Bridgeline Software, Inc.
Form 10KSB
December 29, 2008

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, 2008

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 Acto.

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 Noo.

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 x.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yeso Nox

The issuer's revenues for its most recent fiscal year $21,295,000.

The aggregate market value of the voting and non-voting common equity held by non-affiliates was $5,303,093 based on the closing price of $0.65 of the issuer's common stock, par value $.001 share, as reported by NASDAQ on December 22, 2008.

As of December 22, 2008, there were 10,894,414 shares of common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE: Portions of the definitive proxy statement for our 2008 annual meeting of stockholders, which is to be filed within 120 days after the end of the fiscal year ended September 30, 2008, 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): Yeso Nox

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,” “beli “estimate,” “anticipate,” “intends,” “continue,” or similar terms or variations of those terms or the negative of those terms. These statements appear in a number of places in this Form 10-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 ability to maintain our listing on the Nasdaq Capital Market, the impact of the global financial deterioration on our business, 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 herein and 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® 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 it 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 three 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®.

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 (general release in September 2008) allows non-technical users to create, edit, and publish content via a browser-based interface. The advanced, easy-to-use interface allows businesses to keep content and promotions fresh - whether for a public commercial site or a company intranet. The iAPPS® Content Manager handles the presentation of content based on a sophisticated indexing and security scheme that includes management of front-end access to online applications. The system provides a robust library functionality to manage permissions, versions and organization of different content types, including multimedia files and images. Administrators are 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 (in development) provides 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 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 provides insight into areas like visitor usage, content access, age of content, actions taken, and event triggers, and reports on both client and server-side events. iAPPS® Analytics may 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 2009) 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 2009) 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.

Orgitecture TM

Our Orgitecture TM platform, developed several years ago, provides customers with a suite of on-demand (SaaS) Web-based tools designed to streamline Web site management and reduce web related development costs. Orgitecture software modules include web content management, survey tools, calendaring, email newsletters, online registration, and ecommerce functions.

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. Orgitecture customers have been notified that all R&D on the Orgitecture platform has been suspended and that the company will be sun-setting and no longer provide support for the product on December 31, 2010.

Base 10 TM

Base10 TM is a web based on-demand SaaS platform the Company obtained through the acquisition of Tenthfloor, Inc on January 31, 2008. Base10 provides customers with a suite of on-demand (SaaS) Web-based tools that provides integrated content management, emarketing management, and ecommerce.

Our newly developed iAPPS® web application management software will replace Base10. We plan to migrate Base10 customers to the iAPPS® Framework over the next 18-24 months. Base10 customers have been notified that all R&D on the Base10 platform has been suspended and that the company will be sun-setting and no longer provide support for the product on December 31, 2010.

PowerShop TM

PowerShop TM is a web based eCommerce product the Company obtained through the acquisition of Objectware, Inc on July 5, 2007. PowerShop provides customers with ecommerce capabilities in a coordinated set of tools and services designed to attract new customers and deliver an overall user friendly and satisfying customer experience while automating many required business processes for effective customer service, merchandising and marketing, as well as inventory management, tracking, and reporting.

Our newly developed iAPPS® Commerce product will replace PowerShop when released in mid 2009. We plan to migrate PowerShop customers to iAPPS® Commerce over the next 18-24 months.

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

Revenue from sales of perpetual software license sales is reported as $224 thousand in the accompanying financial statements.

Application Development Services

Application Development

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. 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. 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 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 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 application 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 application development services is reported as Application Development Services in the accompanying financial statements.
Managed Services (including Hosting)

Many of our customers hire us to host and manage the 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, professional sports management and transportation and storage.

We have eight geographic locations in the United States with full-time professional direct sales staffs. Our geographic locations are in the metropolitan Atlanta, Boston, Chicago, Cleveland, Denver, Minneapolis, New York, Washington

DC areas.

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, 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, professional sports management and transportation and storage). 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 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 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.

During fiscal 2008, we have completed the following two acquisitions:

- In January 2008, we acquired Tenth Floor, Inc., a Cleveland, Ohio-based company, with a satellite operation in Minneapolis, Minnesota.
- In July 2008, we acquired Indigio Group, Inc., a Denver, Colorado-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 allows 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 $1.2 million in research and development activities for the fiscal year ended September 30, 2008 which included approximately $397 thousand in capitalized software costs, and we invested approximately $791 thousand in research and development activities for the fiscal year ended September 30, 2007. We believe the cost of India based software developers are 70% lower than the cost of United States based software developers.

Employees

We employed 204 employees worldwide as of September 30, 2008. Substantially all of those employees are full time employees.

Customers

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

- Financial services
- Life sciences & healthcare
- High technology (software and hardware)
- Professional sports management (teams and Individuals)
- Transportation and storage
- Foundations and non profit organizations

We have more than 600 customers of which one customer, Depository Trust Clearing Corporation, generated 7% of revenue in the fiscal year ended September 30, 2008. 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 our competitors in a number of ways. We believe that our competitors generally offer their Web application development software without directly providing 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 reports on Form 10-QSB 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 1A. Risk Factors

This report contains forward-looking statements that involve risks and uncertainties, such as statements of our objectives, expectations and intentions. The cautionary statements made in this report are applicable to all forward-looking statements wherever they appear in this report. Our actual results could differ materially from those discussed herein. In addition to the risks discussed in "Management's Discussion and Analysis of Financial Condition and Results of Operations," our business is subject to the risks set forth below.

We have a limited operating history on which to evaluate our operations and may again incur losses in the future as we expand.

During the most recent four years of operations, in 2005, 2006, 2007 and 2008, we had revenues of approximately $5.8 million, $8.2 million, $11.2 million and $21.3 million, respectively, and net losses of $517,000, $1,448,000, $1,897,000 and

$10,272,000, respectively. We have a limited operating history on which to base an evaluation of our business and prospects. Since 2003, we have funded operations through operating cash flows, when available, sales of equity securities, issuances of debt and lines of credit. Any investment in our company is a high risk investment because you will be placing funds at risk in an unseasoned early stage company with unforeseen costs, expenses, competition and other problems to which such companies are often subject. Our revenues and operating results are difficult to forecast and our projected growth is dependent, in part, on our ability to complete future acquisitions of prospective target companies and the future revenues and operating results of such acquired companies. We therefore believe that period-to-period comparisons of our operating results thus far should not be relied upon as an indication of future performance.

As we have a limited operating history, we may be unable to accurately predict our future operating expenses, which could cause us to experience cash shortfalls in future periods.

In order to substantially grow our business both organically and through additional acquisitions, we may, from time to time, require additional funding. There can be no assurance that we will be able to raise any additionally needed funds on acceptable terms or at all. The procurement of any such additional financing may result in the dilution of your ownership interest in our company.

Because most of our licenses are renewable on a monthly basis, a reduction in our license renewal rate could reduce our revenues.

Our customers have no obligation to renew their monthly subscription licenses, and some customers have elected not to do so. Our license renewal rates may decline or fluctuate as a result of a number of factors, including customer dissatisfaction with our products and services, our failure to update our products to maintain their attractiveness in the market, or constraints or changes in budget priorities faced by our customers. A decline in license renewal rates could cause our revenues to decline which would have a material adverse effect on our operations.

We may not be able to maintain our listing on the Nasdaq Capital Market if we are unable to satisfy the minimum bid price requirements.

Our common stock is currently listed for quotation on the Nasdaq Capital Market. We are required to meet certain financial requirements in order to maintain our listing on the Nasdaq Capital Market. One such requirement is that we maintain a minimum closing bid price of at least $1.00 per share for our common stock. On October 16, 2008, the Nasdaq Stock Market suspended the minimum bid price requirement until January 16, 2009, and on December 19, 2008 extended this suspension until April 20, 2009. Our common stock is currently trading below $1.00 per share. If our common stock trades below $1.00 per share for 30 consecutive business days, after the expiration of the temporary suspension we will receive a deficiency notice from Nasdaq advising us that we have 180 days to regain compliance by maintaining a minimum bid price of at least $1.00 for a minimum of ten consecutive business days. If we fail to satisfy the Nasdaq Capital Market’s continued listing requirements, our common stock could be delisted from the Nasdaq Capital Market. Any potential delisting of our common stock from the Nasdaq Capital Market would make it more difficult for our stockholders to sell our stock in the public market and would likely result in decreased liquidity and have a negative effect on the market price for our shares.

The recent financial crisis and current uncertainty in global economic conditions could negatively affect our business, results of operations, and financial condition.

The recent financial crisis and the current uncertainty in global economic conditions have resulted in a tightening in the credit markets, a low level of liquidity in many financial markets, and extreme volatility in credit, equity and fixed income markets. There could be a number of follow-on effects from these economic developments on our business, including insolvency of customers; decreased customer confidence; and decreased customer demand. Any of these events, or any other events caused by the recent financial crisis, may have a material adverse effect on our business, operating results, and financial condition.

If we are unable to manage our future growth efficiently, our business, revenues and profitability may suffer.

We anticipate that continued expansion of our business will be required to address potential market opportunities. For example, we will need to expand the size of our research and development, sales, corporate finance and operations staff. There can be no assurance that our infrastructure will be sufficiently flexible and adaptable to manage our projected growth or that we will have sufficient resources, human or otherwise, to sustain such growth. If we are unable to adequately address these additional demands on our resources, our profitability and growth might suffer. Also, if we continue to expand our operations, management might not be effective in expanding our physical facilities and our systems, procedures or controls might not be adequate to support such expansion. Our inability to manage our growth could harm our business and decrease our revenues.

Our recent acquisitions involve risks, including our inability to integrate successfully their businesses and our assumption of liabilities.

We have completed four acquisitions since our initial public offering in July 2007. We may not be able to integrate successfully any of such acquired company's business into our existing business. We cannot assure you that we will be able to market the services provided by such acquired companies with the other services we provide to customers. Further, integrating these businesses may involve significant diversion of our management time and resources and be costly. Our acquisitions also involve the risks that the businesses acquired may prove to be less valuable than we expected and/or that such businesses may have unknown or unexpected liabilities, costs and problems. In entering into the definitive merger agreements with the acquired entities, we relied on limited representations and warranties of each company's principal stockholders. Although we have contractual and other legal remedies for losses that we may incur as a result of breaches of his agreements, representations and warranties, we cannot assure you that our remedies will adequately cover any losses that we incur.

If we undertake additional business combinations and acquisitions, they may be difficult to integrate into our existing operations, may disrupt our business, dilute stockholder value or divert management's attention.

During the course of our history, we have acquired seven businesses. A key element of our growth strategy is the pursuit of additional acquisitions in the fragmented Web application development/services industry in the future. These acquisitions could be expensive, disrupt our ongoing business and distract our management and employees. We may not be able to identify suitable acquisition candidates, and if we do identify suitable candidates, we may not be able to make these acquisitions on acceptable terms or at all. If we make an acquisition, we could have difficulty integrating the acquired technology, employees or operations. In addition, the key personnel of the acquired company may choose not to work for us. Acquisitions also involve the risk of potential unknown liabilities associated with the acquired business.

If our products fail to perform properly due to undetected errors or similar problems, our business could suffer, and we could face product liability exposure.

Complex applications software we sell may contain undetected errors, or bugs. Such errors can be detected at any point in a product's life cycle, but are frequently found after introduction of new software or enhancements to existing software. We continually introduce new products and new versions of our products. Despite internal testing and testing by current and potential customers, our current and future products may contain serious defects. If we detect any errors before we ship a product, we might have to delay product shipment for an extended period of time while we address the problem. We might not discover software errors that affect our new or current products or enhancements until after they are deployed, and we may need to provide enhancements to correct such errors. Therefore, it is possible that, despite our testing, errors may occur in our software. These errors could result in:

- harm to our reputation;
- lost sales;
- delays in commercial release;
- product liability claims;

- contractual disputes;
- negative publicity;
- delays in or loss of market acceptance of our products;
- license terminations or renegotiations; or

- unexpected expenses and diversion of resources to remedy errors.

Furthermore, our customers may use our software together with products from other companies. As a result, when problems occur, it might be difficult to identify the source of the problem. Even when our software does not cause these problems, the existence of these errors might cause us to incur significant costs, divert the attention of our technical personnel from our product development efforts; impact our reputation or cause significant customer relations problems.

If we are unable to protect our proprietary technology and other intellectual property rights, our ability to compete in the marketplace may be substantially reduced.

If we are unable to protect our intellectual property, our competitors could use our intellectual property to market products similar to our products, which could decrease demand for such products, thus decreasing our revenues. We rely on a combination of copyright, trademark and trade secret laws, as well as licensing agreements, third-party non-disclosure agreements and other contractual measures, to protect our intellectual property rights. These protections may not be adequate to prevent our competitors from copying or reverse-engineering our products. Our competitors may independently develop technologies that are substantially equivalent or superior to our technology. To protect our trade secrets and other proprietary information, we require employees, consultants, advisors and collaborators to enter into confidentiality agreements. These agreements may not provide meaningful protection for our trade secrets, know-how or other proprietary information in the event of any unauthorized use, misappropriation or disclosure of such trade secrets, know-how or other proprietary information. The protective mechanisms we include in our products may not be sufficient to prevent unauthorized copying. Existing copyright laws afford only limited protection for our intellectual property rights and may not protect such rights in the event competitors independently develop similar products. In addition, the laws of some countries in which our products are or may be licensed do not protect our products and intellectual property rights to the same extent as do the laws of the United States.

Policing unauthorized use of our products is difficult, and litigation could become necessary in the future to enforce our intellectual property rights. Any litigation could be time consuming and expensive to prosecute or resolve, result in substantial diversion of management attention and resources, and materially harm our business or financial condition.

If a third party asserts that we infringe upon its proprietary rights, we could be required to redesign our products, pay significant royalties or enter into license agreements.

Although presently we are not aware of any such claims, a third party may assert that our technology or technologies of entities we acquire violates its intellectual property rights. As the number of software products in our markets increases and the functionality of these products further overlap, we believe that infringement claims will become more common. Any claims against us, regardless of their merit, could:

- be expensive and time consuming to defend;
- result in negative publicity;
- force us to stop licensing our products that incorporate the challenged intellectual property;
- require us to redesign our products;
- divert management's attention and our other resources; or
- require us to enter into royalty or licensing agreements in order to obtain the right to use necessary technologies, which may not be available on terms acceptable to us, if at all.

We believe that any successful challenge to our use of a trademark or domain name could substantially diminish our ability to conduct business in a particular market or jurisdiction and thus decrease our revenues and result in possible losses to our business.

If the security of our software, in particular the hosted Internet solutions products we have developed, is breached, our business and reputation could suffer.

Fundamental to the use of our products is the secure collection, storage and transmission of confidential information. Third parties may attempt to breach our security or that of our customers and their databases. We might be liable to our customers for any breach in such security, and any breach could harm our customers, our business and reputation. Any imposition of liability, particularly liability that is not covered by insurance or is in excess of insurance coverage, could harm our reputation, business and operating results. Computers, including those that utilize our software, are vulnerable to computer viruses, physical or electronic break-ins and similar disruptions, which could lead to interruptions, delays or loss of data. We might be required to expend significant capital and other resources to protect further against security breaches or to rectify problems caused by any security breach, which, in turn could divert funds available for corporate growth and expansion or future acquisitions.

We are dependent upon our management team, and the loss of any of these individuals could harm our business.

We are dependent on the efforts of our key management personnel. The loss of any of our key management personnel, or our inability to recruit and train additional key management and other personnel in a timely manner, could materially and adversely affect our business, operations and future prospects. We do not maintain a key man insurance policy covering any of our employees. In addition, in the event that Thomas Massie, our founder, Chairman and Chief Executive Officer, is terminated by us without cause, he is entitled to receive severance payments equal to the greater of (a) three years' total compensation, including bonus amounts, or (b) $1 million. In the event we are required to pay the severance payments to Mr. Massie, it could have a material adverse effect on our results of operations for the fiscal quarter and year in which such payments are made.

We have shifted a significant portion of our software development operations to India, which poses significant economic, political and security risks.

A significant portion of our software development activities are conducted by our Bridgeline Software, Pvt. Ltd. subsidiary in Bangalore, India, in order to take advantage of cost efficiencies associated with India's lower wage scale. As of September 30, 2008, we have 62 software development employees (39% of total software development employees) at our Bangalore facility which represent approximately 6% of our total development costs. However, we may not continue to achieve the cost savings and other benefits we currently receive from these operations and we may not be able to find sufficient numbers of developers with the necessary skill sets in India to meet our needs as we grow. Due to our activities in India, we are exposed to risks related to changes in the economic, security and political conditions of India. Economic and political instability, military actions and other unforeseen occurrences in India could impair our ability to continue our software development in a timely manner, which could put our products at a competitive disadvantage.

If we fail to maintain an effective system of internal controls, we may not be able to accurately report our financial results or prevent fraud. As a result, current and potential shareholders could lose confidence in our financial reporting, which would harm our business and the trading price of our stock.

Effective internal controls are necessary for us to provide reliable financial reports and effectively minimize the possibility of fraud and its impact on our company. If we cannot provide financial reports or effectively minimize the possibility of fraud, our business reputation and operating results could be harmed. Inferior internal controls could also cause investors to lose confidence in our reported financial information, which could have a negative effect on the trading price of our stock.

In addition, we will be required to include the management and auditor reports on internal controls as part of our annual report for the fiscal year ending September 30, 2008, pursuant to SOX Section 404, which requires, among other things, that we maintain effective internal controls over financial reporting and effective disclosure controls and procedures. In particular, we must perform system and process evaluation and testing of our internal controls over financial reporting to allow management and our independent registered public accounting firm to report on the effectiveness of our internal controls over financial reporting, as required by Section 404. Our compliance with Section 404 will require that we incur substantial accounting expense and expend significant management efforts.

We cannot be certain as to the timing of the completion of our evaluation and testing, the timing of any remediation actions that may be required or the impact these may have on our operations. Furthermore, there is no precedent available by which to measure compliance adequacy. If we are not able to implement the requirements relating to internal controls and all other provisions of Section 404 in a timely fashion or achieve adequate compliance with these requirements or other SOX requirements, we might become subject to sanctions or investigation by regulatory authorities such as the Securities and Exchange Commission or any securities exchange on which we may be trading at that time, which action may be injurious to our reputation and affect our financial condition and decrease the value and liquidity of our securities, including our common stock.

Our auditors identified material weaknesses in our internal controls over financial reporting as of September 30, 2008 and September 30, 2007. Failure to achieve and maintain effective internal control over financial reporting could result in our failure to accurately report our financial results.

In connection with its audit of our financial statements, our external auditors, UHY LLP, advised us that they were concerned that as of and for the years ended September 30, 2008 and September 30, 2007, our accounting resources did not include enough people with the detailed knowledge, experience and training in the selection and application of certain accounting principles generally accepted in the United States of America (GAAP) to meet our financial reporting needs. This control deficiency contributed to material weaknesses in internal control with respect to accounting for revenue recognition, equity and acquisitions. A “material weakness” is a control deficiency or combination of control deficiencies that results in more than a remote likelihood that a material misstatement in the financial statements or related disclosures will not be prevented or detected.

During the fiscal years ended September 30, 2007 and September 30, 2008, we created or enhanced several new positions in our Company, including our controller and a vice-president level, with specific responsibilities for external financial reporting, internal control, revenue recognition and purchase accounting. We estimate that the annual cost of the new positions referred to above will be between $300 thousand and $350 thousand. In addition, we expect to incur significant additional costs in the future.

While we expect to complete the process of bringing our internal control documentation into compliance with SOX Section 404 as quickly as possible, we cannot at this time estimate how long it will take to complete the process or its ultimate cost. We expect such costs to be significant.

We face intense and growing competition, which could result in price reductions, reduced operating margins and loss of market share.

We operate in a highly competitive marketplace and generally encounter intense competition to create and maintain demand for our services and to obtain service contracts. If we are unable to successfully compete for new business and license renewals, our revenue growth and operating margins may decline. The market for our products, i.e., Web development services, content management products, asset management products, e-Training products, foundations management products, and Web analytics are competitive and rapidly changing, and barriers to entry in such markets are relatively low. With the introduction of new technologies and market entrants, we expect competition to intensify in the future. Some of our principal competitors offer their products at a lower price, which may result in pricing pressures. Such pricing pressures and increased competition generally could result in reduced sales, reduced margins or the failure of our product and service offerings to achieve or maintain more widespread market acceptance.

The Web development/services market is highly fragmented with a large number of competitors and potential competitors. Our primary public company competitors are Web.com, Omniture, Cognizant Technology Solutions, and Vignette. We also face competition from customers and potential customers who develop their own applications internally. We also face competition from potential competitors that are substantially larger than we are and who have significantly greater financial, technical and marketing resources, and established direct and indirect channels of distribution. As a result, they are able to respond more quickly to new or emerging technologies and changes in customer requirements, or to devote greater resources to the development, promotion and sale of their products than we can. In addition, current and potential competitors have established or may establish cooperative relationships among themselves or prospective customers. Accordingly, it is possible that new competitors or alliances among competitors may emerge and rapidly acquire significant market share which could reduce our market share and decrease our revenues.

Increasing government regulation could affect our business and may adversely affect our financial condition.

We are subject not only to regulations applicable to businesses generally, but also to laws and regulations directly applicable to electronic commerce. Although there are currently few such laws and regulations, state, federal and foreign governments may adopt laws and regulations applicable to our business. Any such legislation or regulation could dampen the growth of the Internet and decrease its acceptance. If such a decline occurs, companies may choose in the future not to use our products and services. Any new laws or regulations in the following areas could affect our business:

- user privacy;
- the pricing and taxation of goods and services offered over the Internet;
- the content of Websites;
- copyrights;
- consumer protection, including the potential application of “do not call” registry requirements on customers and consumer backlash in general to direct marketing efforts of customers;
- the online distribution of specific material or content over the Internet; or
- the characteristics and quality of products and services offered over the Internet.

Because competition for highly qualified personnel is intense, we might not be able to attract and retain the employees we need to support our planned growth.

We will need to increase the size and maintain the quality of our sales force, software development staff and professional services organization to execute our growth plans. To meet our objectives, we must attract and retain highly qualified personnel with specialized skill sets. Competition for qualified personnel can be intense, and we might not be successful in attracting and retaining them. Our ability to maintain and expand our sales, product development and professional services teams will depend on our ability to recruit, train and retain top quality people with advanced skills who understand sales to, and the specific needs of, our target customers. For these reasons, we have experienced, and we expect to again experience in the future, challenges in hiring and retaining highly skilled employees with appropriate qualifications for our business. In addition to hiring services personnel to meet our needs, we may also engage additional third-party consultants as contractors, which could have a negative impact on our financial results. If we are unable to hire or retain qualified personnel, or if newly hired personnel fail to develop the necessary skills or reach productivity slower than anticipated, it would be more difficult for us to sell our products and services, and we could experience a shortfall in revenue and not achieve our planned growth.

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 40th Street New York, New York 10018	4,400 square feet, professional office space
Arlington, VA	4,300 Wilson Boulevard Arlington, VA 22203	4,801 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	8,547 square feet, professional office space
Chicago, Illinois	30 N. LaSalle Street, 20th Floor Chicago, IL 60602	4,880 square fee, professional office space
Cleveland, Ohio	2077 East 4th Street, 2nd Floor Cleveland, OH 44115	5,705 square fee, professional office space
Minneapolis, Minnesota	800 Washington Ave. North Ste 500 Minneapolis, MN 55402	1,560 square fee, professional office space
Denver, Colorado	410 17th Street, Suite 600 Denver, CO 80202	12,270 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, 2008, 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, 2008	High	Low
Fourth Quarter	$ 2.48	$ 1.18
Third Quarter	3.66	2.25
Second Quarter	3.65	2.45
First Quarter	4.34	3.00

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

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 22, 2008, our common stock was held by approximately 113 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, 2008. 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

Tenth Floor, Inc. - The acquisition of Tenth Floor, Inc. closed on January 31, 2008. At that time, we issued an aggregate of 639,948 shares of our common stock to the four stockholders of Tenth Floor as partial consideration in our acquisition.

Indigio Group, Inc. – The acquisition of Indigio Group, Inc., Inc. closed on July 1, 2008. At that time we issued an aggregate of 1,127,810 shares of our common stock to the eighteen stockholders of Indigio 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.

Contingent Consideration

Objectware, Inc.. - In conjunction with the earn-out provision of the merger agreement, we issued 65,657 shares of our common stock to the sole stockholder of Objectware as contingent consideration payments.

The securities issued as contingent consideration in our acquisition of Objectware 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, 2008, we issued 160,000 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, 2008, we issued 6,667 shares of our common stock pursuant to the exercise of vested stock options. In the fiscal year ended September 30, 2008, we granted options to purchase equity shares on the following dates and amounts:

Date	Number	Exercise Price
October 26, 2007	336,000	$ 3.69
January 2, 2008	6,800	$ 3.22
April 18, 2008	110,500	$ 2.50
July 1, 2008	42,000	$ 2.40
July 25, 2008	15,000	$ 2.20
August 19, 2008	313,000	$ 1.76

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 exemptions from the registration provisions of the Securities Act set forth in Section 4(2) thereof relative to sales by an issuer not involving any public offering, to the extent an exemption from such registration was required.

Item 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 herein and in 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, improving customer service and loyalty, enhancing employee knowledge, and reducing 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 six vertical markets: Financial services, life sciences, high technology, foundations, professional sports management and transportation and storage. We have professional direct sales management in eight geographic specific locations in the United States. They are in the metropolitan Atlanta, Boston, Chicago, Cleveland, Denver, Minneapolis, New York and Washington DC areas.

In fiscal 2008, approximately 61% of our customer base paid Bridgeline Software a monthly subscription fee or a monthly managed service fee. In fiscal 2008 approximately 57% of our total revenue was from existing customers demonstrating a deep customer traction model. The majority of our revenue in 2008 was driven from our 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® 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 Tenth Floor, Inc. ("Tenth Floor") in Cleveland and Minneapolis and Indigio Group, Inc. ("Indigo") in Denver. We now have a geographical presence in eight areas in the United States and expect to make additional expansion acquisitions over the next twenty-four months.

Fiscal 2008 marked yet another milestone for Bridgeline. We achieved record revenues of $21.3 million for the year, a 91% increase over fiscal 2007. In addition, we achieved record earnings before interest, taxes, depreciation and amortization ("EBITDA") and before stock compensation and impairment of goodwill and intangible assets of $1.2 million, an improvement of $1.5 million or 525% over fiscal 2007. 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.

There are a number of items that affect the comparison of fiscal 2008 to 2007. These items include:

- We completed the acquisition of Objectware, Inc. ("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, Inc. ("Purple Monkey") on August 31, 2007. The results for fiscal 2007 include one month of results from this acquisition.
- We completed the acquisition of Tenth Floor on January 31, 2008. The results for fiscal 2008 include eight months of results from this acquisition.
- We completed the acquisition of Indigio on July 1, 2008. The results for fiscal 2008 include three month of results from this acquisition.
- We increased our expenditures for research and development activities to develop our iAPPS® Analytics product during fiscal 2008 and enhanced our Content Management and Framework products. We attained technical feasibility for our iAPPS® Analytics product in February 2008 and release version 2.1 of Content Manager in September 2008.
- As a result of the annual review of the fair value of goodwill, we recorded a non-cash impairment charge of $9.8 million at September 30, 2008.

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

	2008	2007	Change $	Change %
Total revenue	$ 21,295	$ 11,151	$ 10,144	91%
Gross profit margin	10,990	6,131	4,859	79%
Loss from operations	(10,333)	(1,006)	(9,327)	(927)%
Net loss	$ (10,309)	$ (1,897)	$ (8,412)	(443)%

EBITDA	$ 1,255	$ (239)	$ 1,494	525%

EBITDA Reconciliation:

	2008	2007
Net loss	$ (10,309)	$ (1,897)
Plus:		
Interest expense	61	924
Depreciation	578	158
Amortization	672	244
Stock Compensation	425	332
Impairment of goodwill and intangible assets	9,828	—
EBITDA	$ 1,255	$ (239)

Revenue:
Overall, revenue increased $10.1 million, or 91%, when compared to the same period one year earlier. Acquisitions accounted for $3.4 million of this increase. Excluding fiscal 2008 acquisitions, sales increased $6.8 million, or 67%. Approximately $3.8M of this increase was attributable to incremental additional revenues in fiscal 2008 resulting from the acquisitions of Objectware and Purple Monkey which included only three months and one month of revenue, respectively in fiscal 2007. 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 margin increased $4.9 million or 79% as compared to the prior year, although gross profit margin as a percentage of revenues declined to 52% from 55% in fiscal 2007. The increase in gross margin dollars is principally the result of increases in revenues. The decrease in gross margin percentage is principally the result of a revenue mix of lower margin application development services and reduced billing rates inherited from our Indigo acquisition. 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:		2008		2007		Change $	Change %
Application development services	$	16,527	$	8,659	$	7,868	91%
Managed services		3,683		2,050		1,633	80%
Perpetual licenses and subscriptions		1,085		442		643	145%
Total	$	21,295	$	11,151	$	10,144	

Application Development Services:
Revenue from application development services increased $7.9 million, a 91% improvement from fiscal 2007. Acquisitions of Tenth Floor, Inc. and Indigio Group, Inc. accounted for $2.0 million of the increase, and full year incremental revenues generated from Objectware and Purple Monkey in fiscal 2008 accounting for approximately $2.6 million of the increase. Excluding the affect of these acquisitions, revenue increased $3.3 million. Our growth came in a number of industries and customers. First, revenue from existing customers accounted for more than 65% of the fiscal 2008 revenues from application development services. We achieved a record year in sales, with sales from new customers of approximately $9.0 million in the current year. Revenue from existing customers increased by approximately $1.9 million when compared to the same period one year earlier. Four existing customers recorded annual increases in excess of $500 thousand each and $2.9 million in the aggregate offset by a decrease in revenue from one customer of $2.0 million as a result of this customers' changing needs. We continue to develop a diverse customer base with only one customer, Depository Trust Clearing Corporation, representing 6.8% of total revenues and no other customer representing greater than 5% of total revenues. From an industry perspective, we have continued to see broad penetration of our services into multiple industries. Our strongest presence is in the high technology, financial services, non profit industries and life sciences markets. Of the revenue growth from new customers: high technology contributed $2.0 million; financial services contributed $912 thousand; non profit contributed $818 thousand; and life sciences contributed $376 thousand. The remaining growth came from several other industries.

Managed Services:
Revenue from managed services increased $1.6 million, or 80% from the prior year. Acquisitions accounted for $1.0 million of this increase. Excluding acquisitions, managed services increased $633 thousand. The growth is a net result of increases in revenues from over 330 existing customers offset principally by a decrease in revenues from one customer. The average increase was approximately $4,800 per customer offset by a reduction from one customer of approximately $800 thousand. The decrease from the one customer was largely due to the customer's needs changing. Bridgeline won several new engagements during the year that combined with a full year of managed

services revenues resulting from recent acquisitions is expected to provide additional benefits in fiscal 2009.

Perpetual Licenses and Subscriptions:
Revenue from licenses and subscriptions increased $643 thousand from the prior year, or 145%. This increase is largely attributable to $224 thousand in sales of perpetual license products and an increase in subscription revenues of $406 thousand. The acquisition of Tenth Floor accounted for approximately $329 thousand of the subscription revenue growth.

Gross Profit

	2008	2007	Change $	Change %
Application development services	$ 6,844	$ 4,101	$ 2,743	67%
Managed services	3,212	1,614	1,598	99%
Perpetual licenses and subscriptions	934	416	518	125%
Total	$ 10,990	$ 6,131	$ 4,859	

Application Development Services:
Gross profit from application development services increased by $2.7 million, or 67%. This represents a 41% gross profit margin in fiscal 2008, a decrease of 6% from margins achieved in fiscal 2007 of 47%. This increase in gross margin dollars is attributable largely to the increase in sales. Our application development services are primarily driven by salaries and wages and outside contractor costs. Application 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. The decrease in gross profit margin as a percentage of sales in fiscal 2008 is principally attributable to three large engagements completed in fiscal 2008 that included implementation of our new licensed products where our costs significantly exceeded our estimates. Exclusive of these engagements, our gross margin percentage derived from application development services remained consistent with the prior year. We continue to seek margin improvements by utilizing our library of software code to gain efficiencies on engagements where the fee is fixed or when billable hours exceed our estimates without increasing 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 application 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 in subsequent years.

Managed Services:
Gross profit increased by $1.6 million, or 99%. This represents an 87% gross profit margin for fiscal 2008, which is an increase of 8% from gross profit margins attained in fiscal 2007 of 79%. The primary costs associated with managed services revenues are principally the direct third party costs of our co-managed network operation centers (NOCs). As a result of the acquisition of Tenth Floor and Indigio, our total number of NOCs increased from two to four as of September 30, 2008. The increase in costs attributable to the additional NOCs was offset by increases in managed services revenues derived from those locations thus resulting in our ability to increase margins. Our current facilities have capacity and can be expanded with our growth in revenue without adding substantial costs. We are also evaluating the feasibility of consolidating one or more of our NOC locations which may allow us to improve margins 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.

Perpetual Licenses and Subscriptions:
Gross profits from perpetual licenses and subscriptions increased $518 thousand or 125% from the prior year. In fiscal 2008, gross profit margins were 86%, compared to 94% in fiscal 2007. Costs for the subscription revenue include a share of the cost of our NOCs and the costs to maintain our software products. During fiscal 2008, we added an additional product line sold via subscription as a result of our acquisition of Tenth Floor. However, we continued to shift our efforts from maintaining the current and acquired on-demand software products sold through subscriptions and began selling our new product, iAPPS. Costs associated with maintaining the legacy products and costs incurred from operating additional NOC locations resulted in a lower gross profit margin on licensing and subscription revenues in fiscal 2008 compared to the previous year. We plan to begin migrating customers to our new product platform from our legacy products over the next eighteen months which may reduce the cost of maintaining those products and result in increased margins. In addition, we are evaluating the feasibility of consolidating multiple NOCs, thus 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, research and development expenses, depreciation and amortization and impairment of goodwill and intangible assets. Overall, loss from operations before impairment decreased $501 thousand, a 99% improvement. This reduction in loss from operations before impairment is principally a result of an increase in gross profits generated from increased sales in fiscal 2008 compared to fiscal 2007. Sales and marketing expenses remained relatively unchanged as a percentage of sales at 30% in fiscal 2008 versus 31% in fiscal 2007, but general and administrative expenses as a percentage of sales decreased to 17% in fiscal 2008 compared to 22% in fiscal 2007 as we were able to leverage our existing infrastructure in information technology and finance while supporting the growth in revenue. Depreciation and amortization expense increased to 5% of sales in fiscal 2008 compared to 3% in the prior year primarily resulting from increases in purchases of capital equipment to support our growth and additional fixed assets acquired in the acquisitions of Tenth Floor and Indigio. Research and development expenses decreased to 3% of sales in fiscal 2008 compared to 7% in fiscal 2007 principally the result of the capitalization of approximately $397 thousand of software development costs in accordance with SFAS No. 86, Accounting for the

Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed (“SFAS 86”). A brief discussion of each component follows.

Sales and Marketing Expenses

Sales and marketing expenses increased $2.8 million, or 80%, when compared to fiscal 2007. We look at sales and marketing as a percentage of sales. For fiscal 2008, sales and marketing represented 30% of sales, compared to 31% in fiscal 2007. 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 2009. On an absolute dollars basis, the increase is sales and marketing expenses is largely due to increased marketing expenses and increased sales force headcount in fiscal 2008. During fiscal 2008, we sponsored a number of seminars adding to the marketing expenses when compared to fiscal 2007. 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 $1.0 million, or 42%, when compared to the same period in fiscal 2007. This increase is due to several factors. In fiscal 2008, we incurred additional travel, legal, accounting, consulting and professional fees associated with operating as a public company, which represented approximately $291 thousand of the increase. In addition, our payroll expenses increased due to salary increases and additional headcount at our corporate offices. We hired additional personnel during fiscal 2008 primarily in our accounting function when compared to fiscal 2007. As of September 30, 2008, we believe that there are limited needs to hire additional personnel in corporate and that the infrastructure can absorb additional acquisitions without additional administrative personnel. Total payroll and benefits increased in fiscal 2008 by $543 thousand from fiscal 2007.

Research and Development:

Expenses for research and development decreased $172 thousand in fiscal 2008 compared to the prior year net of capitalization of software development costs of approximately $397 thousand. Inclusive of the capitalized costs, research and development spending in fiscal 2008 totaled $1.0 million compared to $791 thousand in fiscal 2007, an increase of $225 thousand or 28%. The increase in total spending during fiscal 2008 was incurred to develop our new on-demand software products, iAPPS Framework, iAPPS Content Manager and iAPPS Analytics. 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 plan to continue investing in research and development as we develop new eCommerce and eMarketing products on our iAPPS platform over the next twenty-four months along with additional releases and enhancements to our current iAPPS product offerings.

Depreciation and Amortization

The increase in depreciation and amortization of $682 thousand during fiscal 2008, a 185% increase, is largely attributable to the additional depreciation and amortization expense associated with acquisitions. In July and August of 2007, we made two acquisitions. The current year includes a full year of depreciation and amortization associated with the assets acquired as compared to three and one months, respectively in fiscal 2007 resulting in an increase of $292 thousand. During the current year, we made two acquisitions and began depreciating and amortizing the acquired assets. This resulted in an increase of $207 thousand to amortization and depreciation expense when compared to fiscal 2007. In addition, during fiscal 2008 we invested in equipment for our NOCs. The remaining increase is attributable the timing of fixed asset expenditures.

Impairment of Definite-Lived Intangible Assets and Goodwill

Under SFAS No. 142, “Goodwill and Other Intangible Assets” (“SFAS No. 142”), goodwill and certain intangible assets are deemed to have indefinite lives and are no longer amortized, but are reviewed at least annually for impairment. In the fourth quarter of fiscal 2008, we completed our annual impairment test and as a result of the present environment impacting our business and results and an overall decline in organic revenue growth in the second half of fiscal 2008, combined with a material decline of our stock price since September 30, 2007, we determined that it had identified an impairment triggering event. Therefore, we engaged an independent third party to assist us in the review of the carrying value of our goodwill and definite-lived intangible asset balances for possible impairment in accordance with the provisions of SFAS No. 142. We evaluated the results of fair value derived utilizing four standard valuation techniques: discounted cash flow (Income Approach); guideline public companies method (Market Approach); direct market data approach ("DMD") for mergers and acquisitions (Market Approach); and direct market data approach for public market capitalization (Market Approach). These methods considered valuation inputs from all three levels of valuation (Level 1, Level 2 and Level 3) described in SFAS No. 157, "Fair Value Measurements" ("SFAS No. 157"). In accordance with the provisions of SFAS No. 142 and SFAS No. 157 we placed significant weighting in our evaluation of fair value derived using the Direct Market Data Method as this result utilized the Level 1 input - our quoted stock price in an active market, and was afforded the highest consideration. Accordingly, the fair values derived under the other three methods utilizing Level 2 and Level 3 inputs were allocated significantly less weighting. The review for impairment indicated that the carrying value goodwill was impaired as of September 30, 2008. Based upon the results of the valuation techniques utilized, we recognized an impairment charge of $9.8 million for the fiscal year ended September 30, 2008.

For the definite-lived intangible asset impairment review, we compared the carrying value of the intangible assets against the estimated undiscounted cash flows to be generated over the remaining life of the intangible assets. Based upon the results, we recognized an impairment charge of $76 thousand related to certain customer relationships, non-compete agreements and trade names.

For the goodwill impairment evaluation, we are required to perform a second step of the goodwill impairment test, used to measure the amount of impairment loss that compares the implied fair value of our one reporting unit goodwill with the carrying amount of that goodwill. We expect to complete this analysis in our first quarter of fiscal 2009.

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 2008, our operations used $387 thousand in cash, compared to $1.0 million in fiscal 2007. The reduction in cash used in operations is primarily attributable to our reduction in net losses before impairment charges in fiscal 2008 when compared to fiscal 2007. During 2008, we completed two acquisitions for a cash use of $1.8 million. In September 2008, we received cash proceeds of $1.0 million from our bank line of credit, which we repaid in full in October 2008. In December 2008, the bank line of credit was amended, increasing the available credit up to the lesser of (a) $3.0 million and (b) 80% of eligible accounts receivable, subject to specified adjustments. We also used cash to fund capital expenditures of $980 thousand and contingent acquisition payments of $528 thousand, and expended $397 thousand in software development costs that were capitalized in accordance with SFAS No. 86. As of September 30 2008, we have $1.9 million in cash available for operations.

As of September 30, 2008, 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 $2.1 million, $1.9 million, $793 thousand and $330 thousand for the fiscal years ending September 30, 2009, 2010, 2011 and 2012, respectively, provided that the contingent results are achieved. The contingent acquisition obligations are based primarily on the achievement sales targets and positive EBITDA, as defined in the acquisition agreements.

Cash Flows

Working Capital

At September 30, 2008, we had working capital of $2.2 million. We define working capital as current assets less current liabilities. We had receivables of $4.0 million. This compares to $2.9 million in receivables at September 30, 2007. The level of trade receivables at September 30, 2008 and September 30, 2007 represented approximately 48 and 64 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, 2008 increased $1.2 million from September 30, 2007 principally due to increases in revenues and the timing of billing in accordance with stated contract terms and acquisitions during the year.

Investing Activities

Net cash used in investing activities was $3.7 million in fiscal 2008, compared to $5.1 million in fiscal 2007. In fiscal 2008, we used $1.8 million in cash for the acquisitions of Tenth Floor and Indigio. We also spent $980 thousand in capital expenditures and expended $397 thousand in software development costs that were capitalized in accordance with SFAS No. 86. During fiscal 2008, we continued to invest 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 $528 thousand.

Financing Activities

Net cash provided by financing activities was $800 thousand for fiscal 2008, compared to $10.7 million in fiscal 2007. As noted above, the Company received proceeds from the bank line of credit of $1.0 million and repaid obligations under capital equipment leases of $202 during fiscal 2008. The cash flows from financing activities in fiscal 2007 were principally attributable to the net proceeds received from our initial public offering.

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 2009. We believe that cash requirements for capital expenditures will be approximately $600 thousand during fiscal 2009. We believe operating cash flows will be used to fund these expenditures. Funds required for acquisitions, if any, and investments in research and development will be funded from the remaining cash flows from operations and our bank line of credit.

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, 2008:

(in thousands)

	FY 09	FY 10	FY 11	FY 12	FY 13	FY 14	Totals
Payment Obligations by Year							
Bank line of credit	$ 1,000	$ —	$ —	$ —	$ —	$ —	$ 1,000
Operating leases (A)	1,238	1,114	998	640	334	211	4,535
Capital lease obligations	130	90	55	12	—	—	287
Contingent acquisition payments (B)	2,054	1,932	793	330	—	—	5,109
Total	$ 4,422	$ 3,136	$ 1,846	$ 982	$ 334	$ 211	$ 10,931

(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 Company's significant accounting policies are described in Note 2 of the Consolidated Financial Statements, that were prepared in accordance with accounting principles generally accepted in the United States of America ("US GAAP"). 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 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;
- Accounting for Cost of Computer Systems to be Sold, Leased or Otherwise Marketed;
- 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.

Accounting for Cost of Computer Systems to be Sold, Leased or Otherwise Marketed. We charge research and development expenditures for technology development to operations as incurred. However, in accordance with SFAS No. 86, we capitalize certain software development costs subsequent to the establishment of technological feasibility. Once the product is available for general release, the capitalized costs are amortized in cost of sales. 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.

Revenue Recognition. Substantially all of our revenue is generated from three activities: Application Development Services, Managed Services, and Perpetual Licenses 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.

Application Development Services

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, e-Commerce, e-Learning and e-Training, search engine optimization, and content management. Application development services engagements often include a hosting arrangement that provides for the use of certain hardware and infrastructure, generally at one of our network operating centers. As described further below, revenue for these hosting arrangements is included in managed services. Application development services engagements that include hosting arrangements are accounted for as multiple element arrangements as described below under “Multiple-Element Arrangements.”

For application development services engagements sold on a stand alone basis, revenue is recognized in accordance with SAB 104. Application 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 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.

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

Managed Services

Managed services primarily include on-going retained professional services, hosting services, and post contract customer support services ("PCS").

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 one of our 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 typically 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 revenues associated with our subscriptions are included in perpetual licenses and subscriptions revenue.

Retained professional services are sold on a stand-alone basis or in multiple element arrangements with application development services and, occasionally, subscriptions. Hosting services are typically sold in connection with application development services but also may be 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."

PCS includes a provision for unspecified product upgrades, error or bug fixes, and telephone and online support during our normal business hours. Revenue for PCS sold separately is recognized ratably on a straight-line basis over the period of performance, typically twelve months. Vendor specific objective evidence of fair value ("VSOE") is established for PCS and is based on the price of PCS when sold separately, which has been established via annual renewal rates and is a consistent percentage of the stipulated software license fee. Revenue recognition for PCS sold as part of a multiple element arrangement is described further below under the caption "Multiple Element Arrangements."

Perpetual Licenses and Subscriptions

We license our 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 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 in accordance with AICPA SOP No. 98-9, Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transactions. 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 our 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 generally 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 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. 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 our 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 SOP 97-2 or EITF 00-21, as applicable. As described further below, we have concluded that each element can be treated as a separate unit of accounting when following EITF 00-21.

When we license our software on a perpetual basis in a multiple element arrangement that also includes application development services and PCS, 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. We have not established VSOE for perpetual licenses or fixed priced application development services and therefore in accordance with SOP 97-2, when perpetual licenses are sold in a multiple element arrangement 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. For the fiscal year ended September 30, 2008 we have recognized revenues of $224 thousand for perpetual licenses. 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 is considered. We also consider 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. We have 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, we recognize the perpetual license on a residual basis. If an application development services arrangement does not qualify for separate accounting, we recognize the perpetual license under the proportional performance model as described above.

When subscription arrangements are sold with application development services, we follow EITF 00-21 and have 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 we generally recognize 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 revenues and related costs are deferred and recognized over the subscription period. Subscriptions also include a PCS component, and we have determined that the two elements cannot be separated and must be recognized as one unit over the applicable service period.

Customer Payment Terms

Our payment terms with customers typically are “due upon receipt” or “net 30 days from invoice”. Payments terms may vary by customer but in generally do not exceed 45 days from invoice date. For Application 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 Application 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.

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.

In the fourth quarter of fiscal 2008, we completed our annual impairment test and as a result of the present economic environment impacting our business and results, an overall decline in organic revenue growth in the fourth quarter of fiscal 2008, and a material decline of the trading price of our common stock since June 30, 2008, we determined that we had identified an impairment triggering event. Therefore, we engaged an independent third party to assist us in the review of the carrying value of goodwill and our definite-lived intangible asset balances for possible impairment in accordance with the provisions of SFAS No. 142 and SFAS No. 144, "Accounting for Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144"), respectively.

In our review of the carrying value of the goodwill and intangible assets we determined the fair value of our single reporting unit using the Income Approach, or more specifically the Discounted Cash Flow Method, the Market Approach, utilizing both the Guideline Company Method and the Comparable Transaction Method, and the Direct Market Data Method, determining the fair value based on active market data at September 30, 2008. The review for impairment indicated that the carrying value of both the goodwill and intangible assets was impaired as of September 30, 2008). In accordance with SFAS No. 157, our evaluation considered inputs from all three levels of hierarchy (Level 1, Level 2 and Level 3). In accordance with the provisions of SFAS No. 142 and SFAS No. 157 we placed significant weighting in our evaluation of fair value derived using the Direct Market Data Method (i.e. market capitalization) as it involves the use of a Level 1 input – the value of our stock in an active market, and therefore is afforded the highest consideration. Accordingly, the fair values derived utilizing the other three methods based on Level 2 and Level 3 inputs were allocated significantly less weighting. We also considered the impact of the current economic recession on our fourth quarter revenues and the 52% decline in our stock price since June 30, 2008. Based upon the results of the valuation techniques utilized, we recognized an impairment charge of $9.8 million for the fiscal year ended September 30, 2008 related to carrying value of goodwill.

As a final requirement to the goodwill impairment evaluation, the amount of impairment is to be allocated to the assets and liabilities of the applicable business units acquired based on implied fair value of each acquired unit's assets with the carrying amount of those assets, including goodwill. We expect to complete this analysis in its first fiscal quarter of 2009.

Stock-Based Compensation

At September 30, 2008, we maintained two stock-based compensation plans which are more fully described in Note 9.

Effective October 1, 2006, the Company adopted the recognition and measurement provisions of Statement of Financial Accounting Standards No. 123 (revised 2004) ("SFAS 123(R)"), Share-Based Payment, which replaces SFAS No. 123, Accounting for Stock-Based Compensation, and supersedes Accounting Principles Board Opinion No. 25 ("APB 25"), Accounting for Stock Issued to Employees, and related interpretations. SFAS 123(R) requires that share-based payments (to the extent they are compensatory) be recognized in our consolidated statements of operations based on their fair values. In addition, we have applied the provisions of the SEC's Staff Accounting Bulletin No.107 in our accounting for Statement 123R. In adopting SFAS 123(R), the Company applied the modified prospective approach to transition. Under the modified prospective approach, the provisions of SFAS 123(R) are to be applied to new awards and to awards modified, repurchased, or cancelled after the required effective date. Additionally, compensation cost for the portion of awards for which the requisite service has not been rendered that are outstanding as of the required effective date shall be recognized as the requisite service is rendered on or after the required effective date.

As required by SFAS 123(R), we recognize stock-based compensation expense for share-based payments issued or assumed after October 1, 2006 that are expected to vest. For all share-based payments granted or assumed beginning October 1, 2006, we recognize stock-based compensation expense on a straight-line basis over the service period of the award, which is generally four years. Upon adoption of SFAS 123 (R), we are required to 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 rates. Stock-based compensation expense recorded using an estimated forfeiture rate is 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. We are required to estimate the stock awards that we ultimately expect to vest and to reduce stock-based compensation expense for the effects of estimated forfeitures of awards over the expense recognition period. 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 "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 have used historical rates of employee turnover by job classification. 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.

Prior to the Company's initial public offering in June 2007, the fair value of the Company's common stock was generally determined using the weighted average of three customary valuation techniques: the discounted cash flow method, the market approach, and the guideline public company method. The Company believes that a weighted average of these three techniques is the most reasonable approach to the valuation of our stock for this period. The Company believed that a value market multiple of comparable public companies based on market value of invested capital to revenues provides an objective basis for measuring its fair market value. Accordingly, the Company placed the highest weighting on this factor in its analysis.

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. Because the deferred tax assets we record are based upon the stock-based compensation expenses in a particular jurisdiction, the aforementioned inputs that affect the fair value of our stock awards also indirectly affect our income tax expense. In addition, differences between the deferred tax assets recognized for financial reporting purposes and the actual tax deduction reported on our income tax returns are recorded in additional paid-in capital. If the tax deduction is less than the deferred tax asset, such shortfalls reduce our pool of excess tax benefits. If the pool of excess tax benefits is reduced to zero, then subsequent shortfalls would increase our income tax expense. Our pool of excess tax benefits is computed in accordance with the alternative transition method as prescribed under FASB Staff Position FAS 123R-3, Transition Election to Accounting for the Tax Effects of Share-Based Payment Awards.

To the extent we change the terms of our employee stock-based compensation programs or refine different assumptions in future periods such as forfeiture rates that differ from our estimates, the stock-based compensation expense that we record in future periods and the tax benefits that we realize may differ significantly from what we have recorded in previous reporting periods.

In October 2008, the Board of Directors approved the modification of incentive option grants totaling 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 Model and will record additional stock-based compensation of approximately $181 thousand over the three year vesting period.

Recent Accounting Pronouncements

In December 2007, the FASB issued Statement No. 141R, Business Combinations (“SFAS 141R”), which replaces FASB Statement No. 141 (“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.

In December 2007, the FASB issued Statement No. 160, Noncontrolling Interests in Consolidated Financial Statements (“SFAS 160”), an amendment of Accounting Research Bulletin No. 51. The standard changes the accounting for noncontrolling (minority) interests in consolidated financial statements including the requirements to classify noncontrolling interests as a component of consolidated stockholders’ equity, and the elimination of “minority interest” accounting in results of operations with earnings attributable to noncontrolling interests reported as a part of consolidated earnings. Additionally, SFAS 160 revises the accounting for both increases and decreases in a parent’s controlling ownership interest. SFAS 160 is effective for fiscal years beginning after December 15, 2008, with early adoption prohibited. We are currently evaluating the impact of the pending adoption of SFAS 160 on our consolidated financial statements.

In March 2008, the FASB issued Statement No.161 (“SFAS 161”), Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133. SFAS 161 requires disclosure of how and why an entity uses derivative instruments, how derivative instruments and related hedged items are accounted for and how derivative instruments and related hedged items affect an entity’s financial position, financial performance, and cash flows. SFAS 161 is effective for fiscal years beginning after November 15, 2008, with early adoption permitted. We are currently evaluating the impact of the pending adoption of SFAS 161 on our consolidated financial statements.

In April 2008, the FASB issued FASB Staff Position (FSP) FAS 142-3, Determination of the Useful Life of Intangible Assets. FSP FAS 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No.142, Goodwill and Other Intangible Assets. FSP FAS 142-3 is effective for fiscal years beginning after December 15, 2008 and early adoption is prohibited. We are currently evaluating the impact of the pending adoption of FSP FAS 142-3 on our consolidated financial statements.

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, 2008 and 2007, 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, 2008 and 2007, 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 29, 2008
Boston, Massachusetts

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

ASSETS	September 30, 2008	2007
Current assets:		
Cash and cash equivalents	$ 1,911	$ 5,219
Accounts receivable (less allowance for doubtful accounts of $380 and $101, respectively)	4,024	2,892
Unbilled receivables	1,576	355
Prepaid expenses and other current assets	529	192
Total current assets	8,040	8,658
Equipment and improvements, net	1,763	961
Definite-lived intangible assets, net	2,980	1,441
Goodwill, net of preliminary impairment charge of $9,752	10,725	14,426
Other assets	751	273
Total assets	$ 24,259	$ 25,759
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Line of credit	$ 1,000	$ —
Capital lease obligations – current	105	76
Accounts payable	1,770	652
Deferred revenue	1,176	725
Accrued liabilities	1,860	1,266
Total current liabilities	5,911	2,719
Capital lease obligations, less current portion	139	146
Other long term liabilities	19	19
Total liabilities	6,069	2,884
Commitments and contingencies		
Shareholders' 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: 10,665,533 and 8,648,950 shares issued and outstanding, respectively	11	9
Additional paid-in capital	34,647	28,908
Accumulated deficit	(16,369)	(6,060)
Accumulated other comprehensive income	(99)	18
Total shareholders' equity	18,190	22,875
Total liabilities and shareholders' equity	$ 24,259	$ 25,759

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

BRIDGELINE SOFTWARE, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(Dollars in thousands, except per share data)

	Year Ended September 30, 2008	2007
Revenue:		
Application development services	$ 16,527	$ 8,659
Managed services	3,683	2,050
Perpetual Licenses and subscriptions	1,085	442
Total revenue	21,295	11,151
Cost of revenue:		
Application development services	9,683	4,558
Managed services	471	436
Perpetual Licenses and subscriptions	151	26
Total cost of revenue	10,305	5,020
Gross profit	10,990	6,131
Operating expenses:		
Sales and marketing	6,294	3,488
General and administrative	3,531	2,489
Research and development	619	791
Depreciation and amortization	1,051	369
Impairment of definite-lived intangible assets	76	—
Impairment of goodwill	9,752	—
Total operating expenses	21,323	7,137
Loss from operations	(10,333)	(1,006)
Interest and other expense	(61)	(924)
Other income	85	33
Loss before income taxes	(10,309)	(1,897)
Income taxes	—	—
Net loss	$ (10,309)	$ (1,897)
Net loss per share:		
Basic and diluted	$ (1.09)	$ (0.36)
Number of weighted average shares:		
Basic and diluted	9,473,408	5,285,787

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

BRIDGELINE SOFTWARE, INC.
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
(Dollars in thousands)

	Common Stock Shares	Common Stock Par Value	Additional Paid in Capital	Accumulated Deficit	Accumulated Other Comprehensive Income	Total Shareholders' Equity
Balance, October 1, 2006	4,273,833	$ 4	$ 9,791	$ (4,163)	$ —	5,632
Stock based compensation	—	—	332	—	—	332
Exercise of stock options	27,831	—	26	—	—	26
Exercise of stock warrants and options	59,724	—	33	—	—	33
Issuance of common stock and options in connection with acquisitions	1,087,562	1	5,195	—	—	5,196
Issuance of common stock in initial public offering	3,200,000	4	13,531	—	—	13,535
Comprehensive loss						
Net loss	—	—	—	(1,897)	—	(1,897)
Foreign currency translation adjustment	—	—	—	—	18	18
Total comprehensive loss	—	—	—			(1,879)
Balance, September 30, 2007	8,648,950	9	28,908	(6,060)	18	22,875
Stock based compensation	—	—	425			