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

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

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

For the quarterly period ended December 31, 2011

OR

o 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	52-2263942
State or other jurisdiction of incorporation or organization	IRS Employer Identification No.
80 Blanchard Road Burlington, Massachusetts	01803
(Address of Principal Executive Offices)	(Zip Code)

(781) 376-5555
(Registrant’s telephone number, including area code)
10 Sixth Road, Woburn, Massachusetts 01801
(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 x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files x Yes o 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 o	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company x

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

The number of shares of Common Stock par value $0.001 per share, outstanding as of February 9, 2012 was 12,472,873.

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Bridgeline Digital, Inc.

Quarterly Report on Form 10-Q

For the Quarterly Period ended December 31, 2011

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Bridgeline Digital, Inc.

Quarterly Report on Form 10-Q

For the Quarterly Period ended December 31, 2011

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," "beli "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 effect of the delisting of our common stock from 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	December 31, 2011	September 30, 2011
Current assets:		
Cash and cash equivalents	$1,684	$2,528
Accounts receivable and unbilled receivables, net	4,132	4,274
Prepaid expenses and other current assets	712	494
Total current assets	6,528	7,296
Equipment and improvements, net	2,218	1,779
Intangible assets, net	1,461	1,527
Goodwill	20,727	20,122
Other assets	704	685
Total assets	$31,638	$31,409
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$872	$1,291
Accrued liabilities	853	1,081
Accrued earnouts, current	572	295
Debt, current	667	1,750
Capital lease obligations, current	235	216
Deferred revenue	1,533	1,169
Total current liabilities	4,732	5,802
Accrued earnouts, net of current portion	1,122	772
Debt, net of current portion	4,098	3,017
Capital lease obligations, net of current portion	209	215
Other long term liabilities	529	395
Total liabilities	10,690	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; 12,472,873 and 12,306,207 shares issued and outstanding, respectively	12	12
Additional paid-in capital	38,292	38,083
Accumulated deficit	(17,233)	(16,770)
Accumulated other comprehensive loss	(123)	(117)
Total stockholders' equity	20,948	21,208

Total liabilities and stockholders’ equity	$31,638	$31,409

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 December 31, 2011	Three Months Ended December 31, 2010
Revenue:		
Web application development services	$5,308	$5,544
Managed service hosting	616	466
Subscription and perpetual licenses	593	519
Total revenue	6,517	6,529
Cost of revenue:		
Web application development services	2,855	3,014
Managed service hosting	106	146
Subscription and perpetual licenses	120	182
Total cost of revenue	3,081	3,342
Gross profit	3,436	3,187
Operating expenses:		
Sales and marketing	1,715	1,644
General and administrative	1,000	897
Research and development	403	382
Depreciation and amortization	415	348
Impairment of intangible asset	281	---
Total operating expenses	3,814	3,271
Loss from operations	(378)	(84)
Interest income (expense), net	(64)	(51)
Loss before income taxes	(442)	(135)
Provision for income taxes	21	21
Net loss	$(463)	$(156)
Net loss per share:		
Basic and diluted	$(0.04)	$(0.01)
Number of weighted average shares:		
Basic and diluted	12,319,643	11,883,860

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)

	Three Months Ended December 31, 2011	2010
Cash flows from operating activities:		
Net loss	$(463)	$(156)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Amortization of intangible assets	195	208
Impairment of intangible asset	281	-
Depreciation	220	162
Other amortization	50	84
Stock-based compensation	60	115
Changes in operating assets and liabilities:		
Accounts receivable and unbilled receivables	281	(204)
Prepaid expenses and other assets	(199)	(89)
Accounts payable and accrued liabilities	(674)	(454)
Deferred revenue	210	57
Other liabilities	134	(36)
Total adjustments	558	(157)
Net cash provided by/(used in) operating activities	95	(313)
Cash flows from investing activities:		
Equipment and improvements	(523)	(122)
Acquisitions, net of cash acquired	(134)	-
Contingent acquisition payments	(83)	(308)
Net cash used in investing activities	(740)	(430)
Cash flows from financing activities:		
Proceeds from sale of common stock, net of issuance costs	-	857
Borrowings from bank line of credit	1,875	2,450
Payments on bank line of credit	(1,835)	(2,625)
Payments on subordinated promissory notes	(42)	-
Payment on acquired debt	(120)	-
Principal payments on capital leases	(71)	(14)
Net cash (used in)/provided by financing activities	(193)	668
Effect of exchange rate changes on cash and cash equivalents	(6)	2
Net decrease in cash and cash equivalents	(844)	(73)
Cash and cash equivalents at beginning of period	2,528	3,045
Cash and cash equivalents at end of period	$1,684	$2,972
Supplemental disclosures of cash flow information:		
Cash paid for:		
Interest	$60	$6
Income taxes	$1	$15
Non cash activities:		
Equipment purchased under capital leases	$76	$473
Equipment and other assets included in accounts payable	$166	$4
Common stock issued in connection with acquisition	$150	$-

Accrued contingent consideration (earnouts)	$600	$-

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.

KMWorld Magazine Editors selected iAPPS as a Trend Setting Product in both 2010 and 2011. 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 December 31, 2011 and the Condensed Consolidated Statements of Operations and Cash Flows for the three months ended December 31, 2011 and 2010, 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 financial statements include all adjustments, consisting of normal recurring adjustments and accruals, necessary for the fair presentation of the Company’s financial position at December 31, 2011 and its results of operations for the three months ended December 31, 2011 and 2010, respectively, and its cash flows for the three months ended December 31, 2011 and 2010, respectively. The results for the three months ended December 31, 2011 are not necessarily indicative of the results to be expected for the year ending September 30, 2012. The accompanying September 30, 2011 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

There have been no recent accounting pronouncements or changes in accounting pronouncements that impacted the first quarter of fiscal 2012, or which are expected to impact future periods, that were not already adopted and disclosed in prior periods.

Subsequent Events

The Company evaluated subsequent events through February 14, 2012 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 December 31, 2011	As of September 30, 2011
Accounts receivable	$ 3,667	$ 4,197
Unbilled receivables	613	365
Subtotal	4,280	4,562
Allowance for doubtful accounts	(148)	(288)
Accounts receivable and unbilled receivables, net	$ 4,132	$ 4,274

4. Acquisitions

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) $150,000 in cash and (ii) contingent consideration of up to $600,000 in cash and 166,666 shares of Bridgeline Digital common stock, valued at $150,000 ($0.90 per share). 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.

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. Revenues for the quarter ended December 31, 2011 were $500 thousand. Proforma financial information for prior periods is not presented as the results of operations were not material, and had no impact on the results of operations.

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

Net assets acquired:	

Cash	$	16
Accounts Receivable, net		139
Other Assets		87
Fixed Assets		57
Intangible Assets		410
Goodwill		522
Total Assets		1,231
Current Liabilities		331
Total liabilities assumed		331
Net assets acquired:	$	900
Purchase Price:		
Cash Paid	$	150
Contingent earnouts - payable in cash		600
Contingent earnouts - payable in common stock		150
	$	900

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.

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

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.

5. Intangible Assets

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

	As of December 31, 2011		
	Gross Amount	Accumulated Amortization	Net Amount
Intangible assets:			
Domain and trade names	$26	$(26)	$-
Customer related	3,747	(2,474)	1,273
Non-compete agreements	697	(509)	188
Acquired software	362	(362)	-
Total intangible assets	$4,832	$(3,371)	$1,461

	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 months ended December 31, 2011 and 2010 is as follows:

Amortization expense charged to:	Three Months Ended December 31, 2011	2010
Operating expense *	$ 476	$ 186
Cost of revenue	-	22
Total	$ 476	$ 208

* Included in amortization expense 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 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. 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 December 31, 2011	As of September 30, 2011
Balance at beginning of period	$ 20,122	$ 20,036
Acquisitions	522	-
Contingent acquisition payments	83	86
Balance at end of period	$ 20,727	$ 20,122

Contingent acquisition payments ("earnouts") related to acquisitions completed before September 30, 2009 are accounted for as an increase to goodwill at the time such earnouts are 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 did not record a goodwill impairment charge.

7. Debt

Debt consists of the following:

	As of December 31, 2011	As of September 30, 2011
Line of credit borrowings	$ 2,432	$ 2,392
Bank term loan	2,000	2,000
Subordinated promissory note	333	375
Total debt	$ 4,765	$ 4,767
Less current portion	$ 667	$ 1,750
Long term debt, net of current portion	$ 4,098	$ 3,017

8. 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 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 fiscal quarter ended December 31, 2011, common shares of 13,889 were earned and issuable.

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.

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

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.

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 December 31, 2011: (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	1,412,667	0.65	—	—
Exercised	—	—	—	—
Forfeited, cancelled or expired	(867,164)	1.10	—	—
Outstanding, December 31, 2011	2,825,707	$ 0.80	207,000	$ 4.13

9. Comprehensive Loss

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

	December 31,	
Comprehensive loss was as follows:	2011	2010

Net loss	$	(463)	$	(156)
Net change in foreign currency translation adjustment		(6)		2
Comprehensive loss	$	(469)	$	(154)

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

10. Net Income Per Share

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.

Basic net loss per share for the three months ended December 31, 2011 and 2010 was ($0.04) and $(0.01), respectively. For the three months ended December 31, 2011 and 2010, options to purchase shares of the Company's common stock of 162,691 and 478,820 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 and 152,777 shares to be issued in connection with the Magnetic acquisition.

11. Income Taxes

Income tax expense was $21 thousand for both the three months ended December 31, 2011 and 2010, respectively. Income tax expense represents 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.

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.

KMWorld Magazine Editors selected iAPPS as a Trend Setting Product in both 2010 and 2011. 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 640 customers at December 31, 2011 compared with approximately 565 customers at December 31, 2010, an increase of 13%. Approximately 465 of the Company’s customers, or 73%, pay a monthly subscription fee or a monthly managed service hosting fee.

For the three months ended December 31, 2011 and 2010, no customer represented 10% or more of total revenue.

Results of Operations for the Three Months Ended December 31, 2011 compared to the Three Months Ended December 31, 2010

Total revenue for the three months ended December 31, 2011 remained flat at $6.5 million compared with three months ended December 31, 2010. We had a net loss of ($463) thousand for the three months ended December 31, 2011 compared with a net loss of ($156) thousand for the three months ended December 31, 2010. Net loss per share for the three months ended December 31, 2011 and 2010 was ($0.04) and ($0.01), respectively.

On October 3, 2011, the Company completed the acquisition of Magnetic Corporation ("Magnetic"), a Tampa, Florida based web technology company. The Company acquired all of the outstanding capital stock of Magnetic for consideration consisting of (i) $150,000 in cash and (ii) contingent consideration of up to $600,000 in cash and 166,666 shares of Bridgeline Digital common stock valued at $150,000 ($0.90 per share). 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.

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.

Revenue:	Three Months Ended December 31, 2011		Three Months Ended December 31, 2010		$ Change		% Change	
Web application development services								
iAPPS application development services	$ 3,015		$ 2,300		$ 715		31	%
% of total revenue	46	%	35	%				
Other application development services	2,293		3,244		(951	)	(29	%)
% of total revenue	35	%	50	%				
Subtotal web application development services	5,308		5,544		(236	)	(4	%)
% of total revenue	81	%	85	%				
Managed service hosting	616		466		150		32	%
% of total revenue	9	%	7	%				
Subscription and perpetual licenses	593		519		74		14	%
% of total revenue	9	%	8	%				
Total revenue	6,517		6,529		(12	)	-	
Cost of revenue:								
Web application development services								
iAPPS application development cost	1,447		1,100		347		32	%
% of iAPPS application revenue	48	%	48	%				
Other application development cost	1,408		1,914		(506	)	(26	%)
% of other application development revenue	61	%	59	%				
Subtotal web application development services	2,855		3,014		(159	)	(5	%)
% of web application development services revenue	54	%	54	%				
Managed service hosting	106		146		(40	)	(27	%)
% of managed service hosting revenue	17	%	31	%				
Subscription and perpetual licenses	120		182		(62	)	(34	%)
% of subscription and perpetual revenue	20	%	35	%				
Total cost of revenue	3,081		3,342		(261	)	(8	%)
Gross profit	3,436		3,187		249		8	%
Gross profit margin	53	%	49	%				
Operating expenses:								

Sales and marketing		1,715			1,644			71		4 %
% of total revenue		26	%		25	%				
General and administrative		1,000			897			103		11 %
% of total revenue		15	%		14	%				
Research and development		403			382			21		6 %
% of total revenue		6	%		6	%				
Depreciation and amortization		415			348			67		19 %
% of total revenue		6	%		5	%				
Impairment of intangible asset		281			-			281		100 %
% of total revenue		4	%		-					
Total operating expenses		3,814			3,271			476		15 %
Loss from operations		(378	)		(84	)		(227	)	270 %
Interest income (expense) net		(64	)		(51	)		(13	)	25 %
Loss before income taxes		(442	)		(135	)		(240	)	178 %
Provision for income taxes		21			21			-		-
Net loss	$	(463	)	$	(156	)	$	(240	)	154 %
Adjusted EBITDA	$	428		$	485			(56	)	(12 %)

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 December 31, 2011 remained flat at $6.5 million compared with the three months ended December 31, 2010.

Web Application Development Services

Revenue from web application development decreased $236 thousand, or 4% to $5.3 million from $5.5 million for the three months ended December 31, 2011 compared to the three months ended December 31, 2010. Web application development services revenue is comprised of iAPPS development related services and other web development related services generated from non iAPPS related web development engagements. Web application development revenue related to iAPPS engagements increased $715 thousand or 31% while non-iAPPS related web application development revenues decreased $951 thousand or 29%, as we continue to focus on iAPPS engagements.

The decrease in total web application revenues is due to: (i) a stoppage in non-iAPPS related development services from a customer due to a loss of their funding and (ii) our decision to stop servicing low margin non-iAPPS opportunities acquired from e.Magination IG, LLC. These decreases were offset by a 31% increase in iAPPS development services and incremental revenues generated from our acquisition of Magnetic.

Web application development services revenue as a percentage of total revenue decreased to 81% from 85% for the three months ended December 31, 2011 compared to the three months ended December 31, 2010. This was due to the increases in license and hosting revenue as we continue to sell more iAPPS licenses.

Managed Service Hosting

Revenue from managed service hosting increased $150 thousand, or 32% to $616 thousand from $466 thousand for the three months ended December 31, 2011 compared to the three months ended December 31, 2010. Managed services revenue as a percentage of total revenue increased to 9% from 7% the three months ended December 31, 2011 compared to the three months ended December 31, 2010, as a result of the increase in revenue. The increase is attributable to an increase in iAPPS related hosting arrangements for perpetual licenses sold and incremental revenues generated from our acquisition of Magnetic.

Subscription and Perpetual Licenses

Revenue from subscription and perpetual licenses increased $74 thousand, or 14% to $593 thousand from $519 thousand for the three months ended December 31, 2011 compared to the three months ended December 31, 2010. Subscription and perpetual license revenue as a percentage of total revenue increased to 9% from 8% for the three months ended December 31, 2011 compared to the three months ended December 31, 2010. The increase is due primarily to a higher amount of iAPPS SaaS subscription revenues, and to a lesser extent iAPPS perpetual license revenue recognized in the three months ended December 31, 2011 compared to iAPPS licenses and subscriptions recognized in the three months ended December 31, 2010.

Costs of Revenue

Total cost of revenue decreased $261 thousand, or 8% to $3.1 million from $3.3 million the three months ended December 31, 2011 compared to the three months ended December 31, 2010.

Cost of Web Application Development Services

Cost of web application development services decreased $159 thousand, or 5% to $2.9 million from $3.0 million for the three months ended December 31, 2011 compared to the three months ended December 31, 2010. The cost of web application development services as a percentage of application development services revenue remained flat at 54% for the both periods. The decrease in cost of web application development services is attributable to the 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 iAPPS application development services related to iAPPS engagements increased $347 thousand in proportion to the increases in iAPPS application development services revenues. Cost of other application development services decreased $509 thousand driven by the decrease in staff previously supporting e.Magination IG, LLC contracts.

Cost of Managed Service Hosting

Cost of managed service hosting decreased $40 thousand or 27% for the three months ended December 31, 2011 compared to the three months ended December 31, 2010. The cost of managed services as a percentage of managed services revenue decreased to 17% from 31% for the three months ended December 31, 2011 compared to the three months ended December 31, 2010. The decrease in managed service hosting costs is due to our continued efforts to streamline expenses.

Cost of Subscription and Perpetual License

Cost of subscription and perpetual licenses decreased $62 thousand, or 34%, for the three months ended December 31, 2011 compared to the three months ended December 31, 2010. The cost of subscription and perpetual licenses as a percentage of subscription and perpetual license revenue decreased to 20% from 35% for the three months ended December 31, 2011 compared to the three months ended December 31, 2010. The decrease in subscription and perpetual license costs and the improvement in margin is attributable to higher percentage of revenues from iAPPS SaaS licenses and maintenance renewals on iAPPS perpetual licenses.

Operating Expenses

Sales and Marketing Expenses

Sales and marketing expenses increased $71 thousand, or 4% to $1.7 million from $1.6 million for the three months ended December 31, 2011 compared to the three months ended December 31, 2010. Sales and marketing expenses represented 26% and 25% of total revenue for the three months ended December 31, 2011 and 2010, respectively. This increase is primarily attributable to additional sales personnel added as a result of acquisition of Magnetic.

General and Administrative Expenses

General and administrative expenses increased $103 thousand, or 11% to $1 million from $897 thousand for the three months ended December 31, 2011 compared to the three months ended December 31, 2010. General and administrative expenses represented 15% and 14% of total revenue for the three months ended December 31, 2011 and 2010, respectively. The increase in general and administrative expenses is primarily due to personnel costs and increased staffing.

Research and Development

Research and development expense increased by $21 thousand, or 6% to $403 thousand from $382 thousand for the three months ended December 31, 2011 compared to the three months ended December 31, 2010. No software costs were capitalized in the three months ended December 31, 2011 or 2010. 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 for our iAPPS Product Suite.

Depreciation and Amortization

Depreciation and amortization expense increased by $67 thousand, or 19% to $415 thousand from $348 thousand for three months ended December 31, 2011 compared to the three months ended December 31, 2010. Depreciation and amortization represented 6% and 5% of revenue for the three months ended December 31, 2011 and 2010, respectively. The increase is attributable to costs related to investments in our cloud-based infrastructure and amortization of intangible assets acquired through acquisitions.

Impairment of Intangible Assets

This increase 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 (Loss) from Operations

The loss from operations was ($378) thousand for the three months ended December 31, 2011, as compared to a loss from operations of ($84) thousand for the three months ended December 31, 2010. The loss from operations for the three months ended December 2011 is primarily attributable to the impairment charge of $281 thousand.

Income Taxes

The provision for income tax expense was $21 thousand for both the three months ended December 31, 2011 and the three months ended December 31, 2010. 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.

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 (which is the most directly comparable GAAP operating performance measure) to EBITDA, and EBITDA to Adjusted EBITDA:

(in thousands)	Three Months Ended December 31,	
	2011	2010
Net loss	$ (463)	$ (156)
Provision for income tax	21	21
Interest expense (income), net	64	51
Amortization of intangible assets	195	208
Impairment of intangible asset	281	--
Depreciation	220	162
EBITDA	318	286
Other amortization	50	84
Stock based compensation	60	115
Adjusted EBITDA	$ 428	$ 485

The decrease in Adjusted EBITDA is primarily related to a larger net loss for the current period and the impairment of intangible assets, partially offset by decreases in other amortization for capitalized software and stock-based compensation charges.

Liquidity and Capital Resources

Cash Flows

Operating Activities

Cash provided by operating activities was $95 thousand for the three months ended December 31, 2011 compared to cash used in operating activities of $313 thousand for the three months ended December 31, 2010. The increase in cash from operating activities is primarily attributable to an increase in deferred revenues and collection of accounts receivable, offset by lower net income for three months ended December 31, 2011 compared to the three months ended December 31, 2010.

Investing Activities

Cash used by investing activities was $740 thousand for the three months ended December 31, 2011 compared to $430 thousand for the three months ended December 31, 2010. This amount included expenditures for equipment and improvements of $523 thousand for the three months ended December 31, 2011 compared with $122 thousand for the three months ended December 31, 2010. Costs for the acquisition of Magnetic Corporation were $134 thousand and contingent acquisition payments were $83 thousand for the three months ended December 31, 2011 compared with costs related to acquisitions and contingent acquisition payments of $308 thousand for the three months ended December 31, 2010.

Financing Activities

Cash used in financing activities was $193 thousand for the three months ended December 31, 2011 compared cash provided by financing activities of $668 thousand for the three months ended December 31, 2010. Cash used in financing activities for the three months ended December 31, 2011 includes payments on capital leases of $71 thousand, payments on subordinated debt of $42 thousand, and payment on bank loans assumed from the acquisition of Magnetic Corporation of $120 thousand.

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.

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.

Contractual Obligations

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 December 31, 2011 include equipment acquired under capitalized lease agreements valued at $76 thousand with payments extending through December 2014.

As of December 31, 2011, we had an accrued contingent earnout liability of $1.7 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 $743 thousand due related to acquisitions completed prior to September 30, 2009, which are not required to be accrued until earned.

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 RevenueArrangements ("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:

- 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 December 31, 2011, 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 December 31, 2011, 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 December 31, 2011 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 may be involved in litigation relating to claims arising out of our operations. 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.

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

The following summarizes all sales of our unregistered securities during the quarter ended December 31, 2011. 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.

Common Stock

On October 3, 2011, the Company completed the acquisition of Magnetic Corporation (“Magnetic”), a Tampa, Florida based web technology company. In connection with this acquisition, the Company issued 166,666 shares of Bridgeline Digital common stock to the sole stockholder of Magnetic as partial contingent consideration for the purchase. The common stock has been issued and is being held in escrow pending satisfaction of the applicable earnout 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.

Item 6. Exhibits.

Exhibit No.	Description of Document
2.1	Agreement and Plan of Merger, dated October 3, 2011, by and among Bridgeline Digital, Inc., Magnetic Corporation and Jennifer Bakunas (incorporated by reference to Exhibit 2.1 to our Current Report on Form 8-K filed on October 6, 2011).
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)
February 14, 2012 Date	/s/ Thomas L. Massie Thomas L. Massie President and Chief Executive Officer (Principal Executive Officer)
February 14, 2012 Date	/s/ Michael D. Prinn Michael D. Prinn Senior Vice President Finance and Chief Accounting Officer (Principal Financial and Accounting Officer)

INDEX OF EXHIBITS

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