Form 10-Q

BLACKBOARD INC - BBBB

Filed: August 03, 2005 (period: June 30, 2005)

Quarterly report which provides a continuing view of a company's financial position

Table of Contents

PART I.

PART I

PART II.

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 June 30, 2005

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	**52-2081178**
(State or Other Jurisdiction of Incorporation or Organization)	*(I.R.S. Employer Identification No.)*
1899 L Street, N.W. Washington D.C.	**20036**
(Address of Principal Executive Offices)	*(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 July 29, 2005
Common Stock, $0.01 par value	26,918,879

Blackboard Inc.
Quarterly Report on Form 10-Q
For the Quarter Ended June 30, 2005
INDEX

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, 2004	June 30, 2005 (Unaudited)
	(In thousands)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 78,149	$ 58,887
Short-term investments	20,000	40,809
Accounts receivable, net of allowance for doubtful accounts of $954,000 and $1,179,000 at December 31, 2004 and June 30, 2005, respectively	21,686	38,719
Inventories	1,994	2,507
Prepaid expenses and other current assets	1,727	2,367
Deferred cost of revenues, current portion	4,547	4,194
Total current assets	128,103	147,483
Deferred cost of revenues, noncurrent portion	369	1,974
Property and equipment, net	8,848	10,348
Goodwill	10,252	10,252
Intangible assets, net	826	692
Total assets	$ 148,398	$ 170,749
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 1,114	$ 1,811
Accrued expenses	9,290	9,256
Equipment note, current portion	525	412
Deferred revenues, current portion	63,901	69,620
Total current liabilities	74,830	81,099
Equipment note, noncurrent portion	237	27
Deferred rent	1,067	915
Deferred revenues, noncurrent portion	3,157	2,533
Stockholders' equity:		
Preferred stock, $0.01 par value; 5,000,000 shares authorized, and no shares issued or outstanding at December 31, 2004 and June 30, 2005	—	—
Common stock, $0.01 par value; 200,000,000 shares authorized; 25,977,822 and 26,825,765 shares issued and outstanding at December 31, 2004 and June 30, 2005, respectively	260	268
Additional paid-in capital	191,664	197,215
Deferred stock compensation	(209)	(173)
Accumulated deficit	(122,608)	(111,135)
Total stockholders' equity	69,107	86,175
Total liabilities and stockholders' equity	$ 148,398	$ 170,749

See notes to unaudited consolidated financial statements.

BLACKBOARD INC.
UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2005	2004	2005
	(In thousands)			
Revenues:				
Product	$ 23,332	$ 29,353	$ 45,948	$ 57,040
Professional services	3,023	3,696	5,626	6,951
Total revenues	26,355	33,049	51,574	63,991
Operating expenses:				
Cost of product revenues, excludes amortization of acquired technology included in amortization of intangibles resulting from acquisitions shown below	5,957	7,095	12,017	14,311
Cost of professional services revenues	2,073	2,552	3,626	4,766
Research and development	3,636	3,307	6,890	6,505
Sales and marketing	9,090	9,462	17,858	17,946
General and administrative	3,360	4,791	6,785	9,396
Amortization of intangibles resulting from acquisitions	879	66	1,759	134
Stock-based compensation	28	18	111	36
Total operating expenses	25,023	27,291	49,046	53,094
Income from operations	1,332	5,758	2,528	10,897
Other income (expense), net:				
Interest expense	(50)	(12)	(128)	(30)
Interest income	23	524	49	1,007
Income before provision for income taxes	1,305	6,270	2,449	11,874
Provision for income taxes	(254)	(207)	(612)	(401)
Net income	1,051	6,063	1,837	11,473
Dividends on and accretion of convertible preferred stock	(3,749)	—	(6,344)	—
Net (loss) income attributable to common stockholders	$ (2,698)	$ 6,063	$ (4,507)	$ 11,473
Net (loss) income attributable to common stockholders per common share:				
Basic	$ (0.37)	$ 0.23	$ (0.71)	$ 0.44
Diluted	$ (0.37)	$ 0.21	$ (0.71)	$ 0.41
Weighted average number of common shares:				
Basic	7,202,017	26,516,106	6,374,493	26,303,114
Diluted	7,202,017	28,201,336	6,374,493	27,930,823

See notes to unaudited consolidated financial statements.

BLACKBOARD INC.
UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Six Months Ended June 30, 2004	Six Months Ended June 30, 2005
	(In thousands)	
Cash flows from operating activities		
Net income	$ 1,837	$ 11,473
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	3,046	3,274
Amortization of intangibles	1,759	134
Change in allowance for doubtful accounts	(272)	225
Noncash stock compensation related to options issued to nonemployees	69	—
Noncash deferred stock amortization	42	36
Changes in operating assets and liabilities:		
Accounts receivable	(13,359)	(17,258)
Inventories	(3)	(513)
Prepaid expenses and other current assets	(302)	(640)
Deferred cost of revenues	(583)	(1,252)
Accounts payable	22	697
Accrued expenses	990	(34)
Deferred rent	(77)	(152)
Deferred revenues	9,357	5,095
Net cash provided by operating activities	2,526	1,085
Cash flows from investing activities		
Purchase of property and equipment	(3,980)	(4,774)
Purchase of held-to-maturity securities	—	(21,159)
Purchase of available-for-sale securities	—	(9,600)
Sale of available-for-sale securities	—	9,950
Net cash used in investing activities	(3,980)	(25,583)
Cash flows from financing activities		
Payments on equipment notes	(503)	(323)
Payments on line of credit	(7,880)	—
Payments on note payable	(1,000)	—
Proceeds from issuance of common stock, net of issuance costs	50,896	—
Proceeds from exercise of Series D Warrants	248	—
Proceeds from exercise of stock options	952	5,559
Net cash provided by financing activities	42,713	5,236
Net increase (decrease) in cash and cash equivalents	41,259	(19,262)
Cash and cash equivalents at beginning of period	30,456	78,149
Cash and cash equivalents at end of period	$ 71,715	$ 58,887

See notes to unaudited consolidated financial statements.

BLACKBOARD INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
For the Six Months Ended June 30, 2004 and 2005

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 a leading provider of enterprise software applications and related services to the education industry. The Company's suites of products include the following five products: *Blackboard Learning System* ™, *Blackboard Community System* ™, *Blackboard Content System* ™, *Blackboard Transaction System* ™and *Blackboard One* ™.

On April 23, 2004, the Company effected a one-for-two reverse stock split of all common stock outstanding. In addition, the Company increased the number of shares of authorized common stock to 40,000,000. 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. Upon consummation of the Company's initial public offering (IPO), the Company adopted its Fourth Restated Certificate of Incorporation, which increased the number of shares of authorized common stock to 200,000,000.

2. Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles 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 U.S. 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 and six months ended June 30, 2005 are not necessarily indicative of the results that may be expected for the full fiscal year. The balance sheet at December 31, 2004 has been derived from the audited consolidated financial statements at that date but does not include all of the information and notes required by U.S. 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, 2003 and 2004 and for each of the three years in the period ended December 31, 2004 included in the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 1, 2005.

Use of Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles 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.

Short-term Investments

All investments with original maturities of greater than 90 days are accounted for in accordance with Statement of Financial Accounting Standards (SFAS) No. 115, *"Accounting for Certain Investments in Debt and Equity Securities."* The Company determines the appropriate classification at the time of purchase and reevaluates such designation as of each balance sheet date. The Company's held-to-maturity securities are stated at amortized cost, adjusted for amortization of premiums and accretion of discounts to maturity under the effective interest method. Such amortization is recorded as interest income. Interest on held-to-maturity securities is recorded as interest income. The Company's available-for-sale securities are carried at cost, which approximates fair value. Realized gains and losses and declines in value judged to be other-than-temporary on available-for-sale securities are recorded as interest income. At June 30, 2005, the Company held $40.8 million in short-term investments which consisted of $21.1 million in government agency bonds, which are classified as held-to-maturity and $19.7 million in auction rate securities, which are classified as available-for-sale.

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 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 six months ended June 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 June 30,		Six Months Ended June 30,	
	2004	2005	2004	2005
	(Unaudited) (In thousands, except share and per share amounts)			
Basic net (loss) income attributable to common stockholders per common share:				
Net income (loss)	$ 1,051	$ 6,063	$ 1,837	$ 11,473
Less preferred stock dividends:				
Redeemable convertible preferred stock	(3,749)	—	(6,344)	—
Net (loss) income attributable to common stockholders	$ (2,698)	$ 6,063	$ (4,507)	$ 11,473
Weighted average shares outstanding	7,202,017	26,516,106	6,374,493	26,303,114
Basic net (loss) income attributable to common stockholders per common share	$ (0.37)	$ 0.23	$ (0.71)	$ 0.44
Diluted net (loss) income attributable to common stockholders per common share:				
Net (loss) income attributable to common stockholders	$ (2,698)	$ 6,063	$ (4,507)	$ 11,473
Weighted average number of basic shares outstanding	7,202,017	26,516,106	6,374,493	26,303,114
Dilutive effect of:				
Stock options related to the purchase of common stock	—	1,567,211	—	1,496,960
Warrants related to the purchase of common stock	—	118,019	—	130,749
Diluted shares outstanding	7,202,017	28,201,336	6,374,493	27,930,823
Diluted net (loss) income attributable to common stockholders per common share	$ (0.37)	$ 0.21	$ (0.71)	$ 0.41

Recent Accounting Pronouncements

On December 16, 2004, the FASB issued FASB Statement No. 123 (revised 2004), *"Share-Based Payment"* (SFAS 123(R)), which is a revision of SFAS 123. SFAS 123(R) supersedes APB No. 25, and amends FASB Statement No. 95, *"Statement of Cash Flows.* " Generally the approach in SFAS 123(R) is similar to the approach described in SFAS 123. However, SFAS 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the statements of operations based on their fair values. Pro forma disclosure is no longer an alternative upon adopting SFAS 123(R).

On April 14, 2005, the Securities and Exchange Commission (the Commission) adopted a new rule that amends the compliance dates for SFAS 123(R). The Commission's new rule allows the Company to implement SFAS 123(R) no later than January 1, 2006. Under SFAS 123(R), the Company would have been required to implement the standard no later than July 1, 2005. The Commission's new rule does not change the accounting required by SFAS 123(R); it changes only the dates for compliance with the standard.

Early adoption will be permitted in periods in which financial statements have not yet been issued. SFAS 123(R) permits public companies to adopt its requirements using one of two methods:

- A "modified prospective" method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of SFAS 123(R) for all share-based payments granted after the effective date and (b) based on the requirements of SFAS 123(R) for all awards granted to employees prior to the effective date of SFAS 123(R) that remain unvested on the effective date.

- A "prospective" method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under SFAS 123(R) for purposes of pro forma disclosures for either (a) all prior periods presented or (b) prior interim periods of the year of adoption.

The Company plans to adopt SFAS 123(R) using the modified prospective method on January 1, 2006.

Comprehensive Net Income

Comprehensive net income includes net income, combined with unrealized gains and losses not included in earnings and reflected as a separate component of stockholders' equity. There were no material differences between net income and comprehensive net income for the three and six months ended June 30, 2004 and 2005.

3. Stock-Based Compensation

Statement of Financial Accounting Standards (SFAS) No. 123, *"Accounting for 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 of 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 June 30,		Six Months Ended June 30,	
	2004	2005	2004	2005
Pro forma net (loss) income attributable to common stockholders:				
As reported	$ (2,698)	$ 6,063	$ (4,507)	$ 11,473
Add: Stock-based compensation included in reported net (loss) income attributable to common stockholders	28	18	111	36
Deduct: Stock-based compensation expense determined under fair value-based method for all awards	(1,338)	(1,835)	(2,165)	(2,637)
Pro forma net (loss) income attributable to common stockholders	$ (4,008)	$ 4,246	$ (6,561)	$ 8,872
Net (loss) income attributable to common stockholders per common share				
Basic — as reported	$ (0.37)	$ 0.23	$ (0.71)	$ 0.44
Basic — pro forma	$ (0.55)	$ 0.16	$ (1.03)	$ 0.34
Diluted — as reported	$ (0.37)	$ 0.21	$ (0.71)	$ 0.41
Diluted — pro forma	$ (0.55)	$ 0.15	$ (1.03)	$ 0.32

The effect of applying SFAS 123 on pro forma net (loss) income attributable to common stockholders and net (loss) income attributable to common stockholders per common share as stated above is not necessarily representative of the effects on reported net (loss) income attributable to common stockholders and net (loss) income attributable to common stockholders per common share 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 the 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 six months ended June 30, 2004 and 2005:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2005	2004	2005
		(Unaudited)		
Dividend yield	0%	0%	0%	0%
Expected volatility	85.0%	48.3%	85.0%	49.9%
Average risk-free interest rate	3.0%	4.0%	3.0%	4.0%
Expected term	5 years	5 years	5 years	5 years

In March 2004, the Company adopted the 2004 Stock Incentive Plan in which 1,887,692 shares of common stock are reserved 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. The Board of the Directors of the Company approved an increase in the total number of shares of common stock issuable under the plan to 2,350,000 shares, which was approved by the Company's stockholders at the Company's annual meeting of stockholders on May 19, 2005.

4. Inventories

	December 31, 2004	June 30, 2005 (Unaudited)
	(In thousands)	
Raw materials	$ 395	$ 672
Work-in-process	518	543
Finished goods	1,081	1,292
Total inventories	$ 1,994	$ 2,507

5. Goodwill and Intangible Assets

The carrying amounts of goodwill and intangible assets as of December 31, 2004 and June 30, 2005 are as follows:

	December 31, 2004	June 30, 2005 (Unaudited)
	(In thousands)	
Goodwill	$ 10,252	$ 10,252
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	(17,131)	(17,265)
Intangible assets, net	$ 826	$ 692

Intangible assets from acquisitions are amortized over three to five years. Amortization expense related to intangible assets was approximately $1,759,000 and $134,000 for the six months ended June 30, 2004 and 2005, respectively. Amortization expense related to intangible assets for the years ended December 31, 2005, 2006, 2007 and 2008 is expected to be approximately $266,000, $266,000, $266,000 and $28,000, respectively.

6. Debt

Working Capital Line of Credit

On April 30, 2005, the Company's working capital line expired by its terms. Based on the Company's current cash position, which includes the net proceeds from its IPO in June 2004 and historic positive cash flows from operations, the Company elected not to renew the working capital line of credit.

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.

8. Stockholders' 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 purchase agreement from 2002 and as a result of the exercises of certain Series E Warrants in connection with the 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 the Company 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.

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.

During the six months ended June 30, 2005, the Company issued 756,566 shares of common stock upon exercise of stock options.

In January 2005, the Company issued 20,190 shares of common stock upon cashless exercise of warrants held by a certain stockholder.

In March 2005, the Company issued 1,086 shares of common stock upon cashless exercise of warrants held by a certain stockholder.

In May 2005, the Company issued 70,101 shares of common stock upon cashless exercise of warrants held by certain stockholders.

In June 2005, the Company issued 1,141 shares of common stock for a cashless exercise of warrants held by a certain stockholder.

9. Income Taxes

In preparing our consolidated financial statements, we assess the likelihood that our deferred tax assets will be realized from future taxable income based on U.S. generally accepted accounting principles and the Company's taxable profitability. 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. In making this determination, we evaluate a number of factors, including whether we have generated cumulative earnings from operations, as outlined in SFAS No. 109, *"Accounting for Income Taxes."* We have included changes in the valuation allowance in our consolidated statements of operations as provision for 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.

During 2004, the Internal Revenue Service issued an Internal Revenue Bulletin — Revenue Procedure 2004-34 (Rev Proc 2004-34), that allows for greater consistency between U.S. generally accepted accounting principles and income tax revenue recognition for companies which recognize revenues in a ratable manner. During the third quarter 2004, we determined that we would adopt this method for our 2004 and subsequent income tax filings. The provision for income taxes for the three and six months ended June 30, 2005 reflects this adoption and represents taxes to be paid for certain international and state taxes.

As of December 31, 2004, we had a valuation allowance of $31.2 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 in the period that event occurs. In subsequent periods, the Company would record a provision for income taxes at a normalized effective tax rate.

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* 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, investor relations, 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 that 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 U.S. generally accepted accounting principles. 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 doubtful accounts. We maintain an allowance for doubtful 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 doubtful 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 fair value of our common stock at the grant date. Because no market for our common stock existed prior to our IPO in June 2004, 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 December 16, 2004, the FASB issued FASB Statement No. 123 (revised 2004), *"Share-Based Payment,"* known as SFAS 123(R), which is a revision of SFAS No. 123. SFAS 123(R) supersedes APB Opinion No. 25 and amends FASB Statement No. 95, *"Statement of Cash Flows."* Generally the approach in SFAS 123(R) is similar to the approach described in SFAS No. 123. However, SFAS 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the statements of operations based on their fair values. Pro forma disclosure is no longer an alternative upon adopting SFAS 123(R).

On April 14, 2005, the Securities and Exchange Commission (the Commission) adopted a new rule that amends the compliance dates for SFAS 123(R). The Commission's new rule allows the Company to implement SFAS 123(R) no later than January 1, 2006. Under SFAS 123(R), the Company would have been required to implement the standard no later than July 1, 2005. The Commission's new rule does not change the accounting required by SFAS 123(R); it changes only the dates for compliance with the standard.

Early adoption will be permitted in periods in which financial statements have not yet been issued. SFAS 123(R) permits public companies to adopt its requirements using one of two methods:

- A "modified prospective" method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of SFAS 123(R) for all share-based payments granted after the effective date and (b) based on the requirements of SFAS 123(R) for all awards granted to employees prior to the effective date of SFAS 123(R) that remain unvested on the effective date.

- A "prospective" method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under SFAS 123(R) for purposes of pro forma disclosures for either (a) all prior periods presented or (b) prior interim periods of the year of adoption.

The Company plans to adopt SFAS 123(R) using the modified prospective method on January 1, 2006.

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 June 30,		Six Months Ended June 30,	
	2004	2005	2004	2005
Pro forma net (loss) income attributable to common stockholders:				
As reported	$ (2,698)	$ 6,063	$ (4,507)	$ 11,473
Add: Stock-based compensation included in reported net (loss) income attributable to common stockholders	28	18	111	36
Deduct: Stock-based compensation expense determined under fair value-based method for all awards	(1,338)	(1,835)	(2,165)	(2,637)
Pro forma net (loss) income attributable to common stockholders	$ (4,008)	$ 4,246	$ (6,561)	$ 8,872
Net (loss) income attributable to common stockholders per common share				
Basic — as reported	$ (0.37)	$ 0.23	$ (0.71)	$ 0.44
Basic — pro forma	$ (0.55)	$ 0.16	$ (1.03)	$ 0.34
Diluted — as reported	$ (0.37)	$ 0.21	$ (0.71)	$ 0.41
Diluted — pro forma	$ (0.55)	$ 0.15	$ (1.03)	$ 0.32

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 based on U.S. generally accepted accounting principles and our taxable profitability. 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. In making this determination, we evaluate a number of factors, including whether we have generated cumulative earnings from operations, as outlined in SFAS No. 109, *"Accounting for Income Taxes."* We have included changes in the valuation allowance in our consolidated statements of operations as provision for 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.

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 U.S. generally accepted accounting principles and income tax revenue recognition for companies that recognize revenues in a ratable manner. During 2004, we determined that we would adopt this method for our 2004 and subsequent income tax filings. The provision for income taxes for the three and six months ended June 30, 2005 reflects this adoption.

As of December 31, 2004, we had a valuation allowance of $31.2 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 in the period that event occurs. In subsequent periods, the Company would record a provision for income taxes at a normalized effective tax rate.

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, hosting arrangements and enhanced support and maintenance contracts related to our software products.

- 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 the sales of *Blackboard One* and *Blackboard Transaction System,* as well as, the 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 the renewal of previously existing licenses, non-recurring ratable revenues primarily reflect one-time sales that do not contractually 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 consolidated statement of operations data expressed as a percentage of total revenues for each of the periods indicated.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2005	2004	2005
	(Unaudited)			
Revenues:				
Product	89%	89%	89%	89%
Professional services	11	11	11	11
Total revenues	100	100	100	100
Operating expenses:				
Cost of product revenues	23	21	24	22
Cost of professional services revenues	8	8	7	8
Research and development	14	10	13	10
Sales and marketing	34	29	35	28
General and administrative	13	15	13	15
Amortization of intangibles resulting from acquisitions	3	0	3	0
Stock-based compensation	0	0	0	0
Total operating expenses	95	83	95	83
Income from operations	5%	17%	5%	17%

Three Months Ended June 30, 2004 Compared to Three Months Ended June 30, 2005

Our total revenues for the three months ended June 30, 2005 were $33.0 million, representing an increase of $6.7 million, or 25.4%, as compared to $26.4 million for the three months ended June 30, 2004.

Product revenues. Product revenues, including domestic and international, for the three months ended June 30, 2005 were $29.4 million, representing an increase of $6.0 million, or 25.8%, as compared to $23.3 million for the three months ended June 30, 2004. A detail of our total product revenues by classification is as follows:

	Three Months Ended June 30,	
	2004	2005
	(Unaudited) (In millions)	
Recurring ratable revenues	$ 17.6	$ 23.3
Non-recurring ratable revenues	4.4	4.6
Other product revenues	1.3	1.5
Total product revenues	$ 23.3	$ 29.4

Certain amounts in the prior period's product revenues classifications have been reclassified to conform to the current period presentation.

The increase in recurring ratable revenues was primarily due to a $1.6 million increase in revenues from *Blackboard Learning System* licenses, a $1.3 million increase in hosting revenues, a $900,000 increase in revenues from *Blackboard Community System* licenses, a $700,000 increase in revenues from *Blackboard Content System* licenses, a $400,000 increase in revenues from *Blackboard Learning System-Basic Edition* tm licenses, a $400,000 increase in revenues from enhanced support and maintenance revenues related to our software products and a $300,000 increase in revenues from *Blackboard Transaction System* licenses. These increases in revenues were attributable to current and 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 increase in non-recurring ratable revenues was primarily due to a $200,000 increase in non-recurring hosting revenues, primarily including set-up revenues, and a $135,000 increase in non-recurring publisher fees. These increases were offset in part by a $100,000 decrease in third-party hardware and software revenues due to a decrease in current and prior period sales.

The increase in other product revenues is primarily due to an increase in *Blackboard One* revenues due to an increase in current and prior period sales.

Of our total revenues, our total international revenues for the three months ended June 30, 2005 were $5.4 million, representing an increase of $820,000, or 17.9%, as compared to $4.6 million for the three months ended June 30, 2004. International product revenues, which consist primarily of recurring ratable revenues, were $5.0 million for the three months ended June 30, 2005, representing an increase of $1.3 million, or 35.1%, as compared to $3.7 million for the three months ended June 30, 2004. 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 from prior period sales to new and existing clients. Further, the increase in international revenues also reflects our investment in increasing the size of our international sales force and international marketing efforts during prior periods, 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. Professional services revenues for the three months ended June 30, 2005 were $3.7 million, representing an increase of $673,000, or 22.3%, as compared to $3.0 million for the three months ended June 30, 2004. 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 June 30, 2005 was $7.1 million, representing an increase of $1.1 million, or 19.1%, as compared to $6.0 million for the three months ended June 30, 2004. The increase in cost of product revenues is due to a $760,000 increase in expenses for our hosting services due to the increase in the number of clients contracting for our hosting services and the expansion of our hosting services facilities during 2005 and a $240,000 increase in our technical support group expenses. Cost of product revenues as a percentage of product revenues decreased to 24.2% for the three months ended June 30, 2005 from 25.5% for the three months ended June 30, 2004, due primarily to the lower sublicense costs on the renewal of our licenses.

Cost of professional services revenues. Our cost of professional services revenues for the three months ended June 30, 2005 was $2.6 million, representing an increase of $479,000, or 23.1%, from $2.1 million for the three months ended June 30, 2004. The increase in cost of professional services revenues is directly related to the increase in professional services revenues. Cost of professional services revenues as a percentage of professional services revenues was 69.0% for the three months ended June 30, 2005 as compared to 68.6% for the three months ended June 30, 2004. The decrease in professional services margins is primarily due to a $300,000 increase in personnel-costs due to an increase in staffing related to the increase in the number and size of service engagements.

Research and development expenses. Our research and development expenses for the three months ended June 30, 2005 were $3.3 million, representing a decrease of $329,000, or 9.0%, as compared to $3.6 million for the three months ended June 30, 2004. This decrease was primarily attributable to a $200,000 decrease in personnel-costs due to a decrease in staffing during 2005 and a $295,000 decrease in recruiting and relocation costs related to hiring efforts during 2004 in our research and development department. These increases were offset in part by a $125,000 increase in professional service expenses resulting from our continued efforts to increase the functionality of our products.

Sales and marketing expenses. Our sales and marketing expenses for the three months ended June 30, 2005 were $9.5 million, representing an increase of $372,000, or 4.1%, as compared to $9.1 million for the three months ended June 30, 2004. This increase was primarily attributable to a $990,000 increase in personnel-related costs due to increase in headcount and compensation and a $580,000 increase in general marketing activities primarily associated with a change in timing of our annual Users Conference, which was held in February in 2004 and in April in 2005. These increases were offset in part by a $975,000 decrease in bad debt expense, which includes a $500,000 income statement benefit for a reduction in our allowance for doubtful accounts, for the three months ended June 30, 2005 as compared to the three months ended June 30, 2004. This decrease is associated with the continued improvement in collections on our accounts receivable over prior periods and the reinstatement and subsequent collections on accounts receivable that were deemed uncollectible in prior periods.

General and administrative expenses. Our general and administrative expenses for the three months ended June 30, 2005 were $4.8 million, representing an increase of $1.4 million, or 42.6%, as compared to $3.4 million for the three months ended June 30, 2004. The increase in general and administrative expenses was due in part to a $630,000 increase in professional service expenses primarily associated with costs of being a public company, including Sarbanes-Oxley compliance expenses, a $300,000 increase in personnel-related costs related to increased headcount and senior management hires during 2004 and 2005, a $200,000 increase in insurance costs due to higher liability coverage costs associated with being a public company and a $260,000 increase in recruiting expenses related to key hiring initiatives across the Company.

Net interest income (expense). Our net interest income for the three months ended June 30, 2005 was $512,000 as compared to net interest expense of $27,000 for the three months ended June 30, 2004. Our interest income was attributable primarily to higher cash and short-term investment balances during the three months ended June 30, 2005 than the three months ended June 30, 2004 resulting from the receipt of proceeds from our IPO in June 2004, cash generated from operations from current and prior periods and the repayment of outstanding debt during prior periods.

Income taxes. Our provision for income taxes for the three months ended June 30, 2005 was $207,000, an effective tax rate of 3.3%, compared to $254,000, an effective tax rate of 19.5%, for the three months ended June 30, 2004. During 2004, the Internal Revenue Service issued an Internal Revenue Bulletin — Revenue Procedure 2004-34, that allows for greater consistency between U.S. generally accepted accounting principles and federal income tax revenue recognition for companies which recognize revenues in a ratable manner. During the third quarter of 2004, we determined that we would adopt this method for our 2004 and subsequent income tax filings. The provision for income taxes for the three months ended June 30, 2005 reflects this adoption and represents taxes to be paid for certain international and state taxes.

Net income. As a result of the foregoing, we reported net income of $6.1 million for the three months ended June 30, 2005, compared to net income of $1.1 million for the three months ended June 30, 2004.

Six Months Ended June 30, 2004 Compared to Six Months Ended June 30, 2005

Revenues. Our total revenues for the six months ended June 30, 2005 were $64.0 million, representing an increase of $12.4 million, or 24.1%, as compared to $51.6 million for the six months ended June 30, 2004.

Product revenues, including domestic and international, for the six months ended June 30, 2004 were $57.0 million, representing an increase of $11.1 million, or 24.1%, as compared to $45.9 million for the six months ended June 30, 2004. A detail of our total product revenues by classification is as follows:

	Six Months Ended June 30, 2004	Six Months Ended June 30, 2005
	(Unaudited) (In millions)	
Recurring ratable revenues	$ 34.3	$ 44.8
Non-recurring ratable revenues	8.9	9.3
Other product revenues	2.7	2.9
Total product revenues	$ 45.9	$ 57.0

Certain amounts in the prior period's product revenues classifications have been reclassified to conform to the current period presentation.

The increase in recurring ratable revenues was primarily due to a $3.1 million increase in revenues from *Blackboard Learning System* licenses, a $2.4 million increase in hosting revenues, a $1.7 million increase in revenues from *Blackboard Community System* licenses, a $1.4 million increase in revenues from *Blackboard Content System* licenses, a $640,000 increase in revenues from enhanced support and maintenance revenues related to our software products, a $640,000 increase in revenues from *Blackboard Transaction System* licenses and a $550,000 increase in revenues from *Blackboard Learning System-Basic Edition* licenses. These increases in revenues were attributable to current and 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 of a *Blackboard Learning System — Basic Edition* license.

The increase in non-recurring ratable revenues was primarily due to a $400,000 increase in non-recurring hosting revenues, primarily including set-up revenues, and a $270,000 increase in non-recurring publisher fees. These increases were offset in part by a $400,000 decrease in *Blackboard Transaction System* hardware revenues due to a decrease in current and prior period sales.

The increase in other product revenues is primarily due to an increase in *Blackboard One* revenues due to an increase in current and prior period sales.

Of our total revenues, our total international revenues for the six months ended June 30, 2005 were $10.5 million, representing an increase of $2.5 million, or 30.3%, as compared to $8.1 million for the six months ended June 30, 2004. International product revenues, which consist primarily of recurring ratable revenues, were $9.6 million, representing an increase of $2.7 million, or 39.3%, as compared to $6.9 million for the six months ended June 30, 2004. 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 international 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. Further, the increase in international revenues also reflects our investment in increasing the size of our international sales force and international marketing efforts during prior periods, 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 six months ended June 30, 2005, were $7.0 million, representing an increase of $1.3 million, or 23.6%, as compared to $5.6 million for the six months ended June 30, 2004. 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 licensees of the enterprise version of the *Blackboard Learning System,* which generally purchase greater volumes of our service offerings.

Cost of product revenues. Our cost of product revenues for the six months ended June 30, 2005 was $14.3 million, representing an increase of $2.3 million, or 19.1%, compared to $12.0 million for the six months ended June 30, 2004. The increase in cost of product revenues is due to an $1.1 million increase in expenses for our hosting services due to the increase in the number of clients contracting for our hosting services and the expansion of our hosting services facilities during 2005, a $650,000 increase in sublicense costs primarily associated with the *Blackboard Content System* which was released in March 2004 and a $500,000 increase in our technical support group expenses. Cost of product revenues as a percentage of product revenues decreased to 25.1% for the six months ended June 30, 2005 from 26.2% for the six months ended June 30, 2004, due primarily to lower sublicense costs on the renewal of our licenses.

Cost of professional services revenues. Our cost of professional services revenues for the six months ended June 30, 2005 was $4.8 million, representing an increase of $1.1 million, or 31.4%, from $3.6 million for the six months ended June 30, 2004. The increase in cost of professional services revenues is directly related to the increase in service revenues. Cost of professional services revenues as a percentage of professional services revenues increased to 68.6% for the six months ended June 30, 2005 from 64.5% for the six months ended June 30, 2004. The decrease in professional services margins is primarily due to a $650,000 increase in personnel-costs due to an increase in staffing related to the increase in the number and size of service engagements.

Research and development expenses. Our research and development expenses for the six months ended June 30, 2005 were $6.5 million, representing a decrease of $385,000, or 5.6%, as compared to research and development expenses of $6.9 million for the six months ended June 30, 2004. This decrease was primarily attributable to a $300,000 decrease in personnel-costs due to a decrease in staffing during 2005 and a $330,000 decrease in recruiting and relocation costs related to hiring efforts during 2004 in our research and development department. These increases were offset in part by a $230,000 increase in professional service expenses resulting from our continued efforts to increase the functionality of our products.

Sales and marketing expenses. Our sales and marketing expenses for the six months ended June 30, 2005 were $17.9 million, which is consistent with sales and marketing expenses of $17.9 million for the six months ended June 30, 2004. For the six months ended June 30, 2005, there was a $1.5 million increase in personnel-related costs due to increase in headcount and compensation and a $200,000 increase in general marketing activities as compared to the six months ended June 30, 2004 primarily associated with a larger annual Users Conference in April 2005 as compared to our Users Conference in February 2004. These increases were offset in part by a $1.6 million decrease in bad debt expense, which includes a $950,000 income statement benefit for a reduction in our allowance for doubtful accounts, for the six months ended June 30, 2005 as compared to the six months ended June 30, 2004. This decrease is associated with the continued improvement in collections on our accounts receivable over prior periods and the reinstatement and subsequent collections on accounts receivable that were deemed uncollectible in prior periods.

General and administrative expenses. Our general and administrative expenses for the six months ended June 30, 2005 were $9.4 million, representing an increase of $2.6 million, or 38.5%, as compared to general and administrative expenses of $6.8 million for the six months ended June 30, 2004. This increase was due in part to a $1.1 million increase in professional service expenses primarily associated with costs of being a public company, including Sarbanes-Oxley compliance expenses, a $675,000 increase in personnel-related costs related to increased headcount and senior management hires during 2004 and 2005, a $565,000 increase in recruiting and relocation expenses related to key hiring initiatives across the Company and a $350,000 increase in insurance costs due to higher liability coverage costs associated with being a public company.

Net interest income (expense). Our net interest income for the six months ended June 30, 2005 was $977,000 as compared to net interest expense of $79,000 for the six months ended June 30, 2004. Our interest income was attributable primarily to higher cash and short-term investment balances during the six months ended June 30, 2005 than the six months ended June 30, 2004 resulting from the receipt of proceeds from our IPO in June 2004, cash generated from operations from current and prior periods and the repayment of outstanding debt during prior periods.

Income taxes. Our provision for income taxes for the six months ended June 30, 2005 was $401,000, an effective tax rate of 3.4%, compared to $612,000, an effective tax rate of 25.0%, for the six months ended June 30, 2004. During 2004, the Internal Revenue Service issued an Internal Revenue Bulletin — Revenue Procedure 2004-34, that allows for greater consistency between U.S. generally accepted accounting principles and federal income tax revenue recognition for companies which recognize revenues in a ratable manner. During the third quarter of 2004, we determined that we would adopt this method for our 2004 and subsequent income tax filings. The provision for income taxes for the six months ended June 30, 2005 reflects this adoption and represents taxes to be paid for certain international and state taxes.

Net income. As a result of the foregoing, we reported net income of $11.5 million for the six months ended June 30, 2005, compared to net income of $1.8 million for the six months ended June 30, 2004.

Liquidity and Capital Resources

We recognize revenues on annually renewable agreements, which results in deferred revenues. Deferred revenues as of June 30, 2005 were $72.2 million, representing an increase of $5.1 million, or 7.6%, from $67.1 million as of December 31, 2004. 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 six months ended June 30, 2005 as compared to the fourth quarter of 2004, offset by the recognition of revenues from prior period sales.

Our cash and cash equivalents were $58.9 million at June 30, 2005 compared to $78.1 million at December 31, 2004. The decrease in cash and cash equivalents was primarily due to our $20.8 million investment of our cash and cash equivalents in higher yield short-term investments during the six months ended June 30, 2005, net of sales of short-term investments.

Net cash provided by operating activities was $1.1 million during the six months ended June 30, 2005 as compared to net cash provided by operating activities of $2.5 million during the six months ended June 30, 2004. This change for the six months ended June 30, 2005 compared to the six months ended June 30, 2004 was due to the unfavorable impact to cash flows of an increase in accounts receivable due to an increase in invoicing associated with increased sales to new and existing clients during 2005 as compared to 2004, a smaller increase in deferred revenues from December 31, 2004 to June 30, 2005 as compared to December 31, 2003 to June 30, 2004 due to significant lower deferred revenues at December 31, 2003 as compared to December 31, 2004 resulting from lower volume of new sales to new and existing clients during 2003 as compared to 2004, an increase in deferred cost of revenues associated with prepayments of certain sublicense costs, an increase in prepaid expenses associated with prepayments of certain expenses and a decrease in amortization of intangibles resulting from acquisitions due to certain intangible balances being fully amortized in prior periods. These unfavorable impacts to cash flows were offset in part by increased net income during the period and higher accounts payable balances at June 30, 2005 resulting primarily from timing of vendor payments.

Net cash used in investing activities was $25.6 million during the six months ended June 30, 2005, an increase in cash usage of $21.6 million, or 542.8%, from $4.0 million during the six months ended June 30, 2004. This increase in cash usage was due to the $30.8 million investment of our cash and cash equivalents in higher yield short-term investments, offset by sales of short-term investments of $10.0 million and purchases of property and equipment of $4.8 million during the six months ended June 30, 2005.

Net cash provided by financing activities was $5.2 million during the six months ended June 30, 2005 as compared to net cash provided by financing activities of $42.7 million during the six months ended June 30,

2004. This change was primarily due to the $50.9 million in proceeds from our IPO in June 2004, net of offering costs, offset in part by $5.6 million in proceeds from exercise of stock options during the six months ended June 30, 2005.

Our working capital line of credit with Silicon Valley Bank expired on April 30, 2005 by its terms. We believe that our existing cash and cash equivalents, short-term investments and future cash provided by operating activities will be sufficient to meet our working capital and capital expenditure needs over the next 12 months. Accordingly, we did not deem the working capital line of credit to be necessary and consequently did not renew it upon its expiration.

As of June 30, 2005, $439,000 was outstanding on our equipment lines of credit with Silicon Valley Bank, which is subject to covenants and restrictions. Pursuant to the terms of this line of credit, we must comply with financial covenants that require us to maintain on a quarterly basis: a quick ratio of 1.5 and positive earnings before interest, taxes, depreciation and amortization. If we were not compliant with these covenants, the bank would have the right to accelerate the debt under the equipment lines of credit. We have pledged all of our domestic assets to secure the equipment lines of credit. We were in compliance with all covenants as of June 30, 2005.

We believe that our existing cash and cash equivalents, short-term investments and future 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. Also, we may make investments in, or acquisitions of, complementary businesses, services or technologies which could also require us to seek additional equity or debt financing. 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. Additional funds may not be available on terms favorable to us or at all.

We do not have any off-balance sheet arrangements with unconsolidated entities or related parties and accordingly, there are no off-balance sheet risks to our liquidity and capital resources from unconsolidated entities.

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 one profitable year and may never achieve sustained profitability.

Although we achieved profitability for the year ended December 31, 2004 on a net income basis, we had not been profitable for a full calendar year previously, and we may not be profitable in future periods, either on a short-or long-term basis. We incurred net losses of $41.7 million and $1.4 million for the years ended December 31, 2002 and 2003, respectively, and had net income of $10.0 million and $11.5 million for the year ended December 31, 2004 and six months ended June 30, 2005, respectively. As of June 30, 2005, we had an accumulated deficit of $111.1 million. We can give you no assurance that operating losses will not recur in the future or that we will ever sustain profitability on a quarterly or annual basis.

Our ability to utilize our net operating loss carryforwards may be limited.

Our federal net operating loss carryforwards are subject to limitations on how much may be utilized on an annual basis. The use of the net operating loss carryforwards may have additional limitations resulting from certain future ownership changes or other factors. If our net operating loss carryforwards are further limited, and we have taxable income which exceeds the available net operating loss carryforwards for that period, we would incur an income tax liability even though net operating loss carryforwards may be available in future years prior to their expiration, and our future cash flow, financial position and financial results may be negatively impacted.

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 product development efforts are delayed, fail to develop a product which gains market acceptance or fail to develop a marketable product at all, our financial results could suffer.

We may experience difficulties that could delay or prevent the successful development, introduction and sale of our new product under development, codenamed Caliper. If introduced for sale, the product may not adequately meet the requirements of the marketplace and may not achieve any significant degree of market acceptance, which could cause our financial results to suffer. In addition, during the development period for the new product, our customers may defer or forego purchases of our products and services, which could have a material adverse effect on our business, financial condition or results of operations.

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.

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 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.

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.

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 competing 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 service we provide to some of our clients. We provide remote hosting through computer hardware that is currently located in third-party co-location facilities in Virginia and The Netherlands. We do not control the operation of these co-location facilities. 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 facilities or if these co-location facilities were to close without adequate notice. Although we have multiple transmission lines into the co-location facilities 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 in the event of an extended loss of service at the co-location facilities. Each Virginia co-location facility provides data backup redundancy for the other Virginia co-location facility, however, is not equipped to provide full disaster recovery to all of our hosted clients. If there are operational failures in our network infrastructure that cause interruptions, slower response times, loss of data or extended loss of service 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 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, Desire2Learn Inc., ANGEL Learning, Inc. and Jenzabar, 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, large diversified software vendors who offer products in numerous markets including the education market and open source software applications such Moodle and Sakai. 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 which may pose a challenge to our business model. As open source offerings become more prevalent, customers may defer or forego purchases of our products which could reduce our sales and lengthen the sales cycle for our products. If we are unable to differentiate our products from competitive products based on open source software, demand for our products and services may decline and we may face pressure to reduce the prices of our products.

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. Our working capital line of credit with Silicon Valley Bank expired on April 30, 2005 by its terms. At June 30, 2005, $439,000 was outstanding on our equipment lines of credit with Silicon Valley Bank, subject to covenants and restrictions. The interest rates on our equipment lines of credit are fixed. 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 and short-term investments 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 three months ended June 30, 2005, a 100 basis-point adverse change in interest rates would have reduced our interest income for the period by approximately $240,000.

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

(a) Evaluation of Disclosure Controls and Procedures.

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures as of June 30, 2005. The term “disclosure controls and procedures,” as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC’s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company’s management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of June 30, 2005, our chief executive officer and chief financial officer concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.

(b) Changes in Internal Control over Financial Reporting.

No change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) occurred during the fiscal quarter ended June 30, 2005 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 May 27, 2005, we issued 59,586 shares of our common stock to a warrant holder pursuant to the cashless exercises of a warrant held by such warrant holder.

On May 27, 2005, we issued 10,515 shares of our common stock to a warrant holder pursuant to the cashless exercises of a warrant held by such warrant holder.

On June 29, 2005, we issued 1,141 shares of our common stock to a warrant holder pursuant to the cashless exercises of a warrant held by such warrant holder.

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

We held our annual meeting of stockholders on May 19, 2005. At the annual meeting, our stockholders elected the persons listed below as Class I directors of our board of directors, approved the Amended and Restated 2004 Stock Incentive Plan to increase the number of shares authorized for issuance under the plan from 1,887,692 to 2,350,000 and make other specified changes, and ratified the selection of Ernst & Young LLP as our independent registered public accounting firm for the fiscal year ending December 31, 2005. The voting results of the meeting are presented in the following tables:

	For	Withheld
Election of Directors		
E. Rogers Novak, Jr.	24,405,554	28,651
William Raduchel	23,795,042	639,163

	For	Against	Abstain
Ratification of Selection of Independent Registered Public Accounting Firm	24,388,969	40,901	4,335
Approval of the Amended and Restated 2004 Stock Incentive Plan to increase the number of shares authorized for issuance under the plan from 1,887,692 to 2,350,000 and make other specified changes	17,342,805	2,341,394	9,136

Item 6. ***Exhibits.***

(a) Exhibits:

Exhibit No.	Description
10.1	Amended and Restated 2004 Stock Incentive Plan(1).
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.

(1) Previously filed on May 25, 2005 as an exhibit to the Registrant's Report on Form 8-K, and incorporated by reference herein.

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

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

Date: August 3, 2005

EXHIBIT 31.1

Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

I, Michael L. Chasen, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Blackboard Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

   a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: August 3, 2005

/s/ Michael L. Chasen

Michael L. Chasen
Chief Executive Officer

EXHIBIT 31.2

Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

I, Peter Q. Repetti, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Blackboard Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

   a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: August 3, 2005

/s/ Peter Q. Repetti

Peter Q. Repetti
Chief Financial Officer

EXHIBIT 32.1

Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

I, Michael L. Chasen, Chief Executive Officer of Blackboard Inc. (the “Company”), do hereby certify, under the standards set forth in and solely for the purposes of 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, to my knowledge that:

1. The Quarterly Report on Form 10-Q of the Company for the period ended June 30, 2005 (the “Quarterly Report”) fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 as amended; and

2. The information contained in the Quarterly Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: August 3, 2005

/s/ Michael L. Chasen

Michael L. Chasen
Chief Executive Officer

EXHIBIT 32.2

Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

I, Peter Q. Repetti, Chief Financial Officer of Blackboard Inc. (the "Company"), do hereby certify, under the standards set forth in and solely for the purposes of 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, to my knowledge that:

1. The Quarterly Report on Form 10-Q of the Company for the period ended June 30, 2005 (the "Quarterly Report") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 as amended; and
2. The information contained in the Quarterly Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: August 3, 2005

/s/ Peter Q. Repetti

Peter Q Repetti
Chief Financial Officer