Bridgeline Digital, Inc.
Form 10-Q
February 14, 2011

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended December 31, 2010

OR

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

Commission File Number: 333-139298

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

Delaware (State or other jurisdiction of incorporation or organization)	52-2263942 (I.R.S. Employer Identification No.)
10 Sixth Road Woburn, Massachusetts (Address of principal executive offices)	01801 (Zip Code)

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

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

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

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

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

Large accelerated filer	¨	Accelerated filer	¨
Non-accelerated filer	¨	Smaller reporting company	þ

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

The number of shares of Common Stock, par value $0.001 per share, outstanding as of February 11, 2011 was 12,226,207.

Bridgeline Software, Inc.

Quarterly Report on Form 10-Q

For the Quarterly Period ended December 31, 2010

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Bridgeline Digital, Inc.

Quarterly Report on Form 10-Q

For the Quarterly Period ended December 31, 2010

Statements contained in this Report on Form 10-Q that are not based on historical facts are “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements may be identified by the use of forward-looking terminology such as “should,” “could,” “may,” “will,” “expect,” “belie “estimate,” “anticipate,” “intends,” “continue,” or similar terms or variations of those terms or the negative of those terms. These statements appear in a number of places in this Form 10-Q and include statements regarding the intent, belief or current expectations of Bridgeline Digital, Inc. Forward-looking statements are merely our current predictions of future events. Investors are cautioned that any such forward-looking statements are inherently uncertain, are not guaranties of future performance and involve risks and uncertainties. Actual results may differ materially from our predictions. Important factors that could cause actual results to differ from our predictions include the impact of the weakness in the U.S. and international economies on our business, our inability to manage our future growth effectively or profitably, fluctuations in our revenue and quarterly results, our license renewal rate, the impact of competition and our ability to maintain margins or market share, the performance of our products, our ability to respond to rapidly evolving technology and customer requirements, our ability to protect our proprietary technology, the security of our software, our dependence on our management team and key personnel, our ability to hire and retain future key personnel, our ability to maintain an effective system of internal controls, or risks associated with our contracts with the U.S. federal government. Although we have sought to identify the most significant risks to our business, we cannot predict whether, or to what extent, any of such risks may be realized, nor is there any assurance that we have identified all possible issues which we might face. We assume no obligation to update our forward-looking statements to reflect new information or developments. We urge readers to review carefully the risk factors described in our Annual Report on Form 10-K for the fiscal year ended September 30, 2010 as well as in the other documents that we file with the Securities and Exchange Commission. You can read these documents at www.sec.gov.

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

PART I—FINANCIAL INFORMATION

Item 1.Financial Statements.

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

ASSETS	December 31, 2010	September 30, 2010
Current assets:		
Cash and cash equivalents	$ 2,972	3,045
Accounts receivable and unbilled receivables, net	4,133	3,929
Prepaid expenses and other current assets	384	351
Total current assets	7,489	7,325
Equipment and improvements, net	1,575	1,171
Intangible assets, net	2,084	2,292
Goodwill	20,034	20,036
Other assets	872	900
Total assets	$ 32,054	$ 31,724
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 1,000	$ 1,270
Accrued liabilities	811	1,024
Accrued earnouts, current	590	900
Debt, current	2,342	2,475
Capital lease obligations, current	206	50
Deferred revenue	956	899
Total current liabilities	5,905	6,618
Accrued earnouts, net of current portion	1,073	1,073
Debt, net of current portion	2,983	3,025
Capital lease obligations, net of current portion	313	11
Other long term liabilities	305	341
Total liabilities	10,579	11,068
Commitments and contingencies		
Stockholders' equity:		
Preferred stock - $0.001 par value; 1,000,000 shares authorized; none issued and outstanding	—	—
Common stock -$0.001 par value; 20,000,000 shares authorized;	12	11

12,188,208 and 11,188,208 shares issued and outstanding, respectively		
Additional paid-in capital	37,721	36,749
Accumulated deficit	(16,144)	(15,988)
Accumulated other comprehensive loss	(114)	(116)
Total stockholders’ equity	21,475	20,656
Total liabilities and stockholders’ equity	$ 32,054	$ 31,724

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

BRIDGELINE DIGITAL, INC.

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

	Three Months Ended December 31, 2010	Three Months Ended December 31, 2009
Revenue:		
Web application development services	$ 5,544	$ 4,613
Managed service hosting	466	494
Subscription and perpetual licenses	519	372
Total revenue	6,529	5,479
Cost of revenue:		
Web application development services	3,014	2,178
Managed service hosting	146	129
Subscription and perpetual licenses	182	133
Total cost of revenue	3,342	2,440
Gross profit	3,187	3,039
Operating expenses:		
Sales and marketing	1,644	1,250
General and administrative	897	1,169
Research and development	382	75
Depreciation and amortization	348	303
Total operating expenses	3,271	2,797
(Loss) income from operations	(84)	242
Interest income (expense), net	(51)	(6)
(Loss) income before income taxes	(135)	236
Provision for income taxes	21	16
Net (loss) income	$ (156)	$ 220
Net (loss) income per share:		
Basic	$ (0.01)	$ 0.02
Diluted	$ (0.01)	$ 0.02
Number of weighted average shares:		
Basic	11,883,860	11,182,209
Diluted	11,883,860	11,520,866

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

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

	Three Months Ended December 31, 2010	Three Months Ended December 31, 2009
Cash flows from operating activities:		
Net (loss) income	$ (156)	$ 220
Adjustments to reconcile net (loss) income to net cash provided by (used in) operating activities:		
Amortization of intangible assets	208	141
Depreciation	162	184
Other amortization	84	51
Stock-based compensation	115	70
Changes in operating assets and liabilities:		
Accounts receivable and unbilled receivables	(204)	(588)
Prepaid expenses and other assets	(89)	(116)
Accounts payable and accrued liabilities	(454)	67
Deferred revenue	57	258
Other liabilities	(36)	34
Total adjustments	(157)	101
Net cash (used in) provided by operating activities	(313)	321
Cash flows from investing activities:		
Purchases of property and improvements	(122)	(58)
Software development capitalization costs	—	(170)
Contingent acquisition payments	(308)	(407)
Net cash used in investing activities	(430)	(635)
Cash flows from financing activities:		
Proceeds from sale of common stock, net of issuance costs	857	—
Borrowings from bank line of credit	2,450	1,350
Payments on bank line of credit	(2,625)	(1,000)
Principal payments on capital leases	(14)	(26)
Net cash provided by financing activities	668	324
Effect of exchange rate changes on cash and cash equivalents	2	6
Net (decrease) increase in cash and cash equivalents	(73)	16
Cash and cash equivalents at beginning of period	3,045	3,060
Cash and cash equivalents at end of period	$ 2,972	$ 3,076
Supplemental disclosures of cash flow information:		
Cash paid for:		
Interest	$ 6	$ 6
Income taxes	$ 15	$ 4
Non cash activities:		
Equipment purchased under capital leases	$ 473	$ —
Equipment and other assets included in accounts payable	$ 4	$ 49
Accrued contingent consideration	$ —	$ 470
Other assets included in accrued expense	$ —	47

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

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

1. Description of Business

Overview

Bridgeline Digital, Inc. ("Bridgeline" or the "Company"), a Delaware corporation, is a developer of a unified web engagement management product suite named iAPPS® and award-winning interactive technology solutions that help organizations optimize business processes. Bridgeline's iAPPS® product suite combined with its interactive development capabilities assist customers in maximizing revenue, improving customer service and loyalty, enhancing employee knowledge, and reducing operational costs by leveraging web based technologies.

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

The iAPPS product suite is delivered through a SaaS ("Software as a Service") business model, in which the Company delivers software over the Internet while providing maintenance, daily technical operation and support; or via traditional perpetual licensing business model, in which the iAPPS software resides on a dedicated server in either the customer's facility or Bridgeline's co-managed hosting facility.

In 2010, KM Magazine Editors selected iAPPS as the Trend Setting Product of the Year. iAPPS Content Manager won the 2010 Codie Award for the Best Content Management Solution Globally. In addition, in 2010, B2B Interactive selected Bridgeline as one of the Top Interactive Technology companies in the United States.

Locations

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

2. Summary of Significant Accounting Policies

Basis of Presentation and Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All significant inter-company accounts and transactions have been eliminated. Certain amounts from the prior period financial statements have been reclassified to conform to the current presentation.

Unaudited Interim Financial Information

The accompanying interim Condensed Consolidated Balance Sheet as of December 31, 2010 and the Condensed Consolidated Statements of Operations and Cash Flows for the three months ended December 31, 2010 and 2009, respectively, are unaudited. The unaudited interim consolidated statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("US GAAP") and in the opinion of the

Company's management have been prepared on the same basis as the audited consolidated financial statements as of and for the year ended September 30, 2010. These financial statements include all adjustments, consisting of normal recurring adjustments and accruals, necessary for the fair presentation of the Company's financial position at December 31, 2010 and its results of operations for the three months ended December 31, 2010 and 2009, respectively, and its cash flows for the three months ended December 31, 2010 and 2009, respectively. The results for the three months ended December 31, 2010 are not necessarily indicative of the results to be expected for the year ending September 30, 2011. The accompanying September 30, 2010 Consolidated Balance Sheet has been derived from the audited financial statements at that date,

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

but does not include all of the information and footnotes required by US GAAP for complete financial statements.

Recent Accounting Pronouncements

There have been no recent accounting pronouncements or changes in accounting pronouncements that impacted the first quarter of fiscal 2011, or which are expected to impact future periods, that were not already adopted and disclosed in prior periods.

Subsequent Events

The Company evaluated subsequent events through February 14, 2011 and concluded there were no material subsequent events requiring adjustment to or disclosure in these interim condensed consolidated financial statements.

3. Accounts Receivable and Unbilled Receivables

Accounts receivable and unbilled receivables consists of the following:

	As of December 31, 2010	As of September 30, 2010
Accounts receivable	$ 4,025	$ 3,854
Unbilled receivables	397	361
Subtotal	4,422	4,215
Allowance for doubtful accounts	(289)	(286)
Accounts receivable and unbilled receivables, net	$ 4,133	$ 3,929

4. Intangible Assets

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

	As of December 31, 2010		
	Gross Asset	Accumulated Amortization	Net Amount
Intangible assets:			
Customer related & non-compete agreements	4,034	(1,957)	2,077
Domain and trade names	$ 26	$ (26)	$ —
Acquired software	362	(355)	7
Total intangible assets	$ 4,422	$ (2,338)	$ 2,084

Total amortization expense related to intangible assets for the three months ended December 31, 2010 and 2009 is as follows:

Amortization expense charged to:	Three Months ended December 31,	
	2010	2009
Cost of revenue	$ 22	$ 22
Operating expense	186	119
Total	$ 208	$ 141

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

5. Goodwill

Changes in the carrying amount of goodwill follows:

	As of December 31, 2010
Balance at beginning of period	$ 20,036
Acquisitions	—
Contingent acquisition payments	—
Purchase price allocation adjustments	(2)
Balance at end of period	$ 20,034

Contingent consideration (“earnouts”) related to acquisitions completed before September 30, 2009 are accounted for as an increase to goodwill at the time such earnouts are paid or earned. No such earnouts were paid or earned during the three months ended December 31, 2010.

Goodwill is tested for impairment annually during the fourth quarter of every year and more frequently if events and circumstances indicate that the asset might be impaired. For the year ended September 30, 2010, the Company did not record a goodwill impairment charge.

6. Debt

Debt consists of the following:

	As of December 31, 2010	As of September 30, 2010
Line of credit borrowings	$ 4,825	$ 5,000
Subordinated promissory note	500	500
Total debt	$ 5,325	$ 5,500
Less current portion	$ (2,342)	(2,475)
Debt, net of current portion	$ 2,983	$ 3,025

7. Shareholder’s Equity

Common Stock

On October 29, 2010, the Company sold 1,000,000 shares of common stock at $1.00 per share for gross proceeds of $1,000,000 in a private placement. Net proceeds to the Company after offering expenses were approximately $857,000.

Common Stock Warrants

In April 2006, the Company issued 280,000 warrants to note holders of Senior Secured Notes issued in a private placement (which have been repaid) (the "Debt Warrants") and issued 112,000 warrants to the underwriters of the debt offering (the "Underwriter's Debt Warrants"). The Debt Warrants are exercisable to purchase shares of the Company's common stock at an exercise price of $0.001 per share any time within five years from the date of grant. After adjustments for anti-dilution provisions, the Underwriter's Debt Warrants are exercisable to purchase shares of the Company's common stock at an exercise price of $4.93 per share any time within five years from the date of grant.

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

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

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

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

As of December 31, 2010: (i) Debt Warrants to purchase 240,000 shares have been exercised and 40,000 Debt Warrants remain outstanding with an exercise price of $0.001; (ii) Underwriter's Debt Warrants to purchase 71,231 shares at an exercise price of $5.00 have been cancelled and 40,769 Underwriter's Debt Warrants remain outstanding with an exercise price of $4.93; (iii) IPO Warrants to purchase 57,000 shares at an exercise price of $7.50 have been cancelled and 93,000 IPO Warrants remain outstanding with an exercise price of $7.39; (iv) placement agent warrants to purchase 64,000 shares at an exercise price of $1.45 are outstanding; and (v) warrants issued to a non-employee consultant to purchase 25,000 shares at an exercise price of $1.00 and 25,000 shares at an exercise price of $2.00 are outstanding.

Summary of Option and Warrant Activity and Outstanding Shares

	Stock Options		Stock Warrants	
	Options	Weighted Average Exercise Price	Warrants	Weighted Average Exercise Price
Outstanding, September 30, 2010	2,345,705	$ 1.01	302,000	$ 5.58
Granted	150,000	1.58	114,000	1.47
Exercised	—	—	—	—
Forfeited, cancelled or expired	(100,333)	1.27	(128,231)	6.11
Outstanding, December 31, 2010	2,395,372	$ 1.03	287,769	$ 3.67

8. Comprehensive Income

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

December 31,

Comprehensive (loss) income was as follows:

	2010	2009
Net (loss) income	$ (156)	$ 220
Net change in foreign currency translation adjustment	2	2
Comprehensive (loss) income	$ (154)	$ 222

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

9. Net Income Per Share

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

Basic net (loss) income per share for the three months ended December 31, 2010 and 2009 was ($0.01) and $0.02, respectively. Diluted net income per share for the three months ended December 31, 2009 was $0.02. For the three months ended December 31, 2010, options to purchase shares of the Company's common stock of 478,820 were excluded from the computation of diluted net loss per share as the effect was anti-dilutive to the Company's net loss. Also, excluded were 675,000 shares to be issued in connection with the e.Magination acquisition. For the three months ended December 31, 2009, options to purchase shares of the Company's common stock of 338,657 shares were included in the computation of diluted net income per share, but options to purchase shares of the Company's common stock of 371,750 were not included in the computation of diluted net income per share because the exercise price of the options was greater than the weighted average market price of the common stock during the period.

10. Income Taxes

Income tax expense was $21 thousand and $16 thousand for the three months ended December 31, 2010 and 2009, respectively. Income tax expense represents the estimated liability for Federal and state income taxes owed by the Company, including the alternative minimum tax. Net operating loss carry forwards are estimated to be sufficient to offset additional taxable income for all periods presented.

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

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

This section contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those anticipated in the forward-looking statements as a result of a variety of factors and risks including risks described in our Annual Report on Form 10-K for the fiscal year ended September 30, 2010 as well as in the other documents that we file with the Securities and Exchange Commission. You can read these documents at www.sec.gov.

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

Overview

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

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

The iAPPS product suite is delivered through a SaaS ("Software as a Service") business model, in which we deliver our software over the Internet while providing maintenance, daily technical operation and support; or via a traditional perpetual licensing business model, in which the iAPPS software resides on a dedicated server in either the customer's facility or Bridgeline's co-managed hosting facility.

In 2010, KM Magazine Editors selected iAPPS as the Trend Setting Product of the Year. iAPPS Content Manager won the 2010 Codie Award for the Best Content Management Solution Globally.

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

In 2010, B2B Interactive selected Bridgeline Digital as one of the Top Interactive Technology companies in the United States.

Customer Information

We had approximately 565 customers at December 31, 2010 compared with approximately 651 customers at December 31, 2009, a decrease of 13%. The Company has proactively been terminating engagements with a number of smaller hosting customers it had obtained through previous acquisitions for which the Companies core competencies are not aligned and margins are not conducive to growth. Approximately 406 of the Company's customers, or 72%, pay a monthly subscription fee or a monthly managed service hosting fee.

For the three months ended December 31, 2010 and 2009 no customer represented 10% or more of total revenue.

Results of Operations for the Three Months Ended December 31, 2010 compared to the Three Months Ended December 31, 2009

Total revenue for the three months ended December 31, 2010 was $6.5 million compared with $5.5 million for the three months ended December 31, 2009, an increase of 19%. We had a net loss of ($156) thousand for the three months ended December 31, 2010 compared with net income of $220 thousand for the three months ended December 31, 2009. Net loss per share for the three months ended December 31, 2010 was ($0.01) compared with net income per share of $0.02 for the three months ended December 31, 2009.

The following items affected the results of operation for the three months ended December 31, 2010 as compared with the three months ended December 31, 2009:

- We released iAPPS® Commerce in the first quarter of fiscal 2010, iAPPS® Marketier in the third quarter of fiscal 2010, and iAPPS Version 4.5 in the fourth quarter of fiscal 2010.

- We completed two acquisitions in fiscal 2010 that are included in our results of operations from the date of acquisition. We acquired TMX Interactive, Inc. ("TMX", now Bridgeline Philadelphia) in May 2010 and e.Magination network, LLC. ("e.magination", now Bridgeline Baltimore) in July 2010.

- In the three months ended December 31, 2009, we capitalized $170 thousand of software development costs. However, in the three months ended December 31, 2010, we did not capitalize any software developments costs, as we have no development projects that have achieved technological feasibility to be eligible for capitalization.

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

Revenue:	Three Months Ended December 30, 2010		Three Months Ended December 30, 2009		$ Change		% Change	
Web application development services	$5,544		$4,613		931		20	%
% of total revenue	85	%	84	%				
Managed service hosting	466		494		(28	)	(6	%)
% of total revenue	7	%	9	%				
Subscription and perpetual licenses	519		372		147		40	%
% of total revenue	8	%	7	%				
Total revenue	6,529		5,479		1,050		19	%
Cost of revenue:								
Web application development services	3,014		2,178		836		38	%
% of web application development revenue	54	%	47	%				
Managed service hosting	146		129		17		13	%
% of managed service hosting revenue	31	%	26	%				
Subscription and perpetual licenses	182		133		49		37	%
% of subscription and perpetual revenue	35	%	36	%				
Total cost of revenue	3,342		2,440		902		37	%
Gross profit	3,187		3,039		148		5	%
Gross profit margin	49	%	55	%				
Operating expenses:								
Sales and marketing	1,644		1,250		394		32	%
% of total revenue	25	%	23	%				
General and administrative	897		1,169		(272	)	(23	%)
% of total revenue	14	%	21	%				
Research and development	382		75		307		409	%
% of total revenue	6	%	1	%				
Depreciation and amortization	348		303		45		15	%
% of total revenue	5	%	6	%				
Total operating expenses	3,271		2,797		474		17	%
(Loss) income from operations	(84	)	242		(326	)	(135	%)
Interest income (expense) net	(51	)	(6	)	(45	)	750	%
(Loss) income before income taxes	(135	)	236		(371	)	(157	%)

Provision for income taxes	21		16		5		31	%
Net (loss) income	$(156	)	$220		$(376	)	(171	%)
Adjusted EBITDA	$485		$688		(203	)	(30	%)

Revenue

Our revenue is derived from three sources: (i) web application development services (ii) managed service hosting and (iii) subscription and perpetual licenses. Total revenue for the three months ended December 31, 2010 was $6.5 million compared with $5.5 million for the three months ended December 31, 2009, an increase of 19%.

Web Application Development Services

Revenue from web application development increased $931 thousand, or 20% to $5.5 million from $4.6 million for the three months ended December 31, 2010 compared to the three months ended December 31, 2009. Web application development services revenue is comprised of iAPPS development related services and other web development related services generated from non iAPPS related web development engagements. Web application development services revenue as a percentage of total revenue increased to 85% from 84% for the three months ended December 31, 2010 compared to the three months ended December 31, 2009 as a result of the increase in iAPPS revenue. The increase in the three months ended December 31, 2010 over the comparable period is primarily related to our acquisitions of TMX (May 2010) and e.Magination (July 2010) completed in the last two quarters of fiscal 2010. Also contributing to the increase are sales of our new generation of iAPPS software released in fiscal 2010; iAPPS Commerce was released in the first quarter of fiscal 2010, iAPPS Marketier was released in the third quarter of fiscal 2010, and iAPPS Version 4.5 was released in the fourth quarter of fiscal 2010.

Managed Service Hosting

Revenue from managed service hosting decreased $28 thousand, or 6% to $466 thousand from $494 thousand for the three months ended December 31, 2010 compared to the three months ended December 31, 2009. The decrease is attributable to our efforts to engage with customers that are aligned with our core competencies and proactively end our engagements with a number of smaller hosting customers we had obtained through previous acquisitions. Managed services revenue as a percentage of total revenue decreased to 7% from 9% the three months ended December 31, 2010 compared to the three months ended December 31, 2009, as a result of the decrease in revenue.

Subscription and Perpetual Licenses

Revenue from subscription and perpetual licenses increased $147 thousand, or 40% to $519 thousand from $372 thousand for the three months ended December 31, 2010 compared to the three months ended December 31, 2009. The increase is due primarily to a higher amount of perpetual license revenue recognized in relation to iAPPS licenses in the three months ended December 31, 2010 compared to the three months ended December 31, 2009. Subscription and perpetual license revenue as a percentage of total revenue increased to 8% from 7% for fiscal 2010 for the three months ended December 31, 2010 compared to the three months ended December 31, 2009.

Costs of Revenue

Total cost of revenue increased $902 thousand, or 37% to $3.3 million from $2.4 million the three months ended December 31, 2010 compared to the three months ended December 31, 2009.

Cost of Web Application Development Services

Cost of web application development services increased $836 thousand, or 38% to $3.0 million from $2.2 million for the three months ended December 31, 2010 compared to the three months ended December 31, 2009. The cost of web application development services as a percentage of application development services revenue increased to 54% from 47% for the three months ended December 31, 2010 compared to the three months ended December 31, 2009. This increase is attributable to the increase in the number of web application development related employees obtained from

the two acquisitions completed during the last two quarters of fiscal 2010.

Cost of Managed Service Hosting

Cost of managed service hosting increased $17 thousand or 13% for the three months ended December 31, 2010 compared to the three months ended December 31, 2009. The cost of managed services as a percentage of managed services revenue increased to 31% from 26% the three months ended December 31, 2010 compared to the three months ended December 31, 2009. The increase in managed service hosting costs is due to investments in our hosting environment. We continue to end engagements with lower margin hosting customers, but also make investments to our hosting environment to support our core customer base.

Cost of Subscription and Perpetual License

Cost of subscription and perpetual licenses increased $49 thousand, or 37% for the three months ended December 31, 2010 compared to the three months ended December 31, 2009. The cost of subscription and perpetual licenses as a percentage of subscription and perpetual license revenue decreased to 35% from 36% for the three months ended December 31, 2010 compared to the three months ended December 31, 2009. The increase in subscription and perpetual license costs is primarily related to additional software development costs that were capitalized in prior periods which are now being amortized. The decrease as a percentage of revenue is due to higher subscription and perpetual license revenue during the current period as compared to the prior period.

Operating Expenses

Sales and Marketing Expenses

Sales and marketing expenses increased $394 thousand, or 32% to $1.6 million from $1.3 million for the three months ended December 31, 2010 compared to the three months ended December 31, 2009. Sales and marketing expenses represented 25% and 23% of total revenue for the three months ended December 31, 2010 and 2009, respectively. This increase is primarily attributable to the increase in the number of sales related employees obtained from the two acquisitions completed during the last two quarters of fiscal 2010.

General and Administrative Expenses

General and administrative expenses decreased $272 thousand, or 23% to $897 thousand from $1.2 million for the three months ended December 31, 2010 compared to the three months ended December 31, 2009. General and administrative expenses represented 14% and 21% of total revenue for the three months ended December 31, 2010 and 2009, respectively. The decrease in general and administrative expenses is primarily due to improved general and administrative staff efficiencies and reduced compensation and consulting expenses.

Research and Development

Research and development expense increased by $307 thousand, or 409% to $382 thousand from $75 thousand for the three months ended December 31, 2010 compared to the three months ended December 31, 2009. No software costs were capitalized in the three months ended December 31, 2010. Capitalized software development costs were $170 thousand for three months ended December 31, 2009. Had such costs not been capitalized, research and development expense would have been $245 thousand for the three months ended December 31, 2009. The increase in research and development expense is primarily due to an increase in the number of research and development employees as we continue to invest in enhancements for our iAPPS Product Suite and the decrease in capitalized software costs quarter over quarter.

Depreciation and Amortization

Depreciation and amortization expense increased by $45 thousand, or 15% to $348 thousand from $303 thousand for three months ended December 31, 2010 compared to the three months ended December 31, 2009. Depreciation and amortization represented 5% and 6% of revenue for the three months ended December 31, 2010 and 2009, respectively. This increase is primarily attributable to additional amortization expense for intangible assets resulting from the two acquisitions completed towards the end of fiscal 2010.

Income Taxes

The provision for income tax expense was $21 thousand and $16 thousand for three months ended December 31, 2010 compared to the three months ended December 31, 2009. Income tax expense represents the estimated liability for Federal and state income taxes owed by the Company, including the alternative minimum tax. The Company has net operating loss carryforwards and other deferred tax benefits that are available to offset future taxable income.

Income (Loss) from Operations

The loss from operations was ($84) thousand for the three months ended December 31, 2010, as compared to income from operations of $242 thousand for the three months ended December 31, 2009. The loss from operations for the three months ended December 2010 is attributable to an increase in personnel costs for employees obtained through the two acquisitions completed during the last two quarters of fiscal 2010, as well as not capitalizing any software development costs for the three months ended December 31, 2010. Software capitalization costs would have approximated $150 thousand based on the previous comparable period’s costs, which would have increased income for the period.

Adjusted EBITDA

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

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

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

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

	Three Months Ended December 31,	
	2010	2009
Net (loss) income	$ (156)	$ 220
Provision for income taxes	21	16
Interest expense, net	51	6
Amortization of intangible assets	208	141
Depreciation	162	184
EBITDA	286	567
Other amortization	84	51
Stock-based compensation	115	70
Adjusted EBITDA	$ 485	$ 688

The decrease in Adjusted EBITDA is primarily related to a lower amount of net income for the current period as compared with the prior period and additional costs related to acquisitions.

Liquidity and Capital Resources

Cash Flows

Operating Activities

Cash used in operating activities was $313 thousand for the three months ended December 31, 2010 compared to cash provided by operating activities of $321 thousand for the three months ended December 31, 2009. The decrease in

cash from operating activities is primarily attributable to lower net income for three months ended December 31, 2010 compared to the three months ended December 31, 2009. The decrease in net income is partially attributable to no capitalization of software development costs. Accounts payable and accrued liabilities also decreased by $454 thousand in the three months ended December 31, 2010, as we made a managed effort to reduce liabilities.

Investing Activities

Cash used in investing activities was $430 thousand for the three months ended December 31, 2010 compared to $635 thousand for the three months ended December 31, 2009. This amount included expenditures for equipment and improvements of $122 thousand for the three months ended December 31, 2010 compared with $58 thousand for the three months ended December 31, 2009, and no capitalized software development costs for the three months ended December 31, 2010 as compared with $170 thousand for

the three months ended December 31, 2009. Contingent acquisition payments were $308 thousand for the three months ended December 31, 2010 compared with $407 thousand for the three months ended December 31, 2009.

Financing Activities

Cash provided by financing activities was $668 thousand for the three months ended December 31, 2010 compared to $324 thousand for the three months ended December 31, 2009. The increase in cash provided by financing activities for the three months ended December 31, 2010 was primarily attributable to proceeds (net of issuance costs) from the sale of common stock of $857 thousand. At December 31, 2010, $4.8 million was outstanding under the bank credit line.

Capital Resources and Liquidity Outlook

On October 29, 2010, we sold 1,000,000 shares of common stock at $1.00 per share for gross proceeds of $1,000,000 in a private placement. Net proceeds after offering expenses were approximately $857,000.

We believe that cash generated from operations and proceeds from the bank line of credit will be sufficient to fund the company's working capital and capital expenditure needs in the foreseeable future.

Off-Balance Sheet Arrangements

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

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

Contractual Obligations

We lease our facilities in the United States and India. During the quarter ended December 31, 2010, the Company signed new office leases for its Baltimore, Maryland location and its Bangalore, India location.

Other new contractual obligations as of December 31, 2010 include equipment acquired under capitalized lease agreements valued at $473 thousand with payments extending through December 2013.

As of December 31, 2010, we had an accrued contingent earnout liability of $1.7 million from acquisitions completed in prior fiscal years, which are scheduled to be paid out through fiscal 2014. Contingent earnout payments related to acquisitions are paid when and if certain revenue and earnings targets are achieved. We also have potential contingent acquisition payments of $1.3 million due related to acquisitions completed prior to September 30, 2009, which are not required to be accrued until earned.

Critical Accounting Policies

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

29, 2010.

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

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

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

Revenue Recognition

Overview

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

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

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

Web Application Development Services

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

Web application development services are contracted for on either a fixed price or time and materials basis. For its fixed price engagements, the Company applies the proportional performance model to recognize revenue based on cost incurred in relation to total estimated cost at completion. The Company has determined that labor costs are the most appropriate measure to allocate revenue among reporting periods, as they are the primary input when providing application development services. Customers are invoiced monthly or upon the completion of milestones. For milestone based projects, since milestone pricing is based on expected hourly costs and the duration of such engagements is relatively short, this input approach principally mirrors an output approach under the proportional performance model for revenue recognition on such fixed priced engagements. For time and materials contracts, revenues are recognized as the services are provided.

Web application development services also include retained professional services contracted for on an "on call" basis or for a certain amount of hours each month. Such arrangements generally provide for a guaranteed availability of a

number of professional services hours each month on a “use it or lose it” basis. For retained professional services sold on a stand-alone basis we recognize revenue as the services are delivered or over the term of the contractual retainer period. These arrangements do not require formal customer acceptance and do not grant any future right to labor hours contracted for but not used.

Web application development services are often sold as part of multiple element arrangements wherein perpetual licenses for the Company’s software products, retained professional services, hosting and/or subscriptions are provided in connection with application development services engagements. The Company’s revenue recognition policy with respect to these multiple element arrangements is described further below under the caption “Multiple Element Arrangements.”

Managed Service Hosting

Managed service hosting includes hosting arrangements that provide for the use of certain hardware and infrastructure, generally at the

Company's network operating centers. The majority of the customers under contractual hosting arrangements have been previous application development services customers. Set-up costs associated with hosting arrangements are not significant and when charged are recognized ratably over the expected period of performance, generally twenty-four months. Hosting agreements are either annual or month-to-month arrangements that provide for termination for convenience by either party generally upon 30-days notice. Revenue is recognized monthly as the hosting services are delivered. As described below, hosting revenue associated with the Company's subscriptions are included in subscription and perpetual license revenue.

Hosting services are typically sold in connection with application development services but also may be sold on a stand-alone basis. The Company's revenue recognition policy with respect to multiple element arrangements is described further below under the caption "Multiple Element Arrangements."

Subscriptions and Perpetual Licenses

The Company licenses its software on a perpetual and subscription basis. Customers who license the software on a perpetual basis receive rights to use the software for an indefinite time period. For arrangements that consist of a perpetual license and post-customer support ("PCS"), the PCS revenue is recognized ratably on a straight-line basis over the period of performance and the perpetual license is recognized on a residual basis and is included with subscription and perpetual license revenue. Under the residual method, the fair value of the undelivered elements are deferred and the remaining portion of the arrangement fee is allocated to the delivered elements and recognized as revenue, assuming all other revenue recognition criteria have been met. Revenue recognition for perpetual licenses sold as part of a multiple element arrangement is described further below under the caption "Multiple Element Arrangements."

Customers also license the software on a subscription basis, which can be described as "Software as a Service" or "SaaS". SaaS is a model of software deployment where an application is hosted as a service provided to customers across the Internet. Subscription agreements include access to the Company's software application via an internet connection, the related hosting of the application, and PCS. Customers receive automatic updates and upgrades, and new releases of the products as soon as they become available. Subscription agreements are either annual or 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 services are delivered. Any up front set-up fees are amortized over 24 months. We have concluded that our Subscription Agreements should be accounted for differently from software sales since the software is only accessible through a hosting arrangement with us and the customer cannot take possession of the software. Revenue recognition for Subscriptions sold as part of a multiple element arrangement is described further below under the caption "Multiple Element Arrangements.

Multiple Element Arrangements

As described above, application development services are often sold as part of multiple element arrangements. Such arrangements may include delivery of a perpetual license for the Company's software products at the commencement of an application 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 either ASC Topic 605-985 Revenue Recognition Software or ASC Topic 605-25 Revenue Recognition Multiple Element Arrangements , as applicable. As described further below, the Company has concluded that each element can be treated as a separate unit of accounting when following ASC Topic 605-25.

In October 2009, the FASB issued Accounting Standards Update No. 2009-13, Revenue Recognition: Multiple-Deliverable Revenue Arrangements ("ASU 2009-13"). ASU 2009-13 provides amendments to certain paragraphs of previously issued ASC Subtopic 605-25 – Revenue Recognition: Multiple-Deliverable Revenue Arrangements. ASU 2009-13 is effective on a prospective basis for revenue arrangements entered into or materially

modified in fiscal years beginning on or after June 15, 2010. As permitted by the ASC, the Company adopted ASU 2009-13 on a retrospective basis. This adoption had no impact on previously reported financial information.

When the Company licenses its software on a perpetual basis in a multiple element arrangement that also includes application development services and PCS, vendor-specific objective evidence of fair value ("VSOE") of each element is considered. VSOE is established for PCS and is based on the price of PCS when sold separately, which has been established via annual renewal rates. Revenue recognition for perpetual licenses sold with application development services are considered on a case by case basis. The Company has not established VSOE for perpetual licenses or fixed price development services and therefore in accordance with ASC Topic 605-985, when perpetual licenses are sold in a multiple element arrangements including application development services where VSOE for the services has not been established, the license revenue is deferred and recognized under the proportional performance model along with the associated application development services.

In determining VSOE for the application development services element, the separability of the application development services from the software license and the value of the services when sold on a standalone basis are considered. The Company also considers the

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

When subscription arrangements are sold with application development services, the Company follows ASC Topic 605-25 Revenue Recognition Multiple Element Arrangements and has concluded that each element can be treated as a separate unit of accounting. In determining separability, the timing of the commencement of the subscription period to the services delivery is considered.

If the subscription period begins after the services delivery then the Company generally recognizes the services as delivered and then commences revenue recognition for the subscription after the services have been delivered. To date, all subscription periods have commenced after the services delivery. If the application development services arrangement does not qualify for separate accounting, the application development services revenue and related costs are deferred and recognized over the subscription period. Subscriptions also include a PCS component, and the Company has determined that the two elements cannot be separated and must be recognized as one unit over the applicable service period.

Customer Payment Terms

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

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

Warranty

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

Reimbursable Expenses

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

Allowance for Doubtful Accounts

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

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

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

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

Accounting for Goodwill and Intangible Assets

Goodwill is tested for impairment annually during the fourth quarter of every year and more frequently if events and circumstances indicate that the asset might be impaired. For the year ended September 30, 2010, the Company did not record a goodwill impairment charge.

At September 30, 2010 (the date of the most recent test), the fair value exceeded the carrying value by 17%. This margin was based on a weighting applied to four different valuation methods which result in fair values ranging from $22.5 million to $28.2 million before the weightings were applied. Had the four methodologies been weighted differently, the percentage by which the fair value exceeded the carrying value may have been larger.

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

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

Management placed significant weight of 75% on its evaluation on the fair value derived using the Market Approach–Direct Market Capitalization Method. Management allocated a higher weighting to this method because it is based upon quoted prices of the Company's common stock. The key assumption included in Market Approach–Direct Market Capitalization Method was a control premium of 65%. This control premium was based on an analysis of control premiums from a study of guideline merger and acquisition transactions which was corroborated by an analysis of potential synergies which could be realized by a market participant in an acquisition transaction.

While there are inherent limitations in any valuation, we believe that placing a significant weighting of 75% on the Market Approach–Direct Market Capitalization is more objective than the other methods which are more assumption based. The 25% weighting on three other methods, which included the Discounted Cash Flow Method, the Guideline Public Company Method and the Guideline Transaction Method, supported the valuation based on the Market Approach–Direct Market Capitalization. We believe the most significant change in circumstances that could affect the key assumptions in our valuation is a significant reduction in our stock price.

During the twelve month period ended September 30, 2010, the carrying value of goodwill increased as a result of the acquisitions of TMX and e.Magination (both of which included contingent earnout payments recorded at the time of the transaction) and the accrual of contingent acquisition payments related to acquisitions completed prior to September 30, 2009 (which are recorded as increases to goodwill as they are earned but not currently recorded). The Company is obligated to continue paying quarterly contingent acquisition payments to former owners of acquired companies in the amount of $1.7 million based on the achievement of certain predefined operating metrics. If such payments are earned they will be recorded as an increase to goodwill. To the extent goodwill continues to increase as a result of such payments and to the extent there are unfavorable changes in assumptions used to determine the Company's fair value (including a decline in the Company's market capitalization), there can be no assurance that the Company will not have another impairment charge in the future.

Accounting for Stock-Based Compensation

At December 31, 2010, we maintained two stock-based compensation plans more fully described in Note 11 to the Consolidated Financial Statements of our Annual Report on Form 10-K filed with the Securities and Exchange Commission on December 29, 2010.

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

We recognize stock-based compensation expense for share-based payments issued or assumed after October 1, 2006 that are expected to vest on a straight-line basis over the service period of the award, which is generally three years. We recognize the fair value of the unvested portion of share-based payments granted prior to October 1, 2006 over the remaining service period, net of estimated forfeitures. In determining whether an award is expected to vest, we use an estimated, forward-looking forfeiture rate based upon our

historical forfeiture rate and reduce the expense over the recognition period. Estimated forfeiture rates are updated for actual forfeitures quarterly. We also consider, each quarter, whether there have been any significant changes in facts and circumstances that would affect our forfeiture rate. Although we estimate forfeitures based on historical experience, actual forfeitures in the future may differ. In addition, to the extent our actual forfeitures are different than our estimates, we record a true-up for the difference in the period that the awards vest, and such true-ups could materially affect our operating results.

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

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

Stock Options Activity (Repricing Plan)

In October 2008, the Board of Directors approved the Repricing Plan which affected approximately 1.6 million shares. The effect of the modification was to adjust the exercise price of the applicable options to the fair value of the underlying common stock on the date of modification. In addition, the vesting period on the applicable options was reset to the standard three year term set forth in our incentive stock option plan.

We estimated the fair value of the stock option modifications using the Black-Scholes-Merton option model and are recording additional stock-based compensation of approximately $300 thousand over the three year vesting period. While we believe that our estimates are based on outcomes that are reasonably likely to occur, if actual results differ significantly from those estimated or if future changes are made to our assumptions, the amount of recognized compensation expense could change significantly. For additional information refer to Footnote 11 of the Consolidated Financial Statements.

Item 3. Qualitative and Quantitative Disclosures About Market Risk.

Not required.

Item 4. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission’s rules and forms, and that such

information is accumulated and communicated to our management, including our President and Chief Executive Officer (Principal Executive Officer) and our Vice President of Finance and Chief Accounting Officer (Principal Financial and Accounting Officer), as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, as ours are designed to do, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As of December 31, 2010 we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Accounting Officer, of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934. Based upon that evaluation, our Chief Executive Officer and Chief Accounting Officer concluded that our disclosure controls and procedures are effective in enabling us to record, process, summarize and report information required to be included in our periodic filings with the Securities and Exchange Commission within the required time period.

Changes in Internal Control over Financial Reporting

There have been no changes in our internal controls over financial reporting that occurred during the quarter ended December 31, 2010 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II – OTHER INFORMATION

Item 1. Legal Proceedings.

From time to time we may be involved in litigation relating to claims arising out of our operations. We are not currently involved in any legal proceedings that we believe are material beyond those previously disclosed in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on December 29, 2010

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

The following summarizes all sales of our unregistered securities during the quarter ended December 31, 2010. The securities in each of the below-referenced transactions were (i) issued without registration and (ii) were subject to restrictions under the Securities Act and the securities laws of certain states, in reliance on the private offering exemptions contained in Sections 4(2), 4(6) and/or 3(b) of the Securities Act and on Regulation D promulgated there under, and in reliance on similar exemptions under applicable state laws as transactions not involving a public offering. Unless stated otherwise, no placement or underwriting fees were paid in connection with these transactions.

Common Stock and Stock Warrants

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

On October 29, 2010, the Company sold 1,000,000 shares of common stock at $1.00 per share for gross proceeds of $1,000,000 in a private placement. Net proceeds to the Company after offering expenses were approximately $857,000. The Company paid a fee to its placement agent of $100,000. The placement agent also received a four year warrant exercisable to purchase 64,000 shares of the Company's common stock at a price equal to $1.45 per share. In return for such warrants, the placement agent agreed to cancel a total of 128,231 warrants previously issued to the placement agent with exercise prices ranging from $5.00 to $7.50.

Item 6. Exhibits.

Exhibit No.	Description of Document
10.1	Employment Agreement between Bridgeline Digital, Inc. and Erez Katz dated October 29, 2010 (incorporated by reference to Exhibit 10.1 to our Current Report on Form 8-K filed on November 4, 2010).
10.2	Securities Purchase Agreement between Bridgeline Digital, Inc. and the investors named therein, dated October 29, 2010 (incorporated by reference to Exhibit 10.1 to our Current Report on Form 8-K filed on November 4, 2010).
10.3	Form of Common Stock Purchase Warrant issued to Placement Agent, dated October 29, 2010 (incorporated by reference to Exhibit 10.2 to our Current Report on Form 8-K filed on November 4, 2010).
31.1	Certification required by Rule 13a-14(a) or Rule 15d-14(a).
31.2	Certification required by Rule 13a-14(a) or Rule 15d-14(a).
32.1	Certification required by Rule 13a-14(b) or Rule 15d-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. §1350).
32.2	Certification required by Rule 13a-14(b) or Rule 15d-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. §1350).

SIGNATURES

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

	Bridgeline Digital, Inc. (Registrant)
February 14, 2011 Date	/s/ Thomas L. Massie Thomas L. Massie President and Chief Executive Officer (Principal Executive Officer)
February 14, 2011 Date	/s/ Michael D. Prinn Michael D. Prinn Vice President Finance and Chief Accounting Officer (Principal Financial and Accounting Officer)

INDEX OF EXHIBITS

Exhibit No.	Description of Document
31.1	Certification required by Rule 13a-14(a) or Rule 15d-14(a).
31.2	Certification required by Rule 13a-14(a) or Rule 15d-14(a).
32.1	Certification required by Rule 13a-14(b) or Rule 15d-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. §1350).
32.2	Certification required by Rule 13a-14(b) or Rule 15d-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. §1350).