Bridgeline Software, Inc.
Form 10KSB
December 26, 2007

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

Form 10-KSB

(Mark One)
x ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended September 30, 2007

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

Delaware	**52-2263942**
State or Other Jurisdiction of Incorporation	IRS Employer Identification No.
10 Sixth Road **Woburn, Massachusetts**	**01801**
(Address of Principal Executive Offices)	(Zip Code)

(781) 376-5555
(Issuer's telephone number)

Securities registered under Section 12(b) of the Exchange Act:

Title of each class	Name of exchange on which registered
Common Stock, $0.001 par value per share	The NASDAQ Stock Market, LLC

Securities registered under Section 12(g) of the Exchange Act:
None

Check whether issuer is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act o.

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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.

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B contained in this form, and no disclosure will be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB o.

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 issuer's revenues for its most recent fiscal year $11,200,000.

The aggregate market value of the voting and non-voting common equity held by non-affiliates was $24,367,324 based on the closing price of $3.71 of the issuer’s common stock, par value $.001 share, as reported by NASDAQ on December 11, 2007.

As of December 11, 2007, there were 8,653,949 shares of common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE: Portions of the definitive proxy statement for our 2007 annual meeting of stockholders, which is to be filed within 120 days after the end of the fiscal year ended September 30, 2007, are incorporated by reference into Part III of this Form 10-KSB, to the extent described in Part III.

Transitional Small Business Disclosure Format (check one): Yes o No x

Forward Looking Statement

Statements contained in this Annual Report on Form 10-KSB 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 thos negative of those terms. These statements appear in a number of places in this Form 10-KSB and include statements regarding the intent, belief or current expectations of Bridgeline Software, 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 our limited operating history, our license renewal rate, our inability to manage our future growth efficiently or profitably, our inability to find, complete and integrate additional acquisitions, the acceptance of our products, the performance of our products, our dependence on our management team and key personnel, our ability to hire and retain future key personnel or the impact of competition and our ability to maintain margins or market share. 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 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 Software, Inc.

PART I

Item 1. Business.

Overview

Bridgeline Software is a developer of web application management software and award-winning web applications that help organizations optimize business processes. Bridgeline's software and services help customers maximize revenue, improve customer service and loyalty, enhance employee knowledge, and reduce operational costs by leveraging web based technologies.

Bridgeline's iAPPS® Framework and Product Suite are SaaS (software as a service) solutions that unify Content Management, Analytics, eCommerce, and eMarketing capabilities; enabling business users to enhance and optimize the value of their web properties. Combined with award-winning application development services, Bridgeline believes they helps customers cost-effectively accommodate the changing needs of today's websites, intranets, extranets, and mission-critical web applications.

The iAPPS® Product Suite is delivered through a SaaS business model, in which we deliver our software over the Internet while providing maintenance, daily technical operation and support.

Bridgeline Software's team of Microsoft®-certified developers specialize in end-to-end web application development, information architecture, usability engineering, SharePoint development, rich media development, search engine optimization, and fully-managed application hosting.

Products and Services

Software Products

On-Demand (SaaS) Web Application Management Software - iAPPS®

Business processes, regardless of industry or vertical market, fall into common categories. Our research found companies must consistently address issues surrounding security, workflow, version control, and user management. While the processes of individual entities may vary, the underlying elements mentioned above share common characteristics. Over the last two and a half years, we have developed a very powerful and scalable .NET application development framework based on leveraging these common characteristics. We call our framework iAPPS®. In August 2007, we released the iAPPS® framework.

The iAPPS® framework offers a unified, common set of shared services that are critical to today's business web environments. The iAPPS® framework empowers companies and developers to create websites and web applications with advanced business logic, state-of-the-art graphical user interfaces, and improved quality – all in a shorter timeframe with less coding than is typically required by comparable products. The iAPPS® framework allows our application development teams to develop web applications based on analyzing and optimizing our customers' business processes, and then map the results to a common software component solution. While a very powerful concept on its own, the real synergies come together when the iAPPS® framework is combined with the iAPPS® product suite of website and application management products. The iAPPS® product suite includes:

- iAPPS® Content Manager (released in October 2007) allows non-technical users to create, edit, and publish content via a browser-based interface. The advanced, easy-to-use interface will allow businesses to keep content and promotions fresh - whether for a public commercial site or a company intranet. The iAPPS® Content Manager will handle the presentation of content based on a sophisticated indexing and security scheme that includes management of front-end access to online applications. The system will provide a robust library functionality to manage permissions, versions and organization of different content types, including multimedia files and images. Administrators will be able to easily configure a simple or advanced workflow. The system can accommodate the complexity of larger companies with strict regulatory policies. In addition, the open nature of the iAPPS® Framework allows for the integration of this content management system functionality into any .NET-based web application.

- iAPPS® Analytics (planned release in February 2008) will provide Bridgeline Software customers the ability to manage, measure and optimize their web presence by recording detailed events and subsequently mine data within a web application for statistical analysis. Our customers will have access to information regarding where their visitors are coming from, what content and products their viewers are most interested in, and how they navigate through a particular web application. Through user-definable web reports, iAPPS® Analytics will provide insight into areas like visitor usage, content access, age of content, actions taken, and event triggers, and will report on both client and server-side events. iAPPS® Analytics will also be used to track events and create integrated reports across the entire iAPPS® product suite including campaign management (iAPPS® Marketier), content management (iAPPS® Content Manager) and commerce (iAPPS® Commerce).

- iAPPS® Commerce (planned released in mid 2008) will provide an online eCommerce solution to assist Bridgeline's customers in maximizing and managing all aspects of their commerce initiatives. The customizable dashboard will provide customers with a real-time overview of the performance of their online stores, such as sales trends, demographics, profit margins, inventory levels, inventory alerts, fulfillment deficiencies, average check out times, potential production issues, and delivery times. Commerce will also provide backend access to payment and shipping gateways. In combining iAPPS® Commerce with Analytics and Marketier, our customers can take their commerce initiatives to a new level by personalizing their product offerings, improving their marketing effectiveness, and providing value-added services or cross selling products.

- iAPPS® Marketier (planned release at the end of 2008) will provide a marketing lifecycle management tool that will include customer transaction analysis, email management, surveys and polls, event registration and issue tracking to measure campaign return on investments and client satisfaction. Web site content and user profiling will be leveraged to deliver targeted campaigns and stronger customer relationships. The email management features will provide comprehensive reporting capabilities including success rate, and recipient activity such as click-thrus and opt-outs. The iAPPS® Marketier will integrate with leading customer relationship management systems (CRM's) such as Salesforce.com and leading ad banner engines such as Google.

The iAPPS® framework and product suite are available as a Software-as-a-Service (SaaS) business model, with associated maintenance, daily technical operation, and support, or as a commercially licensed and supported internal solution for customers preferring a dedicated server environment (within their firewall or at one of our facilities). Due to the flexibility of the core architecture, the iAPPS® framework and product suite can also be sold as a traditional perpetual software license arrangement.

On-Demand (SaaS) Web Tools - Orgitecture™

Our Orgitecture ™ platform, developed several years ago, provides customers with an integrated suite of on-demand (SaaS) Web-based tools designed to streamline Web site management and reduce web related development costs. Orgitecture offers the stability, reliability and economies of scale of a subscription-based service.

Developed on open source standards, Orgitecture facilitates the development and deployment of Web properties. Web solutions developed on Orgitecture are modular by design, so customers can add functionality as their needs evolve. Every Orgitecture Web site is customized by our developers to meet the unique needs of our customers. Software modules include: Web content management, survey tools, calendaring, email newsletters, online registration, and ecommerce.

Our newly developed iAPPS® web application management software will replace Orgitecture. We plan to migrate Orgitecture customers to the iAPPS® Framework over the next 18-24 months.

Revenue from sales of on-demand SaaS web tools are reported as *Subscriptions* in the accompanying financial statements.

Web Application Development Services

Web Application Development

Web application development services address specific customer needs such as usability engineering, information architecture, application development, rich media development, and search engine optimization. We sell these custom services through our internal direct sales force. Web application development engagements often include our software products or hosting arrangements that provide for the use of certain hardware and infrastructure at one of our co-managed network operating centers. Web application development services are often sold as part of multiple element arrangements wherein retained professional services and/or hosting (i.e., Managed Services) are provided subsequent to completion of the web application development.

Information Architecture

Information Architecture is a design methodology focused on structuring information to ensure that users can find the appropriate data and can complete their desired transactions within a Web site or a Web application. Understanding users and the context in which users will be initiating with a Web application is central to information architecture. Information architects try to put themselves in the position of a typical user of an application to better understand a user’s characteristics, behaviors, intentions and motivations. At the same time, the information architect develops an understanding of a Web application’s functionality and data structures. The understanding of these components enables the architect to make customer centric decisions about the end user and then translate those decisions into site maps, wire frames and clickable prototypes.

Information architecture forms the foundation of a Web application’s usability. The extent to which a Web application is user-friendly and is widely adopted by a user base is primarily dependent on the success of the information architecture. Information architecture defines how well users can navigate through a Web site or application and how easily they can find the desired information or function. As Web application development becomes more standard and commoditized, information architecture will increase as a differentiator for application developers.

Usability Engineering

The Web was originally conceived as a hypertextual information space, but the development of increasingly sophisticated user interfaces and applications has fostered its use as a remote software interface. This dual nature has led to much confusion, as user experience has been mixed. Today, usability engineering is a critical component towards developing any successful Web based application.

By integrating usability into traditional Web development life cycles, we believe our usability engineers can significantly enhance a user experience. Our usability professionals provide the following services: usability audits, information architecture, process analysis and optimization, interface design and user testing.

Our systematic and user-centered approach to Web development focuses on developing Web applications that are intuitive, accessible, engaging, and effective. Our goal is to produce a net effect of increased traffic, improved visitor retention, increased user productivity, reduced user error, lower support cost, and reduced long-term development cost.

Search Engine Optimization (SEO)

Bridgeline Software helps customers maximize the effectiveness of their online marketing activities to ensure that their web applications can be exposed to the potential customers that use search engines to locate products and services. Bridgeline's SEO services include competitive analysis, website review, keyword generation, proprietary leading page technology, ongoing registration, monthly reports, and monitoring.

Revenue from the above Web application development services is reported as *Web Development Services* in the accompanying financial statements.

Managed Services *(including Hosting)*

Many of our customers hire us to host and manage the web applications we develop. Bridgeline provides a complete outsourcing solution through our fully managed hosting services. Our hosting facility includes dedicated in-house production and development servers, as well as a dedicated, 24-hour monitored co-location facility for mission critical applications.

Through our partnership with Savvis and Internap, we offer co-location services in state-of-the-art data centers. We provide 24/7 application monitoring, emergency response, version control, load balancing, managed firewall security, and virus protection services. We provide shared hosting, dedicated hosting, and SaaS hosting for our customers.

We also offer our customers retained professional services. These services are either 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 processional services hours each month on a “use it or lose it” basis.

Revenue from Managed Services are reported as *Managed Services* in the accompanying financial statements.

Sales and Marketing

Bridgeline Software employs a direct sales force and each sale is typically a time intensive sale taking anywhere from 30 days to 180 days on average to consummate. Our direct sales force focuses its efforts selling to medium-sized business and large business. These businesses are typically in the following vertical markets: Financial services, life sciences, high technology, foundations, and government agencies.

We have five geographic locations in the United States with full-time professional direct sales staffs. Our geographic locations are in the Atlanta area, Boston area, Chicago area, New York area, and Washington DC area.

Four phase engagement methodology

We use an accountable, strategic engagement process developed specifically for target companies that require a technology based professional approach, such as middle market type companies. We believe it is critical to qualify each opportunity and to assure our skill set and tools match up well with the customer’s needs. As an essential part of every engagement, we believe our four phase engagement methodology streamlines our customer qualification process, strengthens our relationship with our customer, ensures our skill set and tools match the customer’s needs, and we believe results in the submission of accurate proposals.

Organic growth from existing customer base

We have specific programs that consistently market our brand, web application development software, and our services. Our business development professionals seek ongoing business opportunities within our customer base and within other operating divisions or subsidiaries of our existing customer base.

New customer acquisition

In the geographies in which we operate, we identify target customers within our vertical expertise (financial services, life sciences, high technology, foundations, and government). Our business development professionals develop an annual territory plan identifying various strategies to engage our target customers.

Customer retention programs

We use email marketing capabilities when marketing to our customer base. We email eNewsletters, internally generated whitepapers, and Company announcements to our customers. In addition we host educational on-line seminars on a regular basis.

New lead generation programs

We generate targeted leads and new business opportunities by leveraging on-line marketing strategies. We receive leads by maximizing the search engine optimization of our own web site. Through our web site, we provide various educational white papers and promote upcoming on-line seminars. In addition we pay for banner advertisements on various independent newsletters, and paid search advertisements that are linked to our web site. We also participate and exhibit at targeted events.

Acquisitions

Bridgeline Software plans to expand its distribution of iAPPS® and its web application development services throughout North America. Due to the individualized nature of our sales process and delivery requirements, we believe local staff is required in order to maximize market-share results.

We believe the Web application development market in North America is growing and is fragmented. We believe that established yet small Web application development companies have the ability to market, sell and install our iAPPS® Framework and web application management software in their local metropolitan markets. In addition, we believe that these companies also have a customer base and a niche presence in the local markets in which they operate. We believe there is an opportunity for us to acquire multiple companies that specialize in Web application development and are based in other large North American cities in which we currently do not operate. We believe by acquiring certain of these companies and applying our business practices and efficiencies, we can accelerate our time to market in areas other than those in which we currently operate.

Since our initial public offering on June 29, 2007, we have completed the following two acquisitions:

- In July 2007, we acquired Objectware, Inc., an Atlanta, Georgia-based company.
- In August 2007, we acquired Purple Monkey Studios, Inc., a Chicago, Illinois-based company.

We believe these acquisitions contribute to our business strategy by providing us with new geographical distribution opportunities, an expanded customer base, an expanded sales force and an expanded developer force. In addition, integrating the acquired businesses into our existing operations allowed us to consolidate the finance, human resources, legal marketing, research and development, and other expenses of the acquired businesses with our own, reducing the aggregate of these expenses for the combined businesses, and resulting in improved over-all operating results.

Research and Development

Our software development efforts reside in our development center located in Bangalore, India. We invested approximately $791 thousand in research and development activities for the fiscal year ended September 30, 2007, and we invested approximately $176 thousand in research and development activities for the fiscal year ended September 30, 2006. We believe the cost of India based software developers are 70% lower than the cost of United States based software developers.

Employees

We employed 138 employees worldwide as of September 30, 2007. Substantially all of those employees are full time employees.

Customers

We primarily serve five markets that we believe have a history of investing in information technology enhancements and initiatives. These markets are:

- Financial services
- Life sciences
- High technology
- Foundations and non profit organizations
- Federal and state government agencies

We have more than 355 customers of which one customer, Nomura Securities, generated more than 15% of revenue in the fiscal year ended September 30, 2007. No other customer generated more than 5% of revenue during such period.

Competition

The market for our products and services, including Web application development software and Web application development services is highly competitive, fragmented, and rapidly changing. Barriers to entry in such markets remain relatively low. The markets are significantly affected by new product introductions and other market activities of industry participants. With the introduction of new technologies and market entrants, we expect competition to persist and intensify in the future.

We believe that we compete adequately with the others and distinguish ourselves from the competitors in a number of ways. We believe that our competitors generally offer their Web application development software without directly providing Web application development services. In addition our competitors that offer their Web application development software typically offer only single point of entry type products as compared to a unified framework approach. Our ability to develop applications on multiple platforms and the existence of our own Web application development software distinguishes us from our competition. We also believe that our products have been designed for ease of use without substantial technical skills. In addition to the above factors, we believe our Web application development software has a lower cost of ownership than the solutions provided by most of our competitors.

Available Information

This Annual Report on Form 10-KSB, as well as our quarterly report on Form 10-Q and current reports on Form 8-K, along with any amendments to those reports, are made available free of charge, on our website (www.bridgelinesw.com) as soon as reasonably practicable after such material is electronically filed with or furnished to the Securities and Exchange Commission. Copies of the following are also available free of charge through our website under the caption "Governance" and are available in print to any shareholder who requests it:

- Code of Business Ethics
- Committee Charters for the following Board committees: Nominating and Corporate Governance, Audit and Compensation committees respectively.

The public may read and copy any materials that we file with the SEC at the SEC's Public Reference Room at 450 Fifth Street, N.W., Washington, D.C. 20549. Information regarding the SEC's Public Reference Room can be obtained by calling the SEC at 1-800-SEC-0330. The SEC also maintains an Internet site that contains reports, proxy and information statements, and other information and can be found at (http://www.sec.gov).

Item 2. Description of Properties

Our headquarters are located twelve miles north of Boston, Massachusetts at 10 Sixth Road, Woburn, Massachusetts 01801.This office also serves as our New England business unit. The following table lists our offices, all of which are leased:

Location	**Address**	**Size**
Woburn, Massachusetts	10 Sixth Road Woburn, Massachusetts 01801	9,335 square feet, professional office space
New York, New York	104 West 40thStreet New York, New York 10018	4,400 square feet, professional office space
Washington, D.C.	2639 Connecticut Ave., NW Washington, D.C. 20008	9,383 square feet, professional office space
Bangalore, India	71 Sona Towers, West Wing Millers Rd., Bangalore 560 052	7,800 square feet, professional office space
Norcross, Georgia	5555 Triangle Parkway Norcross, Georgia 30092	7,068 square feet, professional office space
Reston, Virginia	11440 Commerce Park Drive, Suite 502, Reston, VA 20191	1,413 square feet, professional office space
Oak Park, Illinois	124 South Marion Street Oak Park, Illinois, 60302	7,350 square fee, professional office space

In fiscal 2006, we also assumed a lease in conjunction with an acquisition for professional office space located in Cambridge, Massachusetts. Shortly after completing the acquisition, the operations were consolidated into our Woburn, Massachusetts location and we commenced subleasing this facility effective January 15, 2007.

Item 3. Legal Proceedings

From time to time we are subject to ordinary routine litigation and claims incidental to our business. As of September 30, 2007, Bridgeline Software is not engaged with any material legal proceedings.

Item 4. Submission of Matters to a Vote of Security Holders

No matters were submitted to a vote of the stockholders during the fourth quarter of the fiscal year.

Part II

Item 5. Market for Common Equity, Related Stockholder Matters and Small Business Issuer Purchase of Equity Securities

The following table sets forth, for the periods indicated, the range of high and low sale prices for our common stock. Our common stock trades on the NASDAQ Capital Market under the symbol BLSW. Trading of our common stock commenced on June 29, 2007, following completion of our initial public offering.

Year Ended September 30, 2007	High	Low
Third Quarter	$ 5.05	$ 4.30
Fourth Quarter	5.09	2.58

We have not declared or paid cash dividends on our common stock and do not plan to pay cash dividends to our shareholders in the near future. As of December 11, 2007, our common stock was held by approximately 163 shareholders of record.

Recent Sales of Unregistered Securities; Use of Proceeds From Registered Securities

The following summarizes all sales of our unregistered securities during the fiscal year ended September 30, 2007. 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 thereunder, and in reliance on similar exemptions under applicable state laws as a transaction not involving a public offering. Unless stated otherwise, no placement or underwriting fees were paid in connection with these transactions. Proceeds from the sales of these securities were used for general working capital purposes.

Acquisitions

Objectware - The acquisition of Objectware, Inc. closed on July 5, 2007. At that time, we issued 610,716 shares of our common stock to the sole stockholder of Objectware as partial consideration in our acquisition.

Purple Monkey Studios, Inc.– The acquisition of Purple Monkey Studios, Inc. closed on August 31, 2007. At that time we issued an aggregate of 476,846 shares of our common stock to the two stockholders of Purple Monkey Studios as partial consideration in our acquisition.

The securities issued as consideration in our acquisitions were issued to U.S. investors in reliance upon 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.

Warrants

In the fiscal year ended September 30, 2007, we issued 59,724 shares of our common stock pursuant to the exercise of outstanding warrants.

The shares of common stock issued upon exercise of such warrants were issued in reliance upon 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.

Options

In the fiscal year ended September 30, 2007, we issued 27,831 shares of our common stock pursuant to the exercise of vested stock options. In the fiscal year ended September 30, 2007, we granted options to purchase equity shares on the following dates and amounts:

Date	**Number**		**Exercise Price**
October 20, 2006	31,880	$	3.75
December 9, 2006	5,000	$	3.75
April 23, 2007	113,998	$	3.75
July 5, 2007	42,500	$	1.74
July 9, 2007	37,000	$	4.60
August 31, 2007	37,400	$	3.92

The securities were issued exclusively to our directors, executive officers, employees and consultants. 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 exemption provided by Rule 701 promulgated under the Securities Act, or, for securities issued after our initial public offering, 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.

Our initial public offering of common stock was completed through our Registration Statement on Form SB-2, Commission file number 333-139298, that was declared effective by the Securities and Exchange Commission on June 28, 2007. Our initial public offering commenced on June 29, 2007 and closed on July 5, 2007. Pursuant to our initial public offering we registered a total of 3,000,000 shares of common stock, with an aggregate offering price of $15,000,000. In addition, we granted the underwriters an option to purchase an additional 450,000 shares of common stock, with an aggregate offering price of $2,250,000. We sold a total of 3,200,000 shares of common stock at an initial public offering price of $5.00 per share, including 200,000 shares of common stock purchased as part of the over-allotment option, for an aggregate offering price of $16,000,000. The managing underwriting in our initial public offering was Joseph Gunnar & Co., LLC.

We received net proceeds from the offering of approximately $13.5 million, after deducting the underwriting discount and other offering costs. Since the closing of our initial public offering on July 5, 2007, we have used net proceeds from our initial public offering as follows: $2.8 million to repay outstanding debt, $4.2 million to complete the acquisitions of Objectware, Inc. and Purple Monkey Studios, Inc. and the remainder for working capital and other general corporate purposes, which may include acquisitions of other businesses.

No offering expenses were paid directly or indirectly to any of our directors or officers (or their associates) or to any persons owning ten percent or more of any class of our equity securities or to any other affiliates

Item 6. Management’s Discussion and Analysis or Plan of Operation

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 our limited operating history, our history of operating losses, our ability to continue to grow sales, the acceptance of our products, our ability to deliver services efficiently, growing competition, our ability to find, make and efficiently integrate acquisitions, our ability to leverage our existing cost structure as acquisitions are completed and our dependence on our management team and key personnel. These and other risks are more fully described in our Registration Statement on Form SB-2 dated June 28, 2007 and our other filings with the Securities and Exchange Commission.

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

Overview:

Founded in 2000, Bridgeline Software, Inc. (Bridgeline or the Company) is a developer of web application management software and award-winning web applications that help organizations optimize business processes. Our software and services are designed to assist customers in maximizing revenue, improve customer service and loyalty, enhance employee knowledge, and reduce operational costs by leveraging web based technologies.

Our internally developed web application management software products (iAPPS® and Orgitecture™) are SaaS (software as a service) solutions that unify Content Management, Analytics, eCommerce, and eMarketing capabilities;

enabling users to enhance and optimize the value of their web properties. Combined with award-winning web application development services, Bridgeline helps customers cost-effectively accommodate the changing needs of today's websites, intranets, extranets, and mission-critical web applications.

We have a team of Microsoft®-certified developers that specialize in end-to-end web application development, information architecture, usability engineering, SharePoint development, rich media development, search engine optimization, and fully-managed application hosting.

Our marketing and selling efforts focus on medium-sized business and large business. These businesses are typically in five vertical markets: Financial services, life sciences, high technology, foundations, and government agencies. We have five geographic specific locations in the United States that have professional direct sales management in each location. They are in the Atlanta area, Boston area, Chicago area, New York area, and Washington DC area.

In 2007, approximately 66% of our customer base paid Bridgeline Software a monthly subscription fee or a monthly managed service fee. In 2007 approximately 62% of our total revenue was from existing customers demonstrating a deep customer traction model. The majority of our revenue in 2007 was driven from our web application development services.

Bridgeline Software plans to expand its distribution of iAPPS® and its web application development services throughout North America. Due to the high-touch nature of our sales process and delivery requirements, we believe local staff is required in order to maximize market-share results.

We believe the Web application development market in North America is growing and is fragmented. We believe established yet small Web application development companies have the ability to market, sell and install our iAPPS® Framework and web application management software in their local metropolitan markets. In addition, we believe these companies also have a customer base and a niche presence in the local markets in which they operate. We believe there is an opportunity for us to acquire multiple companies that specialize in Web application development and are based in other large North American cities. We believe that by acquiring certain of these geographic specific companies and applying our business practices and efficiencies, we can accelerate our time to market in areas other than those in which we currently operate.

Our expansion strategy led us to the recent acquisitions of Objectware in Atlanta and Purple Monkey Studios in Chicago. We now have a geographical presence in five areas in the United States and expect to make additional expansion acquisitions over the next twelve months.

The fourth quarter of fiscal 2007 marked yet another milestone for Bridgeline. We achieved sales of $4.1 million during the quarter, a record quarter in sales volume. We achieved net income of $23 thousand for the quarter ended September 30, 2007. In addition, we achieved record earnings before interest, taxes, depreciation and amortization (“EBITDA”) and before stock compensation of $294 thousand. A reconciliation of net Income to EBITDA for the fiscal year is included below under Results of Operations. This improved performance came during a year in which we completed two acquisitions and started the integration of each while our existing business experienced growth in sales. A more detailed discussion is contained below. This fourth quarter performance helped contain our operating loss to $1.9 million in fiscal 2007 when compared to a $1.4 million loss in fiscal 2006.

There are a number of items that affect the comparison of fiscal 2007 to 2006. These items include:

- We completed the acquisition of Objectware on July 5, 2007. The results for fiscal 2007 include approximately three months of results from this acquisition.
- We completed the acquisition of Purple Monkey Studios on August 31, 2007. The results for fiscal 2007 include one month of results from this acquisition.
- We completed the acquisition of New Tilt in April 2006. The fiscal 2007 results contain a full year of results from this acquisition as compared to five months in fiscal 2006.
- We completed our initial public offering in June 2007.
- During fiscal 2006 and 2007, we incurred additional debt to support operations that resulted in increased interest expense. We repaid this debt with proceeds from our public offering.
- We increased our research and development costs to develop our iAPPS® Framework product during fiscal 2007. We launched iAPPS® framework in August 2007 and we launched the first software module, iAPPS® Content Manager, in October 2007.

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We regularly monitor a number of key metrics including revenue, gross profit margins, and expenses as a percentage of revenue and EBITDA (as defined above). We also monitor and evaluate bookings.

Results of Operations

	2007	2006	Change $	Change %
Total revenue	$ 11,151	$ 8,235	$ 2,916	35%
Gross profit margin	6,131	4,426	1,705	39%
Loss from operations	(1,006)	(810)	(196)	24%
Net loss	$ (1,897)	$ (1,448)	$ (449)	31%
EBITDA	$ (239)	$ (505)	$ 266	53%

EBITDA Reconciliation:

	2007	2006
Net loss	$ (1,897)	$ (1,448)
Plus:		
Interest expense	924	638
Depreciation	158	119
Amortization	244	186
Stock Compensation	332	–
EBITDA	$ (239)	$ (505)

Revenue:
Overall, revenue increased $2.9 million, or 35%, when compared to the same period one year earlier. Acquisitions accounted for $1.5 million of this increase. Excluding acquisitions, sales increased $1.4 million, or 17%. Over 50% of our revenue came from existing customers, while the remainder came from new customers. A detailed discussion of revenue is below.

Gross Profit Margin:
Gross profit margins were largely unchanged at 55% of sales, compared to 54% in the fiscal 2006. Our margins are impacted by several factors. Our largest expense is our cost of direct labor. To supplement full time staff, we utilize outside contractors from time to time. In addition, our revenue is primarily from services. As such, billable hours are an important factor that impacts our gross profit margin. We use measures such as billable utilization to monitor this factor. A discussion of gross margin by revenue source follows.

Sources of Revenue:

Revenue:	2007	2006	Change $	Change %
Web development services	$ 8,659	$ 6,525	$ 2,134	33%
Managed services	2,050	1,243	807	65%
Subscriptions	442	467	(25)	(5)%
Total	$ 11,151	$ 8,235	$ 2,916	

Web Development Services :
Revenue from web services increased $2.1 million, a 33% improvement from fiscal 2006. Acquisitions of Objectware, Inc. and Purple Monkey Studios, Inc. accounted for $1.2 million of the increase. Excluding these acquisitions, revenue increased $900 thousand. Our growth came in a number of industries and customers. First, revenue from existing customers accounted for more than 45% of the fiscal 2007 web development services. We achieved a record year in sales, with sales from new customers of approximately $2.6 million in the current year. Revenue from existing customers decreased by approximately $1.8 million when compared to the same period one year earlier. This decrease came from primarily three customers, whose needs vary by year. One customer, Nomura Securities, had the largest decrease year over year. This customer represented 15% of our total revenues during fiscal 2007. We believe that our business with this customer will decrease in future years, primarily due to

changes in the needs of the customer and our overall revenue growth. Although this customer has been a significant part of our revenue in the past, the combination of new customers and acquired customers are expected to be more than sufficient to replace the revenue that may be lost from this customer. From an industry perspective, we have continued to see broad penetration of our services into multiple industries. Our strongest presence is in the life sciences, financial services, high technology and non profit industries. Of the revenue growth from new customers, life sciences contributed $625 thousand; financial services contributed $842 thousand; high technology contributed $533 thousand and non profit customers contributed $214 thousand. The remaining growth came from several other industries.

Managed Services:
Revenue from managed services increased $807 thousand, or 65% from the prior year. Acquisitions accounted for $367 thousand of this increase. Excluding acquisitions, managed services increased $440 thousand. The majority of this growth came from one customer. During the current year, this customer's need shifted from web services to managed services, increasing revenues more than 75% from the levels in the prior year. Excluding this one customer, managed services were largely unchanged from the prior year. Several new engagements were won during the year, the benefit of which will be seen in fiscal 2008. The revenue from the one major customer is expected to decrease in fiscal 2008 largely due to the customer's needs changing. With recent acquisitions and new engagements, we do not believe that the potential loss of revenue from this customer will be significant to our results in fiscal 2008.

Subscriptions:
Revenue from subscriptions decreased slightly from the prior year level by $25 thousand, or 5%. This decrease is largely due to the loss of five customers during fiscal 2007, resulting in a decrease of $23 thousand when compared to the same period. Otherwise, revenue from subscriptions was largely unchanged from the prior year levels.

Gross Profit

	2007	2006	Change $	Change %
Web development services	$ 4,101	$ 3,136	$ 965	31%
Managed services	1,614	880	734	83%
Subscriptions	416	410	6	1%
Total	$ 6,131	$ 4,426	$ 1,705	

Web Development Services :
Gross profit from web services increased by $965 thousand, or 31%. This represents a 48% gross profit margin in fiscal 2007, consistent with margins achieved in fiscal 2006. This increase in dollars is attributable largely to the increase in sales. Our Web Development Services are primarily driven by salaries and wages and outside contractor costs. Web Development Services revenue is driven by the number of billable hours on a project. Thus, the increased revenue will generally correspond with a similar increase in costs and margins. Margin improvements come from efficiency on engagements where the fee is fixed or when billable hours increases without an increase in headcount. Margin improvements can also come from increased hourly rates at a rate greater than the increase to costs. To encourage this behavior, we use incentive plans that award those performing web services when their billable hours exceed stated goals. Our workforce is largely salaried and as such, increases in billable hours do not result in significant increases to our cost basis. We believe that this and other similar programs will help to improve margins further in subsequent years.

Managed Services:
Gross profit increased by $734 thousand, or 83%. This represents a 79% gross profit margin for fiscal 2007, compared to a gross profit margin of 71% in fiscal 2006. The improvement in margins is primarily due to the increased revenues and cost containment measures taken to reduce costs. Costs for managed services include the cost of operating our network operation centers (NOCs). As of September 30, 2007, we have two NOCs operational. One of those NOCs was part of the acquisition of OW during fiscal 2007. Prior to that acquisition, we operated one NOC for the majority of the fiscal year. Our costs associated with the NOC largely include the facility charges for each location. Our current facilities have capacity and can be expanded with our growth in revenue without adding substantial costs. This allows margins to improve as we continue to grow this revenue source. Our other costs for managed services include wages for retained professional services. Margin improvements in retained professional services are achieved when the amount of services is below the estimated levels included in the “use it or lose it” agreements.

Subscriptions:
Gross profits from subscriptions were largely unchanged in dollars, increasing $6 thousand or 1% from the prior year. In fiscal 2007, gross profit margins were 94%, compared to 88% in fiscal 2006. Costs for the subscription revenue include a shared of the cost of our NOCs and costs to maintain the software product. During fiscal 2007, we shifted much of our efforts from maintaining the current on-demand software product sold through subscriptions to the development of our new product, iAPPS. As such, costs associated with maintaining the product decreased. In addition, we consolidated two NOCs early in the fiscal year, reducing the cost of hosting for the subscription revenues.

Loss from Operations

Included in the loss from operations are costs for sales and marketing, general and administrative expenses, technology development expenses and depreciation and amortization expense. Overall, loss from operations increased

$196 thousand, or 24%. This increased loss from operations is attributable to several factors. In fiscal 2007, we adopted SFAS No. 123R in accounting for stock compensation. The Company recognized $332 thousand in stock compensation, of which $242 thousand was included in operating expenses. In addition, we increased our spending on technology development by $615 thousand. This represents over three times the spending level in fiscal 2006. These increases in costs were offset by our ability to leverage the existing infrastructure, including sales and marketing, finance and human resources, while supporting the growth in revenue. A brief discussion of each component follows.

Sales and Marketing Expenses:
Sales and marketing expenses increased $261 thousand, or 8%, when compared to fiscal 2006. We look at sales and marketing as a percentage of sales. For fiscal 2007, sales and marketing represented 31% of sales, compared to 39% in fiscal 2006. The improvement as a percentage of sales is largely due to our ability to leverage our existing infrastructure as sales increase. We have established a number of incentives and goals for each salesperson to encourage this behavior. We believe that the increased sales volume and our current sales run rate will allow this percentage to continue to decrease into fiscal 2008. On an absolute dollars basis, the increase in sales and marketing expenses is largely due to increased marketing expenses and increased sales force headcount in fiscal 2007. During fiscal 2007, we attended and sponsored a number of seminars and conferences, adding to the marketing expenses when compared to fiscal 2006. The remaining increase in marketing expenses is due to the increase in headcount in marketing. Other sales expenses increased as a result of the increased sales, such as commissions.

General and Administrative Expenses:
General and administrative expenses increased $843 thousand, or 51%, when compared to the same period in fiscal 2006. This increase is due to several factors. In Fiscal 2007, we adopted SFAS No. 123R in accounting for stock compensation. This resulted in the recognition of $242 thousand in additional general and administrative expense when compared to fiscal 2006. In addition, our payroll expenses increased due to increased headcount at our corporate offices. We hired additional personnel during fiscal 2007 primarily in our accounting function when compared to fiscal 2006. As of September 30, 2007, we believe that there are limited needs to hire additional personnel in corporate and that the infrastructure can absorb additional acquisitions without additional personnel. Total payroll increased in fiscal 2007 by $570 thousand.

Technology Development:
Expenses for technology and development increased $615 thousand in fiscal 2007 or more than three times the same level as fiscal 2006. The increased spending during fiscal 2007 was incurred to develop our new on-demand software product, iAPPS Framework. In addition to the development the iAPPS Framework, we also spent funds on the development of the various modules, including iAPPS Content Manager. We anticipate spending additional amounts in fiscal 2008 as we continue to develop and launch the remaining modules during the fiscal year. The majority of our spending is in our India location. We believe that the quality of the developers coupled with the cost factors, has allowed us to spend considerably less than if this product has been developed solely in the U.S. We believe that the cost would have been more than five times that cost had we not used our India personnel.

Depreciation and Amortization:
The increase in depreciation and amortization of $182 thousand during fiscal 2007, a 97% increase, is largely attributable to the additional depreciation and amortization expense associated with acquisitions. In April 2006, we made one acquisition. The current year includes a full year of depreciation and amortization associated with the assets acquired as compared to five months in fiscal 2006. During the current year, we made two acquisitions and began depreciating and amortizing the acquired assets. This resulted in an increase of $75 thousand to amortization and depreciation expense when compared to fiscal 2006. In addition, during fiscal 2007 we invested in equipment for our NOCs. As a result, depreciation associated with our NOCs increased $67 thousand when compared to fiscal 2006. The remaining increase is attributable the timing of fixed asset expenditures.

Liquidity and Capital Resources

We have historically funded our operations principally through issuances of equity and short-term debt. We believe that our operations will generate positive cash flows as our revenues increase. During fiscal 2007, our operations used $1.0 million in cash, compared to $733 thousand in fiscal 2006. The additional cash used is primarily attributable to the increased losses in fiscal 2007 when compared to fiscal 2006. In June 2007, we completed our initial public offering, raising approximately $13.5 million in net proceeds. We used these proceeds to repay the outstanding debt, including the private placement financing of $2.8 million and to make two acquisitions. We also used cash to fund capital expenditures of $457 thousand and contingent acquisition payments of $455 thousand. As of September 30 2007, we have $5.2 million in cash available for operations.

We have incurred annual losses since commencement of operations in 2000 and have used a significant amount of cash to fund our operations over the last several years. As a result, we have an accumulated deficit of $6.1 million at September 30, 2007.

As of September 30, 2007, as part of acquisitions completed, we have remaining contingent acquisition obligations to the prior entities' shareholders which are to be paid in cash up to a maximum of $983 thousand, $775 thousand and $608 thousand for the fiscal years ending September 30, 2008, 2009, and 2010, respectively, provided that the contingent results are achieved. The contingent acquisition obligations are based primarily on the achievement of positive EBITDA, as defined in the acquisition agreements.

Cash Flows

Working Capital

At September 30, 2007, we had working capital of $5.9 million. We define working capital as current assets less current liabilities. We had receivables of $2.9 million. This compares to $810 thousand in receivables at September 30, 2006. The level of trade receivables at September 30, 2007 and September 30, 2006 represented approximately 64 and 45 days of revenues, respectively. Our receivables can vary dramatically due to overall sales volumes, the timing of implementation of services, receipts from large customers, and other contract payments. Unbilled receivables at September 30, 2007 decreased $278 thousand from September 30, 2006 principally due to the timing of billing in accordance with stated contract terms.

Investing Activities

Net cash used in investing activities was $5.1 million in fiscal 2007, compared to $842 thousand in fiscal 2006. In fiscal 2007, we used $4.2 million in cash for the acquisitions of OW and PM, an increase of approximately $3.7 million when compared to 2006. We also spent $457 thousand in capital expenditures. During fiscal 2007, we invested in our network operation centers to support the existing software as a service business and to position the network operation centers for future growth with the introduction of iAPPS. The remaining cash was expended on contingent acquisition obligations, totaling $455 thousand.

Financing Activities

Net cash provided by financing activities was $10.7 million for fiscal 2007, compared to $2.0 million in fiscal 2006. As noted above, the Company completed an initial public offering of equity securities that raised $13.5 million. We used some of these proceeds to repay existing debt.

Capital Resources and Liquidity Outlook

We believe that our operations will generate positive cash flows sufficient to cover any requirements for capital expenditures during fiscal 2008. We believe that cash requirements for capital expenditures will be approximately $500 thousand during fiscal 2008. We believe operating cash flows will be used to fund these expenditures. Funds required for acquisitions, if any, will be funded from the remaining cash flows from operations and existing working capital.

Inflation

We believe that the relatively moderate rates of inflation in recent years have not had a significant impact on our operations. Inflationary increases can cause pressure on wages and the cost of benefits offered to employees. We believe that these increases to date have not had a significant impact on our operations.

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 disclosed below.

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. We are, therefore, 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. Our other contractual obligations include certain equipment acquired under capitalized lease agreements that begin to expire in fiscal year 2009. We have no contractual obligations extending beyond five years.

The following summarizes our long-term contractual obligations as of September 30, 2007:

	(in thousands)					
	FY 08	**FY 09**	**FY 10**	**FY 11**	**FY 12**	**Totals**

Payment Obligations by Year						
Operating leases (A)	$ 698	$ 505	$ 440	$ 340	$ —	$ 1,983
Capital lease obligations	102	75	48	35	10	270
Contingent acquisition payments (B)	1,232	1,150	750	—	—	3,132
Total	$ 2,032	$ 1,730	$ 1,238	$ 375	$ 10	$ 5,385

(A) Net of sublease income

(B) The contingent acquisition payments are maximum potential earn-out consideration payable to the former owners of the acquired companies. Amounts actually paid may be less.

Critical Accounting Policies

The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America 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 include our valuation of accounts receivable and long-term assets, including intangibles and deferred tax assets, 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:

- Allowance for doubtful accounts;
- Revenue recognition;
- Accounting for goodwill and other intangible assets; and
- Accounting for stock-based compensation.

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.

Revenue Recognition. Substantially all of our revenue is generated from three activities: Web Development Services , Managed Services, and Subscriptions. We recognize revenue in accordance with Securities and Exchange Commission Staff Accounting Bulletin No.104, *Revenue Recognition in Financial Statements* (“SAB 104”), Emerging Issues Task Force Issue No. 00-21, *Accounting For Revenue Arrangements with Multiple Deliverables* (“EITF 00-21”), and American Institute of Certified Public Accountants Statement of Position No. 97-2, *Software Revenue Recognition* (“SOP 97-2”) and related interpretations. Revenue is 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.

Web Development Services

Web Development Services include professional services primarily related to our Web development solutions that address specific customer needs such as information architecture and usability engineering, interface configuration, Web application development, rich media, e-Commerce, e-Learning and e-Training, search engine optimization, and content management. Web Development Services engagements often include a hosting arrangement that provides for the use of certain hardware and infrastructure, generally at our network operating center. As described further below, revenue for these hosting arrangements is included in Managed Services. Web Development Services engagements that include hosting arrangements are accounted for as multiple element arrangements as described below under "Multiple-Element Arrangements."

For Web Development Services engagements sold on a stand alone basis, revenue is recognized in accordance with SAB 104. Web Development Services are contracted for on either a fixed price or time and materials basis. For its fixed price engagements, we apply the proportional performance model to recognize revenue based on cost incurred in relation to total estimated cost at completion. We have determined that labor costs are the most appropriate measure to allocate revenue among reporting periods, as they are the primary input when providing Web 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 Development Services are often sold as part of multiple element arrangements wherein perpetual licenses for our software product, retained professional services, hosting and/or Subscriptions are provided in connection with Web Development Services engagements. Our revenue recognition policy with respect to these multiple element arrangements is described further below under the caption "Multiple Element Arrangements."

Sales of perpetual licenses for our software products and related post-contract customer support ("PCS") are included in Web Development Services. Revenues derived from perpetual license sales have been insignificant in all periods presented (representing less than 2% of Web Development Services revenues).

Managed Services

Managed Services include retained professional services and hosting services.

Retained professional services are either 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, revenue is recognized in accordance with SAB 104. 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.

Hosting arrangements provide for the use of certain hardware and infrastructure, generally at our network operating center. For all periods presented, the only customers under contractual hosting arrangements have been previous Web Development Services customers. Hosting revenue has historically been insignificant to both our business strategy and to total revenues. Set-up costs associated with hosting arrangements are not significant and we do not charge our customers any set-up fees. Hosting agreements are month-to-month arrangements that provide for termination for convenience by either party upon 30-days notice. Revenue is recognized monthly as the hosting services are delivered. As described below, hosting revenues associated with our Subscriptions are included in Subscriptions revenue.

Retained professional services are sold on a stand-alone basis or, as described below, in multiple element arrangements with Web Development Services and, occasionally, Subscriptions. Hosting services are only sold in connection with Web Development Services and are not sold on a stand-alone basis. Our revenue recognition policy with respect to multiple element arrangements is described further below under the caption "Multiple Element Arrangements."

Subscriptions

Subscriptions consist of agreements that provide access to our Orgitecture software ("Licensed Subscription Agreements") through a hosting arrangement.

Licensed Subscription Agreements are sold exclusively as a component of multiple element arrangements that include Web Development Services and, occasionally, retained professional services and hosting services. Our revenue recognition policy for such multiple element arrangements is described below under the caption "Multiple Element Arrangements." We have concluded that, consistent with EITF 00-3, *Application of AICPA SOP 97-2, "Software Revenue Recognition", to Arrangements That Include the Right to Use Software Stored on Another Entity's Hardware,* that our Licensed Subscription Agreements are outside the scope of SOP 97-2 since the software is only accessible through a hosting arrangement with us and the customer cannot take possession of the software. Licensed Subscription Agreements are month-to-month arrangements that provide for termination for convenience by either party upon 30 to 45-days notice. Revenue is recognized monthly as the related hosting services are delivered. When an up-front fee is charged, the revenue related to such up-front fee is amortized over 24 months.

Multiple Element Arrangements

As described above, Web Development Services are often sold as part of multiple element arrangements. Such arrangements may include delivery of a perpetual license for our software products at the commencement of a Web Development Services engagement or delivery of retained professional services, hosting services and/or Subscriptions subsequent to completion of such engagement, or combinations thereof. In accounting for these multiple element arrangements, we follow EITF 00-21 and, as described further below, have concluded that each element can be treated as a separate unit of accounting.

When Web Development Services engagements include a perpetual license for our software products, we have concluded that the Web Development Services and the perpetual license are separate units of accounting as each has stand-alone value to the customer and we have established vendor specific objective evidence (VSOE) of fair value for the software and objective and reliable third party evidence of fair value for the Web Development Services. In such arrangements, the perpetual license is the delivered element and the Web Development Services, and any PCS are the undelivered elements. We recognize revenue from perpetual licenses and related PCS in accordance with SOP 97-2 and recognize revenue from Web Development Services following the proportional performance model as described above. The amount of revenue to be recognized upon delivery of the software is determined using the residual method whereby the value ascribed to the delivered element (i.e., the product license) is equal to the total consideration of the multiple element arrangement less the third party evidence of fair value of the undelivered elements (i.e., Web Development Services and, if applicable, PCS).

Following SOP 97-2, revenue is recognized upon delivery of the perpetual license because the Web Development Services are not essential to the functionality of the software and we have established VSOE of fair value for the software. Any related PCS revenue is also recognized upon delivery of the software since PCS is included with the price of the software license, extends only for a period of one year or less and the cost of providing the PCS is deemed to be insignificant. PCS does not contain rights to unspecified upgrades to the software, nor have we issued any upgrades.

When Web Development Services engagements include retained professional services and hosting services and/or Subscriptions, we have concluded that each element can be accounted for separately as the delivered elements (i.e., the Web Development Services) have stand alone value and there is objective and reliable third party evidence of fair value for each of the undelivered elements (i.e., the Retained professional services and hosting services and/or Subscriptions). Web Development Services are available from other vendors and are regularly sold by us on a stand-alone basis pursuant to a standard price list which is not discounted. Web Development Services do not involve significant production, modification, or customization of our licensed software products. Objective and reliable third party evidence of fair value for the undelivered elements has been established as our retained professional services, hosting services and Licensed Subscription Agreements are sold pursuant to standard price lists which are not discounted.

The amount of revenue to be recognized in the multiple element arrangements described above is determined using the residual method whereby the value ascribed to the delivered element (i.e., the Web Development Services) is equal to the total consideration of the multiple element arrangement less the third party evidence of fair value of the undelivered elements (i.e., retained professional services, hosting services and/or Licensed Subscription Agreements).

Direct costs associated with web development services and retained professional services are recorded as the services are delivered and the corresponding revenue is recognized. Direct costs associated with Licensed Subscription Agreements or hosting services are expensed as incurred.

Customer Payment Terms

Our payment terms with customers typically are "net 30 days from invoice". Payments terms may vary by customer but in generally do not exceed 45 days from invoice date. For Web Development Services, we typically invoice project deposits of between 20% and 33% of the total contract value which we record as deferred revenue until such time the related services are completed. Subsequent invoicing for Web Development Services is 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 upon invoice receipt. 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 generally between 30 to 90 days from the completion of work. In hosting arrangements, we may 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.

Accounting for Goodwill and Other Intangible Assets.

Goodwill and other intangible assets require us to make estimates and judgments about the value and recoverability of those assets. We have made several acquisitions of businesses that resulted in both goodwill and intangible assets being recorded in our financial statements.

Goodwill is recorded as the difference, if any, between the aggregate consideration paid for an acquisition and the fair value of the net tangible and intangible assets acquired. The amounts and useful lives assigned to other intangible assets impact the amount and timing of future amortization, and the amount assigned to in-process research and development is expensed immediately. The value of our intangible assets, including goodwill, could be impacted by future adverse changes such as: (i) any future declines in our operating results, (ii) a decline in the value of technology company stocks, including the value of our common stock, (iii) any failure to meet the performance projections included in our forecasts of future operating results. We evaluate goodwill and other intangible assets deemed to have indefinite lives on an annual basis in the quarter ended September 30 or more frequently if we believe indicators of impairment exist. Application of the goodwill impairment test requires judgment including the identification of reporting units, assigning assets and liabilities to reporting units, assigning goodwill to reporting units and determining the fair value of each reporting unit. In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets* ("SFAS 142"), management has determined that there was only one reporting unit to be tested. The goodwill impairment test compares the implied fair value of the reporting unit with the carrying value of the reporting unit. The implied fair value of goodwill is determined in the same manner as in a business combination. Determining the fair value of the implied goodwill is judgmental in nature and often involves the use of significant estimates and assumptions. These estimates and assumptions could have a significant impact on whether or not an impairment charge is recognized and also the magnitude of any such charge. Estimates of fair value are primarily determined using discounted cash flows and market comparisons. These approaches use significant estimates and assumptions, including projection and timing of future cash flows, discount rates reflecting the risk inherent in future cash flows, perpetual growth rates, determination of appropriate market comparables, and determination of whether a premium or discount should be applied to comparables. It is reasonably possible that the plans and estimates used to value these assets may be incorrect. If our actual results, or the plans and estimates used in future impairment analyses, are lower than the original estimates used to assess the recoverability of these assets, we could incur additional impairment charges.

The results of the assessments performed to date was that the fair value of the reporting unit exceeded its carrying amount; therefore, no impairment charges to the carrying value of goodwill have been recorded since inception.

We also assess the impairment of our long-lived assets, including definite-lived intangible assets and equipment and improvements when events or changes in circumstances indicate that an asset's carrying value may not be recoverable. An impairment charge is recognized when the sum of the expected future undiscounted net cash flows is less than the carrying value of the asset. Any impairment charge would be measured by comparing the amount by which the carrying value exceeds the fair value of the asset being evaluated for impairment. Any resulting impairment charge could have an adverse impact on our results of operations.

Stock-Based Compensation

At September 30, 2007, we maintained two stock-based compensation plans which are more fully described in Note 9.

Effective October 1, 2006, we adopted FASB Statement No. 123R, *Share-Based Payments* ("SFAS 123R").Because we used the fair-value-based method for disclosure under SFAS 123, *Accounting for Stock-Based Compensation* ("SFAS 123"), we adopted SFAS 123R using the modified prospective method. Under the modified prospective method, compensation expense recognized beginning on that date will include: (a) compensation expense for all share-based payments granted prior to, but not yet vested as of October 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123, and (b) compensation expense for all share-based payments granted on or after October 1, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS 123R. The pro forma effect of stock-based compensation expenses pursuant to SFAS 123R is disclosed in the financial statements. Under the modified prospective transition method, the results for prior periods are not restated.

Through September 30, 2006, we accounted for stock compensation awards under the provisions of SFAS 123, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation--Transition and Disclosure* (“SFAS 148”). As permitted by SFAS 123, for all periods through September 30, 2006, we measured compensation cost in accordance with Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (“APB 25”) and related interpretations using the intrinsic value method and following the disclosure-only provisions of SFAS 123.

Under the intrinsic value method, compensation expense is determined at the measurement date, generally the date of grant, as the excess, if any, of the estimated fair value of our common stock (the “Stock Price”) and the exercise price, multiplied by the number of options granted. Generally, we grant stock options with exercise prices equal to or greater than the Stock Price; however, to the extent that the Stock Price exceeds the exercise price of stock options on the date of grant, we record stock-based compensation expense using the graded vested attribution method over the vesting schedule of the options, which is generally three years.

Prior to June 28, 2007, there had been no public market for our common stock to observe its Stock Price on award grant dates. Therefore, for purposes of applying the intrinsic value method, management estimated the stock price based on the American Institute of Certified Public Accountants Practice Alert No. 00-1, *Accounting for Certain Equity Transactions*. The estimated fair value of the common stock on the date of grant was based on weighing a variety of different quantitative and qualitative factors including, but not limited to, our financial position, an evaluation of our competition, the economic climate in the marketplace, the illiquid nature of the common stock, contemporaneous and anticipated private sales of the common stock, and our analysis of the trading prices of a peer group of comparable public companies.

Prior to our initial public offering, we had a policy whereby, when issuing stock options or warrants, the fair value of the underlying common stock would be based on valuations prepared by management. Management performed internal valuations ("Level C", as defined in the AICPA Audit and Accounting Aid Series, "*Valuation of Privately-Held-Company Equity Securities Issued as Compensation*") to determine the fair value of the stock. Management utilized market data from a third party in developing our valuation methodology and models.

Determining the fair value of our stock required making complex and subjective judgments. Our approach to valuation was based on several factors. Since August 1, 2005 and up to our initial public offering, we did not complete any private placement sales of our common stock, and accordingly, we used an approach to valuation based on a weighted average of enterprise value as determined using three customary valuation techniques: the discounted cash flow method, the market approach, and the guideline public company method. We believe that due to our size, continued operating losses, a business plan highly dependent on future acquisitions, and our limited ability to raise the capital for such acquisitions, that a weighted average of these three techniques was the most reasonable approach to the valuation of our stock. Management's weighting of the three techniques is subjective. We believe, however, that the enterprise value derived using the public company guideline approach was most representative of our business and, therefore, we have applied the highest weighting to this factor in all periods. We applied a lower weighting to the results derived from the discounted cash flow method because the cash flows used in this method were based on future events with varying degrees of uncertainty. We increased the weighting on this factor slightly during the nine-month period ended June 30, 2007 as we deemed current estimates of cash flow to be more predictable and achievable. We applied the lowest rating to the results of the market approach because this technique depends on analyses of mergers and acquisitions of comparable entities and there have been a relatively small number of such transactions to analyze.

The changes in the fair value of our common stock at the date of stock option grants is principally attributable to the changes in our estimates of earnings and revenues during the applicable periods, and the accretive effect of such changes when applying the weighted values of the three valuation techniques utilized. The slight increase in the weighting applied to the discounted cash flow method described above did not have significant effect on the per share enterprise value determined for that period.

Under the discounted cash flow method, since we are an emerging growth company with a business plan highly dependent on acquisitions, estimates of revenue, market growth rates and costs are used when applying the appropriate discount rates. Discount rates utilized in our analyses ranged from 35% to 21% based on a capital asset pricing model ("CAPM") which considered factors such as risk-free rate of return, an equity risk adjustment, the beta for companies in our SIC code (7372), and a size discount due to our limited revenues. The difference in the discount rates applied is attributable to changes in the above factors that comprise the rate, which factors are updated annually. A higher discount rate is used for periods from August 2005 to September 2006 based on management's forecast of rapid growth in revenues and earnings based on future events with varying degrees of uncertainty. Management determined that a 13% forecasting uncertainty factor should be added to the discount rate computed using the CAPM. The financial estimates we used are consistent with the plans and estimates that we use to manage our business. We complete a five-year business plan each fiscal year, which plans are updated semi-annually. We believe a five-year outlook is consistent with the long-term business cycle of the Web Development Services industry. However, there is inherent uncertainty in making these estimates and based on historical significant differences between prior forecasts and prior actual results, we applied a lower weighting to the enterprise value determined using the discounted cash flow method.

Under the market approach and guideline public company method, we evaluated a variety of financial ratio metrics to determine the value multiples to be utilized in our valuation models, including price-to-cash flow, price-to-earnings, market value of invested capital (“MVIC”)-to-earnings before interest and taxes (“EBIT”),MVIC-to-EBITDA, price-to-assets and MVIC-to-revenue. After evaluating these metrics, we believe, since we have incurred losses historically, and since a number of comparable companies in our analyses have also reported losses, that the most appropriate multiple to apply is MVIC-to-revenues. This is the ratio used in our valuation model under the market approach and guideline public company method.

Under the market approach, we evaluated merger and acquisition transactions involving comparable public and private companies to determine our enterprise value using estimated revenues and applying the comparable multiple derived from such transactions. We used data provided by a third party database to evaluate recent merger and acquisition transactions. We qualified our selection to only include those transactions within SIC code 7372, then we limited those transactions to Internet related companies and then further refined our selection to those entities within the Web Development Services industry that had revenues and total asset size most comparable to ours. Since our revenues are considerably lower and we have incurred losses since inception in relation to the comparable group, we apply the lowest weighting to the enterprise value derived using the market approach.

The final technique utilized in our analysis is the guideline public company method. We used data provided by a third party for ten comparable publicly traded companies. We qualified our selection of comparable public companies to only include those companies within SIC code 7372, then we limited the selection to only internet related companies and then further refined our selection to those companies within the Web Development Services industry. Due to our relatively small size, continued operating losses and the high risks associated with our forecasted revenue growth through acquisitions, we determined our enterprise value by multiplying our rolling twelve months sales by the MVIC-to-revenues ratio applicable to those companies in the statistical 10^{th}percentile (on a scale of 100%). Since revenue growth is dependent on raising large amounts of capital, we believe it results in a higher risk and therefore conclude that a 10^{th} percentile MVIC-to-revenues ratio is reasonable to apply in our model. We believe that a value market multiple of comparable public companies based on MVIC-to-revenues provides an objective basis for measuring our fair market value. Accordingly, we placed the highest weighting on this factor in our analysis.

The weighted average enterprise value determined, as described above, was reduced by a lack of marketability discount of 20% which reflects our small size, our continued losses since inception and our inability to provide a distribution of earnings to shareholders. We also considered the post-public offering holding periods applicable to existing stock, warrant and option holders as potential risks to marketability. These holding periods range from six months to one year.

We used the per share enterprise value determined above as an input to the Black-Scholes-Merton option valuation model in determining stock-based compensation, or if applicable, pro forma stock-based compensation. For fiscal 2007, had the Company used different assumptions, the results of the stock compensation would not be materially different. The most sensitive of theses assumptions is volatility. Had the Company used a volatility 500 basis higher or lower than the current estimates, the related stock compensation could increase or decrease by as much as $55 thousand over the life of options granted in the current year.

Recent Accounting Pronouncements

In September 2006, the SEC staff issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (“SAB 108”). SAB 108 was issued in order to eliminate the diversity of practice surrounding how public companies quantify financial statement misstatements. Traditionally, there have been two widely-recognized methods for quantifying the effects of financial statement misstatements: the “roll-over” method and the “iron curtain” method. The roll-over method focuses primarily on the impact of a misstatement on the income statement — including the reversing effect of prior year misstatements — but its use can lead to the accumulation of misstatements in the balance sheet. The iron-curtain method, on the other hand, focuses primarily on the effect of correcting the period-end balance sheet with less emphasis on the reversing effects of prior year errors on the income statement. In SAB 108, the SEC staff established an approach that requires quantification of financial statement misstatements based on the effects of the misstatements on each of a company’s financial statements and the related financial statement disclosures. This model is commonly referred to as a “dual approach” because it requires quantification of errors under both the iron curtain and the roll-over methods. Management of the Company has evaluated SAB 108 and believes its adoption will not materially impact the consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* ("SFAS 157"), which defines fair value, establishes a framework for measuring fair value in accounting principles generally accepted in the United States of America, and expands disclosures about fair value measurements. SFAS 157 prioritizes the inputs to valuation techniques used to measure fair value into a hierarchy containing three broad levels. The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets and liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). In some cases, the inputs used to measure fair value might fall in different levels of the fair value hierarchy. The level in the fair value hierarchy within which the fair value measurement in its entirety falls shall be determined on the lowest level input that is significant to the fair value measurement in its entirety. Assessing the significance of a particular input to the fair value measurement in its entirety requires judgment, considering factors specific to the asset or liability. SFAS No. 157 is effective for interim and annual financial statements for fiscal years beginning after November 15, 2007. Upon initial adoption of SFAS 157, differences between the carrying value and the fair value of those instruments shall be recognized as a cumulative-effect adjustment to the opening balance of retained earnings for that fiscal year, and the effect of subsequent adjustments resulting from recurring fair measurements shall be recognized in earnings for the period. The Company has not yet adopted SFAS 157. As a result, the consolidated financial statements do not include any adjustments relating to any potential adjustments to the carrying value of assets and liabilities. Management of the Company is currently evaluating the impact of SFAS 157 on the consolidated financial statements.

In June 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes — an Interpretation of FASB Statement No. 109* ("FIN 48"), which clarifies the accounting for uncertainty in tax positions. FIN No. 48 requires that the Company recognize the impact of a tax position in the financial statements, if that position is more likely than not to be sustained on audit, based on the technical merits of the position. The provisions of FIN 48 are effective for fiscal years beginning after December 15, 2006, with the cumulative effect, if any, of the change in accounting principle recorded as an adjustment to opening retained earnings. Management of the Company has evaluated FIN 48 and believes its adoption will not materially impact the consolidated financial statements.

In February 2007, the FASB issued SFAS 159, "The Fair Value Option for Financial Assets and Financial Liabilities" ("SFAS 159"). SFAS 159 provides companies with an option to report selected financial assets and liabilities at fair value and establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. SFAS 159 is effective for fiscal years beginning after November 15, 2007. The Company is in the process of evaluating the impact of the adoption of this statement on the Company's results of operations and financial condition.

In December 2007, the FASB issued SFAS 141R, *Business Combinations* ("SFAS 141R"), which replaces FASB SFAS 141, *Business Combinations.* This Statement retains the fundamental requirements in SFAS 141 that the acquisition method of accounting be used for all business combinations and for an acquirer to be identified for each business combination. SFAS 141R defines the acquirer as the entity that obtains control of one or more businesses in the business combination and establishes the acquisition date as the date that the acquirer achieves control. SFAS 141R will require an entity to record separately from the business combination the direct costs, where previously these costs were included in the total allocated cost of the acquisition. SFAS 141R will require an entity to recognize the assets acquired, liabilities assumed, and any non-controlling interest in the acquired entity at the acquisition date, at their fair values as of that date. This compares to the cost allocation method previously required by SFAS No. 141. SFAS 141R will require an entity to recognize as an asset or liability at fair value for certain contingencies, either contractual or non-contractual, if certain criteria are met. Finally, SFAS 141R will require an entity to recognize contingent consideration at the date of acquisition, based on the fair value at that date. This Statement will be effective for business combinations completed in or after the first annual reporting period beginning on or after December 15, 2008. Early adoption of this standard is not permitted and the standards are to be applied prospectively only. Upon adoption of this standard, there will be no impact to the Company's results of operations and financial condition for acquisitions previously completed. The adoption of this standard will impact any acquisitions completed by the Company in our fiscal 2010.

Item 7. Financial Statements

Report of Independent Registered Public Accounting Firm

To the Board of Directors of
Bridgeline Software, Inc:

We have audited the consolidated balance sheets of Bridgeline Software, Inc. (the "Company") as of September 30, 2007 and 2006, and the related consolidated statements of operations, changes in stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Bridgeline Software, Inc. as of September 30, 2007 and 2006, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

/s/ UHY LLP
December 19, 2007
Boston, Massachusetts

BRIDGELINE SOFTWARE, INC.
CONSOLIDATED BALANCE SHEETS
(Dollars in thousands, except per share data)

ASSETS	September 30, 2007		September 30, 2006	
Current assets:				
Cash and cash equivalents	$	5,219	$	591
Accounts receivable (less allowance for doubtful accounts of $101 and $52, respectively)		2,892		810
Unbilled receivables		355		633
Prepaid expenses and other current assets		192		39
Total current assets		8,658		2,073
Equipment and improvements, net		961		429
Definite-lived intangible assets, net		1,441		303
Goodwill		14,426		6,346
Deferred financing fees, net		—		273
Other assets		273		400
Total assets	$	25,759	$	9,824
LIABILITIES AND SHAREHOLDERS' EQUITY				
Current liabilities:				
Senior notes payable	$	—	$	2,497
Capital lease obligations – current		76		45
Accounts payable		652		581
Deferred revenue		725		264
Accrued liabilities		1,266		706
Total current liabilities		2,719		