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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-Q**

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

**For the quarterly period ended September 30, 2004**

or

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

Commission file number 000-50784

**Blackboard Inc.**

*(Exact name of Registrant as Specified in Its Charter)*

**Delaware**

*(State or Other Jurisdiction of  
Incorporation or Organization)*

**52-2081178**

*(I.R.S. Employer  
Identification No.)*

**1899 L Street, N.W.  
Washington D.C.**

*(Address of Principal Executive Offices)*

**20036**

*(Zip Code)*

**Registrant's Telephone Number, Including Area Code:  
(202) 463-4860**

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 is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes  No

Class

Outstanding at October 31, 2004

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Common Stock, \$0.01 par value

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25,769,064

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**Blackboard Inc.**  
**Quarterly Report on Form 10-Q**  
**For the Quarter Ended September 30, 2004**  
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*Throughout this Quarterly Report on Form 10-Q, the terms "we," "us," "our" and "Blackboard" refer to Blackboard Inc. and its subsidiaries.*

PART I — FINANCIAL INFORMATION

Item 1. Consolidated Financial Statements

BLACKBOARD INC.  
CONSOLIDATED BALANCE SHEETS

	December 31, 2003	September 30, 2004
		(Unaudited)
		(In thousands)
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 30,456	\$ 86,346
Accounts receivable, net of allowance for doubtful accounts of \$1,018,000 and \$1,204,000 at December 31, 2003 and September 30, 2004, respectively	22,870	25,489
Inventories, net of allowance for obsolescence of \$115,000 and \$132,000 at December 31, 2003 and September 30, 2004, respectively	2,050	2,122
Prepaid expenses and other current assets	711	1,370
Deferred cost of revenues	3,846	5,505
	59,933	120,832
Total current assets		
Property and equipment, net	7,683	9,542
Restricted cash	843	653
Goodwill	10,252	10,252
Intangible assets, net	4,343	1,704
	83,054	142,983
Total assets		
<b>LIABILITIES AND STOCKHOLDERS' (DEFICIT) EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 1,833	\$ 1,414
Accrued expenses	9,900	9,122
Line of credit	7,880	—
Equipment note, current portion	949	662
Note payable	2,000	—
Deferred revenues, current portion	51,215	63,447
	73,777	74,645
Total current liabilities		

Equipment note, noncurrent portion	735	312
Deferred rent	1,135	1,116
Deferred revenues, noncurrent portion	1,727	3,552

See notes to unaudited consolidated financial statements.

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**BLACKBOARD INC.**  
**CONSOLIDATED BALANCE SHEETS — (Continued)**

	<b>December 31,</b>	<b>September 30,</b>
	<b>2003</b>	<b>2004</b>
	(Unaudited)	
	(In thousands)	
Commitments and contingencies		
Series A Convertible Preferred Stock, \$0.01 par value; 1,174,484 shares authorized, issued and outstanding at December 31, 2003 and no shares authorized, issued or outstanding at September 30, 2004; liquidation preference of \$876,000 at December 31, 2003	\$ 868	\$ —
Series B Redeemable Convertible Preferred Stock, \$0.01 par value; 5,025,935 shares authorized, issued and outstanding at December 31, 2003 and no shares authorized, issued or outstanding at September, 2004; liquidation preference of \$4,403,000 at December 31, 2003	4,397	—
Series C Redeemable Convertible Preferred Stock, \$0.01 par value; 6,220,049 shares authorized; 5,904,788 shares issued and outstanding at December 31, 2003 and no shares authorized, issued or outstanding at September 30, 2004; liquidation preference of \$21,285,000 at December 31, 2003	21,256	—
Series D Redeemable Convertible Preferred Stock, \$0.01 par value; 4,167,333 shares authorized; 3,451,707 shares issued and outstanding at December 31, 2003 and no shares authorized, issued or outstanding at September 30, 2004; liquidation preference of \$41,248,000 at December 31, 2003	41,215	—
Series E Redeemable Convertible Preferred Stock, \$0.01 par value; 13,000,000 shares authorized; 10,236,934 shares issued and outstanding at December 31, 2003 and no shares authorized, issued or outstanding at September 30, 2004; liquidation preference of \$64,830,000 at December 31, 2003	58,227	—
Warrants to purchase Series E Redeemable Convertible Preferred Stock	4,334	—
Stockholders' (deficit) equity:		
Preferred stock, \$0.01 par value; no shares authorized, issued or outstanding at December 31, 2003; 5,000,000 shares authorized,	—	—

and no shares issued or outstanding at September 30, 2004		
Common stock, \$0.01 par value; 200,000,000 shares authorized; 5,536,396 and 25,765,423 shares issued and outstanding at December 31, 2003 and September 30, 2004, respectively	55	258
Additional paid-in capital	8,020	190,665
Deferred stock compensation	(35)	(226)
Accumulated deficit	(132,657)	(127,339)
Total stockholders' (deficit) equity	(124,617)	63,358
Total liabilities and stockholders' (deficit) equity	\$ 83,054	\$ 142,983

See notes to unaudited consolidated financial statements.

**BLACKBOARD INC.**  
**UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS**

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2003	2004	2003	2004
(In thousands, except share and per share amounts)				
Revenues:				
Product	\$ 22,206	\$ 25,468	\$ 61,199	\$ 71,416
Professional services	3,364	4,308	7,296	9,934
Total revenues	25,570	29,776	68,495	81,350
Operating expenses:				
Cost of product revenues, excludes amortization of acquired technology included in amortization of intangibles resulting from acquisitions shown below	6,528	6,813	17,436	18,830
Cost of professional services revenues	2,186	2,378	5,085	6,004
Research and development	2,980	3,537	8,433	10,427
Sales and marketing	7,633	9,074	22,382	26,932
General and administrative	3,677	3,957	12,415	10,742
Amortization of intangibles resulting from acquisitions	1,445	879	4,313	2,638
Stock-based compensation	105	44	306	155

Total operating expenses	24,554	26,682	70,370	75,728
Income (loss) from operations	1,016	3,094	(1,875)	5,622
Other income (expense), net:				
Interest expense	(146)	(27)	(439)	(155)
Interest income	21	163	80	212
Income (loss) before (provision) benefit for income taxes	891	3,230	(2,234)	5,679
(Provision) benefit for income taxes	(300)	250	(614)	(362)
Net income (loss)	591	3,480	(2,848)	5,317
Dividends on and accretion of convertible preferred stock	(2,531)	—	(7,521)	(6,344)
Net (loss) income attributable to common stockholders	\$ (1,940)	\$ 3,480	\$ (10,369)	\$ (1,027)
Net (loss) income attributable to common stockholders per common share:				
Basic	\$ (0.35)	\$ 0.14	\$ (1.88)	\$ (0.08)
Diluted	\$ (0.35)	\$ 0.12	\$ (1.88)	\$ (0.08)
Weighted average number of common shares:				
Basic	5,519,638	25,683,200	5,511,009	12,868,696
Diluted	5,519,638	27,906,730	5,511,009	12,868,696

See notes to unaudited consolidated financial statements.



**BLACKBOARD INC.**  
**UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS**

Nine Months Ended  
September 30,

2003

2004

(In thousands)

<b>Cash flows from operating activities</b>	2003	2004
Net (loss) income	\$ (2,848)	\$ 5,317
Adjustments to reconcile net (loss) income to net cash provided by operating activities:		
Depreciation and amortization	2,997	4,669
Amortization of intangibles	4,313	2,638
Change in allowance for doubtful accounts	155	186
Change in obsolescence reserve	85	17
Noncash stock compensation related to options issued to nonemployees	—	69
Noncash stock compensation for modification of options	21	—
Noncash deferred stock amortization	56	86
Changes in operating assets and liabilities, net of effect of acquisition:		
Accounts receivable	(10,204)	(2,805)
Inventories	(205)	(89)
Prepaid expenses and other current assets	2,661	(659)
Deferred cost of revenues	(238)	(1,659)
Accounts payable	1,404	(419)
Accrued expenses	863	(950)
Deferred rent	(117)	(19)
Deferred revenues	10,341	14,057
Net cash provided by operating activities	9,284	20,439

<b>Cash flows from investing activities</b>		
Purchase of property and equipment	(3,472)	(6,356)
Acquisition of business, net of cash acquired	(4,500)	—
Net cash used in investing activities	(7,972)	(6,356)
<b>Cash flows from financing activities</b>		
Proceeds from equipment notes	1,540	—
Payments on equipment notes	(1,062)	(710)
Proceeds from line of credit	5,380	—
Payments on line of credit	(4,750)	(7,880)
Payments on note payable	(1,000)	(2,000)
Proceeds from issuance of common stock, net of issuance costs	—	50,896
Proceeds from exercise of Series E Warrants	—	248
Release of letters of credit	210	190
Proceeds from exercise of stock options	140	1,063
Net cash provided by financing activities	458	41,807
Net increase in cash and cash equivalents	1,770	55,890
Cash and cash equivalents at beginning of period	20,372	30,456
Cash and cash equivalents at end of period	\$ 22,142	\$ 86,346

See notes to unaudited consolidated financial statements.

**BLACKBOARD INC.**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**  
**For the Three Months and Nine Months Ended September 30, 2003 and 2004**

*In these Notes to Unaudited Consolidated Financial Statements, the terms the "Company" and "Blackboard" refer to Blackboard Inc. and its subsidiaries.*

**1. Nature of Business**

Blackboard Inc. is an enterprise software company for the education markets. The Company's suites of products include the following five products: *Blackboard Learning System™*, *Blackboard Community System™* (formerly known as *Blackboard Portal System™*), *Blackboard Content System™*, *Blackboard Transaction System™* and *Blackboard One™*.

**2. Basis of Presentation**

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. The results of operations for the three months and nine months ended September 30, 2004 are not necessarily indicative of the results that may be expected for the full fiscal year. The balance sheet at December 31, 2003 has been derived from the audited consolidated financial statements at that date but does not include all of the information and notes required by generally accepted accounting principles for complete financial statements.

These consolidated financial statements should be read in conjunction with the audited consolidated financial statements as of December 31, 2002 and 2003 and for each of the three years in the period ended December 31, 2003 included in the Company's Prospectus dated June 17, 2004 filed with the Securities and Exchange Commission on June 18, 2004.

On April 23, 2004, the Company effected a one-for-two reverse stock split of all common stock outstanding. On May 26, 2004, the Company effected a one-for-1.0594947 reverse stock split of all common stock outstanding. The accompanying consolidated financial statements give retroactive effect to the reverse stock splits for all periods presented.

***Use of Estimates***

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

***Reclassification***

Certain amounts in the prior periods' consolidated financial statements have been reclassified to conform to the current period presentation.

***Basic and Diluted Net (Loss) Income Attributable to Common Stockholders per Common Share***

Basic net (loss) income attributable to common stockholders per common share excludes dilution for potential common stock issuances and is computed by dividing net (loss) income attributable to common stockholders by the weighted-average number of common shares outstanding for the period. Diluted net (loss) income attributable to common stockholders per common share reflects the potential dilution that could occur

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**BLACKBOARD INC.**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

if securities or other contracts to issue common stock were exercised or converted into common stock. Mandatorily redeemable convertible preferred stock, stock options and warrants were not considered in the computation of diluted net (loss) income attributable to common stockholders per common share for the three and nine months ended September 30, 2003 and the nine months ended September 30, 2004 as their effect is anti-dilutive.

The following schedule presents the calculation of basic and diluted net (loss) income attributable to common stockholders per common share:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2003	2004	2003	2004
(Unaudited)				
(In thousands, except share and per share amounts)				
Basic net (loss) income attributable to common stockholders per common share:				
Net income (loss)	\$ 591	\$ 3,480	\$ (2,848)	\$ 5,317
Less preferred stock dividends:				
Redeemable convertible preferred stock	(2,531)	—	(7,521)	(6,344)
Net (loss) income attributable to common	\$ (1,940)	\$ 3,480	\$ (10,369)	\$ (1,027)

stockholders per common share				
Weighted average shares outstanding	5,519,638	25,683,200	5,511,009	12,868,696
Basic net (loss) income attributable to common stockholders per common share	\$ (0.35)	\$ 0.14	\$ (1.88)	\$ (0.08)
Diluted net (loss) income attributable to common stockholders per common share:				
Net (loss) income attributable to common stockholders per common share	\$ (1,940)	\$ 3,480	\$ (10,369)	\$ (1,027)
Weighted average number of basic shares outstanding	5,519,638	25,683,200	5,511,009	12,868,696
Dilutive effect of:				
Stock options	—	1,980,831	—	—

related to the purchase of common stock				
Warrants related to the purchase of common stock	—	242,699	—	—
Diluted shares outstanding	5,519,638	27,906,730	5,511,009	12,868,696
Diluted net (loss) income attributable to common stockholders per common share	\$ (0.35)	\$ 0.12	\$ (1.88)	\$ (0.08)

**Recent Accounting Pronouncements**

On October 13, 2004, the Financial Accounting Standards Board concluded that Statement 123R, "Share-Based Payment" (Statement 123R), which would require all companies to measure compensation cost for all share-based payments (including employee stock options) at fair value, would be effective for public companies (except small business issuer as defined in SEC Regulation S-B) for interim or annual periods beginning after June 15, 2005. Retroactive application of the requirements of Statement of Financial Accounting Standards (SFAS) No. 123, "Accounting for Stock-Based Compensation" (SFAS 123) (not

**BLACKBOARD INC.**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

Statement 123R) to the beginning of the fiscal year that includes the effective date would be permitted, but not required. The pro forma effect on net (loss) income attributable to common stockholders and net (loss) income attributable to common stockholders per common share assuming we had applied the fair value recognition provisions of Statement 123 is included in Note 3. Stock-Based Compensation.

***Comprehensive Net (Loss) Income***

Comprehensive net (loss) income includes net (loss) income, combined with unrealized gains and losses not included in earnings and reflected as a separate component of stockholders' (deficit) equity. There were no differences between net (loss) income and comprehensive net (loss) income for the three and nine months ended September 30, 2003 and 2004.

**3. Stock-Based Compensation**

SFAS 123, as amended by SFAS No. 148, "Accounting for Stock-Based Compensation — Transition and Disclosure, an amendment of SFAS No. 123," allows companies to account for stock-based compensation using either the provisions of SFAS 123 or the provisions of Accounting Principles Bulletin No. 25, "Accounting for Stock Issued to Employees", (APB No. 25) but requires pro forma disclosure in the notes to the financial statements as if the measurement provisions of SFAS 123 had been adopted. The Company accounts for its stock-based employee compensation in accordance with APB No. 25. Stock-based compensation related to options granted to nonemployees is accounted for using the fair value method in accordance with the SFAS 123 and Emerging Issues Task Force No. 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services".

The following table illustrates the effect to net (loss) income attributable to common stockholders and net (loss) income attributable to common stockholders per common share if the Company had applied the fair value recognition provisions of SFAS 123 to stock-based compensation.

Three Months Ended		Nine Months Ended	
September 30,		September 30,	
2003	2004	2003	2004

(Unaudited)

(In thousands, except per share amounts)

Pro forma net (loss)					
----------------------	--	--	--	--	--



income attributable to common stockholders :								
As reported	\$	(1,940)	\$	3,480	\$	(10,369)	\$	(1,027)
Add: Stock-based compensation included in reported net (loss) income attributable to common stockholders		105		44		306		155
Deduct: Stock-based compensation expense determined under fair value-based method for all awards		(1,229)		(1,327)		(3,589)		(3,492)
Pro forma net (loss) income attributable to common stockholders	\$	(3,064)	\$	2,197	\$	(13,652)	\$	(4,364)
Net (loss) income attributable to common stockholders per common share:								
Basic — as reported	\$	(0.35)	\$	0.14	\$	(1.88)	\$	(0.08)
Basic — pro forma	\$	(0.56)	\$	0.09	\$	(2.48)	\$	(0.34)
Diluted — as reported	\$	(0.35)	\$	0.12	\$	(1.88)	\$	(0.08)
Diluted — pro forma	\$	(0.56)	\$	0.08	\$	(2.48)	\$	(0.34)



**BLACKBOARD INC.**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

The effect of applying SFAS 123 on pro forma net (loss) income as stated above is not necessarily representative of the effects on reported net (loss) income for future years due to, among other things, the vesting period of the stock options and the fair value of additional options to be granted in future years.

The fair value of each option is estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions used for grants issued during the three and nine months ended September 30, 2003 and 2004: dividend yield, 0%; expected volatility, 85%; average risk-free interest rate, 3.00%; and expected term, five years.

During February 2004, the Company granted 363,602 options to employees with an exercise price of \$9.98. As a result of these stock options being granted with an exercise price less than the fair value of the underlying common stock as determined by the Company, the Company recorded deferred compensation of approximately \$218,000 in 2004 and is amortizing this amount into expense over the option vesting period of four years.

In March 2004, the Company adopted the 2004 Stock Incentive Plan and reserved 1,887,692 shares of common stock under the plan. The Company's officers, employees, directors, outside consultants and advisors are eligible to receive grants under the plan. The plan expires March 2014.

**4. Inventories**

Inventories consist of the following:

	December 31, 2003	September 30, 2004
		(Unaudited)
		(In thousands)
Raw materials	\$ 840	\$ 654
Work-in-process	294	482
Finished goods	1,031	1,118
	2,165	2,254
Less reserve for obsolescence	(115)	(132)
Inventories, net	\$ 2,050	\$ 2,122

**BLACKBOARD INC.**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

**5. Goodwill and Intangible Assets**

Goodwill and intangible assets consist of the following:

	December 31, 2003	September 30, 2004
		(Unaudited)
	(In thousands)	
Goodwill	\$ 10,252	\$ 10,252
Intangible assets:		
Acquired technology	10,400	10,400
Contracts and customer lists	5,443	5,443
Non-compete agreements	2,043	2,043
Trademarks and domain names	71	71
Subtotal	\$ 17,957	\$ 17,957
Less accumulated amortization	(13,614)	(16,253)
Intangible assets, net	\$ 4,343	\$ 1,704

Intangible assets from acquisitions are amortized over three to five years. Amortization expense related to intangible assets was approximately \$4,313,000 and \$2,638,000 for the nine months ended September 30, 2003 and September 30, 2004, respectively. Amortization expense related to intangible assets for the years ended December 31, 2004, 2005, 2006, 2007 and 2008 is expected to be approximately \$3,523,000, \$266,000, \$266,000, \$266,000 and \$22,000, respectively.

**6. Debt**

***Working Capital and Equipment Lines of Credit***

On August 30, 2004, the Company entered into a Ninth Amendment to the Amended and Restated Loan and Security Agreement between the Company and Silicon Valley Bank, dated as of November 30, 2001, as amended (the "Amendment"). Pursuant to the Amendment, Silicon Valley Bank has agreed to (i) extend the Agreement from August 30, 2004 to November 30, 2004 and (ii) increase the maximum principal amount of the equipment line of credit under the

Agreement from \$1,500,000 to \$4,000,000. As of September 30, 2004, no amount was outstanding on the working capital line of credit and \$8,000,000 was available for borrowing, subject to covenants and restrictions. As of September 30, 2004, \$974,000 was outstanding on the equipment line of credit and \$2,500,000 was available for borrowing, subject to covenants and restrictions.

***Note Payable***

On July 1, 2004, the Company made the final principal and interest payment of \$1,016,250 to The George Washington University in connection with the Company's acquisition of Prometheus in January 2002.

**7. Commitments and Contingencies**

The Company, from time to time, is subject to litigation relating to matters in the ordinary course of business. The Company believes that any ultimate liability resulting from these contingencies will not have a material adverse effect on the Company's results of operations, financial position or cash flows.

**BLACKBOARD INC.**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

**8. Stockholders' (Deficit) Equity**

In April 2004, the Company issued 27,447 shares of common stock to The George Washington University pursuant to an anti-dilution provision in the Prometheus sale agreement from 2002 and as a result of the exercises of certain Series E Warrants in connection with the Company's initial public offering, or IPO.

On June 16, 2004, the Company issued 21,372 shares of common stock upon exercise of warrants held by a certain stockholder.

The Company completed an IPO of 6,325,000 shares of common stock in June 2004, which included the underwriter's over-allotment option exercise of 825,000 shares of common stock. Of the 6,325,000 shares of common stock sold in the IPO, 2,251,062 shares were sold by selling shareholders and 4,073,938 shares were sold by Blackboard Inc., generating approximately \$50,896,000 in proceeds to the Company, net of offering expenses and underwriters discounts. Upon closing of the IPO, 13,371,980 shares of common stock were issued upon conversion of the Company's preferred stock and 2,414,857 shares of common stock were issued in satisfaction of accrued dividends on the Company's preferred stock.

Upon closing of the IPO, our Amended and Restated Certificate of Incorporation became effective. The Amended and Restated Certificate of Incorporation authorized common stock of 200,000,000 shares and authorized 5,000,000 shares of undesignated preferred stock. No shares of preferred stock were outstanding at September 30, 2004.

On June 23, 2004, in connection with the IPO, the Company issued 1,199,334 shares of common stock upon cashless exercises of Series E warrants held by certain stockholders.

On June 30, 2004, the Company issued 23,082 shares of common stock upon a cashless exercise of warrants held by a certain stockholder.

In August 2004, the Company issued 110,997 shares of common stock upon cashless exercises of warrants held by certain stockholders.

**9. Income Taxes**

During 2004, the Internal Revenue Service issued an Internal Revenue Bulletin — Revenue Procedure 2004-34 (Rev Proc 2004-34), which allows for greater consistency between GAAP and income tax revenue recognition for companies that recognize revenues in a ratable manner. During the three months ended September 30, 2004, the Company determined that it will adopt Rev Proc 2004-34 for its 2004 and subsequent income tax filings. As a result of this adoption, the Company will recognize cumulative income tax expense adjustments, which will decrease its federal and state taxable income by approximately \$34.0 million. The benefit for income taxes for the three months ended September 30, 2004 reflects the benefit of this adoption on the Company's 2004 tax liability.

## BLACKBOARD INC.

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

*This report contains forward-looking statements. For this purpose, any statements contained herein that are not statements of historical fact may be deemed to be forward-looking statements. Without limiting the foregoing, the words "believes," "anticipates," "plans," "expects," "intends" and similar expressions are intended to identify forward-looking statements. The important factors discussed under the caption "Risk Factors," presented below, could cause actual results to differ materially from those indicated by forward-looking statements made herein. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.*

#### **General**

We are a leading provider of enterprise software applications and related services to the education industry. Our clients use our software to integrate technology into the education experience and campus life, and to support activities such as a professor assigning digital materials on a class website; a student collaborating with peers or completing research online; an administrator managing a departmental website; or a merchant conducting cash-free transactions with students and faculty through pre-funded debit accounts. Our clients include colleges, universities, schools and other education providers, as well as textbook publishers and student-focused merchants who serve these education providers and their students.

We generate revenues from sales and licensing of products and professional services. Our product revenues consist principally of revenues from annual software licenses, client hosting engagements and the sale of bundled software-hardware systems. We typically sell our licenses and hosting services under annually renewable agreements and our clients generally pay the annual fees at the beginning of the contract term. We recognize revenues from these agreements, as well as revenues from bundled software-hardware systems, which do not recur, ratably over the contractual term, which is typically 12 months. Billings associated with licenses and hosting services are recorded initially as deferred revenues and then recognized ratably into revenues over the contract term. We also generate product revenues from the sale and licensing of third-party software and hardware that is not bundled with our software. These revenues are generally recognized upon shipment of the products to our clients.

We derive professional services revenues primarily from training, implementation, installation and other consulting services. Substantially all of our professional services are performed on a time-and-materials basis. We recognize these revenues as the services are performed.

We typically license our individual applications either on a stand-alone basis or bundled as part of either of two suites, the *Blackboard Academic Suite™* and the *Blackboard Commerce Suite™*. The *Blackboard Academic Suite* includes the *Blackboard Learning System*, the *Blackboard Community System* (formerly known as *Blackboard Portal System*) and the *Blackboard Content System*. The *Blackboard Commerce Suite* includes the *Blackboard Transaction System*, the *Blackboard Community System* and *Blackboard One*. We generally price our software licenses on the basis of full-time equivalent students or users. Accordingly, annual license fees are generally greater for larger institutions.

Our operating expenses consist of cost of product revenues, cost of professional services revenues, research and development expenses, sales and marketing expenses, general and

administrative expenses, amortization of intangibles resulting from acquisitions and stock-based compensation expenses.

Major components of our cost of product revenues include license and other fees that we owe to third parties upon licensing software, and the cost of hardware that we bundle with our software. We initially defer these costs and recognize them into expense over the period in which the related revenue is recognized. Cost of product revenues also includes amortization of internally developed technology available for sale, employee compensation and benefits for personnel supporting our hosting, support and production functions, as well as related facility rent, communication costs, utilities, depreciation expense and cost of external professional services used in these functions. All of these costs are expensed as incurred. The costs of third-party software



and hardware that is not bundled with software are also expensed when incurred, normally upon delivery to our client. Cost of product revenues excludes the amortization of acquired technology recognized from acquisitions, which is included in amortization of intangibles resulting from acquisitions.

Cost of professional services revenues primarily includes the costs of compensation and benefits for employees and external consultants who are involved in the performance of professional services engagements for our clients, as well as travel and related costs, facility rent, communication costs, utilities and depreciation expense used in these functions. All of these costs are expensed as incurred.

Research and development expenses include the costs of compensation and benefits for employees who are associated with the creation and testing of the products we offer, as well as the costs of external professional services, travel and related costs attributable to the creation and testing of our products, related facility rent, communication costs, utilities and depreciation expense. All of these costs are expensed as incurred.

Sales and marketing expenses include the costs of compensation, including bonuses and commissions, and benefits for employees who are associated with the generation of revenues, as well as marketing expenses, costs of external marketing-related professional services, facility rent, utilities, communications and travel attributable to those sales and marketing employees in the generation of revenues. All of these costs are expensed as incurred.

General and administrative expenses include the costs of compensation and benefits for employees in the human resources, legal, finance and accounting, management information systems, facilities management, executive management and other administrative functions who are not directly associated with the generation of revenues or the creation and testing of products. In addition, general and administrative expenses include the costs of external professional services and insurance, as well as related facility rent, communication costs, utilities and depreciation expense used in these functions.

Amortization of intangibles includes the amortization of costs associated with products, acquired technology, customer lists, non-compete agreements and other identifiable intangible assets. These intangible assets were recorded at the time of our acquisitions and relate to contractual agreements, technology and products that we continue to utilize in our business.

Stock-based compensation expenses relate to historic stock option grants and have arisen primarily as a result of options granted below fair market value, modifications made to outstanding options and options granted to non-employees.

#### **Critical Accounting Policies and Estimates**

The discussion of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States, or GAAP. During the preparation of these consolidated financial statements, we are required to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates and assumptions, including those related to revenue recognition, bad debts, fixed assets, long-lived assets, including goodwill, and income taxes. We base our estimates on historical experience and on various other assumptions that we believe are reasonable under the circumstances. The results of our analysis form the basis for making assumptions about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions, and the impact of such differences may be material to our consolidated financial statements. Our critical accounting policies have been discussed with the audit committee of our board of directors.

We believe that the following critical accounting policies affect the more significant judgments and estimates used in the preparation of our consolidated financial statements:

*Revenue recognition.* Our revenues are derived from two sources: product sales and professional services sales. Product revenues include software license, hardware, premium support and maintenance, and hosting

revenues. Professional services revenues include training and consulting services. We recognize software license and maintenance revenues in accordance with the American Institute of Certified Public Accountants' Statement of Position, or SOP 97-2, "*Software Revenue Recognition*", as modified by SOP 98-9, "*Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transactions*". Our software does not require significant modification and customization services. Where services are not essential to the functionality of the software, we begin to recognize software licensing revenues when all of the following criteria are met: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred; (3) the fee is fixed and determinable; and (4) collectibility is probable.

We do not have vendor-specific objective evidence, or VSOE, of fair value for our support and maintenance separate from our software. Accordingly, when licenses are sold in conjunction with our support and maintenance, we recognize the license revenue over the term of the maintenance service period.

We sell hardware in two types of transactions: sales of hardware in conjunction with our software licenses, which we refer to as bundled hardware-software systems, and sales of hardware without software, which generally involve the resale of third-party hardware. After any necessary installation services are performed, hardware revenues are recognized when all of the following criteria are met: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred; (3) the fee is fixed and determinable; and (4) collectibility is probable. We have not determined VSOE of the fair value for the separate components of bundled hardware-software systems. Accordingly, when a bundled hardware-software system is sold, all revenue is recognized over the term of the maintenance service period. Hardware sales without software are recognized upon delivery of the hardware to our client.

Hosting revenues are recorded in accordance with Emerging Issues Task Force, or EITF 00-3, "*Application of AICPA SOP 97-2 to Arrangements That Include the Right to Use Software Stored on Another Entity's Hardware*". We recognize hosting fees and set-up fees ratably over the term of the hosting agreement.

We recognize professional services revenues, which are generally contracted on a time-and-materials basis and consist of training, implementation and installation services, as the services are provided.

We do not offer specified upgrades or incrementally significant discounts. Advance payments are recorded as deferred revenue until the product is shipped, services are delivered or obligations are met and the revenue can be recognized. Deferred revenues represent the excess of amounts invoiced over amounts recognized as revenues. We provide non-specified upgrades of our product only on a when-and-if-available basis.

*Allowance for uncollectible accounts.* We maintain an allowance for uncollectible accounts for estimated losses resulting from the inability, failure or refusal of our clients to make required payments. We analyze accounts receivable, historical percentages of uncollectible accounts and changes in payment history when evaluating the adequacy of the allowance for uncollectible accounts. We use an internal collection effort, which may include our sales and services groups as we deem appropriate, in our collection efforts. Although we believe that our reserves 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, which will result in increased expense in the period in which such determination is made.

*Long-lived assets.* We record our long-lived assets, such as property and equipment, at cost. We review the carrying value of our long-lived assets for possible impairment whenever events or changes in circumstances indicate that the carrying amount of assets may not be recoverable in accordance with the provisions of SFAS No. 144, "*Accounting for the Impairment or Disposal of Long-Lived Assets*". We evaluate these assets by examining estimated future cash flows to

determine if their current recorded value is impaired. We evaluate these cash flows by using weighted probability techniques as well as comparisons of past performance against projections. Assets may also be evaluated by identifying independent market values. If we determine that an asset's carrying value is impaired, we will record a write-down of the carrying value of the identified asset and charge the impairment as an operating expense in the period in which the determination is made. Although we believe that the carrying values of our long-lived assets are appropriately stated, changes in strategy or market

conditions or significant technological developments could significantly impact these judgments and require adjustments to recorded asset balances.

*Goodwill.* We assess the impairment of goodwill in accordance with SFAS No. 142, "Goodwill and Other Intangible Assets". Accordingly, we test our goodwill for impairment annually on October 1, or whenever events or changes in circumstances indicate an impairment may have occurred, by comparing its fair value to its carrying value. Impairment may result from, among other things, deterioration in the performance of the acquired business, adverse market conditions, adverse changes in applicable laws or regulations, including changes that restrict the activities of the acquired business, and a variety of other circumstances. If we determine that an impairment has occurred, we are required to record a write-down of the carrying value and charge the impairment as an operating expense in the period the determination is made. Although we believe goodwill is appropriately stated in our consolidated financial statements, changes in strategy or market conditions could significantly impact these judgments and require an adjustment to the recorded balance.

*Stock-based compensation.* We account for stock-based employee compensation arrangements in accordance with the provisions of APB Opinion No. 25, "Accounting for Stock Issued to Employees", and related interpretations, and comply with the disclosure provisions of SFAS No. 123, "Accounting for Stock-Based Compensation", as modified by SFAS No. 148, "Accounting for Stock-Based Compensation — Transition and Disclosure, an amendment of SFAS No. 123". Several companies recently elected to change their accounting policies and record the fair value of options as an expense. We currently are not required to record stock-based compensation charges if the employee stock option exercise price or restricted stock purchase price equals or exceeds the deemed fair value of our common stock at the grant date. Because no market for our common stock existed prior to our IPO, our board of directors determined the fair value of our common stock based upon several factors, including our operating performance, anticipated future operating results, the terms of redeemable convertible preferred stock issued by us, including the liquidation value and other preferences of our preferred stockholders, as well as the valuations of other companies.

On October 13, 2004, the Financial Accounting Standards Board concluded that Statement 123R, "Share-Based Payment" (Statement 123R), which would require all companies to measure compensation cost for all share-based payments (including employee stock options) at fair value, would be effective for public companies (except small business issuer as defined in SEC Regulation S-B) for interim or annual periods beginning after June 15, 2005. Retroactive application of the requirements of SFAS 123 (not Statement 123R) to the beginning of the fiscal year that includes the effective date would be permitted, but not required. If we had estimated the fair value of the options on the date of grant using the Black-Scholes pricing model and then amortized this estimated fair value over the vesting period of the options, our net (loss) income attributable to common stockholders would have changed, as shown in the table below.

Three Months Ended		Nine Months Ended	
September 30,		September 30,	
2003	2004	2003	2004

(Unaudited)

(In thousands, except per share amounts)

Pro forma net (loss) income attributable to common stockholders:								
As reported	\$	(1,940)	\$	3,480	\$	(10,369)	\$	(1,027)
Add: Stock-based compensation included in reported net loss attributable to common stockholders		105		44		306		155
Deduct: Stock-based compensation expense determined under fair value-based method for all awards		(1,229)		(1,327)		(3,589)		(3,492)
Pro forma net (loss) income attributable to common stockholders	\$	(3,064)	\$	2,197	\$	(13,652)	\$	(4,364)
Net (loss) income attributable to common stockholders per common share:								
Basic — as reported	\$	(0.35)	\$	0.14	\$	(1.88)	\$	(0.08)
Basic — pro forma	\$	(0.56)	\$	0.09	\$	(2.48)	\$	(0.34)
Diluted — as reported	\$	(0.35)	\$	0.12	\$	(1.88)	\$	(0.08)
Diluted — pro forma	\$	(0.56)	\$	0.08	\$	(2.48)	\$	(0.34)

*Accounting for income taxes.* In preparing our consolidated financial statements, we assess the likelihood that our deferred tax assets will be realized from future taxable income. We establish a valuation allowance if we determine that it is more likely than not that some portion or all of the net deferred tax assets will not be realized. We have included changes in the valuation allowance in our statements of operations as provision for or benefit from income taxes. We exercise significant judgment in determining our provisions for income taxes, our deferred tax assets and liabilities and our future taxable income for purposes of assessing our ability to utilize any future tax benefit from our deferred tax assets. Although we believe that our tax estimates are reasonable, the ultimate tax determination involves significant judgments that could become subject to audit by tax authorities in the ordinary course of business. As of December 31, 2003, we had a valuation allowance of \$33.7 million to reduce our deferred tax assets. The valuation allowance primarily relates to deferred tax assets arising from operating loss carryforwards and the book treatment compared to tax treatment of deferred revenues. Should we generate taxable income in the future, we may be able to realize all or part of the operating loss carryforwards against which we have applied the valuation allowance. In that event, our current income tax expense would be reduced or our income tax benefits would be increased, resulting in an increase in net income or a reduction in net loss.

During 2004, the Internal Revenue Service issued an Internal Revenue Bulletin — Revenue Procedure 2004-34 (Rev Proc 2004-34), which allows for greater consistency between GAAP and income tax revenue recognition for companies that recognize revenues in a ratable manner. During the three months ended September 30, 2004, we determined that we will adopt this method for our 2004 and subsequent income tax filings. As a result of this adoption, we will recognize cumulative income tax expense adjustments that will decrease our federal and state taxable income by approximately \$34.0 million. The benefit for income taxes for the three months ended September 30, 2004 reflects the benefit of this adoption on our 2004 tax liability.

#### **Important Factors Considered by Management**

We consider several factors in evaluating both our financial position and our operating performance. These factors, while primarily focused on relevant financial information, also include other measures such as general market and economic conditions, competitor information and the status of the regulatory environment.

To understand our financial results, it is important to understand our business model and its impact on our consolidated financial statements. The accounting for the majority of our contracts requires us to initially record deferred revenue on our consolidated balance sheet upon invoicing the sale and then to recognize revenue in subsequent periods ratably over the term of the contract in our consolidated statements of operations. Therefore, to better understand our operations, one must look at both revenues and deferred revenues.

In evaluating our product revenues, we analyze them in three categories: recurring ratable revenues, non-recurring ratable revenues and other product revenues.

- Recurring ratable revenues include those product revenues that are recognized ratably over the contract term, which is typically one year, and that recur each year assuming clients renew their contracts. These revenues include revenues from the licensing of all of our software products and from our hosting arrangements.
- Non-recurring ratable revenues include those product revenues that are recognized ratably over the term of the contract, which is typically one year, but that do not contractually recur. These revenues include the hardware components of our *Blackboard Transaction System* products, with and without our embedded software, and third-party hardware and software sold to our clients in conjunction with our software licenses.

- Other product revenues include those product revenues that are recognized as earned and are not deferred to future periods. These revenues include *Blackboard One* sales, *Blackboard Transaction System* supplies and commissions we earn from publishers related to digital course supplement downloads. Each of these individual revenue streams has historically been insignificant.



In the case of both recurring ratable revenues and non-recurring ratable revenues, an increase or decrease in the revenues in one period would be attributable primarily to increases or decreases in sales in prior periods. Unlike recurring ratable revenues, which benefit both from new license sales and from license renewals, non-recurring ratable revenues primarily reflect one-time sales that do not renew.

Other factors that we consider in making strategic cash flow and operating decisions include cash flows from operations, capital expenditures, total operating expenses and earnings.

### Results of Operations

The following table sets forth selected unaudited statement of operations data expressed as a percentage of total revenues for each of the periods indicated.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2003	2004	2003	2004
Revenues:				
Product	87 %	86 %	89 %	88 %
Professional services	13	14	11	12
Total revenues	100	100	100	100
Operating expenses:				
Cost of product revenues	25	23	25	23
Cost of professional services revenues	9	8	7	8
Research and development	12	12	12	13
Sales and marketing	30	30	33	33
General and administrative	14	13	18	13
Amortization of intangibles resulting from	6	3	6	3

acquisitions				
Stock-based compensation	0	0	1	0
Total operating expenses	96	89	102	93
Income (loss) from operations	4 %	11 %	(2) %	7 %

**Three Months Ended September 30, 2004 Compared to Three Months Ended September 30, 2003**

*Revenues.* Our total revenues for the three months ended September 30, 2004 were \$29.8 million, representing an increase of \$4.2 million, or 16.4%, as compared to \$25.6 million for the three months ended September 30, 2003.

Product revenues, including domestic and international, for the three months ended September 30, 2004 were \$25.5 million, representing an increase of \$3.3 million, or 14.7%, as compared to \$22.2 million for the three months ended September 20, 2003. A detail of our total product revenues by classification is as follows:

	Three Months Ended September 30,	
	2003	2004
	(In millions)	
Recurring ratable revenues	\$ 15.7	\$ 19.4
Non-recurring ratable revenues	5.5	5.0
Other product revenues	1.0	1.1
Total product revenues	\$ 22.2	\$ 25.5

The increase in recurring ratable revenues was primarily due to a \$1.5 million increase in revenues from *Blackboard Learning System* licenses, a \$700,000 increase in hosting revenues, a \$500,000 increase in revenues from *Blackboard Community System* licenses, a \$400,000 increase in revenues from *Blackboard Content System* licenses and a \$400,000 increase in revenues from *Blackboard Transaction System* licenses. These increases in revenues were attributable to prior period sales to new and existing clients.

The increase in *Blackboard Learning System* license revenue was also attributable to the continued shift from the *Blackboard Learning System — Basic Edition™* to the enterprise version of the *Blackboard Learning System*. The enterprise version of the *Blackboard Learning System* has additional functionality that is not available in the *Blackboard Learning System — Basic Edition* and consequently some *Blackboard Learning System — Basic Edition* clients upgrade to the *Blackboard Learning System*. Licenses of the enterprise version of the *Blackboard Learning System* have higher average pricing, which normally results in at least twice the contractual value as compared to a *Blackboard Learning System — Basic Edition* license.

The decrease in non-recurring ratable revenues was primarily due to a decrease in sales and shipments of *Blackboard Transaction System* hardware during the three months ended September 30, 2004 as compared to prior periods. Other product revenues were relatively consistent between the periods.

Of our total revenues, our total international revenues for the three months ended September 30, 2004 were \$4.0 million, representing an increase of \$826,000, or 25.9%, as compared to \$3.2 million for the three months ended September 30, 2003. International product revenues, which consist primarily of recurring ratable revenues, were \$3.6 million for the three months ended September 30, 2004, representing an increase of \$758,000 or 27.0%, as compared to \$2.8 million for the three months ended September 30, 2003. The increase in international revenues was driven primarily by an increase in recurring ratable revenues. The increase in international recurring ratable revenues was primarily due to an increase in international revenues from *Blackboard Learning System* licenses resulting primarily from a prior period sale to one large international client. Further, the increase in international revenues also reflects our investment in increasing the size of our international sales force and international marketing efforts during 2003 and 2004, which expanded our international presence and enabled us to sell more of our products to new and existing clients in our international markets.

Professional services revenues for the three months ended September 30, 2004 were \$4.3 million, representing an increase of \$944,000, or 28.1%, as compared to \$3.4 million for the three months ended September 30, 2003. The increase in professional services revenues was primarily attributable to an increase in the number and size of service engagements, which is directly related to the increase in the number of *Blackboard Learning System* enterprise version licensees, which generally purchase greater volumes of our service offerings.

*Cost of product revenues.* Our cost of product revenues for the three months ended September 30, 2004 was \$6.8 million, representing an increase of \$285,000, or 4.4%, as compared to \$6.5 million for the three months ended September 30, 2003. The increase in costs of product revenues was primarily due to a \$700,000 increase in our technical support group expenses primarily due to increased personnel-related costs to provide improved service to our clients and a \$250,000 increase in costs related to the *Blackboard Content System*. These increases were primarily offset by a decrease in *Blackboard Transaction System* hardware costs due to the decrease in sales and shipments of *Blackboard Transaction System* hardware during the three months ended September 30, 2004 as compared to prior periods. Cost of product revenues as a percentage of product revenues decreased to 26.7% for the three months ended September 30, 2004 from 29.4% for the three months ended September 30, 2003, due primarily to the decrease in *Blackboard Transaction System* hardware sales and shipments during the

three months ended September 30, 2004. *Blackboard Transaction System* hardware sales generally have lower gross margins than our software product sales.

*Cost of professional services revenues.* Our cost of professional services revenues for the three months ended September 30, 2004 was \$2.4 million, representing an increase of \$192,000, or 8.8%, from \$2.2 million for the three months ended September 30, 2003. The increase in cost of professional services revenues is primarily due to a \$400,000 increase in personnel-related costs due to an increase in headcount and salaries, offset by a \$250,000 decrease in subcontractor costs. Cost of professional services revenues as a percentage of

professional services revenues decreased to 55.2% for the three months ended September 30, 2004 from 65.0% for the three months ended September 30, 2003. The decrease in cost of professional services revenues as a percentage of professional services revenues is primarily due to an increase in utilization rates, an increase in hourly bill rates and a decrease in subcontractor costs for the three months ended September 30, 2004 as compared to the three months ended September 30, 2003.

*Research and development expenses.* Our research and development expenses for the three months ended September 30, 2004 were \$3.5 million, representing an increase of \$557,000, or 18.6%, as compared to \$3.0 million for the three months ended September 30, 2003. The increase in research and development expenses was primarily attributable to a \$200,000 increase in professional services costs and a \$200,000 increase in personnel-related costs for the three months ended September 30, 2004 as compared to the three months ended September 30, 2003. These increases are due to our continued development efforts to increase the functionality of our products.

*Sales and marketing expenses.* Our sales and marketing expenses for the three months ended September 30, 2004 were \$9.1 million, representing an increase of \$1.4 million, or 18.9%, as compared to \$7.6 million for the three months ended September 30, 2003. The increase in sales and marketing expenses was attributable to a \$560,000 increase in general marketing activities, a \$580,000 increase in sales and marketing personnel-related costs and a \$500,000 increase in reseller costs. These increases were offset by a \$350,000 decrease in bonus costs due to lower than expected quarterly sales attainment.

*General and administrative expenses.* Our general and administrative expenses for the three months ended September 30, 2004 were \$4.0 million, representing an increase of \$280,000, or 7.6%, as compared to \$3.7 million for the three months ended September 30, 2003. The increase in general and administrative expenses was due to a \$200,000 increase in professional services costs associated with being a public company and a \$130,000 increase in professional services costs related to the implementation of a new customer relationship management system.

*Net interest income (expense).* Our net interest income for the three months ended September 30, 2004 was \$136,000, compared to net interest expense of \$125,000 for the three months ended September 30, 2003. The increase in net interest income was primarily due to higher cash balances during the three months ended September 30, 2004 than the three months ended September 30, 2003 resulting from the receipt of proceeds from our IPO in June 2004 and repayment of outstanding debt during current and prior periods.

*Income taxes.* Our benefit for income taxes for the three months ended September 30, 2004 was \$250,000 compared to a provision for income taxes of \$300,000 for the three months ended September 30, 2003. During 2004, the Internal Revenue Service issued an Internal Revenue Bulletin — Revenue Procedure 2004-34, which allows for greater consistency between GAAP and income tax revenue recognition for companies that recognize revenues in a ratable manner. During the three months ended September 30, 2004, we determined that we will adopt this method for our 2004 and subsequent income tax filings. As a result of this adoption, we will recognize cumulative income tax expense adjustments which will decrease our federal and state taxable income by approximately \$34.0 million. The benefit for income taxes for the three months ended September 30, 2004 reflects the benefit of this adoption on our 2004 tax liability.

*Net income.* As a result of the foregoing, we reported net income of \$3.5 million for the three months ended September 30, 2004 compared to net income of \$591,000 for the three months ended September 30, 2003.

#### ***Nine Months Ended September 30, 2004 Compared to Nine Months Ended September 30, 2003***

*Revenues.* Our total revenues for the nine months ended September 30, 2004 were \$81.4 million, representing an increase of \$12.9 million, or 18.8%, as compared to \$68.5 million for the nine months ended September 30, 2003.

Product revenues, including domestic and international, for the nine months ended September 30, 2004 were \$71.4 million, representing an increase of \$10.2 million, or 16.6%, as compared to \$61.2 million for the nine months ended September 30, 2003. A detail of our total product revenues by classification is as follows:

	Nine Months Ended September 30,	
	2003	2004
	(In millions)	
Recurring ratable revenues	\$ 42.5	\$ 53.9
Non-recurring ratable revenues	15.2	14.6
Other product revenues	3.5	2.9
	61.2	71.4
Total product revenues	\$ 61.2	\$ 71.4

The increase in recurring ratable revenues was primarily due to a \$4.7 million increase in revenues from *Blackboard Learning System* licenses, a \$2.1 million increase in revenues from *Blackboard Transaction System* licenses, a \$2.0 million increase in hosting revenues, a \$1.7 million increase in revenues from *Blackboard Community System* licenses and a \$600,000 increase in *Blackboard Content System* licenses. These increases in revenues were attributable to prior period sales to new and existing clients.

The increase in *Blackboard Learning System* license revenue was also attributable to the continued shift from the *Blackboard Learning System — Basic Edition* to the enterprise version of the *Blackboard Learning System*. The enterprise version of the *Blackboard Learning System* has additional functionality that is not available in the *Blackboard Learning System — Basic Edition* and consequently some *Blackboard Learning System — Basic Edition* clients upgrade to the *Blackboard Learning System*. Licenses of the enterprise version of the *Blackboard Learning System* have higher average pricing, which normally results in at least twice the contractual value as compared to a *Blackboard Learning System — Basic Edition* license.

The decrease in non-recurring ratable revenues was primarily due to a decrease in sales and shipments of *Blackboard Transaction System* hardware during the nine months ended September 30, 2004 as compared to prior periods. The decrease in other product revenues was due to a decrease in publisher marketing fees related to revenues recognized during the nine months ended September 30, 2003 from a large non-recurring sale.

Of our total revenues, our total international revenues for the nine months ended September 30, 2004 were \$12.1 million, representing an increase of \$3.1 million, or 34.6%, as compared to \$9.0 million for the nine months ended September 30, 2003. International product revenues, which consist primarily of recurring ratable revenues, were \$10.5 million, representing an increase of \$2.4 million, or 35.8%, as compared to \$7.6 million for the nine months ended September 30, 2003. The increase in international revenues was driven primarily by an increase in recurring ratable revenues. This increase was primarily due to an increase in international

revenues from *Blackboard Learning System* licenses resulting from prior period sales to new and existing clients, including a prior period sale to one large client. The increase in international *Blackboard Learning System* revenues was primarily attributable to the same factors that contributed to the increase in overall *Blackboard Learning System* revenues. The increase in international revenues also reflects our investment in increasing the size of our international sales force and international marketing efforts during 2003 and 2004, which expanded our international presence and enabled us to sell more of our products to new and existing clients in our international markets.

Professional services revenues for the nine months ended September 30, 2004 were \$9.9 million, representing an increase of \$2.6 million, or 36.1%, as compared to \$7.3 million for the nine months ended September 30, 2003. The increase in professional services revenues was primarily attributable to an increase in the number and size of service engagements, which is directly related to the increase in the number of *Blackboard Learning System* enterprise version licensees, which generally purchase greater volumes of our service offerings.

*Cost of product revenues.* Our cost of product revenues for the nine months ended September 30, 2004 was \$18.8 million, representing an increase of \$1.4 million, or 7.9%, compared to \$17.4 million for the nine



months ended September 30, 2003. The increase in costs of product revenues was primarily due to a \$1.9 million increase in our technical support group expenses primarily due to increased personnel-related costs to provide improved service to our clients and a \$400,000 increase in costs related to the *Blackboard Content System*. These increases were offset by a \$600,000 decrease in *Blackboard Transaction System* hardware costs due to the decrease in sales and shipments of *Blackboard Transaction System* hardware during the three months ended September 30, 2004 as compared to the three months ended September 30, 2003 and lower sublicense costs on the renewal of our licenses. The cost of sublicenses is generally lower after the initial year of the sale. Cost of product revenues as a percentage of product revenues decreased to 26.4% for the nine months ended September 30, 2004 from 28.5% for the nine months ended September 30, 2003, due primarily to the decrease in *Blackboard Transaction System* hardware sales and shipments during the three months ended September 30, 2004 and lower sublicense costs. *Blackboard Transaction System* hardware sales have lower gross margins than our software product sales.

*Cost of professional services revenues.* Our cost of professional services revenues for the nine months ended September 30, 2004 was \$6.0 million, representing an increase of \$919,000, or 18.0%, from \$5.1 million for the nine months ended September 30, 2003. The increase in cost of professional services revenues is due to a \$500,000 increase in personnel-related costs due to an increase in headcount and salaries and a \$400,000 increase in subcontractor costs. Cost of professional services revenues as a percentage of professional services revenues decreased to 60.4% for the nine months ended September 30, 2004 from 69.7% for the nine months ended September 30, 2003. The decrease in cost of professional services revenues as a percentage of professional services revenues is primarily due to an increase in utilization rates and an increase in hourly bill rates for the nine months ended September 30, 2004 as compared to the nine months ended September 30, 2003.

*Research and development expenses.* Our research and development expenses for the nine months ended September 30, 2004 were \$10.4 million, representing an increase of \$2.0 million, or 23.6%, as compared to research and development expenses of \$8.4 million for the nine months ended September 30, 2003. The increase in research and development expenses was primarily attributable to a \$750,000 increase in personnel-related costs, a \$300,000 increase in relocation and recruiting costs and a \$305,000 increase in professional services. These increases are due to an increase in headcount and development efforts related to our continued efforts to increase the functionality of our products.

*Sales and marketing expenses.* Our sales and marketing expenses for the nine months ended September 30, 2004 were \$26.9 million, representing an increase of \$4.5 million, or 20.3%, as compared to sales and marketing expenses of \$22.4 million for the nine months ended September 30, 2003. The increase in sales and marketing expenses was attributable to a \$2.0 million increase in personnel-related costs due to increase in headcount and salaries, a \$1.3 million increase in general marketing activities, including our User Conference in March 2004 that was larger than in prior years, and a \$500,000 increase in reseller costs.

*General and administrative expenses.* Our general and administrative expenses for the nine months ended September 30, 2004 were \$10.7 million, representing a decrease of \$1.7 million, or 13.4%, as compared to general and administrative expenses of \$12.4 million for the nine months ended September 30, 2003. This decrease was due primarily to a \$900,000 decrease in legal and accounting expenses associated with litigation and international operations during the nine months ended September 30, 2003 and a \$600,000 decrease in personnel-related costs associated with movement of some personnel to other functional areas within the Company during 2003.

*Net interest income (expense).* Our net interest income for the nine months ended September 30, 2004 was \$57,000, compared to net interest expense of \$359,000 for the nine months ended September 30, 2003. The increase in net interest income was primarily due to

higher cash balances during the nine months ended September 30, 2004 than the nine months ended September 30, 2003 resulting from the receipt of proceeds from our IPO in June 2004 and repayment of outstanding debt during current and prior periods.

*Income taxes.* Our provision for income taxes for the nine months ended September 30, 2004 was \$362,000, compared to \$614,000 for the nine months ended September 30, 2003. During 2004, the Internal Revenue Service issued an Internal Revenue Bulletin — Revenue Procedure 2004-34, which allows for greater

consistency between GAAP and income tax revenue recognition for companies that recognize revenues in a ratable manner. During the three months ended September 30, 2004, we determined that we will adopt this method for our 2004 and subsequent income tax filings. As a result of this adoption, we will recognize cumulative income tax expense adjustments, which will decrease our federal and state taxable income by approximately \$34.0 million. The provision for income taxes for the nine months ended September 30, 2004 reflects the benefit of this adoption on our 2004 tax liability.

*Net income (loss).* As a result of the foregoing, we reported net income of \$5.3 million for the nine months ended September 30, 2004, compared to a net loss of \$2.8 million for the nine months ended September 30, 2003.

#### **Liquidity and Capital Resources**

We recognize revenues ratably on annually renewable agreements, which results in deferred revenues. Deferred revenues as of September 30, 2004 were \$67.0 million, representing an increase of \$14.1 million, or 26.6%, from \$52.9 million as of December 31, 2003. This increase was expected due to the seasonal variations in our business. We historically have lower sales to new and existing clients in our fourth quarter due to the timing of our clients' budget cycles and the renewal dates for our existing clients' annual licenses. Consequently, deferred revenues increased due to the higher volume of new sales to new and existing clients and the higher level of renewing licenses during the three months ended September 30, 2004 than the fourth quarter of 2003, offset by the recognition of revenues from prior period sales.

Our cash and cash equivalents were \$86.3 million at September 30, 2004 as compared to \$30.5 million at December 31, 2003.

Net cash provided by operating activities was \$20.4 million during the nine months ended September 30, 2004 as compared to \$9.3 million during the nine months ended September 30, 2003. This change was primarily due to increased sales to new and existing clients and improved collections during the nine months ended September 30, 2004 as compared to the nine months ended September 30, 2003.

Net cash used in investing activities was \$6.4 million during the nine months ended September 30, 2004, a decrease of \$1.6 million, or 20.3%, from \$8.0 million during the nine months ended September 30, 2003. This decrease in cash usage was primarily due to our payment of the \$4.5 million cash purchase price for the SA Cash division of Student Advantage, Inc. in January 2003. Exclusive of the SA Cash acquisition, investing activities increased \$2.9 million for the nine months ended September 30, 2004 as compared to the nine months ended September 30, 2003, primarily due to the purchase of internal telecommunications equipment and additional computer equipment for our hosting facility due to the increase in the number of clients purchasing our hosting offering.

Net cash provided by financing activities was \$41.8 million during the nine months ended September 30, 2004 as compared to net cash provided by financing activities of \$458,000 during the nine months ended September 30, 2003. This change was primarily due to the \$50.9 million in proceeds from our IPO in June 2004, net of offering costs, offset by the \$7.9 million repayment of our working capital line of credit in April 2004 and a total of \$2.0 million in payments to The George Washington University in January 2004 and July 2004.

We have an \$8.0 million working capital line of credit and a \$4.0 million equipment line of credit, each with Silicon Valley Bank. The working capital line of credit expires in November 2004, at which time we intend to negotiate a new working capital line of credit. The interest rate on the working capital line is equal to the prime rate, effectively 4.0% as of September 30, 2004, and the interest rate on new advances under the equipment line is 9.0%. Prior borrowings under the equipment line had interest rates ranging from 6.0% to 9.0%. Pursuant to the terms of these lines of credit, we must comply with financial covenants that require us to maintain on a quarterly basis: specified revenue amounts; a quick ratio of 1.5; and positive earnings before

interest, taxes, depreciation and amortization. For the nine months ended September 30, 2004, we are obligated to recognize revenues of at least \$22.3 million. We were in compliance with all covenants as of September 30, 2004. If we were not compliant with these covenants, the bank would have the right to

accelerate the debt under the equipment and working capital lines of credit. We have pledged all of our domestic assets to secure the working capital and equipment lines of credit. As of September 30, 2004, \$974,000 was outstanding on the equipment lines and there was no amount outstanding on the working capital line of credit, each subject to covenants and restrictions. As of September 30, 2004, we had \$8.0 million in borrowings available under the working capital line of credit and no amount was outstanding.

We believe our existing cash and cash equivalents and cash provided by operating activities will be sufficient to meet our working capital and capital expenditure needs over the next 12 months. Our future capital requirements will depend on many factors, including our rate of revenue growth, the expansion of our marketing and sales activities, the timing and extent of spending to support product development efforts and expansion into new territories, the timing of introductions of new products or services, the timing of enhancements to existing products and services and the timing of capital expenditures. To the extent that available funds are insufficient to fund our future activities, we may need to raise additional funds through public or private equity or debt financing. Although we are currently not a party to any agreement or letter of intent with respect to potential investments in, or acquisitions of, complementary businesses, services or technologies, we may enter into these types of arrangements in the future, which could also require us to seek additional equity or debt financing. Additional funds may not be available on terms favorable to us or at all.

#### **Seasonality**

Our operating results normally fluctuate as a result of seasonal variations in our business, principally due to the timing of client budget cycles and student attendance at client facilities. Historically, we have had lower new sales in our first and fourth quarters than in the remainder of our year. Our expenses, however, do not vary significantly with these changes and, as a result, such expenses do not fluctuate significantly on a quarterly basis. Historically, we have performed a disproportionate amount of our professional services, which are recognized as incurred, in our second and third quarters each year. In addition, deferred revenues can vary on a seasonal basis for the same reasons. We expect quarterly fluctuations in operating results to continue as a result of the uneven seasonal demand for our licenses and services offerings. This pattern may change, however, as a result of acquisitions, new market opportunities or new product introductions.

## RISK FACTORS

There are a number of important factors that could affect our business and future operating results, including without limitation, the factors set forth below. The information contained in this report should be read in light of such factors. Any of the following factors could harm our business and future operating results.

***We have only had a few profitable quarters and may never achieve sustained profitability.***

Although we have been profitable in the last five quarters on a net income basis, we have not yet been profitable for a full calendar year, and may not be profitable in future periods, either on a short- or long-term basis. We incurred a net loss of \$41.8 million, \$41.7 million and \$1.4 million for the years ended December 31, 2001, 2002 and 2003, respectively. As of September 30, 2004, we had an accumulated deficit of \$127.3 million. We can give no assurance that operating losses will not occur in the future or that we will ever sustain profitability on a quarterly or annual basis.

***Providing enterprise software applications to the education industry is an emerging and uncertain business; if the market for our products fails to develop, we will not be able to grow our business.***

Our success will depend on our ability to generate revenues by providing enterprise software applications and services to colleges, universities, schools and other education providers. This market has only recently developed and the viability and profitability of this market is unproven. Our ability to grow our business will be compromised if we do not develop and market products and services that achieve broad market acceptance with our current and potential clients and their students and employees. The use of online education, transactional or content management software applications and services in the education industry may not become widespread and our products and services may not achieve commercial success. Even if potential clients decide to implement products of this type, they may still choose to design, develop or manage all or a part of their system internally.

Given our clients' relatively early adoption of enterprise software applications aimed at the education industry, they are likely to be less risk-averse than most colleges, universities, schools and other education providers. Accordingly, the rate at which we have been able to establish relationships with our clients in the past may not be indicative of the rate at which we will be able to establish additional client relationships in the future.

***Some of our clients use our products to facilitate online education, which is a relatively new field; if online education does not continue to develop and gain acceptance, demand for our products could suffer.***

Our success will depend in part upon the continued adoption by our clients and potential clients of online education initiatives. Some academics and educators are opposed to online education in principle and have expressed concerns regarding the perceived loss of control over the education process that can result from offering courses online. Some of these critics, particularly college and university professors, have the capacity to influence the market for online education, and their opposition could reduce the demand for our products and services. In addition, the growth and development of the market for online education may prompt some members of the academic community to advocate more stringent protection of intellectual

property associated with course content, which may impose additional burdens on clients and potential clients offering online education. This could require us to modify our products, or could cause these clients and potential clients to abandon their online education initiatives.

***Our level of fixed expenses may cause us to incur operating losses if we are unsuccessful in achieving revenue growth.***

Our expense levels are based, in significant part, on our estimates of future revenues and are largely fixed in the short term. As a result, we may be unable to adjust our spending in a timely manner if our revenues fall short of our expectations. Accordingly, any significant shortfall of revenues in relation to our expectations would have an immediate and material effect on our results of operations. In addition, as our business grows, we anticipate increasing our operating expenses to expand our product development, technical support, sales

and marketing and administrative organizations. Any such expansion could cause material losses to the extent we do not generate additional revenues sufficient to cover the additional expenses.

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

Our clients have no obligation to renew their licenses for our products after the expiration of the initial license period, which is typically one year, and some clients have elected not to do so. A decline in license renewal rates could cause our revenues to decline. Although we have experienced favorable license renewal rates in recent periods, we have limited historical data with respect to rates of renewals, so we cannot accurately predict future renewal rates. Our license renewal rates may decline or fluctuate as a result of a number of factors, including client dissatisfaction with our products and services, our failure to update our products to maintain their attractiveness in the market or budgetary constraints or changes in budget priorities faced by our clients.

***If our newest product, the Blackboard Content System, does not gain widespread market acceptance, our financial results could suffer.***

We introduced our newest software application, the *Blackboard Content System*, in March 2004. Our ability to grow our business will depend, in part, on client acceptance of this product, which is currently unproven. If we are not successful in gaining widespread market acceptance of this product, our revenues may fall below our expectations, which could cause our stock price to decline.

***Because we generally recognize revenues ratably over the term of our contract with a client, downturns or upturns in sales will not be fully reflected in our operating results until future periods.***

We recognize most of our revenues from clients monthly over the terms of their agreements, which are typically 12 months, although terms can range from one month to 48 months. As a result, much of the revenue we report in each quarter is attributable to agreements entered into during previous quarters. Consequently, a decline in sales, client renewals, or market acceptance of our products in any one quarter will not necessarily be fully reflected in the revenues in that quarter, and will negatively affect our revenues and profitability in future quarters. This ratable revenue recognition also makes it difficult for us to rapidly increase our revenues through additional sales in any period, as revenues from new clients must be recognized over the applicable agreement term.

***Our operating margins may suffer if our professional services revenues increase in proportion to total revenues because our professional services revenues have lower gross margins.***

Because our professional services revenues typically have lower gross margins than our product revenues, an increase in the percentage of total revenues represented by professional services revenues could have a detrimental impact on our overall gross margins, and could adversely affect our operating results. In addition, we sometimes subcontract professional services to third parties, which further reduces our gross margins on these professional services.



As a result, an increase in the percentage of professional services provided by third-party consultants could lower our overall gross margins.

***If our products contain errors or if new product releases are delayed, we could lose new sales and be subject to significant liability claims.***

Because our software products are complex, they may contain undetected errors or defects, known as bugs. Bugs can be detected at any point in a product's life cycle, but are more common when a new product is introduced or when new versions are released. In the past, we have encountered product development delays

and defects in our products. We would expect that, despite our testing, errors will be found in new products and product enhancements in the future. Significant errors in our products could lead to:

- delays in or loss of market acceptance of our products;
- diversion of our resources;
- a lower rate of license renewals or upgrades;
- injury to our reputation; and
- increased service expenses or payment of damages.

Because our clients use our products to store and retrieve critical information, we may be subject to significant liability claims if our products do not work properly. We cannot be certain that the limitations of liability set forth in our licenses and agreements would be enforceable or would otherwise protect us from liability for damages. A material liability claim against us, regardless of its merit or its outcome, could result in substantial costs, significantly harming our business reputation and divert management's attention from our operations.

***The length and unpredictability of the sales cycle for our software could delay new sales and cause our revenues and cash flows for any given quarter to fail to meet our projections or market expectations.***

The sales cycle between our initial contact with a potential client and the signing of a license with that client typically ranges from 6 to 15 months. As a result of this lengthy sales cycle, we have only a limited ability to forecast the timing of sales. A delay in or failure to complete license transactions could harm our business and financial results, and could cause our financial results to vary significantly from quarter to quarter. Our sales cycle varies widely, reflecting differences in our potential clients' decision-making processes, procurement requirements and budget cycles, and is subject to significant risks over which we have little or no control, including:

- clients' budgetary constraints and priorities;
- the timing of our clients' budget cycles;
- the need by some clients for lengthy evaluations that often include both their administrators and faculties; and
- the length and timing of clients' approval processes.

Potential clients typically conduct extensive and lengthy evaluations before committing to our products and services and generally require us to expend substantial time, effort and money educating them as to the value of our offerings.

***Our sales cycle with international postsecondary education providers and U.S. K-12 schools may be longer than our historic U.S. postsecondary sales cycle, which could cause us to incur greater costs and could reduce our operating margins.***

As we target more of our sales efforts at international postsecondary education providers and U.S. K-12 schools, we could face greater costs, longer sales cycles and less predictability in completing some of our sales, which may harm our business. In both of these markets, a potential client's decision to use our products and services may be a decision involving multiple institutions and, if so, these types of sales would require us to provide greater levels of education to prospective clients regarding the use and benefits of our products and services. In addition, we expect that potential clients in both of these markets may demand more customization, integration services and features. As a result of these factors, these sales opportunities may require us to devote greater sales support and professional services resources to individual sales, thereby increasing the costs and time required to complete sales and diverting sales and professional services resources to a smaller number of international and U.S. K-12 transactions.

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***We may not be able to effectively manage our expanding operations, which could impair our ability to operate profitably.***

We may be unable to operate our business profitably if we fail to manage our growth. We have experienced significant expansion since our inception, which has sometimes strained our managerial, operational, financial and other resources. Future growth could continue to strain our resources. Our failure to successfully manage growth and to continue to refine our financial controls and accounting and reporting systems and to add and retain personnel that adequately support our growth would disrupt our business.

Our future success and our ability to pursue our growth strategy will depend to a significant extent on the continued service of our key management personnel, including Michael L. Chasen, our chief executive officer and president, and Matthew L. Pittinsky, our chairman. Although we have employment agreements with several of our executive officers, including Mr. Chasen and Mr. Pittinsky, these agreements do not obligate them to remain employed by us. The loss of services of any key management personnel could make it more difficult to successfully pursue our business goals.

***Our future success depends on our ability to continue to retain and attract qualified employees.***

Our future success depends upon the continued service of our key management, technical, sales and other critical personnel. Whether we are able to execute effectively on our business strategy will depend in large part on how well key management and other personnel perform in their positions and are integrated within our company. Key personnel have left our company over the years, and there may be additional departures of key personnel from time to time. In addition, as we seek to expand our global organization, the hiring of qualified sales, technical and support personnel has been difficult due to the limited number of qualified professionals. Failure to attract, integrate and retain key personnel would result in disruptions to our operations, including adversely affecting the timeliness of product releases, the successful implementation and completion of company initiatives and the results of our operations.

***If we do not maintain the compatibility of our products with third-party applications that our clients use in conjunction with our products, demand for our products could decline.***

Our software applications can be used with a variety of third-party applications used by our clients to extend the functionality of our products, which we believe contributes to the attractiveness of our products in the market. If we are not able to maintain the compatibility of our products with third-party applications, demand for our products could decline and we could lose sales. We may desire in the future to make our products compatible with new or existing third-party applications that achieve popularity within the education marketplace, and these third-party applications may not be compatible with our designs. Any failure on our part to modify our applications to ensure compatibility with such third-party applications would reduce demand for our products and services.

***If we are unable to protect our proprietary technology and other rights, it will reduce our ability to compete for business.***

If we are unable to protect our intellectual property, our competitors could use our intellectual property to market products similar to our products, which could decrease demand for our products. In addition, we may be unable to prevent the use of our products by persons who have not paid the required license fee, which could reduce our revenues. We rely on a combination of copyright, trademark and trade secret laws, as well as licensing agreements, third-party nondisclosure agreements and other contractual provisions and technical measures, to protect our intellectual property rights. These protections may not be adequate to prevent our competitors from copying or reverse-engineering our products. Our competitors may independently develop technologies that are substantially equivalent or superior to our technology. To protect our trade secrets and other proprietary information, we require employees, consultants, advisors and collaborators to enter into confidentiality agreements. These agreements may not provide meaningful protection for our trade secrets, know-how or other proprietary information in the event of any unauthorized use, misappropriation or disclosure of such trade secrets, know-how or other proprietary information. The protective mechanisms we

include in our products may not be sufficient to prevent unauthorized copying. Existing copyright laws afford only limited protection for our intellectual property rights and may not protect such rights in the event competitors independently develop products similar to ours. In addition, the laws of some countries in which our products are or may be licensed do not protect our products and intellectual property rights to the same extent as do the laws of the United States.

***If we are found to infringe the proprietary rights of others, we could be required to redesign our products, pay significant royalties or enter into license agreements with third parties.***

A third party may assert that our technology violates its intellectual property rights. As the number of software products in our markets increases and the functionality of these products further overlap, we believe that infringement claims will become more common. Any claims, regardless of their merit, could:

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

***Expansion of our business internationally will subject our business to additional economic and operational risks that could increase our costs and make it difficult for us to operate profitably.***

One of our key growth strategies is to pursue international expansion. Expansion of our international operations may require significant expenditure of financial and management resources and result in increased administrative and compliance costs. As a result of such expansion, we will be increasingly subject to the risks inherent in conducting business internationally, including:

- foreign currency fluctuations, which could result in reduced revenues and increased operating expenses;
- potentially longer payment and sales cycles;
- difficulty in collecting accounts receivable;
- the effect of applicable foreign tax structures, including tax rates that may be higher than tax rates in the United States or taxes that may be duplicative of those imposed in the United States;

- tariffs and trade barriers;
- general economic and political conditions in each country;
- inadequate intellectual property protection in foreign countries;
- uncertainty regarding liability for information retrieved and replicated in foreign countries;
- the difficulties and increased expenses in complying with a variety of foreign laws, regulations and trade standards; and
- unexpected changes in regulatory requirements.

***Unauthorized disclosure of data, whether through breach of our computer systems or otherwise, could expose us to protracted and costly litigation or cause us to lose clients.***

Maintaining the security of online education and transaction networks is an issue of critical importance for our clients because these activities involve the storage and transmission of proprietary and confidential client and student information, including personal student information and consumer financial data, such as credit card numbers. Individuals and groups may develop and deploy viruses, worms and other malicious software programs that attack or attempt to infiltrate our products. If our security measures are breached as a

result of third-party action, employee error, malfeasance or otherwise, we could be subject to liability or our business could be interrupted. Penetration of our network security could have a negative impact on our reputation and could lead our present and potential clients to choose competitive offerings. Even if we do not encounter a security breach ourselves, a well-publicized breach of the consumer data security of any major consumer Web site could lead to a general public loss of confidence in the use of the Internet, which could significantly diminish the attractiveness of our products and services.

***If we undertake business combinations and acquisitions, they may be difficult to integrate, disrupt our business, dilute stockholder value or divert management attention.***

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

As a result of these risks, we may not be able to achieve the expected benefits of any acquisition. If we are unsuccessful in completing or integrating acquisitions that we may pursue in the future, we would be required to reevaluate our growth strategy and we may have incurred substantial expenses and devoted significant management time and resources in seeking to complete and integrate the acquisitions.

Future business combinations could involve the acquisition of significant intangible assets. We currently record in our statements of operations ongoing significant amortization of intangible assets acquired in connection with our historic acquisitions, and may need to recognize similar charges in connection with any future acquisitions. In addition, we may need to record write-downs from future impairments of identified intangible assets and goodwill. These accounting charges would reduce any future reported earnings, or increase a reported loss. In addition, we could use substantial portions of our available cash to pay the purchase price for acquisitions. We could also incur debt to pay for acquisitions, or issue additional equity securities as consideration for these acquisitions, which could cause our stockholders to suffer significant dilution.

***Operational failures in our network infrastructure could disrupt our remote hosting service, could cause us to lose current hosting clients and sales to potential hosting clients and could result in increased expenses and reduced revenues.***

Unanticipated problems affecting our network systems could cause interruptions or delays in the delivery of the hosting product we provide to some of our clients. If there are operational failures in our network infrastructure that cause interruptions, slower response times or loss of data for our remotely hosted clients, we may be required to issue credits or pay penalties, current hosting clients may terminate their contracts or elect not to renew them, and we may lose sales to potential hosting clients. We provide remote hosting through computer hardware that is currently located in a third-party co-location facility in Vienna, Virginia. We do not control the operation of this co-location facility. Lengthy interruptions in our hosting service could be caused by the occurrence of a natural disaster, power loss, vandalism or other telecommunications problems at the co-location facility or if this co-location facility were to close without adequate notice. Although we have multiple transmission lines into the co-location facility



through two telecommunications service providers, we have experienced problems of this nature from time to time in the past, and we will continue to be exposed to the risk of network failures in the future.

We currently do not have adequate computer hardware and systems to provide alternative service for most of our hosted clients. Our current back-up system, located in our corporate headquarters in Washington, D.C., is vulnerable to risks similar to those faced at the co-location facility in Virginia, and its location close to the facility in Virginia means that many of the factors that could cause a failure of the Virginia facility

could also affect the back-up facility. Our back-up system has not been fully tested under actual disaster conditions. We have begun the process of securing another co-location facility for disaster recovery purposes, but we do not believe we will have a geographically remote back-up facility in operation before December 2004, if ever.

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

We operate in highly competitive markets and generally encounter intense competition to win contracts. If we are unable to successfully compete for new business and license renewals, our revenue growth and operating margins may decline. The markets for online education, transactional, portal and content management products are intensely competitive and rapidly changing, and barriers to entry in such markets are relatively low. With the introduction of new technologies and market entrants, we expect competition to intensify in the future. Some of our principal competitors offer their products at a lower price, which has resulted in pricing pressures. Such pricing pressures and increased competition generally could result in reduced sales, reduced margins or the failure of our product and service offerings to achieve or maintain more widespread market acceptance.

Our primary competitors for the *Blackboard Academic Suite* are companies that provide course management systems, such as WebCT, Inc., eCollege.com and Desire2Learn Inc., learning content management systems, such as HarvestRoad Ltd. and Concord USA, Inc., and education enterprise information portal technologies, such as SunGard SCT Inc., an operating unit of SunGard Data Systems Inc. We also face competition from clients and potential clients who develop their own applications internally. Our primary competitors for the *Blackboard Commerce Suite* are companies that provide university transaction systems, such as Diebold, Incorporated's Card Systems division and The CBORD Group, Inc., as well as off-campus merchant relationship programs.

We may also face competition from potential competitors that are substantially larger than we are and have significantly greater financial, technical and marketing resources, and established, extensive direct and indirect channels of distribution. As a result, they may be able to respond more quickly to new or emerging technologies and changes in client requirements, or to devote greater resources to the development, promotion and sale of their products than we can. In addition, current and potential competitors have established or may establish cooperative relationships among themselves or prospective clients. Accordingly, it is possible that new competitors or alliances among competitors may emerge and rapidly acquire significant market share to our detriment.

***If potential clients or competitors use open source software to develop products that are competitive with our products and services, we may face decreased demand and pressure to reduce the prices for our products.***

The growing acceptance and prevalence of open source software may make it easier for competitors or potential competitors to develop software applications that compete with our products, or for clients and potential clients to internally develop software applications that they would otherwise have licensed from us. One of the aspects of open source software is that it can be modified or used to develop new software that competes with proprietary software applications, such as ours. Such competition can develop without the degree of overhead and lead time required by traditional proprietary software companies. If potential clients use open

source software to internally develop software or if a current or potential competitor develops products using open source software that are competitive with our products and services, we may face decreased demand for our products and services.

***We could lose revenues if there are changes in the spending policies or budget priorities for government funding of colleges, universities, schools and other education providers.***

Most of our clients and potential clients are colleges, universities, schools and other education providers who depend substantially on government funding. Accordingly, any general decrease, delay or change in

federal, state or local funding for colleges, universities, schools and other education providers could cause our current and potential clients to reduce their purchases of our products and services, to exercise their right to terminate licenses, or to decide not to renew licenses, any of which could cause us to lose revenues. In addition, a specific reduction in governmental funding support for products such as ours would also cause us to lose revenues.

***U.S. and foreign government regulation of the Internet could cause us to incur significant expenses, and failure to comply with applicable regulations could make our business less efficient or even impossible.***

The application of existing laws and regulations potentially applicable to the Internet, including regulations relating to issues such as privacy, defamation, pricing, advertising, taxation, consumer protection, content regulation, quality of products and services and intellectual property ownership and infringement, can be unclear. It is possible that U.S., state and foreign governments might attempt to regulate Internet transmissions or prosecute us for violations of their laws. In addition, these laws may be modified and new laws may be enacted in the future, which could increase the costs of regulatory compliance for us or force us to change our business practices. Any existing or new legislation applicable to us could expose us to substantial liability, including significant expenses necessary to comply with such laws and regulations, and dampen the growth in use of the Internet.

Specific federal laws that could also have an impact on our business include the following:

- The Children's Online Protection Act and the Children's Online Privacy Protection Act restrict the distribution of certain materials deemed harmful to children and impose additional restrictions on the ability of online services to collect personal information from children under the age of 13; and
- The Family Educational Rights and Privacy Act imposes parental or student consent requirements for specified disclosures of student information, including online information.

Our clients' use of our software as their central platform for online education initiatives may make us subject to any such laws or regulations, which could impose significant additional costs on our business or subject us to additional liabilities.

***Our status under state and federal financial services regulation is currently unclear, and any violation of any present or future regulation could expose us to liability, force us to change our business practices or force us to stop selling or modify our products and services.***

Our transaction processing product and service offering could be subject to state and federal financial services regulation. The *Blackboard Transaction System* supports the creation and management of student debit accounts and the processing of payments against those accounts for both on-campus vendors and off-campus merchants. For example, one or more federal or state governmental agencies that regulate or monitor banks or other types of providers of electronic commerce services may conclude that we are engaged in banking or other financial services activities that are regulated by the Federal Reserve under the U.S. Federal Electronic Funds Transfer Act or Regulation E thereunder or by state agencies under similar state statutes or regulations. Regulatory requirements may include, for example:

- disclosure of our business policies and practices;

- restrictions on specified uses and disclosures of information;
- data security requirements;
- government registration; and
- reporting and documentation requirements.

A number of states have enacted legislation regulating check sellers, money transmitters or transaction settlement service providers as banks. If we were deemed to be in violation of any current or future regulations, we could be exposed to financial liability and adverse publicity or forced to change our business practices or stop selling some of our products and services. As a result, we could face significant legal fees, delays in

extending our product and services offerings, and damage to our reputation that could harm our business and reduce demand for our products and services. Even if we are not required to change our business practices, we could be required to obtain licenses or regulatory approvals that could cause us to incur substantial costs.

**Item 3. *Quantitative and Qualitative Disclosures About Market Risk.***

Our principal exposure to market risk relates to changes in interest rates. At September 30, 2004, we had no borrowings under our line of credit, which bears interest at a floating rate equal to the prime rate (4.0% as of September 2004). The fair value of our fixed rate long-term debt is sensitive to interest rate changes. Interest rate changes would result in increases or decreases in the fair value of our debt due to differences between market interest rates and rates in effect at the inception of our debt obligation. Changes in the fair value of our fixed rate debt have no impact on our cash flows or consolidated financial statements.

Interest income on our cash and cash equivalents is subject to interest rate fluctuations, but we believe that the impact of these fluctuations does not have a material effect on our financial position due to the short-term nature of these financial instruments. For the quarter ending September 30, 2004, a 100 basis-point adverse change in interest rates would not have had a material effect on our consolidated financial position, earnings or cash flows.

**Item 4. *Controls and Procedures.***

**Disclosure Controls and Procedures**

Our management, with the participation of our principal executive officer and principal financial officer, has evaluated 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 (the "Exchange Act")) as of September 30, 2004. Based on this evaluation, our principal executive officer and principal financial officer concluded that, as of September 30, 2004, these disclosure controls and procedures are effective and designed to ensure that the information required to be disclosed in our reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the requisite time periods.

**Changes in Internal Control over Financial Reporting**

There was no change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) identified in connection with the evaluation of our internal control that occurred during our last fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

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

During the period covered by this report, we issued the following equity securities under the exemptions from registration provided in Section 4(2) of the Securities Act and Regulation D promulgated thereunder:

On August 20, 2004, we issued 22,158 shares of our common stock to a warrant holder pursuant to the cashless exercise of a warrant held by the warrant holder.

On August 23, 2004, we issued 88,839 shares of our common stock to certain warrant holders pursuant to the cashless exercises of warrants held by such warrant holders.

The following table summarizes the expenses incurred by us in connection with our initial public offering in June 2004, none of which were paid to our directors, officers, general partners or their associates, persons owning 10% or more of our equity securities, or our affiliates:

Underwriting Discounts and Commissions	Expenses Paid to or for the Underwriters	Other Expenses	Total Expenses
\$ 3,992,459	\$ 50,000	\$ 2,097,037	\$ 6,139,496

Our net proceeds from our initial public offering after expenses were approximately \$50.9 million. From June 17, 2004 until September 30, 2004, we have not used any of the net proceeds. We have not made any specific plans with respect to the use of the remaining net proceeds of the offering. We will use the net proceeds from the offering for general corporate purposes, including working capital and capital expenditures. We may also use a portion of the net proceeds to acquire businesses, products or technologies that are complementary to our business. Since our June 17, 2004 offering, we have continued to collect outstanding receivables and generate positive cash flow from operations. As a result, our actual cash and cash equivalents as of September 30, 2004 were \$86.3 million.

### **Item 6. *Exhibits.***

(a) Exhibits:

Exhibit No.	Description
10.1(*)	Ninth Amendment to the Amended and Restated Loan and Security Agreement between Blackboard and Silicon Valley Bank
31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-

Oxley Act of 2002

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(\*) Incorporated herein by reference to the exhibits to the Company's Current Report on Form 8-K filed on September 2, 2004.

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**SIGNATURE**

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.

BLACKBOARD INC.

By: /s/ PETER Q. REPETTI

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Peter Q. Repetti  
*Chief Financial Officer*  
*(On behalf of the registrant and as Principal  
Financial Officer)*

Date: November 10, 2004

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