighted average number of common shares outstanding during the period plus the dilutive effect of outstanding stock options and warrants using the “treasury stock” method.

For the three and six months ended March 31, 2011, options to purchase shares of the Company’s common stock of 467,490 and 433,275 were excluded from the computation of diluted net loss per share as the effect was anti-dilutive to the Company’s net loss. Also, excluded were 675,000 shares to be issued in connection with the e.Magination acquisition. Options to purchase shares of the Company’s common stock of 180,126 and 154,654 for the three and six months ended March 31, 2012 were excluded from the computation of diluted net loss per share as the effect was anti-dilutive to the Company’s net loss. Also excluded for the three and six months ended March 31, 2012 were 138,888 shares to be issued in connection with the Magnetic acquisition.

13. Income Taxes

Income tax expense was \$48 thousand and \$21 thousand for the three months ended March 31, 2012 and 2011, respectively, and \$69 thousand and \$42 thousand for the six months ended March 31, 2012 and 2011, respectively. Income tax expense consists of the estimated liability for Federal and state income taxes owed by the Company, including the alternative minimum tax. Net operating loss carry forwards are estimated to be sufficient to offset additional taxable income for all periods presented.

The Company does not provide for U.S. income taxes on the undistributed earnings of its Indian subsidiary, which the Company considers to be a permanent investment.

14. Related Party Transactions

The Company has retained the services of one of its outside directors as a management consultant to assist the executive management team. The term of the engagement is one year, expiring in January 2013, at a rate of \$8,000 per month. The consulting arrangement is terminable by either party with thirty days written notice.

As part of the Magnetic acquisition, the Company entered into an operating lease for the Bridgeline Tampa location with the previous owner of Magnetic who now serves as the Senior Vice President and General Manager of Bridgeline Tampa. The lease term is three years and rent is \$85 thousand per year.

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15. Legal Proceedings

Bridgeline Digital, Inc. vs. e.Magination network, LLC and its principal owner, Daniel Roche.

In August 2010, Bridgeline initiated a lawsuit against e.Magination network, LLC and its principal owner, Daniel Roche, in the Federal District Court of Massachusetts. Bridgeline seeks damages for accounts receivable allegedly collected by Mr. Roche and e.Magination and used to pay obligations of e.Magination and Mr. Roche (accounts receivable contractually belonging to Bridgeline). e.Magination and Mr. Roche have asserted counterclaims against Bridgeline and Thomas Massie alleging that Bridgeline has breached Mr. Roche's employment agreement by improperly terminating Mr. Roche for cause and also alleging breach of the Asset Purchase Agreement by Bridgeline. This lawsuit remains unresolved as of March 31, 2012.

Ingeniador, LLC vs. Interwoven, Inc., Bridgeline Digital, Inc., et al

On April 26, 2012, the Company was informed that on such date the United States District Court for the District of Puerto Rico entered a default judgment against the Company as part of a patent infringement lawsuit brought by Ingeniador, LLC against 16 companies, including Bridgeline. The Company is currently seeking to have the default judgment set aside as it was never informed of the lawsuit and were not offered an opportunity to address the complaint. Ingeniador, LLC alleges Bridgeline has been infringing its patent rights and is seeking monetary damages. The Company believes this lawsuit is without merit and intends to defend this case vigorously.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

This section contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those anticipated in the forward-looking statements as a result of a variety of factors and risks including risks described in our Annual Report on Form 10-K for the fiscal year ended September 30, 2011 as well as in the other documents that we file with the Securities and Exchange Commission. You can read these documents at www.sec.gov.

This section should be read in combination with the accompanying unaudited consolidated financial statements and related notes prepared in accordance with United States generally accepted accounting principles.

Overview

Bridgeline Digital is a developer of an award-winning Web Experience Management (WEM) product suite named iAPPS® and award-winning interactive technology solutions that help organizations optimize business processes. Bridgeline's iAPPS product suite combined with its interactive development capabilities assists customers in maximizing revenue, improving customer service and loyalty, enhancing employee knowledge, and reducing operational costs by leveraging web based technologies.

Bridgeline Digital's iAPPS product suite provides solutions that deeply integrate web Content Management, eCommerce, eMarketing, deep within the website, web applications, or on-line stores in which they reside; enabling business users to enhance and optimize the value of their web properties. Combined with award-winning interactive development capabilities, Bridgeline helps customers cost-effectively accommodate the changing needs of today's rapidly evolving web properties.

The iAPPS product suite is delivered through a Cloud-based SaaS ("Software as a Service") business model, whose flexible architecture provides customers with state of the art deployment providing maintenance, daily technical operation and support; or via a traditional perpetual licensing business model, in which the iAPPS software resides on a dedicated server in either the customer's facility or Bridgeline's co-managed hosting facility.

In 2012, KMWorld Magazine Editors selected iAPPS one of the 100 Companies That Matter in Knowledge Management and also selected iAPPS as a Trend Setting Product in both 2010 and 2011. iAPPS Content Manager and iAPPS Commerce were selected as finalists for the 2012 Codie Awards for Best Content Management and Best Electronic Commerce Solution, globally. iAPPS Content Manager won the 2010 Codie Award for Best Content Management Solution globally, and was a finalist for the same award in 2011. iAPPS Commerce was also selected as a finalist for the 2011 Codie Award for Best Electronic Commerce Solution, globally. B2B Interactive has selected Bridgeline Digital as one of the Top Interactive Technology companies in the United States in 2009, 2010 and 2011.

Bridgeline's team of Microsoft® Gold Certified developers specialize in end-to-end interactive technology solutions which include digital strategy, user-centered design, web application development, SharePoint development, rich media development, search engine optimization and web application hosting management.

Customer Information

We had approximately 639 customers at March 31, 2012 compared with approximately 553 customers at March 31, 2011, an increase of 16%. Approximately 465 of the Company's customers, or 73%, pay a monthly subscription fee or a monthly managed service hosting fee.

For the three and six months ended March 31, 2012 and 2011 no customer represented 10% or more of total revenue.

Results of Operations for the Three and Six Months Ended March 31, 2012 compared to the Three and Six Months Ended March 31, 2011

Total revenue for the three months ended March 31, 2012 was \$6.7 million compared with \$6.6 million for the three months ended March 31, 2011. We had a net loss of \$(166) thousand for the three months ended March 31, 2012 compared with net loss of \$(329) thousand for the three months ended March 31, 2011. Net loss per share for the three months ended March 31, 2012 was \$(0.01) compared with net loss per share of \$(0.03) for the three months ended March 31, 2011.

Total revenue for the six months ended March 31, 2012 was \$13.2 million compared with \$13.1 million for the six months ended March 31, 2011. We had a net loss of \$(629) thousand for the six months ended March 31, 2012 compared with net loss of \$(485) thousand for the six months ended March 31, 2011. Net loss per share for the six months ended March 31, 2012 was \$(0.05) compared with net loss per share of \$(0.04) for the six months ended March 31, 2011.

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The following table sets forth the percentages of revenue for items included in our unaudited condensed consolidated statement of operations presented in our Quarterly Reports on Form 10-Q for the periods presented.

	Three Months Ended March 31, 2012	Three Months Ended March 31, 2011	\$ Change	% Change	Six Months Ended March 31, 2012	Six Months Ended March 31, 2011	\$ Change	% Change
Revenue:								
Web application development services								
iAPPS application development services	\$ 3,524	\$ 2,083	1,441	69 %	\$6,539	\$4,383	2,156	49 %
% of total revenue	53 %	31 %			50 %	33 %		
Other application development services	1,917	3,298	(1,381)	(42 %)	4,210	6,541	(2,331)	(36 %)
% of total revenue	29 %	50 %			32 %	50 %		
Subtotal web application development services	5,441	5,381	60	1 %	10,749	10,924	(175)	(2 %)
% of total revenue	82 %	81 %			81 %	83 %		
Managed service hosting	611	501	110	22 %	1,227	968	259	27 %
% of total revenue	9 %	8 %			9 %	7 %		
Subscription and perpetual licenses	620	731	(111)	(15 %)	1,213	1,250	(37)	(3 %)
% of total revenue	9 %	11 %			9 %	10 %		
Total revenue	6,672	6,613	59	1 %	13,189	13,142	47	0 %
Cost of revenue:								
Web application development services								
iAPPS application development costs	1,692	993	699	70 %	3,139	2,105	1,034	49 %
% of iAPPS application development revenue	48 %	48 %			48 %	48 %		
Other application development costs	1,079	1,970	(891)	(45 %)	2,487	3,871	(1,384)	(36 %)
% of other application development	56 %	60 %			59 %	59 %		

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revenue									
Subtotal web application development costs	2,771	2,963	(192)	(6 %)	5,626	5,976	(350)	(6 %)	
% of web application development services revenue	51 %	55 %			52 %	55 %			
Managed service hosting	85	115	(30)	(26 %)	191	261	(70)	(27 %)	
% of managed service hosting revenue	14 %	23 %			16 %	27 %			
Subscription and perpetual licenses	100	178	(78)	(44 %)	220	361	(141)	(39 %)	
% of subscription and perpetual revenue	16 %	24 %			18 %	29 %			
Total cost of revenue	2,956	3,256	(300)	(9 %)	6,037	6,598	(561)	(9 %)	
Gross profit	3,716	3,357	359	11 %	7,152	6,544	608	9 %	
Gross profit margin	56 %	51 %			54 %	50 %			
Operating expenses:									
Sales and marketing	1,846	1,779	67	4 %	3,561	3,422	139	4 %	
% of total revenue	28 %	27 %			27 %	26 %			
General and administrative	1,001	1,022	(21)	(2 %)	2,001	1,920	81	4 %	
% of total revenue	15 %	15 %			15 %	15 %			
Research and development	480	470	10	2 %	883	852	31	4 %	
% of total revenue	7 %	7 %			7 %	6 %			
Depreciation and amortization	435	333	102	31 %	850	681	169	25 %	
% of total revenue	7 %	5 %			13 %	5 %			
Impairment of intangible asset	-	-	-	-	281	-	281	(100 %)	
% of total revenue	-	-			6 %	-			
Total operating expenses	3,762	3,604	158	4 %	7,576	6,875	701	10 %	
Loss from operations	(46)	(247)	201	(81 %)	(424)	(331)	(93)	28 %	
Interest income (expense) net	(72)	(61)	(11)	18 %	(136)	(112)	(24)	21 %	
Loss before income taxes	(118)	(308)	190	(62 %)	(560)	(443)	(117)	26 %	

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Provision for income taxes	48	21	27	129 %	69	42	27	64 %
Net loss	\$ (166)	\$ (329)	\$ 163	(50 %)	\$(629)	\$(485)	\$ (144)	30 %
Adjusted EBITDA	\$ 524	\$ 256	\$ 268	105 %	\$952	\$741	\$ 211	28 %

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Revenue

Our revenue is derived from three sources: (i) web application development services (ii) managed service hosting and (iii) subscription and perpetual licenses. Total revenue for the three months ended March 31, 2012 was \$6.7 million compared with \$6.6 million for the three months ended March 31, 2011. Total revenue for the six months ended March 31, 2012 was \$13.2 million compared with \$13.1 million for the six months ended March 31, 2011.

Web Application Development Services

Web application development services revenue is comprised of iAPPS development related services and other web development related services generated from non iAPPS related engagements. Revenue from web application development services increased \$60 thousand, or 1%, to \$5.4 million for the three months ended March 31, 2012. The increase compared to the prior period is due to an increase in iAPPS application development services revenue as we continue to concentrate on selling higher-margin iAPPS engagements to both new and existing customers. Revenue from iAPPS application development increased \$1.4 million, or 69% to \$3.5 million compared to the three months ended March 31, 2011. Revenue from other application development (non-iAPPS) decreased \$1.4 million, or 42%, to \$1.9 million compared to the three months ended March 31, 2011. The decreases in non-iAPPS application development services revenues is primarily attributable to a stoppage in non-iAPPS related development services from a customer due to a loss of their funding, as well as our decision to stop servicing low margin non-iAPPS opportunities acquired from e.Magination IG, LLC.

Web application development services revenue as a percentage of total revenue increased to 82% from 81% for the three months ended March 31, 2012 compared to the three months ended March 31, 2011. The increase is attributable to a larger mix of iAPPS services as compared to sales of iAPPS perpetual license revenue sales in the current period.

Revenue from web application development services decreased \$175 thousand, or 2% to \$10.7 million for the six months ended March 31, 2012. The decrease compared to the prior period is primarily related to a decrease in non-iAPPS application development services revenue of \$2.3 million, or 36%, to \$4.2 million compared to the six months ended March 31, 2011. The decrease in non-iAPPS application development services revenue is attributable to a stoppage in non-iAPPS related development services from a customer due to a loss of their funding, as well as our decision to stop servicing low margin non-iAPPS opportunities acquired from e.Magination IG, LLC. Revenue from iAPPS application development services increased \$2.2 million, or 49%, to \$6.5 million compared to the six months ended March 31, 2011.

Web application development services revenue as a percentage of total revenue decreased to 81% from 83% compared to the six months ended March 31, 2011. The decrease as a percentage of total revenues is primarily attributable to a 27% increase in managed service hosting as a number of customers who purchased perpetual iAPPS licenses also chose us to host their website.

Managed Service Hosting

Revenue from managed service hosting increased \$110 thousand, or 22%, to \$611 thousand compared to the three months ended March 31, 2011. Revenue from managed service hosting increased \$259 thousand, or 27%, to \$1.2 million compared to the six months ended March 31, 2011. The increases are attributable to incremental revenues generated from our acquisition of Magnetic in October 2011 and increases in iAPPS related hosting arrangements for perpetual licenses sold.

Managed services revenue as a percentage of total revenue increased to 9% from 8% compared to the three months ended March 31, 2011, and increased to 9% from 7% compared to the six months ended March 31.

Subscription and Perpetual Licenses

Revenue from subscription and perpetual licenses decreased \$111 thousand, or 15%, to \$620 thousand compared to the three months ended March 31, 2011. Revenue from subscription and perpetual licenses decreased \$37 thousand, or 3%, to \$1.2 million compared to the six months ended March 31, 2011. The decreases are primarily attributable to decreases in the number of perpetual licenses sold partially offset by increases in the number of SaaS licenses and annual maintenance renewals recognized. Historically, revenue from perpetual licenses has fluctuated from quarter to quarter.

Subscription and perpetual license revenue as a percentage of total revenue decreased to 9% from 11% compared to the three months ended March 31, 2011, and decreased to 9% from 10% compared to the six months ended March 31, 2011. The decreases are primarily attributable to the larger mix of iAPPS web application development services revenues and managed hosting revenues compared to perpetual licenses sold.

Costs of Revenue

Total cost of revenue decreased \$300 thousand, or 9%, to \$3.0 million compared to the three months ended March 31, 2011. Total cost of revenue decreased \$561 thousand, or 9%, to \$6.0 million compared to the six months ended March 31, 2011. These decreases are due to increases in iAPPS related application development services (discussed below) and our decision to stop servicing low margin opportunities related to our prior acquisition of e.Magination IG, LLC.

Cost of Web Application Development Services

Cost of web application development services decreased \$192 thousand, or 6%, to \$2.8 million compared to the three months ended March 31, 2011. The cost of web application development services as a percentage of application development services revenue decreased to 51% from 55% compared to the prior period. Cost of web application development services decreased \$350 thousand, or 6%, to \$5.6 million compared to the six months ended March 31, 2011. The cost of web application development services as a percentage of application development services revenue decreased to 52% from 55% compared to the prior period.

The decreases in the cost of web application development services in the three and six months ended March 31, 2012 over the comparable periods are primarily attributable to an increase in iAPPS application development services as iAPPS related engagements have more profitable margins and a decrease in personnel as a result of our decision to stop servicing low margin opportunities related to our prior acquisition of e.Magination IG, LLC.

Cost of Managed Service Hosting

Cost of managed service hosting decreased \$30 thousand, or 26%, to \$85 thousand compared to the three months ended March 31, 2011. The cost of managed services as a percentage of managed services revenue decreased to 14% from 23% compared to the three months ended March 31, 2011.

Cost of managed service hosting decreased \$70 thousand, or 27%, to \$191 thousand compared to the six months ended March 31, 2011. The cost of managed services as a percentage of managed services revenue decreased to 16% from 27% compared to the six months ended March 31, 2011.

The decreases in managed service hosting costs for the three and six months ended March 31, 2012 over the comparable periods are due to our efforts to streamline costs in relation to ending engagements with lower margin hosting customers. We will continue to make investments to our hosting environment to support our core iAPPS customer base, which is a higher margin business.

Cost of Subscription and Perpetual License

Cost of subscription and perpetual licenses decreased \$78 thousand, or 44%, to \$100 thousand compared to the three months ended March 31, 2011. The cost of subscription and perpetual licenses as a percentage of subscription and perpetual license revenue decreased to 16% from 24% compared to the three months ended March 31, 2011. Cost of subscription and perpetual licenses decreased \$141 thousand, or 39%, to \$220 thousand compared to the six months ended March 31, 2011. The cost of subscription and perpetual licenses as a percentage of subscription and perpetual license revenue decreased to 18% from 29% compared to the six months ended March 31, 2011.

The decreases in subscription and perpetual license costs for both the three and six months ended March 31, 2012 compared to the prior periods is attributable to cost efficiencies realized on our iAPPS SaaS environment and a decrease in amortization of software costs associated with the development of iAPPS.

Operating Expenses

Sales and Marketing Expenses

Sales and marketing expenses increased \$67 thousand, or 4%, to \$1.8 million compared to the three months ended March 31, 2011. Sales and marketing expenses represented 28% and 27% of total revenue for the three months ended March 31, 2012 and 2011, respectively. Sales and marketing expenses increased \$139 thousand, or 4%, to \$3.6 million compared to the six months ended March 31, 2011. Sales and marketing expenses represented 27% and 26% of total revenue for the six months ended March 31, 2012 and 2011, respectively.

The increases for the three and six months ended March 31, 2012 compared to the prior periods primarily are attributable to incremental sales and marketing expenses from the acquisition of Magnetic completed during the first quarter of fiscal 2012.

General and Administrative Expenses

General and administrative expenses decreased \$21 thousand, or 2%, to \$1.0 million compared to the three months ended March 31, 2011. General and administrative expenses represented 15% of total revenue for both the three months ended March 31, 2012 and 2011. The decrease in general and administrative expenses is primarily due to a reduction of \$313 thousand recorded for the settlement of contingent earnout payments from a prior acquisition that will not be achieved, offset by an increase in personnel costs and increases in staffing.

General and administrative expenses increased \$81 thousand, or 4%, to \$2.0 million compared to the six months ended March 31, 2011. General and administrative expenses represented 15% of total revenue for both the six months ended March 31, 2012 and 2011. The increase in general and administrative expenses is primarily due to personnel costs and increases in staffing, offset by the reduction of \$313 thousand recorded for the settlement of contingent earnout payments from a prior acquisition that will not be achieved.

Research and Development

Research and development expense increased by \$10 thousand, or 2%, to \$480 thousand compared to the three months ended March 31, 2011. Research and development expense increased by \$31 thousand, or 14%, to \$883 compared to the six months ended March 31, 2011.

The increase in research and development expense is primarily due to an increase in the number of research and development employees as we continue to invest in enhancements to our iAPPS product suite. We capitalized \$14 thousand of software development costs in the six months ended March 31, 2012. No software development costs were capitalized in the previous period.

Depreciation and Amortization

Depreciation and amortization expense increased by \$102 thousand, or 31%, to \$435 thousand compared to the three months ended March 31, 2011. Depreciation and amortization represented 7% and 5% of revenue for the six months ended March 31, 2012 and 2011, respectively. Depreciation and amortization expense increased by \$169 thousand, or 25%, to \$850 thousand compared to the six months ended March 31, 2011. Depreciation and amortization represented 13% and 5% of revenue for the six months ended March 31, 2012 and 2011, respectively.

The increases are primarily attributable to costs related to investments in our cloud-based infrastructure, amortization of leasehold improvements related to new office leases, and amortization of intangible assets acquired through acquisitions.

Impairment of Intangible Assets

The increase for the six months ended March 31, 2012 compared to the six months ended March 31, 2011 is attributable to an impairment charge recorded in the three months ended December 31, 2011. We incurred a charge to operations of \$281 thousand for impairment charges related to an intangible asset assumed from our fiscal 2010 acquisition of e.Magination and its wholly-owned subsidiary eMagination IG, LLC. In the first quarter of fiscal 2012, the Company stopped servicing low margin non-iAPPS opportunities acquired from e.Magination IG, LLC. It was therefore determined that a portion of the customer list was impaired.

Income Taxes

The provision for income tax expense was \$48 thousand and \$21 thousand for the three months ended March 31, 2012 compared to the three months ended March 31, 2011, and \$69 thousand and \$42 thousand for the six months ended March 31, 2012 compared to the six months ended March 31, 2011. Income tax expense represents the estimated liability for Federal and state income taxes owed by the Company, including the alternative minimum tax. The Company has net operating loss carryforwards and other deferred tax benefits that are available to offset future taxable income.

Loss from Operations

The loss from operations was \$(46) thousand for three months ended March 31, 2012, an improvement of \$201 thousand compared to the prior period. This increase was due to an improvement in gross profit of \$359 thousand, or 11% compared to the prior period, and a gain of \$313 recorded for contingent earnout payments from a prior acquisition that will not be achieved. These were offset by the increases in general and administrative expenses, sales and marketing expenses, and depreciation and amortization.

The loss from operations was \$(424) thousand for six months ended March 31, 2012 compared to a loss of \$(331) thousand in prior period. This increase was due to the increases in general and administrative expenses, sales and marketing expenses and depreciation and amortization, offset by an improvement in gross profit of \$608 thousand, or 9%, compared to the prior period.

Adjusted EBITDA

We also measure our performance based on a non-GAAP (“Generally Accepted Accounting Principles”) measurement of earnings before interest, taxes, depreciation, and amortization and before stock-based compensation expense and impairment of goodwill and intangible assets (“Adjusted EBITDA”).

We believe this non-GAAP financial measure of Adjusted EBITDA is useful to management and investors in evaluating our operating performance for the periods presented and provides a tool for evaluating our ongoing operations.

Adjusted EBITDA, however, is not a measure of operating performance under GAAP and should not be considered as an alternative or substitute for GAAP profitability measures such as (i) income from operations and net income, or (ii) cash flows from operating, investing and financing activities, both as determined in accordance with GAAP. Adjusted EBITDA as an operating performance measure has material limitations since it excludes the financial statement impact of income taxes, net interest expense, amortization of intangibles, depreciation, other amortization and stock-based compensation, and therefore does not represent an accurate measure of profitability. As a result, Adjusted EBITDA should be evaluated in conjunction with net income for a complete analysis of our profitability, as net income includes the financial statement impact of these items and is the most directly comparable GAAP operating performance measure to Adjusted EBITDA. Our definition of Adjusted EBITDA may also differ from and therefore may not be comparable with similarly titled measures used by other companies, thereby limiting its usefulness as a comparative measure. Because of the limitations that Adjusted EBITDA has as an analytical tool, investors should not consider it in isolation, or as a substitute for analysis of our operating results as reported under GAAP.

The following table reconciles net (loss) income (which is the most directly comparable GAAP operating performance measure) to EBITDA, and EBITDA to Adjusted EBITDA:

(in thousands)	Three Months Ended March 31,		Six Months Ended March 31,	
	2012	2011	2012	2011
Net loss	\$ (166)	\$ (329)	\$ (629)	\$ (485)
Provision for income tax	48	21	69	42
Interest expense (income), net	72	61	136	112
Amortization of intangible assets	191	190	386	398
Impairment of intangible asset	-	-	281	-
Depreciation	244	150	464	312
EBITDA	389	93	707	379
Other amortization	40	91	90	175
Stock based compensation	95	72	155	187
Adjusted EBITDA	\$ 524	\$ 256	\$ 952	\$ 741

The increase in Adjusted EBITDA for the three and six months ended March 31, 2012 as compared to the prior period is due to the aforementioned improvements in gross profit and the reduction of contingent earnout payments from a prior acquisition that will not be achieved, offset by increases in operating expenses as we continue to invest in sales and marketing, research and development, and other operating expenses in order to support iAPPS sales growth.

Liquidity and Capital Resources

Cash Flows

Operating Activities

Cash provided by operating activities was \$40 thousand for the six months ended March 31, 2012 compared to \$20 thousand for the six months ended March 31, 2011. The increase in cash provided from operating activities is primarily attributable to collection of accounts receivable, offset by decreases in accounts payable and lower net income for the period.

Investing Activities

Cash used in investing activities was \$888 thousand for the six months ended March 31, 2012 compared to \$626 thousand for the six months ended March 31, 2011. This amount included expenditures for equipment and improvements of \$580 thousand for the six months ended March 31, 2012 compared with \$213 thousand for the six months ended March 31, 2011. Costs for the acquisition of Magnetic Corporation were \$33 thousand. Cash consideration for the Magnetic acquisition was reduced by \$100 thousand for a working capital adjustment. Contingent acquisition payments were \$261 thousand for the six months ended March 31, 2012 compared with \$413 thousand for the six months ended March 31, 2011.

Financing Activities

Cash used in financing activities was \$292 thousand for the six months ended March 31, 2012 compared to cash provided by financing activities \$679 thousand for the six months ended March 31, 2011. Contributing to the use of cash for financing activities were payments on capital leases of \$135 thousand, payments on subordinated notes of \$83 thousand, and payments of \$120 thousand for debt acquired from the Magnetic Corporation acquisition.

Capital Resources and Liquidity Outlook

We believe that cash generated from operations and proceeds from the bank line of credit will be sufficient to fund the company's working capital and capital expenditure needs in the foreseeable future. We may choose to explore additional financing sources if needed to support our merger and acquisition strategy.

In May 2012, the Company amended its loan arrangement (the "2012 Amendment") with Silicon Valley Bank extending the maturity date of the line of credit for one year to March 31, 2014. The 2012 Amendment also revised certain financial covenants.

Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements, financings or other relationships with unconsolidated entities or other persons, other than our operating leases and contingent acquisition payments.

We currently do not have any variable interest entities. We do not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. Therefore, we are not materially exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in such relationships.

Commitments and Contingencies

We lease our facilities in the United States and India. During the quarter ended December 31, 2011, the Company signed a new office lease for its Burlington, MA corporate office location. The lease term expires in January 2019, with future minimum lease payments totaling \$1.8 million.

Other new contractual obligations as of March 31, 2012 include equipment acquired under capitalized lease agreements valued at \$104 thousand with payments extending through March 2015.

As of March 31, 2012, we had an accrued contingent earnout liability of \$1.5 million from acquisitions completed in prior fiscal years, which are scheduled to be paid out through fiscal 2015. Contingent earnout payments related to

acquisitions are paid when and if certain revenue and earnings targets are achieved. We also have potential contingent acquisition payments of \$660 thousand due related to acquisitions completed prior to January 1, 2009, which are not required to be accrued until earned.

On April 26, 2012, the Company was informed that on such date the United States District Court for the District of Puerto Rico entered a default judgment against the Company as part of a patent infringement lawsuit brought by Ingeniador, LLC against 16 companies, including Bridgeline. The Company is currently seeking to have the default judgment set aside as it was never informed of the lawsuit and were not offered an opportunity to address the complaint. Ingeniador, LLC alleges Bridgeline has been infringing its patent rights and is seeking monetary damages. The Company believes this lawsuit is without merit and intends to defend this case vigorously.

Additional Information

We have entered into a multi-year strategic alliance agreement with a Fortune 500 company. Due to the nature of iAPPS sales cycles and integration lead times, we do not expect to realize any material benefits from this alliance until the fourth quarter of fiscal 2012.

Critical Accounting Policies

These critical accounting policies and estimates by our management should be read in conjunction with Note 2 Summary of Significant Accounting Policies to the Consolidated Financial Statements that were prepared in accordance with accounting principles generally accepted in the United States of America (“US GAAP”) that are included in our Annual Report on Form 10-K and filed with the Securities and Exchange Commission on December 29, 2011.

The preparation of financial statements in accordance US GAAP requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses in the reporting period. We regularly make estimates and assumptions that affect the reported amounts of assets and liabilities. The most significant estimates included in our financial statements are the valuation of accounts receivable and long-term assets, including intangibles, goodwill and deferred tax assets, stock-based compensation, amounts of revenue to be recognized on service contracts in progress, unbilled receivables, and deferred revenue. We base our estimates and assumptions on current facts, historical experience and 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 values of assets and liabilities and the accrual of costs and expenses that are not readily apparent from other sources. The actual results experienced by us may differ materially and adversely from our estimates. To the extent there are material differences between our estimates and the actual results, our future results of operations will be affected.

We consider the following accounting policies to be both those most important to the portrayal of our financial condition and those that require the most subjective judgment:

- Revenue recognition;
- Allowance for doubtful accounts;
- Accounting for cost of computer software to be sold, leased or otherwise marketed;
- Accounting for goodwill and other intangible assets; and
- Accounting for stock-based compensation.

Revenue Recognition

Overview

We enter into arrangements to sell web application development services (professional services), software licenses or combinations thereof. Revenue is categorized into (i) Web Application Development Services (ii) Managed Service Hosting, and (iii) Subscriptions and Perpetual Licenses.

We recognize revenue as required by the Revenue Recognition Topic of the Codification. Revenue is generally recognized when all of the following conditions are satisfied: (1) there is persuasive evidence of an arrangement; (2) delivery has occurred or the services have been provided to the customer; (3) the amount of fees to be paid by the customer is fixed or determinable; and (4) the collection of the fees is reasonably assured. Billings made or payments received in advance of providing services are deferred until the period these services are provided.

During fiscal 2010, we began to develop a reseller channel to supplement our direct sales force for our iAPPS Product Suite. We continued to develop this reseller channel in fiscal 2012. Resellers are generally located in territories where we do not have a direct sales force. Customers generally sign a license agreement directly with us. Revenue from perpetual licenses sold through resellers is recognized upon delivery to the end user as long as evidence of an arrangement exists, collectability is probable, and the fee is fixed and determinable. Revenue for subscription licenses is recognized monthly as the services are delivered.

Web Application Development Services

Web application development services include professional services primarily related to the Company's web development solutions that address specific customer needs such as information architecture and usability engineering, interface configuration, application development, rich media development, back end integration, search engine optimization, and project management.

Web application development services are contracted for on either a fixed price or time and materials basis. For its fixed price engagements, after assigning the relative selling price to the elements of the arrangement, the Company applies the proportional performance model (if not subject to contract accounting) to recognize revenue based on cost incurred in relation to total estimated cost at completion. The Company has determined that labor costs are the most appropriate measure to allocate revenue among reporting periods, as they are the primary input when providing application development services. Customers are invoiced monthly or upon the completion of milestones. For milestone based projects, since milestone pricing is based on expected hourly costs and the duration of such engagements is relatively short, this input approach principally mirrors an output approach under the proportional performance model for revenue recognition on such fixed priced engagements. For time and materials contracts, revenues are recognized as the services are provided.

Web application development services also include retained professional services contracted for on an “on call” basis or for a certain amount of hours each month. Such arrangements generally provide for a guaranteed availability of a number of professional services hours each month on a “use it or lose it” basis. For retained professional services sold on a stand-alone basis we recognize revenue as the services are delivered or over the term of the contractual retainer period. These arrangements do not require formal customer acceptance and do not grant any future right to labor hours contracted for but not used.

Managed Service Hosting

Managed service hosting includes hosting arrangements that provide for the use of certain hardware and infrastructure for those customers who do not wish to host our applications independently. Hosting agreements are either annual or month-to-month arrangements that provide for termination for convenience by either party generally upon 30-days notice. Revenue is recognized monthly as the hosting services are delivered. Set up fees paid by customers in connection with managed hosting services are deferred and recognized ratably over the longer of the life of the hosting period or the expected lives of customer relationships. We continue to evaluate the length of the amortization period of the set up fees as we gain more experience with customer contract renewals.

Subscriptions and Perpetual Licenses

The Company licenses its software on either a perpetual or subscription basis. Customers who license the software on a perpetual basis receive rights to use the software for an indefinite time period and an option to purchase post-customer support (“PCS”). For arrangements that consist of a perpetual license and PCS, as long as Vendor Specific Objective Evidence (“VSOE”) exists for the PCS, then PCS revenue is recognized ratably on a straight-line basis over the period of performance and the perpetual license is recognized on a residual basis. Under the residual method, the fair value of the undelivered elements are deferred and the remaining portion of the arrangement fee is allocated to the delivered elements and recognized as revenue, assuming all other revenue recognition criteria have been met.

Customers may also license the software on a subscription basis, which can be described as “Software as a Service” or “SaaS”. SaaS is a model of software deployment where an application is hosted as a service provided to customers across the Internet. Subscription agreements include access to the Company’s software application via an internet connection, the related hosting of the application, and PCS. Customers receive automatic updates and upgrades, and new releases of the products as soon as they become available. Customers cannot take possession of the software. Subscription agreements are either annual or month-to-month arrangements that provide for termination for convenience by either party upon 90 days notice. Revenue is recognized monthly as the services are delivered. Set up fees paid by customers in connection with subscription services are deferred and recognized ratably over the longer of the life of subscription period or the expected lives of customer relationships. We continue to evaluate the length of the amortization period of the set up fees as we gain more experience with customer contract renewals.

Multiple Element Arrangements

In accounting for multiple element arrangements, we follow either ASC Topic 605-985 Revenue Recognition Software or ASC Topic 605-25 Revenue Recognition Multiple Element Arrangements, as applicable.

In October 2009, the FASB issued Accounting Standards Update No. 2009-13, Revenue Recognition: Multiple-Deliverable Revenue Arrangements (“ASU 2009-13”). ASU 2009-13 provides amendments to certain paragraphs of previously issued ASC Subtopic 605-25 – Revenue Recognition: Multiple-Deliverable Revenue Arrangements. In accordance with ASU 2009-13, each deliverable within a multiple-deliverable revenue arrangement is accounted for as a separate unit of accounting if both of the following criteria are met (1) the delivered item has value to the customer on a standalone basis and (2) for an arrangement that includes a right of return relative to the delivered item, delivery or performance of the delivered item is considered probable and within our control. If the deliverables do not meet the criteria for being a separate unit of accounting then they are combined with a deliverable that does meet that criterion. The accounting guidance also requires that arrangement consideration be allocated at the inception of an arrangement to all deliverables using the relative selling price method. The accounting guidance also establishes a selling price hierarchy for determining the selling price of a deliverable. We determine selling price using VSOE, if it exists; otherwise, we use Third-party Evidence (“TPE”). If neither VSOE nor TPE of selling price exists for a unit of accounting, we use Estimated Selling Price (“ESP”).

VSOE is generally limited to the price at which we sell the element in a separate stand-alone transaction. TPE is determined based on the prices charged by our competitors for a similar deliverable when sold separately. It is difficult for us to obtain sufficient information on competitor pricing, so we may not be able to substantiate TPE. If we cannot establish selling price based on VSOE or TPE then we will use ESP. ESP is derived by considering the selling price for similar services and our ongoing pricing strategies. The selling prices used in our allocations of arrangement consideration are analyzed at minimum on an annual basis and more frequently if our business necessitates a more timely review. We have determined that we have VSOE on our SaaS offerings, certain application development services, managed hosting services, and PCS because we have evidence of these elements sold on a stand-alone basis.

When the Company licenses its software on a perpetual basis in a multiple element arrangement that arrangement typically includes PCS and application development services, we follow the guidance of ASC Topic 605-985. In assessing the hierarchy of relative selling price for PCS, we have determined that VSOE is established for PCS. VSOE for PCS is based on the price of PCS when sold separately, which has been established via annual renewal rates. Similarly, when the Company licenses its software on a perpetual basis in a multiple element arrangement that also includes managed service hosting (“hosting”), we have determined that VSOE is established for hosting based on the price of the hosting when sold separately, which has been established based on renewal rates of the hosting contract. Revenue recognition for perpetual licenses sold with application development services are considered on a case by case basis. The Company has not established VSOE for perpetual licenses or fixed price development services and therefore in accordance with ASC Topic 605-985, when perpetual licenses are sold in multiple element arrangements including application development services where VSOE for the services has not been established, the license revenue is deferred and recognized using contract accounting. The Company has determined that services are not essential to the functionality of the software and it has the ability to make estimates necessary to apply percentage-of-completion accounting. In those cases where perpetual licenses are sold in a multiple element arrangement that includes application development services where VSOE for the services has been established, the license revenue is recognized under the residual method and the application services are recognized upon delivery.

In determining VSOE for the application development services element, the separability of the application development services from the software license and the value of the services when sold on a standalone basis are considered. The Company also considers the categorization of the services, the timing of when the services contract was signed in relation to the signing of the perpetual license contract and delivery of the software, and whether the services can be performed by others. The Company has concluded that its application development services are not required for the customer to use the product but, rather enhance the benefits that the software can bring to the customer. In addition, the services provided do not result in significant customization or modification of the software and are not essential to its functionality, and can also be performed by the customer or a third party. If an application development services arrangement does qualify for separate accounting, the Company recognizes the perpetual license on a residual basis. If an application development services arrangement does not qualify for separate accounting, the Company recognizes the perpetual license under the proportional performance model as described above.

When subscription arrangements are sold with application development services, the Company uses its judgment as to whether the application development services qualify as a separate unit of accounting. When subscription service arrangements involve multiple elements that qualify as separate units of accounting, the Company allocates arrangement consideration in multiple-deliverable arrangements at the inception of an arrangement to all deliverables based on the relative selling price model in accordance with the selling price hierarchy, which includes: (i) VSOE when available; (ii) TPE if VSOE is not available; and (iii) ESP if neither VSOE or TPE is available. For those subscription arrangements sold with multiple elements whereby the application development services do not qualify as a separate unit of accounting, the application services revenue is recognized ratably over the subscription period. Subscriptions also include a PCS component, and the Company has determined that the two elements cannot be separated and must be recognized as one unit over the applicable service period. Set up fees paid by customers in connection with subscription arrangements are deferred and recognized ratably over the longer of the life of the

hosting period or the expected lives of customer relationships, which generally range from two to three years. We continue to evaluate the length of the amortization period of the set up fees as we gain more experience with customer contract renewals and our newer product offerings.

Customer Payment Terms

Payment terms with customers typically require payment 30 days from invoice date. Payment terms may vary by customer but generally do not exceed 45 days from invoice date. Invoicing for web application development services are either monthly or upon achievement of milestones and payment terms for such billings are within the standard terms described above. Invoicing for subscriptions and hosting are typically issued monthly and are generally due in the month of service.

Our agreements with customers do not provide for any refunds for services or products and therefore no specific reserve for such is maintained. In the infrequent instances where customers raise concerns over delivered products or services, we have endeavored to remedy the concern and all costs related to such matters have been insignificant in all periods presented.

Warranty

Certain arrangements include a warranty period which is generally 30 days from the completion of work. In hosting arrangements, we provide warranties of up-time reliability. We continue to monitor the conditions that are subject to the warranties to identify if a warranty claim may arise. If we determine that a warranty claim is probable, then any related cost to satisfy the warranty obligation is estimated and accrued. Warranty claims to date have been immaterial.

Reimbursable Expenses

In connection with certain arrangements, reimbursable expenses are incurred and billed to customers and such amounts are recognized as both revenue and cost of revenue.

Allowance for Doubtful Accounts

We maintain an allowance for doubtful accounts which represents estimated losses resulting from the inability, failure or refusal of our clients to make required payments.

We analyze historical percentages of uncollectible accounts and changes in payment history when evaluating the adequacy of the allowance for doubtful accounts. We use an internal collection effort, which may include our sales and services groups as we deem appropriate. Although we believe that our allowances are adequate, if the financial condition of our clients deteriorates, resulting in an impairment of their ability to make payments, or if we underestimate the allowances required, additional allowances may be necessary, resulting in increased expense in the period in which such determination is made.

Accounting for Cost of Computer Software to be Sold, Leased or Otherwise Marketed

We charge research and development expenditures for technology development to operations as incurred. However, in accordance with Codification 985-20 Costs of Software to be Sold Leased or Otherwise Marketed, we capitalize certain software development costs subsequent to the establishment of technological feasibility. Based on our product development process, technological feasibility is established upon completion of a working model. Certain costs incurred between completion of a working model and the point at which the product is ready for general release are capitalized if significant. Once the product is available for general release, the capitalized costs are amortized in cost of sales.

Accounting for Goodwill and Intangible Assets

Goodwill is tested for impairment annually during the fourth quarter of every year and more frequently if events and circumstances indicate that the asset might be impaired. Though the Company's stock price declined from \$1.22 at September 30, 2010 (the date of the fiscal 2010 annual test) to \$0.53 at September 30, 2011, the Company did not consider the decline in stock price a triggering event as:

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The Company's performance since the last annual test has not deteriorated as both revenue and gross profit have increased and loss from operations was greater compared to fiscal 2010 due the Company's decision to invest in its iAPPS product suite; and

- The significant decrease in stock price is relatively recent as the stock price was \$1.44 at December 31, 2010, \$1.10 at March 31, 2011, and \$0.95 at June 30, 2011 and is not related to a change in the market conditions that would affect the Company.

At September 30, 2011 (the date of the fiscal 2011 annual test), the fair value exceeded the carrying value by \$4.3 million. This margin was based on a weighting applied to four different valuation methods which result in fair values ranging from \$24.6 million to \$27.2 million before the weightings were applied. Had the four methodologies been weighted differently, the percentage by which the fair value exceeded the carrying value may have been larger.

The factors the Company considers important that could indicate impairment include its stock price, significant under performance relative to prior operating results, change in projections, significant changes in the manner of the Company's use of assets or the strategy for the Company's overall business, and significant negative industry or economic trends.

In evaluating goodwill impairment, the Company considers a number of factors including discounted cash flow projections, guideline public company comparisons, acquisition transactions of comparable third party companies and capitalization value. Evaluating the potential impairment of goodwill is highly subjective and requires the Company to make significant estimates and judgment at many points during the analysis, especially with regard to the Company's future cash flows.

For the fiscal 2010 annual test, the Company weighted the Market Approach–Direct Market Capitalization Method 75% in its evaluation of the fair value of the Company's one reporting unit, which was a decrease from the 90% weighting used in fiscal 2009. For the fiscal 2011 annual test, the Company reduced the weighting further to 25% as the low level of market activity and substantial variation in price quotations based on the low activity of the Company's stock support the view that the Company's stock is inactive. The key assumption included in the Market Approach–Direct Market Capitalization Method was a control premium of 150%. This control premium was primarily based on an analysis of control premiums from a study of guideline merger and acquisition transactions. Specifically, the implied revenue multiples (the most commonly used valuation method for mergers and acquisitions in the technology industry) from the guideline transactions averaged 2.4 times revenue. The control premium of 150% implies a revenue multiple of 0.9 which the Company's management believes is reasonable and conservative. The control premium assumption of 150% was also corroborated by an analysis of potential synergies which could be realized by a market participant in an acquisition transaction. Using this control premium resulted in the fair value determined by the Market Approach–Direct Market Capitalization Method exceeding carrying value by \$2.5 million. The Company believes the most significant change in circumstances that could affect the key assumptions in its valuation is a significant reduction in the observed revenue multiples implied by future mergers and acquisitions.

While there are inherent limitations in any valuation, the Company believes that placing a significant weighting of 75% on the Discounted Cash Flow Method, the Guideline Public Company Method, and the Guideline Transaction Method are more indicative of the fair value, or the price, that the Company would be sold at in an orderly transaction between market participants. The Company believes the most significant change in circumstances that could affect the key assumptions in our valuation are a significant reduction in the observed revenue multiples implied by future mergers and acquisitions and/or a significant deterioration of the Company's projected financial performance.

During the twelve month period ended September 30, 2011, the carrying value of goodwill increased as a result of the acquisitions of TMX and e.Magination (both of which included contingent earnout payments recorded at the time of the transaction) and the accrual of contingent acquisition payments related to acquisitions completed prior to September 30, 2009 (which are recorded as increases to goodwill as they are earned but not currently recorded). The Company is obligated to continue paying quarterly contingent acquisition payments to former owners of acquired companies in the amount of \$825 thousand based on the achievement of certain predefined operating metrics. If such payments are earned they will be recorded as an increase to goodwill. To the extent goodwill continues to increase as a result of such payments and to the extent there are unfavorable changes in assumptions used to determine the Company's fair value (including a decline in the Company's market capitalization), there can be no assurance that the Company will not have an impairment charge in the future.

Accounting for Stock-Based Compensation

At March 31, 2012, we maintained two stock-based compensation plans more fully described in Note 11 to the Consolidated Financial Statements of our Annual Report on Form 10-K filed with the Securities and Exchange Commission on December 29, 2011.

The Company accounts for stock compensation awards in accordance with the Compensation-Stock Compensation Topic of the Codification. Share-based payments (to the extent they are compensatory) are recognized in our consolidated statements of operations based on their fair values.

We recognize stock-based compensation expense for share-based payments issued or assumed after October 1, 2006 that are expected to vest on a straight-line basis over the service period of the award, which is generally three years. We recognize the fair value of the unvested portion of share-based payments granted prior to October 1, 2006 over the remaining service period, net of estimated forfeitures. In determining whether an award is expected to vest, we use an estimated, forward-looking forfeiture rate based upon our historical forfeiture rate and reduce the expense over the recognition period. Estimated forfeiture rates are updated for actual forfeitures quarterly. We also consider, each quarter, whether there have been any significant changes in facts and circumstances that would affect our forfeiture rate. Although we estimate forfeitures based on historical experience, actual forfeitures in the future may differ. In addition, to the extent our actual forfeitures are different than our estimates, we record a true-up for the difference in the period that the awards vest, and such true-ups could materially affect our operating results.

We estimate the fair value of employee stock options using the Black-Scholes-Merton option valuation model. The fair value of an award is affected by our stock price on the date of grant as well as other assumptions including the estimated volatility of our stock price over the term of the awards and the estimated period of time that we expect employees to hold their stock options. The risk-free interest rate assumption we use is based upon United States treasury interest rates appropriate for the expected life of the awards. We use the historical volatility of our publicly traded options in order to estimate future stock price trends. In order to determine the estimated period of time that we expect employees to hold their stock options, we use historical trends of employee turnovers. Our expected dividend rate is zero since we do not currently pay cash dividends on our common stock and do not anticipate doing so in the foreseeable future. The aforementioned inputs entered into the option valuation model we use to fair value our stock awards are subjective estimates and changes to these estimates will cause the fair value of our stock awards and related stock-based compensation expense we record to vary.

We record deferred tax assets for stock-based awards that result in deductions on our income tax returns, based on the amount of stock-based compensation recognized and the statutory tax rate in the jurisdiction in which we will receive a tax deduction.

Stock Options Activity (Repricing Plans)

On October 28, 2011, the Company offered its employees the opportunity to have certain outstanding options modified by (i) reducing the grant exercise price to \$0.67, the fair market value of the common stock as of the modification date and (ii) starting a new three year vesting schedule. The aggregate fair value of the modified options of approximately \$90 thousand was calculated using the difference in value between the original terms and the new terms as of the modification date. The incremental cost of the modified option over the original option will be recognized as additional compensation expense over the new three year vesting period beginning on the date of modification. This opportunity was generally limited to options issued subsequent to the October 2008 repricing described above and in Note 11 to the Company's Annual Report on Form 10-K for fiscal 2011.

Item 3. Qualitative and Quantitative Disclosures About Market Risk.

Not required.

Item 4. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed under the Securities Exchange Act of 1934, as amended, 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 President and Chief Executive Officer (Principal Executive Officer) and our Senior Vice President of Finance and Chief Accounting Officer (Principal Financial and Accounting Officer), as appropriate, to allow 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, as ours are designed to do, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As of March 31, 2012 we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Accounting Officer, of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934. Based upon that evaluation, our Chief Executive Officer and Chief Accounting Officer concluded that our disclosure controls and procedures are effective in enabling us to record, process, summarize and report information required to be included in our periodic filings with the Securities and Exchange Commission within the required time period.

Changes in Internal Control over Financial Reporting

There have been no changes in our internal controls over financial reporting that occurred during the quarter ended March 31, 2012 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II – OTHER INFORMATION

Item 1. Legal Proceedings.

From time to time we are subject to ordinary routine litigation and claims incidental to our business. We are not currently involved in any legal proceedings that we believe are material beyond those previously disclosed in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on December 29, 2011 and that which is described below.

Bridgeline Digital, Inc vs. e.Magination network, LLC and its principal owner, Daniel Roche.

In August 2010, Bridgeline initiated a lawsuit against e.Magination network, LLC and its principal owner, Daniel Roche, in the Federal District Court of Massachusetts. Bridgeline seeks damages for accounts receivable allegedly collected by Mr. Roche and e.Magination and used to pay obligations of e.Magination and Mr. Roche (accounts receivable contractually belonging to Bridgeline). e.Magination and Mr. Roche have asserted counterclaims against Bridgeline and Thomas Massie alleging that Bridgeline has breached Mr. Roche's employment agreement by improperly terminating Mr. Roche for cause and also alleging breach of the Asset Purchase Agreement by Bridgeline. This lawsuit remains unresolved as of March 31, 2012.

Ingeniador, LLC vs. Interwoven, Inc., Bridgeline Digital, Inc., et al

On April 26, 2012, the Company was informed that on such date the United States District Court for the District of Puerto Rico entered a default judgment against the Company as part of a patent infringement lawsuit brought by Ingeniador, LLC against 16 companies, including Bridgeline. The Company is currently seeking to have the default judgment set aside as it was never informed of the lawsuit and was not offered an opportunity to address the complaint. Ingeniador, LLC alleges Bridgeline has been infringing its patent rights and is seeking monetary damages. The Company believes this lawsuit is without merit and intends to defend this case vigorously.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

The following summarizes all sales of our unregistered securities during the quarter ended March 31, 2012. The securities in each of the below-referenced transactions were (i) issued without registration and (ii) were subject to restrictions under the Securities Act and the securities laws of certain states, in reliance on the private offering exemptions contained in Sections 4(2), 4(6) and/or 3(b) of the Securities Act and on Regulation D promulgated there under, and in reliance on similar exemptions under applicable state laws as transactions not involving a public offering. Unless stated otherwise, no placement or underwriting fees were paid in connection with these transactions.

Other

During the fiscal quarter ended March 31, 2012, the Company granted 325,000 stock options under its Amended and Restated Stock Incentive Plan at a weighted average exercise price of \$0.75 per share.

The securities were issued exclusively to our directors, executive officers and employees. The issuance of options and the shares of common stock issuable upon the exercise of such options as described above were issued pursuant to written compensatory plans or arrangements with our employees, directors and consultants, in reliance on the exemptions from the registration provisions of the Securities Act set forth in Section 4(2) thereof relative to sales by an issuer not involving any public offering, to the extent an exemption from such registration was required.

Item 5. Other Information

On May 11, 2012, the Company amended its loan arrangement with Silicon Valley Bank ("2012 Amendment"). The 2012 Amendment extends the maturity date of the line of credit for one year to March 31, 2014 and also revises certain financial covenants.

Item 6. Exhibits.

The exhibits listed in the accompanying exhibit index are filed or incorporated by reference as part of this quarterly report.

Exhibit No.	Description of Document
10.1	Sixth Loan Modification Agreement dated May 11, 2012 between Bridgeline Digital, Inc., Bridgeline Intelligence Group, Inc. and Silicon Valley Bank.
31.1	Certification required by Rule 13a-14(a) or Rule 15d-14(a).
31.2	Certification required by Rule 13a-14(a) or Rule 15d-14(a).
32.1	Certification required by Rule 13a-14(b) or Rule 15d-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. §1350).
32.2	Certification required by Rule 13a-14(b) or Rule 15d-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. §1350).
101.INS*	XBRL Instance
101.SCH*	XBRL Taxonomy Extension Schema
101.CAL*	XBRL Taxonomy Extension Calculation
101.DEF*	XBRL Taxonomy Extension Definition
101.LAB*	XBRL Taxonomy Extension Labels
101.PRE*	XBRL Taxonomy Extension Presentation

*XBRL information is furnished and not filed or a part of a registration statement or prospectus for purposes of sections 11 and 12 of the Securities Act of 1933, as amended, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections.

SIGNATURES

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

Bridgeline Digital, Inc.
(Registrant)

May 14, 2012
Date

/s/ Thomas L. Massie
Thomas L. Massie
President and Chief Executive Officer
(Principal Executive Officer)

May 14, 2012
Date

/s/ Michael D. Prinn
Michael D. Prinn
Senior Vice President Finance and Chief Accounting
Officer
(Principal Financial and Accounting Officer)

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