Bridgeline Digital, Inc.
Form 10-Q
August 14, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2014

OR

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

For the transition period from ______________ to ______________

Commission File Number 333-139298

Bridgeline Digital, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**52-2263942**
State or other jurisdiction of incorporation or organization	IRS Employer Identification No.

80 Blanchard Road	
Burlington, Massachusetts	**01803**
(Address of Principal Executive Offices)	(Zip Code)

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

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

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

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

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

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

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

The number of shares of Common Stock par value $0.001 per share, outstanding as of August 12, 2014 was 21,897,904

Bridgeline Digital, Inc.

Quarterly Report on Form 10-Q

For the Quarterly Period ended June 30, 2014

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Bridgeline Digital, Inc.

Quarterly Report on Form 10-Q

For the Quarterly Period ended June 30, 2014

Statements contained in this Report on Form 10-Q that are not based on historical facts are "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements may be identified by the use of forward-looking terminology such as "should," "could," "may," "will," "expect," "believe," "estimate," "anticipate," "intends," "continue," or similar terms or variations of those terms or the negative of those terms. These statements appear in a number of places in this Form 10-Q and include statements regarding the intent, belief or current expectations of Bridgeline Digital, Inc. Forward-looking statements are merely our current predictions of future events. Investors are cautioned that any such forward-looking statements are inherently uncertain, are not guaranties of future performance and involve risks and uncertainties. Actual results may differ materially from our predictions. Important factors that could cause actual results to differ from our predictions include the impact of the weakness in the U.S. and international economies on our business, our inability to manage our future growth effectively or profitably, fluctuations in our revenue and quarterly results, our license renewal rate, the impact of competition and our ability to maintain margins or market share, our ability to maintain our listing on the NASDAQ Capital Market, the effect of the delisting of our common stock from the NASDAQ Capital Market, the limited market for our common stock, the volatility of the market price of our common stock, the performance of our products, our ability to respond to rapidly evolving technology and customer requirements, our ability to protect our proprietary technology, the security of our software, our dependence on our management team and key personnel, our ability to hire and retain future key personnel, or our ability to maintain an effective system of internal controls. Although we have sought to identify the most significant risks to our business, we cannot predict whether, or to what extent, any of such risks may be realized, nor is there any assurance that we have identified all possible issues which we might face. We assume no obligation to update our forward-looking statements to reflect new information or developments. We urge readers to review carefully the risk factors described in our Annual Report on Form 10-K for the fiscal year ended September 30, 2013 as well as in the other documents that we file with the Securities and Exchange Commission. You can read these documents at www.sec.gov.

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

PART I—FINANCIAL INFORMATION

Item 1. Financial Statements.

BRIDGELINE DIGITAL, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(Dollars in thousands, except share and per share data)

(Unaudited)

ASSETS	**June 30, 2014**	**September 30, 2013**
Current assets:		
Cash and cash equivalents	$1,547	$ 2,830
Accounts receivable and unbilled receivables, net	3,827	3,194
Prepaid expenses and other current assets	844	963
Total current assets	6,218	6,987
Equipment and improvements, net	2,436	3,065
Intangible assets, net	1,729	1,517
Goodwill	23,151	23,777
Other assets	1,427	1,631
Total assets	$34,961	$ 36,977
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$1,192	$ 1,746
Accrued liabilities	1,022	1,093
Accrued earnouts, current	591	561
Debt, current	-	1,165
Capital lease obligations, current	369	397
Deferred revenue	2,506	1,960
Total current liabilities	5,680	6,922
Accrued earnouts, net of current portion	456	950
Debt, net of current portion	5,901	4,725
Capital lease obligations, net of current portion	340	544
Other long term liabilities	1,010	1,088
Total liabilities	13,387	14,229

Commitments and contingencies		
Stockholders' equity:		
Preferred stock - $0.001 par value; 1,000,000 shares authorized; none issued and outstanding	-	-
Common stock - $0.001 par value; 30,000,000 shares authorized; 21,869,699 at June 30, 2014 and 18,313,765 at September 30, 2013 shares issued and outstanding	22	18
Additional paid-in capital	47,568	44,206
Accumulated deficit	(25,711)	(21,314)
Accumulated other comprehensive loss	(305)	(162)
Total stockholders' equity	21,574	22,748
Total liabilities and stockholders' equity	$34,961	$ 36,977

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

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BRIDGELINE DIGITAL, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Dollars in thousands, except share and per share data)

(Unaudited)

	Three Months Ended June 30, 2014	Three Months Ended June 30, 2013	Nine Months Ended June 30, 2014	Nine Months Ended June 30, 2013
Revenue:				
Digital engagement services	$4,233	$4,276	$12,392	$13,614
Subscription and perpetual licenses	1,510	915	4,394	2,726
Managed service hosting	409	409	1,181	1,456
Total revenue	6,152	5,600	17,967	17,796
Cost of revenue:				
Digital engagement services	2,531	2,341	7,703	7,566
Subscription and perpetual licenses	422	330	1,271	770
Managed service hosting	66	76	218	224
Total cost of revenue	3,019	2,747	9,192	8,560
Gross profit	3,133	2,853	8,775	9,236
Operating expenses:				
Sales and marketing	1,992	2,275	6,030	6,266
General and administrative	1,110	1,140	3,308	3,440
Research and development	613	515	1,715	893
Depreciation and amortization	510	412	1,515	1,226
Total operating expenses	4,225	4,342	12,568	11,825
Loss from operations	(1,092)	(1,489)	(3,793)	(2,589)
Interest and other expense, net	(190)	(59)	(524)	(194)
Loss before income taxes	(1,282)	(1,548)	(4,317)	(2,783)
Provision for income taxes	24	21	80	110
Net loss	$(1,306)	$(1,569)	$(4,397)	$(2,893)
Net loss per share:				
Basic and diluted	$(0.06)	$(0.10)	$(0.23)	$(0.19)
Number of weighted average shares outstanding:				
Basic and diluted	21,296,484	15,037,767	19,028,445	14,902,419

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

BRIDGELINE DIGITAL, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS

(Dollars in thousands)

(Unaudited)

	Three Months Ended June 30, 2014	**2013**	**Nine Months Ended June 30, 2014**	**2013**
Net Loss	$(1,306)	$(1,569)	$(4,397)	$(2,893)
Other Comprehensive Gain (Loss): Net change in Foreign Currency Translation Adjustment	(18)	(12)	(143)	39
Comprehensive loss	$(1,324)	$(1,581)	$(4,540)	$(2,854)

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

BRIDGELINE DIGITAL, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in thousands)

(Unaudited)

	Nine Months Ended June 30, 2014	2013
Cash flows from operating activities:		
Net loss	$(4,397)	$(2,893)
Adjustments to reconcile net loss to net cash used in operating activities:		
Amortization of intangible assets	498	391
Depreciation	980	835
Other amortization	399	201
Stock-based compensation	339	334
Contingent earnout liability adjustment	-	(497)
Changes in operating assets and liabilities:		
Accounts receivable and unbilled receivables	(640)	562
Prepaid expenses and other assets	614	(162)
Accounts payable and accrued liabilities	(1,139)	(512)
Deferred revenue	546	1,381
Other liabilities	(78)	(92)
Total adjustments	1,519	2,441
Net cash used in operating activities	(2,878)	(452)
Cash flows from investing activities:		
Equipment and improvements	(264)	(545)
Software development capitalization costs/other intangibles	(134)	(739)
Contingent acquisition payments	(464)	(314)
Net cash used in investing activities	(862)	(1,598)
Cash flows from financing activities:		
Proceeds from issuance of common stock, net of issuance costs	2,749	2,062
Proceeds from issuance of convertible debt, net of issuance costs	913	-
Proceeds from exercise of employee stock options	185	75
Proceeds from employee stock purchase plan	21	74
Borrowings from bank line of credit	746	725
Payments on bank line of credit	(1,336)	(652)
Payments on bank term loan	(273)	(275)
Payments on subordinated promissory notes	(86)	(168)
Principal payments on capital leases	(319)	(241)
Net cash provided by financing activities	2,600	1,600

Effect of exchange rate changes on cash and cash equivalents	(143)	39
Net decrease in cash and cash equivalents	(1,283)	(411)
Cash and cash equivalents at beginning of period	2,830	2,126
Cash and cash equivalents at end of period	$1,547	$1,715
Supplemental disclosures of cash flow information:		
Cash paid for:		
Interest	$50	$194
Income taxes	$10	$13
Non cash activities:		
Equipment purchased under capital leases	$89	$912
Accrued contingent consideration (earnouts)	$-	$83

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

BRIDGELINE DIGITAL, INC.

NOTES TO UNAUDITED INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except share and per share data)

1. Description of Business

Overview

Bridgeline Digital, The Digital Engagement Company™, enables its customers to maximize the performance of their mission critical websites, intranets, and online stores. Bridgeline's iAPPS® platform deeply integrates Web Content Management, eCommerce, eMarketing, Social Media management, and Web Analytics to help marketers deliver online experiences that attract, engage and convert their customers across all digital channels. Bridgeline's iAPPS platform combined with its digital services assists customers in maximizing on-line revenue, improving customer service and loyalty, enhancing employee knowledge, and reducing operational costs.

In fiscal 2012, Bridgeline Digital announced the release of iAPPSds ("distributed subscription"), a platform that empowers franchise and large dealer networks with state-of-the-art web engagement management while providing superior oversight of corporate branding. iAPPSds deeply integrates content management, eCommerce, eMarketing and web analytics and is a self-service web platform that is offered to each authorized franchise or dealer for a monthly subscription fee. On August 1, 2013, we acquired franchise web developer ElementsLocal, expanding Bridgeline Digital's presence in the franchise market place.

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

iAPPS Content Manager and iAPPS Commerce were selected as finalists for the 2014, 2013, and 2012 CODiE Awards for Best Content Management Solution and Best Electronic Commerce Solution, globally. In 2014, Bridgeline Digital won ten Horizon Interactive Awards for outstanding development of web applications and websites and won fifteen Horizon Interactive Awards in 2013. Also in 2013, the Web Marketing Association sponsored Internet Advertising Competition honored Bridgeline Digital with three awards for iAPPS customer websites and B2B Magazine selected Bridgeline Digital as one of the Top Interactive Technology companies in the United States. In 2013, KMWorld Magazine Editors selected Bridgeline Digital as one of the 100 Companies That Matter in Knowledge Management and also selected iAPPS as a Trend Setting Product in 2013.

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

Locations

The Company's corporate office is located in Burlington, Massachusetts. The Company maintains regional field offices serving the following geographical locations: Atlanta, GA; Baltimore, MD; Boston, MA; Chicago, IL; Dallas, TX; Denver, CO; New York, NY; San Diego, CA; San Luis Obispo, CA; and Tampa, FL. The Company has one wholly-owned subsidiary, Bridgeline Digital Pvt. Ltd. located in Bangalore, India.

2. Summary of Significant Accounting Policies

Basis of Presentation and Principles of Consolidation

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

BRIDGELINE DIGITAL, INC.

NOTES TO UNAUDITED INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except share and per share data)

Unaudited Interim Financial Information

The accompanying interim Condensed Consolidated Balance Sheet as of June 30, 2014 and September 30, 2013, and the interim Condensed Consolidated Statements of Operations, Comprehensive Loss, and Cash Flows for the three and nine months ended June 30, 2014 and 2013 are unaudited. The unaudited interim condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("US GAAP") and with the instructions to Form 10-Q and Regulation S-X, and in the opinion of the Company's management have been prepared on the same basis as the audited consolidated financial statements as of and for the year ended September 30, 2013. These interim condensed consolidated financial statements include all adjustments, consisting of normal recurring adjustments and accruals, necessary for the fair presentation of the Company's financial position at June 30, 2014 and September 30, 2013 and the results of its operations and cash flows for the three and nine months ended June 30, 2014 and 2013, respectively. The results for the nine months ended June 30, 2014 are not necessarily indicative of the results to be expected for the year ending September 30, 2014. The accompanying September 30, 2013 Condensed Consolidated Balance Sheet has been derived from the audited financial statements at that date, but does not include all of the information and footnotes required by US GAAP for complete financial statements.

Subsequent Events

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

Recent Accounting Pronouncements

In June 2014, the Financial Accounting Standards Board ("FASB") issued a standards update on accounting for share-based payments when the terms of the award provide that a performance target could be achieved after a requisite service period. The standard is effective beginning January 1, 2016, with early adoption permitted. Management does not expect it to have a material impact on our consolidated financial position, results of operations or cash flows.

In May 2014, the FASB issued a standard on revenue recognition providing a single, comprehensive revenue recognition model for all contracts with customers. The revenue standard is based on the principle that revenue should be recognized to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The standard is effective beginning January 1, 2017, with no early adoption permitted. The amendments may be applied retrospectively to each prior period presented or retrospectively with the cumulative effect recognized as of the date of initial application. Management is currently evaluating the adoption method options and the impact of this new guidance on our condensed consolidated financial statements.

In April 2014, the FASB issued new accounting guidance on reporting discontinued operations and disclosures of disposals of components of an entity which clarifies the scope of what should be reported as discontinued operations and expands required disclosures. This new guidance is effective beginning October 1, 2015, with early adoption permitted. The impact of this guidance will be dependent on the nature and significance of any transactions within the scope of this new guidance.

In July 2013, the FASB issued new guidance on the presentation of unrecognized tax benefits. This guidance requires an unrecognized tax benefit related to a net operating loss carryforward, a similar tax loss or a tax credit carryforward to be presented as a reduction to a deferred tax asset, unless the tax benefit is not available at the reporting date to settle any additional income taxes under the tax law of the applicable tax jurisdiction. The guidance is effective for the fiscal years and interim periods beginning after December 15, 2013 with early adoption permitted. Management is in the process of evaluating the effects of this guidance but does not believe it will have a significant impact on our condensed consolidated financial statements.

All other Accounting Standards Updates issued but not yet effective are not expected to have a material effect on the Company’s future financial statements.

BRIDGELINE DIGITAL, INC.

NOTES TO UNAUDITED INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except share and per share data)

3. Accounts Receivable and Unbilled Receivables

Accounts receivable and unbilled receivables consists of the following:

	As of June 30, 2014	As of September 30, 2013
Accounts receivable	$3,704	$ 3,188
Unbilled receivables	222	111
Subtotal	3,926	3,299
Allowance for doubtful accounts	(99)	(105)
Accounts receivable and unbilled receivables, net	$3,827	$ 3,194

4. Intangible Assets

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

	As of June 30, 2014	As of September 30, 2013
Domain and trade names	$11	$ 34
Customer related	1,412	1,182
Non-compete agreements	306	301
Balance at end of period	$1,729	$ 1,517

Total amortization expense related to intangible assets was $157 and $117 for the three months ended June 30, 2014 and 2013 and $498 and $391 for the nine months ended June 30, 2014 and 2013, respectively. Amortization expenses are reflected in operating expenses on the Condensed Consolidated Statements of Operations.

5. Goodwill

Changes in the carrying amount of goodwill are as follows:

	As of June 30, 2014	**As of September 30, 2013**
Balance at beginning of period	$23,777	$ 21,545
Acquisitions	-	1,897
Contingent acquisition payments	-	83
Purchase price allocation adjustments	(626)	252
Balance at end of period	$23,151	$ 23,777

BRIDGELINE DIGITAL, INC.

NOTES TO UNAUDITED INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except share and per share data)

6. Debt

Debt consists of the following:

	As of June 30, 2014	**As of September 30, 2013**
Line of credit borrowings	$2,913	$ 3,504
Bank term loan	-	272
Subordinated convertible debt	3,000	2,000
Subordinated promissory notes	28	114
Other (debt warrants)	(48)	-
Total debt	$5,901	$ 5,890
Less current portion	$-	$ 1,165
Long term debt, net of current portion	$5,901	$ 4,725

Line of Credit

In December 2013, the Company entered into a Loan and Security Agreement with BridgeBank (the "BridgeBank Loan Agreement"). The Loan Agreement has a 27 month term which expires on March 31, 2016. The Loan Agreement provides for up to $5 million of revolving credit advances which may be used for acquisitions and working capital purposes. Borrowings are limited to the lesser of (i) $5 million and (ii) 80% of eligible receivables as defined. The Company can borrow up to $1.0 million in out of formula borrowings for specified periods of time. Borrowings bear interest at BridgeBank's prime plus 1.00%. The Company pays an annual commitment fee of 0.25%. Borrowings are secured by all of the Company's assets and all of the Company's intellectual property. The Company is also required to comply with certain financial and reporting covenants including an Asset Coverage Ratio. The Company was in compliance with all financial and reporting covenants for the period ended June 30, 2014. The BridgeBank Loan Agreement replaced the Company's prior credit facility with Silicon Valley Bank ("SVB"), which expired on December 31, 2013. As of June 30, 2014, the Company had an outstanding balance under the BridgeBank Loan Agreement of $2.9 million. Funds available for borrowing at June 30, 2014 were $329.

The Company had an Amended and Restated Loan and Security Agreement with SVB (the "Loan Agreement"). The Loan Agreement had a two year term which expired on March 31, 2012. The Loan Agreement provided for up to $5.0 million of revolving credit advances, of which $3.0 million may be used for acquisitions and up to $5.0 million may be used for working capital purposes. Borrowings were limited to the lesser of (i) $5.0 million and (ii) 80% of eligible receivables as defined. In the event that the borrowing base formula resulted in less than $5.0 million in available borrowing, the Company could have borrowed up to $2.0 million in out of formula borrowings (provided such amount does not exceed $5.0 million) for specified periods of time. Borrowings bore interest at SVB's prime plus 1.00% or 1.25%, depending on the level of the adjusted EBITDA, as defined. The Company paid an annual commitment fee of 0.50% and an unused fee of 0.25%. Borrowings were secured by all of the Company's assets and all of the Company's intellectual property. The Company was also required to comply with certain financial and performance covenants.

In May 2011, the Company amended its loan arrangement (the "Amendment") with SVB Under the terms of the existing agreement with SVB, the Company's line of credit was limited to the lesser of (i) $5 million and (ii) 80% of eligible receivables as defined, and up to $2.0 million could be borrowed in out of formula borrowings for specified periods of time (provided the total amount outstanding does not exceed $5.0 million).

The Amendment: (i) extended the maturity date of the line of credit for one year to March 31, 2012; (ii) revised certain financial covenants; and (iii) amended the out of formula borrowings to be structured as a $2 million term loan and interest on the term loan will be at SVB's prime rate plus 1.75%. Interest on the term loan was paid until April 1, 2012 and on and after April 2, 2012, principal and interest on the term loan was being paid over 36 months ending on April 1, 2015. In May 2012, we amended our loan agreement (the "2012 Amendment") with SVB, extending the maturity date of the line of credit for one year to March 31, 2014. The 2012 Amendment also revised a financial covenant, increasing our minimum liquidity requirement. Minimum liquidity is defined as funds held with SVB plus borrowing availability on our line of credit.

BRIDGELINE DIGITAL, INC.

NOTES TO UNAUDITED INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except share and per share data)

In February 2013, the Company amended its loan agreement (the “February 2013 Amendment”) with SVB, extending the maturity date of the line of credit for one year to March 31, 2015. The 2013 Amendment also revised certain financial covenants. The Company would not have been in compliance with one of its covenants for the three months ended December 31, 2012 if the amendment was not completed. In July 2013, the Company amended its loan arrangement (the “July 2013 Amendment”) with SVB. The July 2013 Amendment increased the borrowing availability on accounts receivable, revised certain financial covenants, and increased the interest rate on the line of credit from prime plus 1.25% to prime plus 2.25% and increased the interest rate on the term loan from prime plus 1.75% to prime plus 2.75%In addition, the repayment schedule for the term loan was accelerated to end in April 2014. There was $611 remaining on the term loan as of June 30, 2013. The July 2013 Amendment also included a waiver by SVB of certain financial covenant defaults. The Company would not have been in compliance with certain of its financial covenants as of June 30, 2013 if the July 2013 Amendment had not been completed and the waiver had not been granted. In November 2013, the Company amended its loan agreement (“the November 2013 Amendment”) with SVB. The November 2013 Amendment accelerated the maturity date of the line of credit to December 31, 2013 at which time this line was replaced with the BridgeBank Loan Agreement and the term loan was paid in full.

Subordinated Convertible Debt

On September 30, 2013, Bridgeline Digital entered into a Note Purchase Agreement (the "Purchase Agreement") with accredited investors pursuant to which Bridgeline Digital sold an aggregate of $2.0 million of 10% secured subordinated convertible notes (the "Notes"). The gross proceeds to Bridgeline Digital at the closing of this private placement were $2.0 million. The Notes accrue interest at a rate of ten percent (10%) per annum and mature on September 30, 2016. Interest on the Notes is payable quarterly in cash. The Notes are convertible at the election of the holder into shares of common stock of Bridgeline Digital at a conversion price equal to $1.30 per share at any time prior to the maturity date, provided that no holder may convert the Notes if such conversion would result in the holder beneficially owning more than 4.99% of the number of shares of Bridgeline Digital common stock outstanding at the time of conversion.

On November 6, 2013, Bridgeline Digital entered into an amendment (the "Amendment") to the Purchase Agreement by and among Bridgeline Digital and the accredited investors’ party thereto. The Amendment increased the aggregate amount of 10% secured subordinated convertible notes (the "New Notes") able to be sold by Bridgeline Digital to $3.0 million. On November 6, 2013, Bridgeline Digital sold an additional $1.0 million of New Notes (the "Second Closing"). The gross proceeds to Bridgeline Digital at the Second Closing of this private placement were $1.0 million.

The Notes accrue interest at a rate of ten percent (10%) per annum and mature on November 6, 2016. Interest on the Notes is payable quarterly in cash. The Notes are convertible at the election of the holder into shares of common stock of Bridgeline Digital at a conversion price equal to $1.30 per share at any time prior to the maturity date, provided that no holder may convert the Notes if such conversion would result in the holder beneficially owning more than 4.99% of the number of shares of Bridgeline Digital common stock outstanding at the time of conversion.

The Notes are secured by all of Bridgeline Digital's assets. The security interest granted to the holders of the Notes is subordinate to the security interest held by Bridgeline Digital's senior lender, BridgeBank. Bridgeline Digital may prepay any portion of the principal amount of the outstanding Notes at any time, provided that if Bridgeline Digital prepays any principal on or before September 30, 2014, Bridgeline Digital will pay a penalty equal to 10% of the principal amount being prepaid. Under certain circumstances Bridgeline Digital has the right to force conversion of the Notes into shares of Bridgeline Digital common stock in the event the Bridgeline Digital common stock trades in excess of $2.60 per share for 20 trading days out of any 30 trading day period.

The Notes contain customary events of default. Upon the occurrence of any event of default the interest rate under the Notes will increase. In addition, upon the occurrence of a payment default under the Notes, Bridgeline Digital must pay a premium equal to 20% of the outstanding principal amount of the Notes. In the event of a change in control of Bridgeline Digital while the Notes are outstanding, Bridgeline Digital will provide the holders of the Notes with the opportunity to convert the Notes immediately prior to the change in control. In the event the holders of the Notes do not elect to convert the Notes, Bridgeline Digital may prepay all outstanding principal and accrued interest under the Notes.

The placement agent for both transactions was Taglich Brothers, Inc. As compensation for the initial transaction on September 30 2013, Bridgeline Digital paid a fee of $160 and issued to Taglich Brothers, Inc., or its designees, five-year warrants to purchase an aggregate of 153,846 shares of common stock at an exercise price equal to $1.30 per share. The warrants are first exercisable on March 30, 2014, and provide the holders piggyback registration rights with respect to the shares of common stock underlying the warrants and contain a cashless exercise provision. As compensation for the Second Closing, Bridgeline Digital paid Taglich Brothers, Inc. a fee of $80 and issued to Taglich Brothers, Inc., or its designees, five-year warrants to purchase an aggregate of 76,923 shares of common stock at an exercise price equal to $1.30 per share. The warrants are first exercisable on May 6, 2014, provide the holders piggyback registration rights with respect to the shares of common stock underlying the warrants and contain a cashless exercise provision. Fair market value of the warrants are $49 and is included in current liabilities and non-current debt with the offsetting amount recorded to additional paid in capital in the Condensed Consolidated Balance Sheet. The fair market value of the warrants will be amortized on a straight-line basis over the estimated life of two years.

BRIDGELINE DIGITAL, INC.

NOTES TO UNAUDITED INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except share and per share data)

The shares of common stock issuable upon conversion of the Notes and upon exercise of the warrants are restricted securities and may be sold only pursuant to Rule 144 or in another transaction exempt from the registration requirements under the Securities Act of 1933. Pursuant to the terms of the Purchase Agreement, Bridgeline Digital has agreed to provide piggyback registration rights with respect to the shares of common stock issuable upon conversion of the Notes in the event Bridgeline Digital files a registration statement, with certain limited exceptions.

Subordinated Promissory Notes

In May 2010, in connection with the acquisition of TMX, the Company issued a $500 subordinated promissory note ("the Note") payable to TMX. The Note is subordinated to the Company's primary lender and is payable in twelve quarterly installments of $42, plus interest at 1%, with the first payment due on January 15, 2011. The Note may be paid in whole or in part at any time without discount, premium, or penalty.

In May 2012, the Company assumed two Promissory Notes in connection with the acquisition of MarketNet, Inc. The first Promissory Note in the amount of $63 is payable in eight equal installments of $8, including interest accrued at 5%, and matured in May 2014 and was paid in full. The first installment was paid in July 2012. The second Promissory Note in the amount of $80 is payable in twelve equal installments of $7, including interest accrued at 5%, and matures in May 2015. The first installment was paid in July 2012.

7. Fair Value Measurement and Fair Value of Financial Instruments

The Company follows ASC 820, "Fair Value Measurements and Disclosures" ("ASC 820") for fair value measurements. ASC 820 defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. The standard provides a consistent definition of fair value, which focuses on an exit price, which is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The standard also prioritizes, within the measurement of fair value, the use of market-based information over entity specific information and establishes a three-level hierarchy for fair value measurements based on the nature of inputs used in the valuation of an asset or liability as of the measurement date.

The hierarchy established under ASC 820 gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3).

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

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

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

The Company's other financial instruments consist principally of accounts receivable, accounts payable, and debt. The Company believes the recorded values for accounts receivable and accounts payable approximate current fair values as of June 30, 2014 and September 30, 2013 because of their nature and durations. The carrying value of debt instruments also approximates fair value as of June 30, 2014 and September 30, 2013 based on acceptable valuation methodologies which use market data of similar size and situated debt issues.

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(Dollars in thousands, except share and per share data)

Assets and liabilities of the Company measured at fair value on a recurring basis as of June 30, 2014 and September 30, 2013 are as follows:

	June 30, 2014			
	Level 1	Level 2	Level 3	Total
Financial Liabilities:				
Contingent consideration related to acquisitions			$1,047	$1,047
Total Liabilities	$-	$ -	$1,047	$1,047

	September 30, 2013			
	Level 1	Level 2	Level 3	Total
Financial Liabilities:				
Contingent consideration related to acquisitions			$1,511	$1,511
Total Liabilities	$-	$ -	$1,511	$1,511

The Company determines the fair value of acquisition-related contingent consideration based on assessment of the probability that the Company would be required to make such future payments. Changes to the fair value of contingent consideration are recorded in general and administrative expenses. The following table provides a rollforward of the fair value, as determined by Level 3 inputs, of the contingent consideration.

	Contingent Consideration As of June 30, 2014
Balance at September 30, 2013	$ 1,511
Payments	(464)
Balance at June 30, 2014	$ 1,047

8. Other Long Term Liabilities

Deferred Rent

In connection with leases for the Company's headquarters in Burlington, Massachusetts and New York, the Company made investments in leasehold improvements at these locations of approximately $1.4 million, of which the respective landlords funded approximately $857. The capitalized leasehold improvements are being amortized over the life of each lease. The improvements funded by the landlords are treated as lease incentives. Accordingly, the funding received from the landlords was recorded as fixed asset additions and a deferred rent liability on the Condensed Consolidated Balance Sheet. As of June 30, 2014, $137 was reflected in Accrued Liabilities and $775 is reflected in Other Long Term Liabilities. The deferred rent liability is being amortized as a reduction of rent expense over the lives of the leases.

9. Shareholders' Equity

Common Stock

In March 2014, the Company sold 3,200,000 shares of common stock at $0.95 per share for gross proceeds of $3 million in a private placement. Net proceeds to the Company after offering expenses were approximately $2.7 million. In addition, the Company issued the placement agent five year warrants to purchase an aggregate of 320,000 shares of Bridgeline's common stock at a price equal to $1.05 per share. There are no plans to register the common stock issued in this offering, however in the event the Company does register other Common stock, the Company agreed to provide piggyback registration rights with respect to the shares of common stock sold in the offering and underlying the warrants.

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In January 2014, the Company issued 56,897 shares of common stock at $1.16 per share to four members of its Board of Directors in lieu of cash payments for their services as board members. The shares vest in equal installments on a monthly basis through the end of the service period of September 30, 2014. The aggregate fair value of the shares is $66 and will be expensed over the service period. A total of $19 was recorded as expense in the three months ended June 30, 2014.

In connection with the acquisition of ElementsLocal on August 1, 2013, the Company issued 526,438 shares to the sellers of ElementsLocal. In addition, contingent consideration not to exceed 338,461 shares of Bridgeline Digital common stock is contingently issuable to the sellers of ElementsLocal. The contingent consideration is payable quarterly over the 12 consecutive calendar quarters following the acquisition, contingent upon the acquired business achieving certain revenue targets. As of June 30, 2014, the stockholders of ElementsLocal earned 84,615 shares of common stock, with 28,205 shares issued during the three months ended June 30, 2014.

On June 19, 2013, the Company sold 2,300,000 shares of common stock at $1.00 per share for gross proceeds of $2.3 million in a private placement. Net proceeds to the Company after offering expenses were approximately $2.1 million. In addition, the Company issued the investors and placement agent and its affiliates five year warrants to purchase an aggregate of 460,000 and 230,000 shares, respectively, of Bridgeline's common stock at a price equal to $1.25 per share. There are no plans to register the common stock issued in this offering, however in the event the Company does register other Common stock, the Company agreed to provide piggyback registration rights with respect to the shares of common stock sold in the offering and underlying the warrants.

In connection with the acquisition of MarketNet on May 31, 2012, contingent consideration of 204,331 shares of Bridgeline Digital common stock is contingently issuable to the sole stockholder of MarketNet. The contingent consideration is payable quarterly over the 12 consecutive calendar quarters following the acquisition, contingent upon the acquired business achieving certain operating and revenue targets. The common stock has been issued and is being held in escrow pending satisfaction of the applicable earnout targets. As of June 30, 2014, the sole stockholder of MarketNet earned 119,196 shares of common stock, with 17,028 shares issued during the three months ended June 30, 2014. In addition, MarketNet is also eligible to earn additional equity consideration of 200,000 shares of Bridgeline Digital common stock if a certain annual revenue threshold is met in any fiscal year during the next three years.

In connection with the acquisition of Magnetic Corporation on October 3, 2011, contingent consideration of 166,666 shares of Bridgeline Digital common stock is contingently issuable to the sole stockholder of Magnetic. The contingent consideration is payable quarterly over the 12 consecutive calendar quarters following the acquisition, contingent upon the acquired business achieving certain operating and revenue targets. The common stock has been issued and is being held in escrow pending satisfaction of the applicable earnout targets. As of June 30, 2014, the sole stockholder of Magnetic earned 152,768 shares of common stock, with 13,898 shares issued during the three months ended June 30, 2014.

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

The Company has granted common stock, common stock warrants, and common stock option awards (the "Equity Awards") to employees, consultants, advisors and debt holders of the Company and to former owners and employees of acquired companies that have become employees of the Company. At June 30, 2014, the Company maintained one stock option plan and one employee stock purchase plan.

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Amended and Restated Stock Incentive Plan

Effective April 2013, the Company's Amended and Restated Stock Incentive Plan (the "Plan") provides for the issuance of up to 3,900,000 million shares of common stock. The Plan authorizes the award of incentive stock options, non-statutory stock options, restricted stock, unrestricted stock, performance shares, stock appreciation rights and any combination thereof to employees, officers, directors, consultants, independent contractors and advisors of the Company. Options granted under the Plan may be granted with contractual lives of up to ten years. There were 3,600,389 options outstanding reserved under the Plan as of June 30, 2014 and 299,611 shares available for future issuance.

Employee Stock Purchase Plan

On April 12, 2012, the Company's stockholders approved and adopted the Bridgeline Digital, Inc. 2012 Employee Stock Purchase Plan (the "ESPP"). Under the terms of the ESPP, the Company will grant eligible employees the right to purchase shares of Bridgeline common stock through payroll deductions at a price equal to 85% of the fair market value of Bridgeline common stock on the purchase termination date of defined offering or purchase periods. Each offering period is six months in duration. The ESPP permits the Company to offer up to 300,000 shares of common stock. The maximum number of shares of common stock that may be purchased by all participants in any purchase period may not exceed 150,000 shares. During the quarter ended June 30, 2014, employees purchased 12,318 shares of common stock for the most recent offering period.

Common Stock Warrants

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

$1.00 per share and 25,000 are exercisable at an exercise price of $2.00 per share.

On May 31, 2012, the Company issued five year warrants to the placement agent in the Company's private placement. The warrants are exercisable to purchase 217,931 shares of the Company's common stock at a price equal to $1.40 per share.

On June 19, 2013, the Company issued five year warrants to the investors and placement agent in the Company's private placement. The warrants are exercisable to purchase 460,000 and 230,000 shares, respectively, of the Company's common stock at a price equal to $1.25 per share.

On September 30, 2013, the Company issued five year warrants to the placement agent in the Company's placement of subordinated convertible debt. The warrants are exercisable to purchase 153,846 of the Company's common stock at a price equal to $1.30 per share. The warrants are first exercisable on March 30, 2014, provide the holders piggyback registration rights with respect to the shares of common stock underlying the warrants and contain a cashless exercise provision.

On November 1, 2013, the Company issued five year warrants to the placement agent in the Company's placement of subordinated convertible debt. The warrants are exercisable to purchase 76,923 shares of the Company's common stock at a price equal to $1.30 per share. The warrants are first exercisable on May 6, 2014, provide the holders piggyback registration rights with respect to the shares of common stock underlying the warrants and contain a cashless exercise provision.

On March 28, 2014, the Company issued five year warrants to the investors and placement agent in the Company's private placement. The warrants are exercisable to purchase 320,000 shares of the Company's common stock at a price equal to $1.05 per share.

As of June 30, 2014: (i) placement agent warrants to purchase 217,931, 230,000, 230,769, and 320,000 shares at an exercise price of $1.40, $1.25, $1.30 and $1.05, respectively are outstanding; (ii) investor warrants to purchase 460,000 shares at an exercise price of $1.25, and (iii) warrants issued to a non-employee consultant to purchase 25,000 shares at an exercise price of $1.00 and 25,000 shares at an exercise price of $2.00 are outstanding.

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Summary of Option and Warrant Activity and Outstanding Shares

	Stock Options		**Stock Warrants**	
	Options	**Weighted Average Exercise Price**	**Warrants**	**Weighted Average Exercise Price**
Outstanding, September 30, 2013	2,872,844	$ 0.94	1,111,777	$ 1.30
Granted	1,147,500	$ 1.11	396,923	$ 1.10
Exercised	(215,087)	$ 0.83	-	-
Forfeited or expired	(204,868)	$ 1.22	-	-
Outstanding, June 30, 2014	3,600,389	$ 0.98	1,508,700	$ 1.25

10. Accumulated Other Comprehensive Loss

The following table presents changes in accumulated other comprehensive loss for nine months ended June 30, 2014:

	Cumulative Foreign Currency Translation

	Adjustment
Balance at September 30, 2013	$ (162)
Foreign currency translation adjustment	(143)
Balance at June 30, 2014	$ (305)

11. Net Loss Per Share

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

	Three Months Ended June 30, 2014	2013	Nine Months Ended June 30, 2014	2013
Net loss	$(1,306)	$(1,569)	$(4,397)	$(2,893)
Weighted average common shares outstanding - basic and diluted	21,296	15,038	19,028	14,902
Net loss per share - basic and diluted	$(0.06)	$(0.10)	$(0.23)	$(0.19)

Basic net loss per share is computed by dividing net loss available to common shareholders by the weighted average number of common shares outstanding. Diluted net income per share is computed using the weighted average number of common shares outstanding during the period plus the dilutive effect of outstanding stock options and warrants using the "treasury stock" method. The computation of diluted earnings per share does not include the effect of outstanding stock options and warrants that are anti-dilutive.

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For the three and nine months ended June 30, 2014, options to purchase shares of the Company's common stock of 333,972 and 503,564 were excluded from the computation of diluted net loss per share as the effect was anti-dilutive to the Company's net loss. Warrants to purchase 1,508,700 shares of common stock and contingent shares to be issued in connection with prior acquisitions of e.Magination, Marketnet, Magnetic, and ElementsLocal have also been excluded as they are anti-dilutive to the Company's net loss.

12. Income Taxes

Income tax expense was $24 and $21 for the three months ended June 30, 2014 and 2013 and $80 and $110 for the nine months ended June 30, 2014 and 2013, respectively. Income tax expense consists of the estimated liability for federal and state income taxes owed by the Company, including the alternative minimum tax. Net operating loss carry forwards are estimated to be sufficient to offset additional taxable income for all periods presented.

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

13. Related Party Transactions

In October 2013, Michael Taglich joined the Board of Directors. Mr. Taglich is the Chairman and President of Taglich Brothers, Inc. a New York based securities firm. Taglich Brothers, Inc. was the agent for the past three private placements of Bridgeline Digital common stock which took place in 2012, 2013 and in March 2014. Taglich Brothers, Inc was also the agent for Bridgeline's convertible debt offerings of $2 million and $1 million in September and November 2013, respectively. Mr. Taglich personally owns 467,000 shares of Bridgeline. Other employees, affiliates and clients of Taglich Brothers, Inc. own approximately 6,200,000 shares of Bridgeline stock. The fees paid to Taglich Brothers, Inc. in connection with the 2012, 2013 and 2014 private placements of common stock were $651. Fees paid to Taglich Brothers, Inc. in connection with the 2013 convertible debt offerings were $240. The Company also has an annual service contract for $18 with Taglich Brothers, Inc to perform market research.

14. Legal Proceedings

The Company is subject to ordinary routine litigation and claims incidental to its business. As of June 30, 2014, the Company was not engaged with any material legal proceedings.

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

This section contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those anticipated in the forward-looking statements as a result of a variety of factors and risks including risks described in our Annual Report on Form 10-K for the fiscal year ended September 30, 2013 as well as in the other documents that we file with the Securities and Exchange Commission. You can read these documents at www.sec.gov.

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

Overview

Bridgeline Digital, The Digital Engagement Company™, enables its customers to maximize the performance of their mission critical websites, intranets, and online stores. Bridgeline's iAPPS® platform deeply integrates Web Content Management, eCommerce, eMarketing, Social Media management, and Web Analytics to help marketers deliver online experiences that attract, engage and convert their customers across all digital channels. Bridgeline's iAPPS platform combined with its digital services assists customers in maximizing on-line revenue, improving customer service and loyalty, enhancing employee knowledge, and reducing operational costs.

In fiscal 2012, Bridgeline Digital announced the release of iAPPSds ("distributed subscription"), a platform that empowers franchise and large dealer networks with state-of-the-art web engagement management while providing superior oversight of corporate branding. iAPPSds deeply integrates content management, eCommerce, eMarketing and web analytics and is a self-service web platform that is offered to each authorized franchise or dealer for a monthly or annual subscription fee. On August 1, 2013, we acquired franchise web developer ElementsLocal, expanding Bridgeline Digital's presence in the franchise market place.

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

iAPPS Content Manager and iAPPS Commerce were selected as finalists for the 2014, 2013, and 2012 CODiE Awards for Best Content Management Solution and Best Electronic Commerce Solution, globally. In 2014, Bridgeline

Digital won ten Horizon Interactive Awards for outstanding development of web applications and websites and won fifteen Horizon Interactive Awards in 2013. Also in 2013, the Web Marketing Association sponsored Internet Advertising Competition honored Bridgeline Digital with three awards for iAPPS customer websites and B2B Magazine selected Bridgeline Digital as one of the Top Interactive Technology companies in the United States. In 2013, KMWorld Magazine Editors selected Bridgeline Digital as one of the 100 Companies That Matter in Knowledge Management and also selected iAPPS as a Trend Setting Product in 2013.

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

Customer Information

We currently have over 3,500 customers, the majority of which are iAPPSds customers who pay a monthly subscription fee. For the three and nine months ended June 30, 2014 and 2013 no customer represented 10% or more of total revenue.

Acquisitions

ElementsLocal

In the fourth quarter of fiscal 2013, we had one acquisition. On August 1, 2013, the Company completed the acquisition of Transformational Technologies, Inc. (“ElementsLocal”), a California based developer of an online SaaS platform for the franchise marketplace. The Company acquired all of the outstanding capital stock of ElementsLocal for consideration consisting of (i) $463 thousand in cash; (ii) $604 thousand in shares of Bridgeline Digital common stock (valued at $1.15 per share); (iii) assumption of $188 thousand of indebtedness; and (iv) contingent consideration of up to $904 thousand in cash and $396 thousand in shares of Bridgeline Digital common stock. The contingent consideration is payable quarterly over the 12 consecutive calendar quarters following the acquisition, contingent upon the acquired business achieving a certain quarterly revenue target during the period. The contingent common stock payable each earnout period is determined by dividing $33 thousand by the greater of: (i) the average closing price for Bridgeline Digital common stock for the 30 day trading period preceding the end of the earnout period; or (ii) $1.17. To the extent that a quarterly revenue target is not met in a particular quarter, the earn-out period will be extended for up to four additional quarters. The Company is required to assess the probability of the acquired business achieving the contingent cash and stock payments which requires management to make estimates and judgments based on forecasts of future performance. ElementsLocal’s operating results are reflected in the Company’s condensed consolidated financial statements as of the acquisition date.

There were no acquisitions during our first three fiscal quarters of 2014.

Results of Operations

Three and Nine Months Ended June 30, 2014 compared to the Three and Nine Months Ended June 30, 2013

Consolidated Revenue, Cost of Revenue, Gross Profit, and Gross Margin

Revenue:	**Three Months Ended June 30, 2014**	**Three Months Ended June 30, 2013**	**$ Change**	**% Change**	**Nine Months Ended June 30, 2014**	**Nine Months Ended June 30, 2013**	**$ Change**	**% Change**
Digital engagement services	$ 3,737	$ 3,384	353	**10** %	$ 10,738	$ 10,359	379	**4** %

iAPPS digital engagement services								
% of total revenue	*61 %*	*60 %*			*60 %*	*58 %*		
Other digital engagement services	496	892	(396)	**(44 %)**	1,654	3,255	(1,601)	**(49 %)**
% of total revenue	*8 %*	*16 %*			*9 %*	*15 %*		
Subtotal digital engagement services	4,233	4,276	(43)	**(1 %)**	12,392	13,614	(1,222)	**(9 %)**
% of total revenue	*69 %*	*76 %*			*69 %*	*77 %*		
Subscription and perpetual licenses	1,510	915	595	**65 %**	4,394	2,726	1,668	**61 %**
% of total revenue	*25 %*	*16 %*			*24 %*	*15 %*		
Managed service hosting	409	409	-	**0 %**	1,181	1,456	(275)	**(19 %)**
% of total revenue	*7 %*	*7 %*			*7 %*	*8 %*		
Total revenue	**$ 6,152**	**$ 5,600**	**$ 552**	**10 %**	**$ 17,967**	**$ 17,796**	**$ 171**	**1 %**
Cost of revenue:								
Digital engagement services								
iAPPS digital engagement services	2,297	1,920	377	**20 %**	6,777	5,610	1,167	**21 %**
% of iAPPS digital engagement services revenue	*61 %*	*57 %*			*63 %*	*54 %*		
Other digital engagement costs	234	421	(187)	**(44 %)**	926	1,956	(1,030)	**(53 %)**
% of other digital engagement services revenue	*47 %*	*47 %*			*56 %*	*60 %*		
Subtotal digital engagement services costs	2,531	2,341	190	**8 %**	7,703	7,566	137	**2 %**
% of digital engagement services revenue	*60 %*	*55 %*			*62 %*	*56 %*		
Subscription and perpetual licenses	422	330	92	**28 %**	1,271	770	501	**65 %**
% of subscription and perpetual revenue	*28 %*	*36 %*			*29 %*	*28 %*		
Managed service hosting	66	76	(10)	**(13 %)**	218	224	(6)	**(3 %)**
% of managed service hosting revenue	*16 %*	*19 %*			*18 %*	*15 %*		
Total cost of revenue	3,019	2,747	272	**10 %**	9,192	8,560	632	**7 %**
Gross profit	**$ 3,133**	**$ 2,853**	**$ 280**	**10 %**	**$ 8,775**	**$ 9,236**	**$ (461)**	**(5 %)**
Gross profit margin	*51 %*	*51 %*			*49 %*	*52 %*		

Revenue

Our revenue is derived from three sources: (i) digital engagement services; (ii) subscription and perpetual licenses; and (iii) managed service hosting.

Digital Engagement Services

Digital engagement services revenue is comprised of iAPPS digital engagement related services and other digital engagement related services generated from non-iAPPS related engagements. In total, revenue from digital engagement services decreased $43 thousand, or 1%, to $4.2 million for the three months ended June 30, 2014 compared to the prior period. Revenue from iAPPS digital engagement services increased $353 thousand, or 10% to $3.7 million compared to the three months ended June 30, 2013. The increase in iAPPS digital engagements services is related to an increased demand for our iAPPS related services. Revenue from non-iAPPS digital engagement services decreased $396 thousand, or 44%, compared to the three months ended June 30, 2013. The decrease in non-iAPPS digital engagements services compared to the prior period is related to our focus on selling higher-margin iAPPS digital engagements to both new and existing customers.

Digital engagement services revenue as a percentage of total revenue decreased to 69% from 76% for the three months ended June 30, 2014 compared to the prior period. The decrease is attributable to the decrease in non-iAPPS digital engagement services revenue and the timing of recognizing revenue from new engagements.

Revenue from iAPPS digital engagement services increased $379 thousand to $10.7 million for the nine months ended June 30, 2014 compared to the nine months ended June 30, 2013. The increase in iAPPS digital engagements services is related to an increase in demand for our iAPPS product suite and an increase in iAPPS subscription and perpetual licenses sold. Revenue from non-iAPPS digital engagement services decreased $1.6 million, or 49%, compared to the nine months ended June 30, 2013. In total, revenue from digital engagement services decreased $1.2 million, or 9%, to $12.4 million for the nine months ended June 30, 2014. The decrease compared to the prior period is due to a decrease in non-iAPPS engagement services as we continue to concentrate on selling higher-margin iAPPS digital engagements to both new and existing customers.

Digital engagement services revenue as a percentage of total revenue decreased to 69% from 77% for the nine months ended June 30, 2014 compared to the prior period. The decrease is attributable to the decrease in non-iAPPS digital engagement services revenue.

Subscription and Perpetual Licenses

Revenue from subscription and perpetual licenses increased $595 thousand, or 65%, to $1.5 million for the three months ended June 30, 2014 compared to the three months ended June 30, 2013. Revenue from subscription and perpetual licenses increased $1.7 million, or 61%, to $4.4 million for the nine months ended June 30, 2014 compared to the nine months ended June 30, 2013. The increases are due to the increase in license revenues from our product for the multi-unit organizations and franchise industry, iAPPSds, and incremental SaaS licenses from our acquisition of ElementsLocal (acquired in the fourth quarter of fiscal 2013), and incremental iAPPS annual maintenance revenue.

Subscription and perpetual license revenue as a percentage of total revenue for the three months ended June 30, 2014 increased to 25% from 16% compared to the three months ended June 30, 2013. Subscription and perpetual license revenue as a percentage of total revenue for the nine months ended June 30, 2014 increased to 24% from 15% compared to the nine months ended June 30, 2013.

Managed Service Hosting

Revenue from managed service hosting remained flat for the three months ended June 30, 2014 compared to the three months ended June 30, 2013 and decreased $275 thousand, or 19%, to $1.2 million for the three months ended June 30, 2014 compared to the nine months ended June 30, 2013. The decrease is due to our efforts to engage with customers that are aligned with our core competencies and proactively end our engagements with a number of smaller hosting customers obtained through acquisitions.

Managed services revenue as a percentage of total revenue was 7% for the three months ended June 30, 2014 and 2013, and decreased to 6% for the nine months ended June 30, 2014 compared to 8% for nine months ended June 30, 2013.

Costs of Revenue

Total cost of revenue increased $272 thousand, or 10%, to $3.0 million for the three months ended June 30, 2014 compared to the three months ended June 30, 2013. Total cost of revenue increased $632 thousand, or 7%, to $9.2 million for the nine months ended June 30, 2014 compared to the nine months ended June 30, 2013. The increases for the three and nine months ended June 30, 2014 compared to the previous periods are due to fixed costs to support revenue due to the increases in revenues.

Cost of Digital Engagement Services

Cost of digital engagement services increased $190 thousand, or 8%, to $2.5 million for the three months ended June 30, 2014 compared to the three months ended June 30, 2013. Costs associated with non-iAPPS related engagements decreased in line with non-iAPPS digital engagement services, however, our costs associated with iAPPS related engagements increased in correlation to our increases in iAPPS related service revenue growth.

Cost of digital engagement services increased $137 thousand, or 2%, to $7.7 million for the nine months ended June 30, 2014 compared to the nine months ended June 30, 2013. Costs associated with non-iAPPS related engagements decreased in line with non-iAPPS digital engagement services, however, our costs associated with iAPPS related engagements increased in correlation to our increases in iAPPS related service revenue growth.

Cost of Subscription and Perpetual License

Cost of subscription and perpetual licenses increased $92 thousand, or 28%, to $422 thousand for the three months ended June 30, 2014 compared to the three months ended June 30, 2013. This increase is attributable to amortization of software costs associated with the development of our iAPPS product, as we released new versions of iAPPS that have commenced amortization over a three year period. In addition, the increases are due to incremental license costs related to ElementsLocal acquired in the fourth quarter of fiscal 2013, as well as, costs to support our network operations center.

The cost of subscription and perpetual licenses as a percentage of subscription and perpetual license revenue for the three months ended June 30, 2014 decreased to 28% from 36% compared to the three months ended June 30, 2013. This is due to amortization of software costs associated with the development of iAPPS and acquired non-iAPPS SaaS license costs which have a lower margin than iAPPS SaaS licenses.

Cost of subscription and perpetual licenses increased $501 thousand, or 65%, to $1.3 million for the nine months ended June 30, 2014 compared to the nine months ended June 30, 2013. This increase is due to amortization of software costs associated with the development of iAPPS, incremental license costs related to the acquisition of ElementsLocal, and additional costs to support our network operations center.

The cost of subscription and perpetual licenses as a percentage of subscription and perpetual license revenue for the nine months ended June 30, 2014 increased to 29% from 28% compared to the nine months ended June 30, 2013. This is due to amortization of software costs associated with the development of iAPPS and incremental license costs related to the acquisition of ElementsLocal.

Cost of Managed Service Hosting

Cost of managed service hosting decreased $10 thousand, or 13%, to $66 thousand for the three months ended June 30, 2014 compared to the three months ended June 30, 2013. The cost of managed services as a percentage of managed services revenue decreased to 16% from 19% compared to the three months ended June 30, 2013. The percentage increase is attributable to fixed costs to support the network operations center.

Cost of managed service hosting decreased $6 thousand, or 3%, to $218 thousand for the nine months ended June 30, 2014 compared to the nine months ended June 30, 2013. The cost of managed services as a percentage of managed services revenue increased to 18% from 15% compared to the nine months ended June 30, 2013. The percentage increases are attributable to fixed costs to support the network operations center.

Operating Expenses

Operating Expenses:	Three Months Ended June 30, 2014	Three Months Ended June 30, 2013	$ Change	% Change	Nine Months Ended June 30, 2014	Nine Months Ended June 30, 2013	$ Change	% Change
Sales and marketing	$1,992	$2,275	$(283)	**(12%)**	$6,030	$6,266	$(236)	**-4%**
% of total revenue	***32 %***	***41 %***			***34 %***	***35 %***		
General and administrative	1,110	1,140	(30)	**(3%)**	3,308	3,440	(132)	**(4%)**
% of total revenue	***18 %***	***20 %***			***18 %***	***19 %***		
Research and development	613	515	98	**19%**	1,715	893	822	**92%**
% of total revenue	***10 %***	***9 %***			***10 %***	***5 %***		
Depreciation and amortization	510	412	98	**24%**	1,515	1,226	289	**24%**
% of total revenue	***8 %***	***7 %***			***8 %***	***7 %***		
Total operating expenses	**$4,225**	**$4,342**	**$(117)**	(3%)	**$12,568**	**$11,825**	**$743**	**6%**

Sales and Marketing Expenses

Sales and marketing expenses decreased $283 thousand, or 12%, to $1.9 million for the three months ended June 30, 2014 compared to the three months ended June 30, 2013 and decreased $236 thousand, or 4%, to $6.0 million compared to the nine months ended June 30, 2013. Sales and marketing expenses represented 32% and 41% for the three months ended June 30, 2014 and 2013 and represented 34% and 35% of total revenue for the nine months ended June 30, 2014 and 2013.

The decreases for the three months ended June 30, 2014 compared to the prior period is primarily attributable to a decrease in marketing and sales related compensation expense. The decrease for the nine months ended June 30, 2014 compared to the prior period is primarily attributable to a decrease in overall sales and marketing expenses, offset by incremental expenses from the acquisition of ElementsLocal in August 2013.

General and Administrative Expenses

General and administrative expenses decreased $30 thousand, or 3%, to $1.1 million compared to the three months ended June 30, 2013 and decreased $132 thousand, or 4%, to $3.3 million compared to the nine months ended June

30, 2013. General and administrative expenses represented 18% and 20% of total revenue for the three months ended June 30, 2014 and 2013 and represented 18% and 19% for the nine months ended June 30, 2014 and 2013. The decrease in expense for the three and nine months ended June, 2014 compared to the prior period was due to decreases in headcount and general legal expenses.

Research and Development

Research and development expense increased by $98 thousand, or 19%, to $613 thousand for the three months ended June 30, 2014 compared to the three months ended June 30, 2013 and increased $822 thousand, or 92%, to $1.7 million compared to the nine months ended June 30, 2013. The increases in research and development expense for the three and nine months ended June 30, 2014 compared to the prior period is due to the capitalization of software development costs related to enhancements to our iAPPS product platform in the three and nine months ended June 2013, which decreases our overall research and development expenses. We capitalized $398 thousand in the three months ended June 30, 2013 and there were no costs capitalized in the current quarter. In the nine months ended June 30, 2013, we capitalized $670 thousand of software development costs, however, we only capitalized $117 thousand of software development costs in the current nine month period. Costs are not capitalized until technological feasibility is achieved.

Depreciation and Amortization

Depreciation and amortization expense increased $98 thousand, or 24%, compared to the three months ended June 30, 2013 and increased $289 thousand, or 24%, compared to the nine months ended June 30, 2013. The increases in depreciation and amortization for the three and nine months ended June 30, 2014 are attributable to depreciation related to our network operation center and amortization of intangible assets acquired from acquisitions.

Depreciation and amortization expenses represented 8% and 7% of total revenue for the three months ended June 30, 2014 and 2013 and represented 8% and 7% of total revenue for the nine months ended June 30, 2014 and 2013.

Non-Operating Expenses and Adjusted EBITDA

Non-Operating and Other:	Three Months Ended June 30, 2014	Three Months Ended June 30, 2013	$ Change	% Change	Nine Months Ended June 30, 2014	Nine Months Ended June 30, 2013	$ Change	% Change
Loss from operations	$(1,092)	$(1,489)	$ 397	**(27%)**	$(3,793)	$(2,589)	$(1,204)	**47%**
Interest and other expense, net	(190)	(59)	(131)	**222%**	(524)	(194)	(330)	**170%**
Loss before income taxes	(1,282)	(1,548)	266	**(17%)**	(4,317)	(2,783)	(1,534)	**55%**
Provision for income taxes	24	21	3	**14%**	80	110	(30)	**(27%)**
Net loss	**$(1,306)**	**$(1,569)**	**$ 263**	**(17%)**	**$(4,397)**	**$(2,893)**	**$(1,504)**	**52%**
Non-GAAP Measure								
Adjusted EBITDA	$(336)	$(899)	$ 563	(63%)	$(1,639)	$(828)	$(811)	98%

Loss from Operations

The loss from operations was ($1.1) million for three months ended June 30, 2014, compared to a loss of ($1.5) million in the prior period. The improvement in the current quarter can be attributed to an increase in revenue combined with decreases in operating costs, primarily sales and marketing costs. Depreciation and amortization expenses have increased as we continue to support the growth and expansion of the Company. The loss from operations was ($3.8) million for nine months ended June 30, 2014, compared to a loss of ($2.6) million in the prior period. The decrease in income is partially attributable to the expected decline in non-iAPPS digital engagement services combined with the prior period favorable earnout adjustment of $312 thousand and capitalized software of $670 thousand.

Income Taxes

The provision for income tax expense increased $3 thousand, or 14%, compared to the three months ended June 30, 2013 and decreased $30 thousand or 27%, compared to the months ended June 30, 2013. The decreases are attributable to a reduction in taxes paid by our foreign subsidiary in India. Income tax expense represents the estimated liability for federal and state income taxes owed, including the alternative minimum tax. We have net operating loss carryforwards and other deferred tax benefits that are available to offset future taxable income.

Adjusted EBITDA

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

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

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

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

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2014	2013	2014	2013
Net loss	$(1,306)	$(1,569)	$(4,397)	$(2,893)
Provision for income tax	24	21	80	110
Interest and other expense, net	190	59	524	194
Amortization of intangible assets	157	118	498	390
Depreciation	333	295	980	836
EBITDA	(602)	(1,076)	(2,315)	(1,363)
Other amortization	132	122	375	201
Stock-based compensation	134	55	301	334
Adjusted EBITDA	$(336)	$(899)	$(1,639)	$(828)

The increase in Adjusted EBITDA for the three months ended June 30, 2014 compared to the prior period is primarily due to the increase in iAPPS revenues and decreases in operating expenses. The decrease in Adjusted EBITDA for the nine months ended June 30, 2014 compared to the prior period is primarily due a decline in gross margin combined with fixed costs to support the overall revenue base. In addition, in comparison to the previous period which recognized and earnout adjustment of $312 thousand and capitalized software of $670 thousand, we had no earnout adjustments and only $117 thousand of software. Depreciation and amortization have also increased as we continue to support the growth and expansion of the Company.

Liquidity and Capital Resources

Cash Flows

Operating Activities

Cash used in operating activities was $2.9 million for the nine months ended June 30, 2014 compared to cash used in operating activities of $452 thousand for the nine months ended June 30, 2013. This decrease compared to the prior period was due to higher net loss, adjusted for non-cash items such as amortization and depreciation for the period, an increase in accounts receivable and a decrease in accounts payable and other liabilities.

Investing Activities

Cash used in investing activities was $862 thousand for the nine months ended June 30, 2014 compared to cash used in investing activities of $1.6 million for the nine months ended June 30, 2013. In the nine months ended June 30, 2014, we purchased additional equipment to support our network operations center and made contingent earnout payments related to acquisitions.

Financing Activities

Cash provided by financing activities was $2.6 million for the nine months ended June 30, 2014 compared to cash provided by financing activities of $1.6 million for the nine months ended June 30, 2013. During the first nine months of 2014, we generated net proceeds of $2.8 million from a private sale of common stock and $913 thousand from issuance of convertible debt, as well as $206 thousand generated from stock option exercises and the employee stock purchase plan. The proceeds generated were partially offset by payments of acquired debt and paydown of our discontinued line of credit with Silicon Valley Bank. We have a new line of credit with BridgeBank with a balance of $2.9 million as of June 30, 2014.

Capital Resources and Liquidity Outlook

We believe that cash generated from financing activities and operations, and our bank line of credit will be sufficient to fund the company's working capital and capital expenditure needs for at least the next twelve months.

In December 2013, the Company entered into a Loan and Security Agreement with BridgeBank (the "BridgeBank Loan Agreement"). The Loan Agreement has a 27 month term which expires on March 31, 2016. The Loan Agreement provides for up to $5 million of revolving credit advances which may be used for acquisitions and working capital purposes. Borrowings are limited to the lesser of (i) $5 million and (ii) 80% of eligible receivables as defined. The Company can borrow up to $1.0 million in out of formula borrowings for specified periods of time. Borrowings bear interest at BridgeBank's prime plus 1.00%. The Company pays an annual commitment fee of 0.25%. Borrowings are secured by all of the Company's assets and all of the Company's intellectual property. The Company is also required to comply with certain financial covenants. The BridgeBank Loan Agreement replaced the Company's prior credit facility with Silicon Valley Bank, which expired on December 31, 2013. As of June 30, 2014, the Company had an outstanding balance under the BridgeBank Loan Agreement of $2.9 million.

Off-Balance Sheet Arrangements

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

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

Commitments and Contingencies

As of June 30, 2014, we had an accrued contingent earnout liability of $1.0 million from acquisitions completed in prior fiscal years, which are scheduled to be paid out through fiscal 2016. Contingent earnout payments related to acquisitions are paid when and if certain revenue and earnings targets are achieved.

Critical Accounting Policies

These critical accounting policies and estimates by our management should be read in conjunction with Note 2 *Summary of Significant Accounting Policies* to the Consolidated Financial Statements that were prepared in accordance with accounting principles generally accepted in the United States of America ("US GAAP") that are included in our Annual Report on Form 10-K and filed with the Securities and Exchange Commission on December 20, 2013.

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

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

Revenue recognition;

Allowance for doubtful accounts;

Accounting for cost of computer software to be sold, leased or otherwise marketed;

Accounting for goodwill and other intangible assets; and

Accounting for stock-based compensation.

Revenue Recognition

Overview

We enter into arrangements to sell digital engagement services (professional services), software licenses or combinations thereof. Revenue is categorized into (i) Digital Engagement Services (ii) Subscriptions and Perpetual Licenses and (iii) Managed Service Hosting.

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

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

Digital Engagement Services

Digital engagement services include professional services primarily related to the Company's web development solutions that address specific customer needs such as digital strategy, information architecture and usability engineering, .Net development, rich media development, back end integration, search engine optimization, quality assurance and project management.

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

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

Subscriptions and Perpetual Licenses

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

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

Managed Service Hosting

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

Multiple Element Arrangements

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

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

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

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

In determining VSOE for the digital engagement services element, the separability of the services from the software license and the value of the services when sold on a standalone basis are considered. The Company also considers the categorization of the services, the timing of when the services contract was signed in relation to the signing of the perpetual license contract and delivery of the software, and whether the services can be performed by others. The Company has concluded that its digital engagement 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 a digital engagement services arrangement does qualify for separate accounting, the Company recognizes the perpetual license on a residual basis. If the digital engagement services arrangement does not qualify for separate accounting, the Company recognizes the perpetual license under the proportional performance model as described above.

When subscription arrangements are sold with digital engagement services, the Company uses its judgment as to whether the services qualify as a separate unit of accounting. When subscription service arrangements involve multiple elements that qualify as separate units of accounting, the Company allocates arrangement consideration in multiple-deliverable arrangements at the inception of an arrangement to all deliverables based on the relative selling price model in accordance with the selling price hierarchy, which includes: (i) VSOE when available; (ii) TPE if VSOE is not available; and (iii) ESP if neither VSOE or TPE is available. For those subscription arrangements sold with multiple elements whereby the digital engagement services do not qualify as a separate unit of accounting, the digital engagement services revenue is recognized ratably over the subscription period. Subscriptions also include a PCS component, and the Company has determined that the two elements cannot be separated and must be recognized as one unit over the applicable service period. Set up fees paid by customers in connection with subscription arrangements are deferred and recognized ratably over the longer of the life of the hosting period or the expected lives of customer relationships, which generally range from two to three years. We continue to evaluate the length of the amortization period of the set up fees as we gain more experience with customer contract renewals and our newer product offerings.

Customer Payment Terms

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

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

Warranty

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

Reimbursable Expenses

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

Allowance for Doubtful Accounts

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

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

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

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

Accounting for Goodwill and Intangible Assets

Goodwill is tested for impairment annually during the fourth quarter of every year and more frequently if events and circumstances indicate that the asset might be impaired. In assessing goodwill for impairment, an entity has the option to assess qualitative factors to determine whether events or circumstances indicate that it is not more likely than not that the fair value of a reporting unit is less than its carrying amount. We assess goodwill at the consolidated level as one reporting unit. If this is the case, then performing the quantitative two-step goodwill impairment test is unnecessary. An entity can choose not to perform a qualitative assessment for any or all of its reporting units, and proceed directly to the use of the two-step impairment test. In assessing qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount, we assess relevant events and circumstances that may impact the fair value and the carrying amount of a reporting unit. The identification of relevant events and circumstances and how these may impact a reporting unit's fair value or carrying amount involve significant judgments by management. These judgments include the consideration of macroeconomic conditions, industry and market considerations, cost factors, overall financial performance, events which are specific to Bridgeline, and trends in the market price of our common stock. Each factor is assessed to determine whether it impacts the impairment test positively or negatively, and the magnitude of any such impact.

For fiscal 2013, we performed the annual assessment of our goodwill during the fourth quarter of 2013, using the qualitative approach described above. Based on our qualitative assessment, we concluded that it was not more likely than not that the fair values of any of our reporting units were less than their carrying amounts, and therefore it was not necessary to perform the quantitative two-step impairment test. The key qualitative factors that led to our conclusion included the following: (i) our stock price of $1.10 as of September 30, 2013 did not materially change from the stock price of $1.20 of September 30, 2013; (ii) the successful launch of iAPPSds in 2013 with our first iAPPSds customer, a franchisor with over 4,000 locations, and our strategic acquisition of ElementsLocal in 2013, has improved predictability of our forecasts by increasing contractually recurring revenue; and (iii) inputs from recent transactions within the technology sector, such as revenue multiples used to value transactions, have either remained steady since the fiscal 2013 assessment.

The factors the Company considers important that could indicate impairment include its stock price, significant under performance relative to prior operating results, change in projections, significant changes in the manner of the Company's use of assets or the strategy for the Company's overall business, and significant negative industry or economic trends. To the extent there are unfavorable changes in assumptions used to determine the Company's fair value there can be no assurance that the Company will not have an impairment charge in the future.

During the nine months ended June 30, 2014 the carrying value of goodwill decreased by $626,000 due primarily to a reclassification to intangible assets as a result of a purchase price adjustment related to the acquisition of ElementsLocal completed in the prior fiscal year.

Accounting for Stock-Based Compensation

At June 30, 2014, we maintained one stock-based compensation plan and one employee stock purchase plan which are more fully described in Note 11 to the Consolidated Financial Statements of our Annual Report on Form 10-K filed with the Securities and Exchange Commission on December 20, 2013.

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

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

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

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

Item 3. Qualitative and Quantitative Disclosures About Market Risk.

Not required.

Item 4. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed under the *Securities Exchange Act of 1934*, as amended, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and that such information is accumulated and communicated to our management, including our President and Chief Executive Officer (Principal Executive Officer) and our Executive Vice President and Chief Financial Officer (Principal Financial and Accounting Officer), as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, as ours are designed to do, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As of June 30, 2014 we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective in enabling us to record, process, summarize and report information required to be included in our periodic filings with the Securities and Exchange Commission within the required time period.

Changes in Internal Control over Financial Reporting

There have been no changes in our internal controls over financial reporting that occurred during the quarter ended June 30, 2014 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II – OTHER INFORMATION

Item 1. Legal Proceedings.

From time to time we are subject to ordinary routine litigation and claims incidental to our business. We are not currently involved in any legal proceedings that we believe are material beyond those previously disclosed in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on December 20, 2013.

Item 1A. Risk Factors.

For additional risk factors other than the below please refer to our Annual Report on Form 10-K for the year ended September 30, 2013 filed with the Securities and Exchange Commission on December 20, 2013.

We will not be able to maintain our listing on the NASDAQ Capital Market if we are unable to satisfy NASDAQ's minimum bid price requirements of $1.00 per share.

We are currently not in compliance with the requirements for listing on the NASDAQ Capital Market. We are required to meet certain financial criteria 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. Because our stock traded below $1.00 per share for 30 consecutive business days, on May 28, 2014, the NASDAQ Capital Market notified us that we are no longer in compliance with Marketplace Rule 5550(a)(2). We were provided 180 calendar days, or until November 24, 2014, to regain compliance with the minimum closing bid price requirement. In accordance with Marketplace Rule 5810(c)(3)(A), we can regain compliance if the closing bid price of our common stock meets or exceeds $1.00 per share for at least 10 consecutive business days.

If we are unable to demonstrate compliance by November 24, 2014, our shares of common stock will be subject to delisting. At that point, the NASDAQ staff will determine whether we meet the NASDAQ Capital Market initial listing criteria, except for the minimum bid price requirement. If NASDAQ determines that we meet the initial listing criteria, the NASDAQ staff will grant us an additional 180 calendar day compliance period. If we are not eligible for an additional compliance period, the NASDAQ staff will provide written notice that our securities will be delisted from the NASDAQ Capital Market.

The delisting of our common stock could have a negative effect on the market price for our shares.

If our common stock is delisted from NASDAQ it may be traded on the OTCQX or the OTC Bulletin Board which may limit the market for our stock and affect our ability to raise capital.

We are currently not in compliance with the requirements for listing on the NASDAQ Capital Market. If our common stock is delisted from NASDAQ, we will apply to have our common stock quoted on the OTCQX, the world's largest interdealer quotation system, which is operated by OTC Market Groups, Inc. Our stock may also be traded on the OTC Bulletin Board.

There may be a limited market for our common stock if it is quoted on the OTCQX or the OTC Bulletin Board. Trading in our stock may become more difficult and our share price could decrease. Specifically, you may not be able to resell your shares of common stock at or above the price you paid.

In addition, the delisting of our common stock from NASDAQ may impair our ability to raise additional capital due to the less liquid nature of the OTCQX and OTC Bulletin Board markets. While we cannot guarantee that we would be able to complete an equity financing on acceptable terms, or at all, we believe that dilution from any equity financing while our shares are quoted on an over-the-counter market would likely be substantially greater than if we were to complete a financing while our common stock is traded on a national securities exchange. Further, if our common stock is not traded on an exchange, we will no longer be eligible to use short-form registration statements on Form S-3 for the registration of our securities, which could impair our ability to raise additional capital as needed.

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

The following summarizes all sales of our unregistered securities during the quarter ended June 30, 2014. The securities in the below-referenced transactions were (i) issued without registration and (ii) were subject to restrictions under the Securities Act and the securities laws of certain states, in reliance on the private offering exemptions contained in Sections 4(2), 4(6) and/or 3(b) of the Securities Act and on Regulation D promulgated there under, and in reliance on similar exemptions under applicable state laws as transactions not involving a public offering. Unless stated otherwise, no placement or underwriting fees were paid in connection with these transactions.

During the fiscal quarter ended June 30, 2014, we granted 45,000 stock options under our Amended and Restated Stock Incentive Plan at a weighted average exercise price of $0.92 per share.

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

Item 6. Exhibits.

Exhibit No.	Description of Document
31.1	Certification required by Rule 13a-14(a) or Rule 15d-14(a).
31.2	Certification required by Rule 13a-14(a) or Rule 15d-14(a).
32.1	Certification required by Rule 13a-14(b) or Rule 15d-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. §1350).
32.2	Certification required by Rule 13a-14(b) or Rule 15d-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. §1350).
101.INS*	XBRL Instance
101.SCH*	XBRL Taxonomy Extension Schema
101.CAL*	XBRL Taxonomy Extension Calculation
101.DEF*	XBRL Taxonomy Extension Definition
101.LAB*	XBRL Taxonomy Extension Labels
101.PRE*	XBRL Taxonomy Extension Presentation

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

SIGNATURES

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

	Bridgeline Digital, Inc. (Registrant)
August 14, 2014	/s/ Thomas L. Massie **Thomas L. Massie**
Date	**President and Chief Executive Officer** (Principal Executive Officer)
August 14, 2014	/s/ Michael D. Prinn **Michael D. Prinn**
Date	**Executive Vice President and Chief Financial Officer** (Principal Financial and Accounting Officer)

INDEX OF EXHIBITS

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