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**FORM 10-Q**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

(Mark One)

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

For the quarterly period ended June 30, 2003

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 00-15997

**FILENET CORPORATION**

(Exact name of Registrant as specified in its charter)

**Delaware**

\_\_\_\_\_  
(State or other jurisdiction of incorporation or organization)

**95-3757924**

\_\_\_\_\_  
(I.R.S. Employer Identification No.)

**3565 Harbor Boulevard, Costa Mesa, CA 92626**

\_\_\_\_\_  
(Address of principal executive offices) (Zip code)

**(714) 327-3400**

\_\_\_\_\_  
(Registrant's telephone number including area code)

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 Securities Exchange Act of 1934:

Yes ☒ No ☐

As of August 12, 2003, there were 36,496,332 shares of the Registrant's common stock outstanding.

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**FILENET CORPORATION****Index**

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PART I. FINANCIAL INFORMATION

**Item 1. Unaudited Condensed Consolidated Financial Statements**

FILENET CORPORATION  
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS  
(In thousands, except share amounts)

	June 30, 2003	December 31, 2002
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 157,330	\$ 130,154
Short-term investments	25,694	29,188
Accounts receivable, net	37,611	44,839
Inventories, net	1,919	2,568
Prepaid expenses and other current assets	15,201	13,317
Deferred income taxes	802	802
Total current assets	238,557	220,868
Property, net	30,883	34,641
Long-term investments	22,814	25,864
Goodwill	24,480	16,907
Intangible assets, net	8,606	3,029
Deferred income taxes	20,048	21,792
Other assets	3,929	4,935
Total assets	\$ 349,317	\$ 328,036
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 7,074	\$ 7,706
Customer deposits	4,611	2,962
Accrued compensation and benefits	18,213	20,729
Unearned maintenance revenue	51,348	38,945
Other accrued liabilities	14,237	15,224
Total current liabilities	95,483	85,566
Unearned maintenance revenue and other liabilities	2,584	3,565
Commitments and contingencies (Note 9)		
Stockholders' equity:		
Preferred stock - \$0.10 par value; 7,000,000 shares authorized; none issued and outstanding		
Common stock - \$0.01 par value; 100,000,000 shares authorized; 37,464,825 shares issued and 36,366,825 shares outstanding at June 30, 2003; and 37,014,512 shares issued and 35,916,512 shares outstanding at December 31, 2002	210,911	206,676
Retained earnings	55,966	53,178
Accumulated other comprehensive loss	(1,060)	(6,382)
Treasury stock, at cost; 1,098,000 shares	(14,567)	(14,567)
Net stockholders' equity	251,250	238,905
Total liabilities and stockholders' equity	\$ 349,317	\$ 328,036

*See accompanying notes to unaudited condensed consolidated financial statements.*

FILENET CORPORATION  
 UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
 (In thousands, except per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
Revenue:				
Software	\$ 33,555	\$ 34,350	\$ 69,077	\$ 65,590
Customer support	41,164	37,281	79,862	73,844
Professional services and education	11,802	14,491	23,933	30,327
Hardware	596	2,105	1,294	4,707
Total revenue	<u>87,117</u>	<u>88,227</u>	<u>174,166</u>	<u>174,468</u>
Costs:				
Software	3,608	2,674	6,616	4,755
Customer support	8,715	9,807	18,484	19,895
Professional services and education	10,335	13,187	21,415	26,642
Hardware	1,253	1,585	2,055	3,510
Total cost of revenue	<u>23,911</u>	<u>27,253</u>	<u>48,570</u>	<u>54,802</u>
Gross Profit	63,206	60,974	125,596	119,666
Operating expenses:				
Sales & marketing	34,856	32,761	69,255	65,050
Research and development	19,680	18,924	38,982	36,229
In-process research and development	-	400	-	400
General and administrative	8,326	8,605	16,152	16,793
Total operating expenses	<u>62,862</u>	<u>60,690</u>	<u>124,389</u>	<u>118,472</u>
Operating income	344	284	1,207	1,194
Other income, net	<u>1,620</u>	<u>1,921</u>	<u>2,665</u>	<u>2,829</u>
Income before income taxes	1,964	2,205	3,872	4,023
Provision for income taxes	<u>512</u>	<u>471</u>	<u>1,084</u>	<u>925</u>
Net income	<u>\$ 1,452</u>	<u>\$ 1,734</u>	<u>\$ 2,788</u>	<u>\$ 3,098</u>
Earnings per share:				
Basic	\$ 0.04	\$ 0.05	\$ 0.08	\$ 0.09
Diluted	\$ 0.04	\$ 0.05	\$ 0.08	\$ 0.08
Weighted-average shares outstanding:				
Basic	36,173	35,543	36,057	35,452
Diluted	37,296	36,741	36,960	36,983

*See accompanying notes to unaudited condensed consolidated financial statements.*

FILENET CORPORATION  
 UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE OPERATIONS  
 (In thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
Net income	\$ 1,452	\$ 1,734	\$ 2,788	\$ 3,098
Other comprehensive income:				
Foreign currency translation adjustments	3,363	5,401	5,360	4,991
Unrealized gains on securities:				
Unrealized holding gains	(28)	89	(38)	14
Total other comprehensive income	3,335	5,490	5,322	5,005
Comprehensive income	\$ 4,787	\$ 7,224	\$ 8,110	\$ 8,103

*See accompanying notes to unaudited condensed consolidated financial statements.*

FILENET CORPORATION  
 UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
 (In thousands)

	Six Months Ended June 30,	
	2003	2002
Cash flows from operating activities:		
Net income	\$ 2,788	\$ 3,098
Adjustments to reconcile net income to net cash		
Provided by operating activities:		
Purchased in-process research and development	-	400
Depreciation and amortization	9,937	10,724
Loss on sale of fixed assets	28	10
Provision for doubtful accounts	26	612
Deferred income taxes	1,731	9
Changes in operating assets and liabilities, net of the effects of acquisition:		
Accounts receivable	8,918	(15,403)
Inventories	698	458
Prepaid expenses and other current assets	514	(3,969)
Accounts payable	(1,188)	2,630
Accrued compensation and benefits	1,633	2,438
Customer deposits and advances	(3,363)	(983)
Unearned maintenance revenue	9,965	9,845
Income taxes payable	(808)	886
Other	(2,628)	(5,015)
Net cash provided by operating activities	28,251	5,740
Cash flows from investing activities:		
Capital expenditures	(5,030)	(6,506)
Proceeds from sale of property	66	40
Note receivable from officer	-	(1,900)
Cash paid for acquisition	(8,073)	(9,359)
Purchases of marketable securities	(60,199)	(73,497)
Proceeds from sales and maturities of marketable securities	64,305	55,100
Net cash used in investing activities	(8,931)	(36,122)
Cash flows from financing activities:		
Proceeds from issuance of common stock	4,187	3,603
Principal payments on capital lease obligations	-	(854)
Net cash provided by financing activities	4,187	2,749
Effect of exchange rate changes on cash and cash equivalents	3,669	4,421
Net increase in cash and cash equivalents	27,176	(23,212)
Cash and cash equivalents, beginning of year	130,154	107,502
Cash and cash equivalents, end of period	157,330	84,290
Supplemental cash flow information:		
Interest paid	32	51
Income taxes paid	\$ 2,638	\$ 120

*See accompanying notes to unaudited condensed consolidated financial statements.*

FILENET CORPORATION  
Notes To Condensed Consolidated Financial Statements  
(Unaudited)

1. BASIS OF PRESENTATION

The accompanying unaudited interim condensed consolidated financial statements of FileNet Corporation (the "Company" or "FileNet") reflect all adjustments (consisting of normal recurring adjustments) necessary to present fairly the financial position of the Company at June 30, 2003, the results of its operations, and its comprehensive operations for the three and six months ended June 30, 2003 and 2002, and its cash flows for the six months ended June 30, 2003 and 2002. Certain information and footnote disclosures normally included in financial statements have been condensed or omitted pursuant to rules and regulations of the Securities and Exchange Commission (the "SEC"), although the Company believes that the disclosures in the condensed consolidated financial statements are adequate to ensure the information presented is not misleading. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto, contained in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2002 filed with the SEC on March 28, 2003. The results of operations for the interim periods are not necessarily indicative of the operating results for the year, or any other future period.

2. RECENTLY ADOPTED ACCOUNTING PRONOUNCEMENTS

In June 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 141, "Business Combinations," which was effective immediately. SFAS No. 141 requires that the purchase method of accounting be used for all business combinations initiated after June 30, 2001 and it eliminated the pooling-of-interests method. The adoption of this standard did not have a significant impact on the Company's consolidated financial statements. The Company's acquisition of certain assets and certain liabilities of eGrail, Inc. in April 2002, and the acquisition of Shana Corporation in April 2003 were accounted for in compliance with this pronouncement (See Note 3 for details).

In June 2001, the FASB issued SFAS No. 142, "Goodwill and Other Intangible Assets," which the Company adopted January 1, 2002. SFAS No. 142 requires that goodwill and other intangible assets with indefinite useful lives no longer be amortized, but instead be tested for impairment at least annually and written down when impaired. SFAS No. 142 requires purchased intangible assets other than goodwill to be amortized over their useful lives, unless these lives are determined to be indefinite. In accordance with this Standard, the Company does not amortize goodwill and indefinite life intangible assets but evaluates their carrying value annually or when events or circumstances indicate that their carrying value may be impaired. On the first day of July of each year, goodwill will be tested for impairment by determining if the carrying value of each reporting unit exceeds its fair value. As of June 30, 2003, no impairment of goodwill has been recognized. If estimates change, a materially different impairment conclusion could result. The Company is currently testing for impairment with results expected by late August 2003.

In August 2001, the FASB issued SFAS No. 144, "Accounting for Impairment or Disposal of Long-Lived Assets." This Statement addresses financial accounting and reporting for the impairment of long-lived assets and for the disposal of long-lived assets and discontinued operations. SFAS No. 144 superseded SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of," and is effective for fiscal years beginning after December 15, 2001. The adoption of this Standard on January 1, 2002 did not have a material impact on the Company's consolidated financial position and results of operations.

In July 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities," which addresses financial accounting and reporting for costs associated with exit or disposal activities and supersedes Emerging Issues Task Force ("EITF") Issue 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)." SFAS No. 146 requires that costs associated with exit or disposal activities be recognized when they are incurred rather than at the date of a commitment to an exit or disposal plan. SFAS No. 146 also establishes that the liability should initially be measured and recorded at fair value. The Company adopted the provisions of SFAS No. 146 for exit or disposal activities initiated after December 31, 2002. The adoption of the provisions of SFAS No. 146 in the three and six months ended June 30, 2003 did not have a material impact on the Company's consolidated results of operations or financial position.

In November 2002, the FASB issued FASB Interpretation No. ("FIN") 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees and Indebtedness of Others," an interpretation of FASB Statement Nos. 5, 57 and 107, and rescission of FIN 34, "Disclosure of Indirect Guarantees of Indebtedness of Others." FIN 45 elaborates on the disclosures to be made by the guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. It also requires that a guarantor recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. The provisions related to recognizing a liability at inception of the guarantee for the fair value of the guarantor's obligations does not apply to product warranties or to guarantees accounted for as derivatives. The initial recognition and measurement provisions of this interpretation are applicable on a prospective basis to guarantees issued or modified after December 31, 2002, while the disclosure requirements are effective for financial statements for interim or annual periods ending after December 15, 2002. The adoption of the recognition provisions of FIN 45 in the three and six months ended June 30, 2003 did not have a material impact on the Company's consolidated results of operations or financial position.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation Transition and Disclosure." This statement amends SFAS No. 123, "Accounting for Stock-Based Compensation," to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, this statement amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The transition guidance and annual disclosure provisions of SFAS No. 148 are effective for fiscal years ending after December 15, 2002. The interim disclosure provisions are effective for financial reports containing financial statements for interim periods beginning after December 15, 2002. The adoption of SFAS No. 148 did not have a material impact on the Company's consolidated results of operations or financial position.



The following table summarizes the Company's net income (loss) and net income (loss) per share on a pro forma basis had compensation cost for the Company's stock-based compensation plans been determined based on the provisions of SFAS No. 123, for the three and six months ended June 30, 2003 and 2002:

(In thousands, except per share amounts)	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
Net income, as reported	\$ 1,452	\$ 1,734	\$ 2,788	\$ 3,098
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(2,062)	(2,075)	(4,101)	(4,537)
Pro forma net loss	(610)	(341)	(1,313)	(1,439)
Earnings per share:				
Basic earnings per share - as reported	\$ .04	\$ .05	\$ .08	\$ .09
Basic earnings (loss) per share - pro forma	(.02)	(.01)	(.04)	(.04)
Diluted earnings per share - as reported	.04	.05	.08	.08
Diluted earnings (loss) per share - pro forma	\$ (.02)	\$ (.01)	\$ (.04)	\$ (.04)

Pro forma compensation cost of shares issued under the Employee Qualified Stock Purchase Plan is measured based on the discount from market value on the date of purchase in accordance with SFAS No. 123. For purposes of computing proforma net income, we estimate the fair value of each option grant and employee stock purchase plan right on the date of grant using the Black-Scholes option-pricing model. The Black-Scholes option-pricing model was developed for use in estimating the value of traded options that have no vesting restrictions and are fully transferable, while the options issued by the Company are subject to both vesting and restrictions on transfer. In addition, option-pricing models require input of highly subjective assumptions including the expected stock price volatility. The Company uses projected data for expected volatility and expected life of its stock options based upon historical data.

The assumptions used to value the option grants and the purchase rights are stated as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
Expected life (in years)	2 to 5	2 to 5	2 to 5	2 to 5
Expected volatility	64%	78%	64 - 66%	75 - 78%
Risk free interest rates	1.63 to 4.36%	3.58 to 5.28%	1.63 to 4.76%	2.16 to 5.28%
Expected dividend	0%	0%	0%	0%

In January 2003, the FASB issued FIN 46, "Consolidation of Variable Interest Entities." In general, a variable interest entity is a corporation, partnership, trust, or any other legal structure used for business purposes that either (a) does not have equity investors with voting rights or (b) has equity investors that do not provide sufficient financial resources for the entity to support its activities. FIN 46 requires a variable interest entity to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity's activities or entitled to receive a majority of the entity's residual returns or both. The consolidation requirements of FIN 46 apply immediately to variable interest entities created after January 31, 2003. The consolidation requirements apply to older entities in the first fiscal year or interim period beginning after June 15, 2003. Certain of the disclosure requirements apply in all financial statements issued after January 31, 2003, regardless of when the variable interest entity was established. The Company does not have any variable interest entities as of June 30, 2003. The adoption of FIN 46 did not have a material impact on the Company's consolidated results of operations or its financial position.

In April 2003, FASB issued SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities." SFAS No. 149 (1) clarifies under what circumstances a contract with an initial net investment meets the characteristic of a derivative discussed in paragraph 6(b) of Statement 133, (2) clarifies when a derivative contains a financing component, (3) amends the definition of an underlying derivative to conform it to language used in FIN 45, and (4) amends certain other existing pronouncements, which will collectively result in more consistent reporting of contracts as either derivatives or hybrid instruments. SFAS No. 149 is effective for contracts and hedging relationships entered into or modified after June 30, 2003. The Company does not believe that the adoption of SFAS No. 149 will have a material impact on its consolidated financial statements.

In May 2003, FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both debt and equity and requires an issuer to classify the following instruments as liabilities in its balance sheet:

- a financial instrument issued in the form of shares that is mandatorily redeemable and embodies an unconditional obligation that requires the issuer to redeem it by transferring its assets at a specified or determinable date or upon an event that is certain to occur;
- a financial instrument, other than an outstanding share, that embodies an obligation to repurchase the issuer's equity shares, or is indexed to such an obligation, and requires the issuer to settle the obligation by transferring assets; and
- a financial instrument that embodies an unconditional obligation that the issuer must settle by issuing a variable number of its equity shares if the monetary value of the obligation is based solely or predominantly on (1) a fixed monetary amount, (2) variations in something other than the fair value of the issuer's equity shares, or (3) variations inversely related to changes in the fair value of the issuer's equity shares.

SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003 and is effective for all other financial instruments as of the first interim period beginning after June 15, 2003. SFAS No. 150 is to be implemented by reporting the cumulative effect of a change in accounting principle. The Company does not expect the adoption of SFAS No. 150 to have a material impact on its consolidated financial statements.

**Reclassifications.** Certain reclassifications have been made to prior-years' balances to conform to the current-year's presentation.

### 3. ACQUISITIONS

On April 2, 2002, the Company acquired certain assets and assumed certain liabilities of eGrail, Inc. ("eGrail"), a Web content management company. This strategic acquisition provides additional Web Content Management ("WCM") software application capabilities that expand the Company's position in the Enterprise Content Management ("ECM") market, which contributed to the purchase price that resulted in goodwill. The purchase price for the acquisition consisted of \$9.0 million in cash consideration and direct acquisition costs of \$359,000.

On April 2, 2003, the Company completed a stock purchase acquisition of Shana Corporation ("Shana"), an electronic forms management company. This strategic acquisition provides technology and experience to expand the Company's ECM offering with Enterprise Forms Management capability, which contributed to the purchase price and resulted in goodwill. The purchase price for the acquisition consisted of \$8.55 million in cash, less \$938,000 of acquired cash consideration, plus \$184,000 in acquisition expenses and \$277,000 paid for Non-Compete Agreements.

In accordance with SFAS No. 141, "Business Combinations," these acquisitions were accounted for under the purchase method of accounting. The purchase price was allocated as follows:

	<u>eGrail, Inc. April 2, 2002</u>	<u>Shana Corp. April 2, 2003</u>
<i>(In thousands)</i>		
Net tangible assets	\$ 581	\$ 2,725
Patents	24	-
Acquired technology	3,300	4,000
Technical manuals and design documents	-	600
Customer maintenance relationships	-	800
In-process research and development	400	-
Non-Compete Agreements	-	277
Liabilities assumed	(739)	(2,494)
Goodwill	5,793	3,103
Total purchase price	\$ 9,359	\$ 9,011
Less cash acquired	-	(938)
Net cash paid	\$ 9,359	\$ 8,073

The Company allocated the purchase price of these acquisitions based on fair value. Statement of Financial Accounting Concepts No. 7 defines fair value as the amount at which an asset (or liability) could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale.

The valuation of the eGrail assets included \$400,000 of in-process research and development, which was expensed upon acquisition because technological feasibility had not been established and no future alternative uses, existed. New product development underway at eGrail at the time of the acquisition included the next generation of their WCM product that was in the early stages of design and only 5% complete at the date of the acquisition. The cost to complete the project was estimated at approximately \$3.0 million to occur over a 12-month period. As of March 31, 2003 the project was complete and the Company incurred approximately \$4.8 million of research and development expenses related to the project. The remaining purchase price was primarily allocated to tangible assets and goodwill. The acquired technology of \$3.3 million was assigned a useful life of five years and patents of \$24,000 were assigned a useful life of two years. The remaining purchase price of \$6.0 million was primarily allocated to tangible assets and goodwill. Goodwill is tax deductible for this asset purchase.

The valuation of Shana resulted in acquired technology, technical manuals and design documents, and customer maintenance relationships. Since Shana had recently completed Version 4.1 of its eForms product, there was no in-process research and development underway at the time of the acquisition. Shana's technology manuals and design documents are the "roadmaps" for the eForms technology and will be used by FileNet product development. Recurring maintenance revenues are expected and estimable for Shana's customers based on the older and newer versions of eForms technology. The acquired technology of \$4.0 million, the technical manuals and design documents of \$600,000, and the customer maintenance relationships of \$800,000 were assigned a useful life of five years. The remaining purchase price of \$3.6 million was allocated primarily to goodwill. In accordance with SFAS No. 142, goodwill for both acquisitions will not be amortized but will be reviewed for impairment on an annual basis in July. (This evaluation is currently underway with an estimated completion date in late August.) Although the goodwill stemming from the Shana stock purchase is non-deductible for Canadian tax purposes, a Section 338(g) election will result in the reduction of taxable income for U.S. tax purposes on this transaction.

Actual results of operations of the acquired eGrail business, as well as assets and liabilities of the acquired eGrail business, are included in the unaudited condensed consolidated financial statements from the date of acquisition. The pro forma results of operations data for the six-month period ended June 30, 2003 and 2002 presented below assumes that the eGrail acquisition had been made at the beginning of fiscal 2002. The pro forma data is presented for informational purposes only and is not necessarily indicative of the results of future operations nor of the actual results that would have been achieved had the acquisition taken place at the beginning of fiscal 2002. No pro forma information has been presented for the Shana acquisition, as the result did not have a material impact on the financial statements of the company during the reporting period.

	Six Months Ended June 30,	
	2003 Actual	2002 Pro Forma
<i>(In thousands)</i>		
Revenue	\$ 174,166	\$ 175,220
Net income	2,788	1,245
Earnings per share:		
Basic	\$ .08	\$ .04
Diluted	\$ .08	\$ .03

#### 4. GOODWILL AND PURCHASED INTANGIBLE ASSETS

In acquisitions accounted for using the purchase method, goodwill is recorded for the difference, if any, between the aggregate consideration paid for an acquisition and the fair value of the net tangible and identified intangible assets acquired. SFAS No. 142 requires a periodic review of goodwill and indefinite life intangibles for possible impairment. Intangible assets with definite lives must be amortized over their estimated useful lives. Shana goodwill and intangible assets were recorded on our Canadian subsidiary and a portion of the goodwill and intangible assets for previous acquisitions was allocated to our Ireland subsidiary. This results in expected foreign exchange translation fluctuation. The following table represents the balance of goodwill as of December 31, 2002 and the changes in goodwill for the six months ended June 30, 2003:

Goodwill (in thousands)

Balance as of December 31, 2002	\$	16,907
Goodwill acquired during the period		3,103
Adjustments		3,498
Foreign currency gain		972
Balance as of June 30, 2003	\$	24,480

Adjustments to goodwill included \$1.7 million for the write-off of a prepaid royalty and the recognition of a \$1.7 million deferred tax asset. Prior to the Shana acquisition, FileNet licensed the eForms technology from Shana under an agreement that resulted in a prepaid royalty. The remaining balance of this prepaid royalty fee was considered additional investment in Shana and was allocated to goodwill. A deferred tax asset was recorded under purchase accounting for the estimated future tax effects of the identified intangibles with a corresponding entry to goodwill of \$1.7 million.

Acquired technology, technical manuals and design documents, customer maintenance relationships, non-compete agreements and patents are the Company's only intangible assets subject to amortization under SFAS No. 142. These assets were recorded in connection with the acquisition of assets of eGrail in April 2002 and the acquisition of Shana in April 2003, and are comprised of the following as of December 31, 2002 and June 30, 2003:

Intangible Assets Subject to Amortization

Balance as of December 31, 2002 (In thousands)	Gross	Accumulated Amortization	Foreign Currency Fluctuation	Net
Acquired technology & Other Intangibles	\$ 3,468	(532)	\$ 79	\$ 3,015
Non-compete agreements	-	-	-	-
Patents	25	(12)	1	14
Total	\$ 3,493	\$ (544)	\$ 80	\$ 3,029

Intangible Assets Subject to Amortization

Balance as of June 30, 2003 (In thousands)	Gross	Accumulated Amortization	Foreign Currency Fluctuation	Net
Acquired technology & Other Intangibles	\$ 8,868	(1,213)	\$ 673	\$ 8,328
Non-compete agreements	277	(29)	24	272
Patents	25	(21)	2	6
Total	\$ 9,170	\$ (1,263)	\$ 699	\$ 8,606

Acquired technology, technical manuals and design documents, and customer maintenance relationships are being amortized over a useful life of five years, patents are being amortized over a useful life of two years, and the non-compete agreements are being amortized between two and three years. Amortization expense for amortizing intangible assets was \$494,000 and \$677,000 for the three and six months ended June 30, 2003, and \$168,000 for the three and six months ended June 30, 2002. Estimated future amortization expense (excluding foreign exchange effect) of purchased intangible assets as of June 30, 2003 is as follows (in thousands):

<u>Fiscal Year</u>	<u>Amount</u>
2003 (remaining 6 months)	\$ 1,017
2004	2,024
2005	1,990
2006	1,926
2007	1,356
2008	293
Total Amortization Expense	<u>\$ 8,606</u>

## 5. EARNINGS PER SHARE

Basic earnings per share are computed by dividing net income for the period by the weighted-average number of common shares outstanding during the period. Diluted earnings per share is computed by dividing net income by the weighted-average number of common shares outstanding plus the dilutive effect of outstanding stock options and shares issuable under the employee stock purchase plan using the treasury stock method. The number of dilutive options excluded from the basic EPS calculation for the three and six months ended June 30, 2003 were 1,123,000 and 903,000 shares, compared to 1,198,000 and 1,531,000 for the comparable periods in 2002. The following table sets forth the computation of basic and diluted earnings per share for the three and six months ended June 30, 2003 and 2002:

	<u>Three Months Ended June 30,</u>		<u>Six Months Ended June 30,</u>	
	<u>2003</u>	<u>2002</u>	<u>2003</u>	<u>2002</u>
<i>(In thousands, except per share amounts)</i>				
Net Income	\$ 1,452	\$ 1,734	\$ 2,788	\$ 3,098
Shares used in computing basic earnings per share	36,173	35,543	36,057	35,452
Dilutive effect of stock plans	<u>1,123</u>	<u>1,198</u>	<u>903</u>	<u>1,531</u>
Shares used in computing diluted earnings per share	37,296	36,741	36,960	36,983
Earnings per basic share	\$ 0.04	\$ 0.05	\$ 0.08	\$ 0.09
Earnings per diluted share	\$ 0.04	\$ 0.05	\$ 0.08	\$ 0.08

## 6. ACCUMULATED OTHER COMPREHENSIVE LOSS

Accumulated other comprehensive loss for the six months ended June 30, 2003 is comprised of the following:

<i>(In thousands)</i>	Foreign Currency Translation Adjustment	Unrealized Holding Gain (Loss)	Accumulated Other Comprehensive (Loss)
Balance, December 31, 2002	\$ (6,448)	\$ 66	\$ (6,382)
Six month period changes	5,360	(38)	5,322
Balance, June 30, 2003	\$ (1,088)	\$ 28	\$ (1,060)

## 7. OPERATING SEGMENT DATA

The Company has prepared operating segment information in accordance with SFAS No. 131, "Disclosures About Segments of An Enterprise and Related Information," to report components that are evaluated regularly by the Company's chief operating decision maker, or decision-making group, in deciding how to allocate resources and in assessing performance. The Company is organized geographically and by line of business. The line of business management structure is the primary basis upon which financial performance is assessed and resources allocated.

The Company's reportable operating segments include Software, Customer Support, Professional Services and Education, and Hardware. The Software operating segment develops and markets the Company's Enterprise Content, Business Process and Forms Management software products. The Customer Support segment provides after-sale support for software, as well as providing software upgrades when and if available pursuant to the Company's right to new versions program. The Professional Services and Education segment provides fee-based implementation and technical services related to the Company's software products, and also provides training. The Hardware operating segment manufactures and markets the Company's line of Optical Storage And Retrieval ("OSAR") libraries.

The financial results of the segments reflect allocation of certain functional expense categories consistent with the basis and manner in which Company management internally disaggregates financial information for the purpose of assisting in making internal operating decisions, which is not the same as generally accepted accounting principles reporting. The Company evaluates performance based on stand-alone segment operating results. Because the Company does not evaluate performance based on the return on assets at the operating segment level, assets are not tracked internally by segment. Therefore, segment asset information is not presented.

Operating segments data for the three and six months ended June 30, 2003 and 2002 are as follows:

<i>In thousands</i>	Three months ended June 30,		Six months ended June 30,	
	2003	2002	2003	2002
Software				
Revenue	\$ 33,555	\$ 34,350	\$ 69,077	\$ 65,590
Operating loss	(16,220)	(11,307)	(29,221)	(22,027)
Customer Support				
Revenue	\$ 41,164	\$ 37,281	\$ 79,862	\$ 73,844
Operating income	17,792	12,710	32,961	24,527
Professional Services and Education				
Revenue	\$ 11,802	\$ 14,491	\$ 23,933	\$ 30,327
Operating loss	(566)	(1,167)	(1,488)	(1,500)
Hardware				
Revenue	\$ 596	\$ 2,105	\$ 1,294	\$ 4,707
Operating income (loss)	(662)	48	(1,045)	194
Total				
Revenue	\$ 87,117	\$ 88,227	\$ 174,166	\$ 174,468
Operating income	344	284	1,207	1,194

## 8. STOCK OPTIONS

The following is a summary of stock option transactions regarding all stock option plans for the three months ended June 30, 2003:

	Number of Options	Weighted- Average Exercise Price
Balance, March 31, 2003	8,735,984	\$ 15.10
Granted (weighted-average fair value of \$6.95)	128,650	14.61
Exercised	(217,710)	9.43
Canceled	(59,461)	17.48
Balance, June 30, 2003	<u>8,587,463</u>	<u>\$ 15.22</u>



The following table summarizes information concerning outstanding and exercisable stock options at June 30, 2003:

Options Outstanding			Options Exercisable		
Range of Exercise Price	Number Outstanding	Weighted-Average Remaining Contractual Life (Years)	Weighted-Average Exercise Price	Number Exercisable	Weighted-Average Exercise Price
\$ 1.39 - 9.00	1,585,576	4.39	\$ 8.00	1,585,076	\$ 8.00
9.17 - 12.86	1,795,037	7.77	11.91	581,627	10.66
12.97 - 14.19	1,687,022	7.85	13.48	735,289	13.61
14.39 - 18.45	1,566,425	7.62	16.69	799,737	16.60
19.53 - 25.28	1,444,781	6.87	22.89	1,137,067	23.02
26.09 - 41.84	508,622	6.02	28.89	432,906	28.97
\$ 1.39 - 41.84	8,587,463	6.52	\$ 13.51	5,271,702	\$ 12.96

*Reference Note No. 2 regarding SFAS No. 148, "Accounting for Stock-Based Compensation Transition and Disclosure."*

## 9. COMMITMENTS AND CONTINGENCIES

### Leases

The Company leases its corporate offices, sales offices, development and manufacturing facilities, and other equipment under non-cancelable operating leases, some of which have renewal options and generally provide for escalation of the annual rental amount. Amounts related to deferred rent are recorded in other accrued liabilities on the consolidated balance sheet. Future annual minimum lease payments under all non-cancelable operating leases with an initial term in excess of one year as of June 30, 2003 were as follows:

	(In thousands)
2003 (remaining 6 months)	\$ 5,407
2004	12,553
2005	10,871
2006	10,004
2007	9,101
2008	7,370
Thereafter	6,732
Total	\$ 62,038

### Product Warranties

The Company provides a 90-day warranty for its hardware products against defects in materials and workmanship and for its software products against substantial nonconformance to the published documentation at time of delivery. For hardware products the Company accrues warranty costs based on historical trends in product return rates and the expected material and labor costs to provide warranty services. For software products, the Company records the estimated cost of technical support during the warranty period. A provision for these estimated warranty costs is recorded at the time of

sale or license. If the Company were to experience an increase in warranty claims compared with historical experience, or costs of servicing warranty claims were greater than the expectations on which the accrual had been based, gross margins could be adversely affected.

The following table represents the warranty activity and balance for the six months ended June 30, 2003 and 2002:

<i>(In thousands)</i>	2003	2002
Beginning balance at January 1	\$ 728	\$ 772
Additions	396	543
Deductions	<u>(636)</u>	<u>(647)</u>
Ending balance at June 30	\$ 488	\$ 668

#### Guarantees and Indemnities

In November 2002, the FASB issued FIN 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others." The initial recognition and initial measurement provisions apply on a prospective basis to guarantees issued or modified after December 15, 2002. The disclosure requirements are effective for financial statements of interim and annual periods ending after December 15, 2002.

The Company has made guarantees and indemnifications, under which it may be required to make payments to a guaranteed or indemnified party, in relation to certain transactions. In connection with the sales of its products, the Company provides intellectual property indemnities to its customers. Guarantees and indemnities to customers in connection with product sales and service generally are subject to limits based upon the amount of the related product sales or service. Payment by the Company is conditioned upon the other party filing a claim pursuant to the terms and conditions of the agreement. The Company may challenge this claim and may also have recourse against third parties for certain payments made by the Company. Predicting the maximum potential future payment under these agreements is not possible due to the unique facts and circumstances involved with each agreement. Historically, the Company has made no payments under these agreements. The fair value of guarantees issued during the six months ended June 30, 2003 is insignificant.

In connection with certain facility leases and other performance guarantees, the Company has guaranteed payments on behalf of some of its subsidiaries. To provide subsidiary guarantees, the Company obtains unsecured bank guarantees from local banks. These bank guarantees totaled an equivalent of approximately \$1.3 million issued in local currency in Europe and Asia as of June 30, 2003. Approximately \$0.4 million of the \$1.3 million is secured by cash deposit..

The Company indemnifies its directors and officers to the maximum extent permitted under the laws of the State of Delaware.

There have been no modifications or new guarantees issued during the first half of fiscal year 2003. The Company has not recorded a liability for the guarantees and indemnities described above in the accompanying consolidated balance sheet and the maximum amount of potential future payments under such guarantees and indemnities is not determinable, other than as described above. The Company's product warranty liability as of June 30, 2003 is disclosed in this item under the heading "Product Warranties."

10. LEGAL PROCEEDINGS

In the normal course of business, the Company is subject to ordinary routine litigation and claims incidental to business. While the results of litigation and claims cannot be predicted with certainty, management believes that the final outcome of these matters will not have a materially adverse effect on the Company's consolidated results of operations or financial condition.

11. FOREIGN CURRENCY TRANSACTIONS

As of June 30, 2003, the Company had forward foreign exchange contracts outstanding totaling approximately \$ 2.1 million in 10 currencies. These contracts were opened on the last business day of the quarter and mature within three months. Accordingly, the fair value of such contracts is zero at June 30, 2003.

12. RELATED-PARTY TRANSACTIONS

In July 2001, the Compensation Committee of the Company's Board of Directors ("the Board") entered into discussions with Lee Roberts, the Company's Chief Executive Officer, regarding a secured loan by the Company to Mr. Roberts to enable him to purchase a home in Orange County, California. In July 2001, the Compensation Committee forwarded its recommendation to the Board to approve, in principle, a secured loan, in the amount of \$1.2 million to Mr. Roberts. In September 2001, the Compensation Committee approved, in principle, an increase in the previously requested loan amount to \$1.9 million, subject to review of final loan documents and approval of the Board. In May 2002, the Compensation Committee reviewed proposed loan documentation for a secured loan to Mr. Roberts and forwarded its recommendation to the Board to approve the loan on the terms set forth in the loan documents. The loan documents provided that the loan would be secured by the real estate purchased by Mr. Roberts. Subsequently, on June 5, 2002, the Board approved the loan documents and the loan. As of June 30, 2003, FileNet has an outstanding secured note receivable from Mr. Roberts in the amount of \$1.9 million that relates to the above-referenced loan and is included in other assets on the consolidated balance sheet. The note bears interest at 2.89% per annum. Accrued interest on the principal balance of this note is payable annually beginning February 15, 2003 and on each February 15th thereafter until the entire principal balance becomes due. Accrued interest as of June 30, 2003 was approximately \$21,000. The entire outstanding principal balance of this note and any accrued interest is due and payable at the earliest of (a) June 7, 2005, (b) one year after termination of Mr. Roberts' employment by the Company, or (c) ninety (90) days after voluntary termination of employment by Mr. Roberts. Imputed interest for the difference between the stated interest rate of the note and a fair value interest rate of 7% was recorded as compensation expense and a discount that is being amortized over the term of the note to interest income using the effective interest method. The loan to Mr. Roberts is permitted under Section 13 of the Securities Exchange Act of 1934, as amended by Section 402 of the Sarbanes-Oxley Act on July 30, 2002, because it was outstanding on that date. However, its terms cannot be renewed or materially modified in the future.

John Savage, a member of FileNet's Board of Directors and the Audit Committee of FileNet's Board of Directors, is Managing Partner of Alliant Partners, who acted as financial advisor to eGrail in connection with our acquisition of assets from eGrail and was paid approximately \$500,000 by eGrail. Accordingly, John Savage recused himself from all discussions related to the acquisition between FileNet and eGrail and abstained from voting on the transaction.

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

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 21E of the Securities and Exchange Act of 1934, as amended, and Section 27A of the Securities Act of 1933, as amended, and is subject to the safe harbors created by those sections. Words such as “anticipates,” “expects,” “intends,” “plans,” “believes,” “seeks,” “estimates,” “may,” “will” and variations of these words or similar expressions are intended to identify forward-looking statements. In addition, any statements that refer to expectations, projections or other characterizations of future events or circumstances, including any underlying assumptions, are forward-looking statements. These statements are not guarantees of future performance and are subject to risks, uncertainties and assumptions that are difficult to predict. Therefore, our actual results could differ materially and adversely from those expressed in any forward-looking statements as a result of various factors. We undertake no obligation to revise or publicly release the results of any revisions to these forward-looking statements. Readers should carefully review the risk factors described below under the heading “Risk Factors That May Affect Future Results” and in other documents we file from time to time with the Securities and Exchange Commission, including our Annual Report on Form 10-K for the fiscal year ended December 31, 2002. Our filings with the Securities and Exchange Commission, including our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to those filings, pursuant to Sections 13(a) and 15(d) of the Securities Exchange Act of 1934, are available free of charge at [www.filenet.com](http://www.filenet.com), when such reports are available at the Securities and Exchange Commission Web site.

### **Overview**

FileNet Corporation develops, markets, sells and supports Enterprise Content Management (“ECM”) software to enable organizations to improve operational efficiency and leverage their content, process and connectivity resources to make decisions faster. In the first quarter of 2003, we introduced FileNet P8, our new architecture that provides a unified platform and framework for ECM. The FileNet P8 architecture is designed to provide an integrated solution for our customers to easily configure, design, build and deploy a variety of enterprise-wide ECM applications to meet a broad range of content management needs within a single scalable framework. We also offer professional services and training for the implementation of these software solutions, as well as 24 hours a day, seven days a week technical support and services to our customers on a global basis.

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

The consolidated financial statements of FileNet are prepared in conformity with accounting principles generally accepted in the United States of America. The consolidated financial statements include our accounts and the accounts of our wholly owned subsidiaries. All intercompany balances and transactions have been eliminated. The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual amounts could differ from estimates. The significant accounting policies we believe are most critical to aid in fully understanding and evaluating our reported financial results include the following:

**Revenue Recognition.** FileNet accounts for the licensing of software in accordance with the American Institute of Certified Accountants (“AICPA”) Statement of Position (“SOP”) 97-2, “Software Revenue Recognition.” We enter into contracts for the sale of our products and services. The majority of these contracts relate to single elements and contain standard terms and conditions. However, there are agreements that contain multiple elements or non-standard terms and conditions. Contract interpretation is sometimes required to determine the appropriate accounting, including how the price should be allocated among the deliverable elements and when to recognize revenue.

Software license revenue generated from sales through direct and indirect channels, which do not contain multiple elements, are recognized upon shipment and passage of title of the related product, if the requirements of SOP 97-2, are met. If the requirements of SOP 97-2, including evidence of an arrangement, delivery, fixed or determinable fee, collectibility or vendor specific evidence about the value of an element are not met at the date of shipment, revenue is not recognized until these elements are known or resolved. Fees are deemed to be fixed and determinable for transactions with a set price that is not subject to refund or adjustment and payment is due within 90 days from the invoice date. Software license revenue from channel partners is recognized when the product is shipped and sale by the channel partner to a specified end user is confirmed.

For arrangements with multiple elements, we allocate revenue to each element of a transaction based upon its fair value as determined in reliance on vendor specific objective evidence. This evidence of fair value for all elements of an arrangement is based on the normal pricing and discounting practices for those products and services when sold separately. If fair value of any undelivered element cannot be determined objectively, we defer the revenue until all elements are delivered, services have been performed or until fair value can objectively be determined.

Customer support contracts are renewable on an annual basis and provide after-sale support for our software, as well as software upgrades under the Company’s right to new versions program, on a when-and-if-available basis. Revenue from post-contract customer support is recognized ratably over the term of the arrangement, which is typically 12 months.

Professional services revenue consists of consulting and implementation services provided to end users of our software products and technical consulting services provided to our resellers. Consulting engagements average from one to three months. We do not make changes to the standard software code in the field. Revenue from these services and from training classes is recognized as such services are delivered and accepted by the customer. Revenue and cost is recognized using the percentage-of-completion method for fixed-price consulting contracts. However, revenue and profit are subject to revision as the contract progresses and anticipated losses on fixed-price professional services contracts are recognized in the period when they become known.

**Allowance for Doubtful Accounts and Sales Returns.** We evaluate the creditworthiness of our customers prior to order fulfillment, and we perform ongoing credit evaluations of our customers to adjust credit limits based on payment history and the customer’s current creditworthiness. We constantly monitor collections from our customers and maintain an allowance for estimated credit losses that is based on historical experience and on specific customer collection issues. While credit losses have historically been within our expectations and the provisions established in our financial statements, we cannot guarantee that we will continue to experience the same credit loss rates that we have in the past. Since our revenue recognition policy requires customers to be creditworthy, our accounts receivable are based on customers whose payment is reasonably assured. Our accounts receivable are derived from sales to a wide variety of customers.

We do not believe a change in liquidity of any one customer or our inability to collect from any one customer would have a material adverse impact on our consolidated financial position. Based on historical experience, we also maintain a sales return allowance for the estimated amount of potential

returns. While product returns have historically been minimal and within our expectations and the allowances established by us, we cannot guarantee that we will continue to experience the same return rates that we have in the past.

***Goodwill and Other Intangible Assets.*** Goodwill is recorded at cost and is not amortized. In June 2001, the FASB issued SFAS No. 142, “Goodwill and Other Intangible Assets,” which we adopted January 1, 2002. SFAS No. 142 requires that goodwill and other intangible assets with indefinite useful lives no longer be amortized, but instead be tested for impairment at least annually and written down when impaired. On the first day of July of each year, goodwill will be tested for impairment by determining if the carrying value of each reporting unit exceeds its fair value. We also periodically evaluate whether events and circumstances have occurred which indicate that the carrying value of goodwill may not be recoverable. As of June 30, 2003, no impairment of goodwill has been recognized. If estimates change, a materially different impairment conclusion could result. (Note – We are currently testing for impairment with results expected in late August.)

***Long-Lived Assets.*** Property, plant and equipment, intangible assets, and capitalized software costs are recorded at cost less accumulated depreciation or amortization. They are amortized using the straight-line method over estimated useful lives of generally three to six years. The determination of useful lives and whether or not these assets are impaired involves judgment and are reviewed for impairment whenever events or circumstances indicate that the carrying amount of such assets may not be recoverable. We evaluate the carrying value of long-lived assets and certain identifiable intangible assets for impairment of value based on undiscounted future cash flows resulting from the use of the asset and its eventual disposition. While we have not experienced impairment of intangible assets in prior periods, we cannot guarantee that there will not be impairment in the future.

***Deferred Income Taxes.*** Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. We maintain a valuation allowance against a portion of the deferred tax asset due to uncertainty regarding the future realization based on historical taxable income, projected future taxable income, and the expected timing of the reversals of existing temporary differences. If we operate at a loss or are unable to generate sufficient future taxable income we could be required to increase the valuation allowance against all or a significant portion of our deferred tax assets which would result in a substantial increase to our effective tax rate and could result in a material adverse impact on our operating results. Conversely, if the Company continues to generate profits and ultimately determines that it is more likely than not that all or a portion of the remaining deferred tax assets will be utilized to offset future taxable income, the valuation allowance could be decreased or eliminated all together, thereby resulting in a substantial decrease to our effective tax rate and an increase to additional paid in capital.

***Research and Development Costs.*** We expense research and development costs as incurred. No amounts are required to be capitalized in accordance with SFAS No. 86, “Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed,” because our software is substantially completed concurrently with the establishment of technological feasibility.

## Results of Operations

The following table sets forth certain consolidated statements of operations data as a percentage of total revenue for the periods indicated:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
Revenue:				
Software	38.5 %	38.9 %	39.7 %	37.6 %
Customer support	47.3	42.3	45.9	42.3
Professional services and education	13.5	16.4	13.7	17.4
Hardware	.7	2.4	.7	2.7
Total Revenue	100.0	100.0	100.0	100.0
Cost of revenue:				
Software	4.1	3.0	3.8	2.7
Customer support	10.0	11.1	10.6	11.4
Professional services and education	11.9	15.0	12.3	15.3
Hardware	1.4	1.8	1.2	2.0
Total cost of revenue	27.4	30.9	27.9	31.4
Gross Profit	72.6	69.1	72.1	68.6
Operating expenses:				
Sales and marketing	40.0	37.1	39.8	37.3
Research and development	22.6	21.4	22.4	20.8
In-process research and development	-	.5	-	.2
General and administrative	9.6	9.8	9.2	9.6
Total operating expenses	72.2	68.8	71.4	67.9
Operating income	.4	.3	.7	.7
Other income, net	1.9	2.2	1.5	1.6
Income before income tax	2.3 %	2.5 %	2.2 %	2.3 %

## Revenue

Total revenue for the three months ended June 30, 2003 was \$87.1 million compared to \$88.2 million for the three months ended June 30, 2002, a decrease of \$1.1 million, or 1%. Total revenue for the six months ended June 30, 2003 was \$174.2 million compared to \$174.5 million for the six months ended June 30, 2002, a decrease of \$0.3 million or less than 1%. International revenue for the three and six months ended June 30, 2003 was 34% and 33% of total revenue, compared to 27% and 28% for the three and six months ended June 30, 2002. As more fully discussed and explained below, total revenue remained essentially the same between comparable six-month periods as increases in software and customer support revenue were offset by decreases in professional services and hardware revenue. The unchanged revenue level during the first half of 2003, as compared to the same period in 2002, is indicative of the continuing difficult information technology-spending environment.

*Software:* Software revenue consists of fees earned from the licensing of our software products to customers. Software revenue decreased \$0.8 million, or 2%, to \$33.6 million for the three months ended June 30, 2003, from \$34.4 million for the three months ended June 30, 2002. Software revenue increased \$3.5 million, or 5%, to \$69.1 million for the six months ended June 30, 2003, from \$65.6 million for the three months ended June 30, 2002. Software revenue represented 39% of total revenue for the three months ended June 30, 2003 and for the comparable period of 2002. Software revenue represented 40% of total revenue for the six months ended June 30, 2003 compared to 38% for the comparable period of 2002.

Software revenue for the three months ended June 30, 2003 was comparable to the same period in 2002, and software revenue for the six months ended June 30, 2003 increased 5% compared to the six months ended June 30, 2002. Some of the factors contributing to this increase include a slight increase in our average selling price and further penetration of our existing customer base. We believe that enterprise content management will continue to be a corporate priority over the intermediate term. The current economic environment is still very uncertain however, and any reduction in information technology spending could have a negative effect on our software revenue growth.

*Customer Support:* Customer support revenue consists of revenue from software maintenance contracts, “fee for service” revenue and the sale of spare parts and supplies. Customer support revenue increased \$3.9 million, or 10%, to \$41.2 million for the three months ended June 30, 2003 from \$37.3 million for the three months ended June 30, 2002. Customer support revenue increased \$6.1 million, or 8%, to \$79.9 million for the six months ended June 30, 2003 from \$73.8 million for the six months ended June 30, 2002. Customer support revenue represented 47% of total revenue for the three months ended June 30, 2003 compared to 42% for the comparable period of 2002. Customer support revenue represented 46% of total revenue for the six months ended June 30, 2003 compared to 42% for the comparable period of 2002.

The increase in customer support revenue was primarily due to the growth in our base of customers who receive ongoing maintenance as a result of new and add-on customer software sales made during the reporting period. Additionally, the Company has experienced a high rate of renewal on maintenance contracts from its customer base. However, over time the growth rate for customer support revenue is dependent on the Company’s success in achieving software revenue growth. The occurrence of a prolonged economic slowdown, or other factors that negatively impact software revenue growth, would result in a reduced future growth rate for customer support revenue.

*Professional Services and Education:* Professional services and education revenue is generated primarily from consulting and implementation services provided to end users of our software products, technical consulting services provided to our resellers and training services provided to end users and resellers. Professional services are performed on a time and material basis or fixed price contract. Professional services and education revenue decreased \$2.7 million, or 19%, to \$11.8 million for the



three months ended June 30, 2003 from \$14.5 million for the three months ended June 30, 2002. Professional services and education revenue decreased \$6.4 million, or 21%, to \$23.9 million for the six months ended June 30, 2003 from \$30.3 million for the six months ended June 30, 2002. Professional services and education revenue represented 14% of total revenue for the three months ended June 30, 2003 compared to 16% for the comparable period in 2002. Professional services and education revenue represented 14% of total revenue for the six months ended June 30, 2003 compared to 17% for the comparable period in 2002.

Professional services revenue is dependent on the level and the nature of software sales over time. Generally, software sales for new system implementations will generate larger professional service consulting engagements than sales of additional licenses to existing customer installations. In recent quarters, we have experienced relatively level software revenue characterized by repeat purchases for additional software licenses with fewer large-scale software installations. These factors have adversely impacted professional services revenue resulting in fewer and smaller consulting engagements. The aforementioned, coupled with pricing pressures, have reduced professional services and education revenue, and we do not expect a significant improvement in the near future.

*Hardware:* Hardware revenue is generated primarily from the sale of 12-inch Optical Storage And Retrieval (“OSAR”) libraries. Hardware revenue decreased \$1.5 million, or 72%, to \$0.6 million for the three months ended June 30, 2003 from \$2.1 million for the three months ended June 30, 2002. Hardware revenue decreased \$3.4 million, or 73%, to \$1.3 million for the six months ended June 30, 2003 from \$4.7 million for the six months ended June 30, 2002. Hardware revenue represented slightly less than 1% of total revenue for the three months ended June 30, 2003, compared to 2% for the comparable period of 2002. Hardware revenue represented less than 1% of total revenue for the six months ended June 30, 2003, compared to 3% for the comparable period of 2002. The decline in hardware revenue reflects that hardware is not a strategic focus for us, and we expect hardware revenue to continue to decrease in the future.

## **Cost of Revenue**

Total cost of revenue decreased \$3.4 million, or 12%, to \$23.9 million for the three months ended June 30, 2003, from \$27.3 million for the comparable period in 2002. Total cost of revenue decreased \$6.2 million, or 11%, to \$48.6 million for the six months ended June 30, 2003, from \$54.8 million for the comparable period in 2002. The decrease for the three and six month comparisons is primarily due to the decrease in the cost of professional services and education revenue and hardware revenue as more fully discussed below.

*Software:* Cost of software revenue includes royalties paid to third parties, amortization expense for acquired technology and other intangible assets, partner commissions, software media costs, and the cost to manufacture and distribute software. The cost of software revenue increased \$0.9 million, or 35%, to \$3.6 million for the three months ended June 30, 2003 from \$2.7 million for the three months ended June 30, 2002. The cost of software revenue increased \$1.8 million, or 39%, to \$6.6 million for the six months ended June 30, 2003 from \$4.8 million for the six months ended June 30, 2002. The costs of software revenue represented 11% and 8% of the related software revenue for the three months ended June 30, 2003 and June 30, 2002, respectively. The costs of software revenue represented 10% and 7% of the related software revenue for the six months ended June 30, 2003 and June 30, 2002, respectively.

The increase in software cost of revenue for the three and six month periods of 2003, as compared to the same periods in 2002, is due primarily to higher partner commission expense and the additional amortization expense of acquired technology and other intangible assets associated with the acquisition of assets from eGrail in April 2002 and the stock of Shana in April 2003. We anticipate

cost of software revenue as a percentage of software revenue to remain comparable to historical levels in future periods, however additional technology acquisitions or unexpected increases in third party royalty costs could increase software cost of revenue in the future.

*Customer Support:* Cost of customer support revenue includes costs of customer support personnel, cost of supplies and spare parts, and the cost of third-party hardware maintenance. The cost of customer support revenue decreased \$1.1 million, or 11%, to \$8.7 million for the three months ended June 30, 2003 from \$9.8 million for the three months ended June 30, 2002. The cost of customer support revenue decreased \$1.4 million, or 7%, to \$18.5 million for the six months ended June 30, 2003 from \$19.9 million for the six months ended June 30, 2002. These costs represented 21% and 26% of the related customer support revenue for the three months ended June 30, 2003 and 2002, respectively. These costs represented 23% and 27% of the related customer support revenue for the six months ended June 30, 2003 and 2002, respectively.

The decrease in cost of customer support revenue for the three and six months ended June 30, 2003 compared to the same period in 2002 is primarily attributable to lower variable compensation expense and lower supplies cost. The decrease in cost of customer support revenue as a percentage of customer support revenue was primarily due to automation and process improvements that allowed growth in the customer and revenue base without a proportional increase in support personnel and cost. Going forward, we expect customer support cost of revenue to remain relatively stable in the near term.

*Professional Services and Education:* Cost of professional services and education revenue consists primarily of costs of professional services personnel, training personnel, and third-party independent consultants. The cost of professional services and education revenue decreased \$2.9 million, or 22%, to \$10.3 million for the three months ended June 30, 2003 from \$13.2 million for the three months ended June 30, 2002. The cost of professional services and education revenue decreased \$5.2 million, or 20%, to \$21.4 million for the six months ended June 30, 2003 from \$26.6 million for the six months ended June 30, 2002. These costs represented 88% and 91% of the related professional services and education revenue for the three months ended June 30, 2003 and 2002, respectively. These costs represented 89% and 88% of the related professional services and education revenue for the six months ended June 30, 2003 and 2002, respectively.

The decrease in cost of professional services and education revenue in 2003 compared to 2002 was primarily attributable to a reduction in the use of third-party independent consultants, as well as lower variable compensation expense; all directly related to the decrease in professional services and education revenue. We expect professional services and education costs as a percentage of professional services and education revenue to vary from period to period, depending on the utilization rates of internal resources and the mix between the use of internal resources and third-party independent consultants.

*Hardware:* Cost of hardware revenue includes the cost of assembling and distributing our OSAR library products, the cost of hardware integration personnel, and warranty costs. The cost of hardware revenue decreased \$0.3 million, or 21%, to \$1.3 million for the three months ended June 30, 2003 from \$1.6 million for the three months ended June 30, 2002. The cost of hardware revenue decreased \$1.4 million, or 41%, to \$2.1 million for the six months ended June 30, 2003 from \$3.5 million for the six months ended June 30, 2002. These costs represented 210% and 75% of the related hardware revenue for the three months ended June 30, 2003 and 2002, respectively. These costs represented 159% and 75% of the related hardware revenue for the six months ended June 30, 2003 and 2002, respectively.

The decrease in costs of revenue is directly related to the decrease in sales of OSAR library products. The increase in costs as a percentage of sales reflects the fixed operating costs relative to reduced sales volume. As we have discussed previously, this operating segment is not a strategic focus for us.

## Operating Expenses

*Research and Development:* Research and development expense primarily consists of costs of personnel to support product development. Research and development expense increased \$0.8 million to \$19.7 million, or 4%, for the three months ended June 30, 2003 from \$18.9 million for the three months ended June 30, 2002, and represented 23% and 21% of total revenue for these respective periods. Research and development expense increased \$2.7 million to \$39.0 million, or 8%, for the six months ended June 30, 2003 from \$36.3 million for the six months ended June 30, 2002, and represented 22% and 21% of total revenue for these respective periods. The increase year over year in the first half of 2003 is primarily the result of increased headcount resulting in higher compensation, benefits and relocation costs related to the eGrail and Shana acquisitions in April of 2002 and 2003, respectively. This increase was partially offset by a decrease in variable compensation expense. Research and development headcount for the three and six month periods ending June 2003 was 455 and 472, compared to 430 and 461 for the same periods in 2002, respectively. We expect research and development expense to be at approximately 22% of revenue in the near-term due to the continuing enhancement of ECM capabilities.

Our research and development efforts are focused on enhancing our ECM capabilities within the FileNet P8 product line and maintaining legacy products. These efforts will focus on enhancements to our FileNet P8 platform, Business Process Management, Web Content Management and the development of integrated records management and other capabilities. We intend to complement internal development with third-party software through OEM agreements and may execute additional technology acquisitions. We expect that competition for qualified technical personnel will remain intense and may result in higher levels of compensation expense for us in the future. We believe that research and development expenditures, including compensation of technical personnel, are essential to maintaining our competitive position and expect these costs will continue to constitute a higher than normal percentage of total revenue, as compared to our competitors, in the near term.

*Sales and Marketing:* Sales and marketing expense consists primarily of salaries and benefits, sales commissions and other expenses related to the direct and indirect sales force, various marketing expenses and the cost of other market development programs. Sales and marketing expense increased \$2.1 million to \$34.9 million, or 6%, for the three months ended June 30, 2003 from \$32.8 million for the three months ended June 30, 2002, and represented 40% and 37% of total revenue for these respective periods. Sales and marketing expense increased \$4.2 million to \$ 69.3 million, or 6%, for the six months ended June 30, 2003 from \$65.1 million for the six months ended June 30, 2002, and represented 40% and 37% of total revenue for these respective periods.

The increase in 2003 was primarily due to investment in our sales and marketing capabilities that include targeted contact and campaign management for specific industries, and channel partner development expenses associated with the launch of our FileNet P8 ECM product that occurred in the first half of 2003. This increase was partially offset by reduced commissions and variable compensation expense. We expect marketing and sales expense to be at approximately 39% of revenue in the near-term due to the continuing investment in demand generation capabilities for targeted customers through our direct and indirect sales channels.

*General and Administrative:* General and administrative expense consists primarily of personnel costs for finance, information technology, legal, human resources and general management, and the cost of outside professional services. General and administrative expense decreased \$0.3 million to \$8.3 million, or 3%, for the three months ended June 30, 2003 from \$8.6 million for the three months ended June 30, 2002, and represented 10% of total revenue for these respective periods. General and administrative expense decreased \$0.6 million to \$16.2 million, or 4%, for the six months ended June 30, 2003 from \$16.8 million for the six months ended June 30, 2002, and represented 10% of total revenue for these respective periods.

The decrease in the first six months of 2003 compared to first six months of 2002 was primarily due to on-going cost containment efforts and reduced variable compensation expense. We expect general and administrative expenses to remain at approximately 10% of revenue for the near term.

### **Amortization of Purchased Intangible Assets**

The April 2002 purchase of eGrail assets resulted in intangible assets comprised of acquired technology of \$3.3 million and patents of \$24,000 with assigned useful lives of five years and two years, respectively. The April 2003 purchase of Shana resulted in \$5.7 million of intangible assets; comprised of acquired technology of \$4.0 million, customer maintenance relationships of \$800,000 and technology manuals and design documents of \$600,000. All intangible assets for this acquisition were assigned a useful life of five years. Non-compete agreements with former executives of Shana were valued at \$277,000 and were assigned a useful life of between two and three years.

Amortization of acquired technology, and technical manuals and design documents are recorded on a straight-line basis as a cost of software revenue. Customer maintenance relationships are amortized on a straight-line basis as cost of customer support revenue. Amortization of patents and Covenants Not to Compete are recorded on a straight-line basis as an operating expense. Amortization expense was approximately \$494,000 and \$ 677,000 for the three and six months ended June 30, 2003, respectively, for all intangible assets. Amortization expense was approximately \$168,000 for the three and six months ended June 30, 2002, respectively, for all intangible assets. We determined that these assets were not impaired at June 30, 2003.

### **Other Income, Net**

Other income, net, consists primarily of interest income earned on our cash and cash equivalents, short and long-term investments, and other items including foreign exchange gains and losses, the gain (loss) on sale of fixed assets, and interest expense. Other income, net was \$1.6 million for the three months ended June 30, 2003 compared to other income, net of \$1.9 million for the three months ended June 30, 2002. Other income, net was \$2.7 million for the six months ended June 30, 2003 compared to other income, net of \$2.8 million for the six months ended June 30, 2002. Other income was essentially unchanged between comparable periods as foreign exchange gains were offset with reduced investment earnings.

### **Income Taxes**

Our combined federal, state and foreign annual effective tax rate for the three months ended June 30, 2003 is 26% compared to 21% for the comparable period in 2002. The combined federal, state and foreign annual effective tax rate for the six months ended June 30, 2003 is 28% compared to 23% for the comparable period in 2002. The increased tax rate in 2003 was primarily due to the mix of income earned by the domestic group versus the foreign subsidiaries. FileNet management will continue weighing various factors throughout the year to assess the recoverability of its recorded deferred assets and the need for any valuation allowance against such amounts. Any adjustment to the valuation allowance could affect both additional paid in capital and the effective tax rate in subsequent quarters.

## **Liquidity and Capital Resources**

At June 30, 2003, combined cash, cash equivalents and investments totaled \$205.8 million, an increase of \$20.6 million from December 31, 2002.

Cash provided by operating activities during the six months ended June 30, 2003 totaled \$28.3 million and resulted primarily from: an increase in unearned maintenance revenue related to prepaid maintenance contracts of \$10.0 million, additions to net income for depreciation and amortization expense of \$9.9 million, net income of \$2.8 million, and a decrease in accounts receivable of \$8.9 million, partially offset by a decrease of \$3.4 million in customer deposits and advances. The increase in unearned maintenance revenue is primarily the result of the growth in our base of annual support contracts resulting from new customer sales and sales of additional products to the existing base. Additionally, a significant number of maintenance contracts renew early in the year and are amortized ratably throughout the year resulting in a lower balance in unearned maintenance by December 31.

For the six months ended June 30, 2003, cash used for investing activities totaled \$8.9 million and included: capital expenditures of \$5.0 million and \$8.1 million for the acquisition of Shana, offset by net proceeds of the sales of marketable securities of \$4.1 million.

Cash provided by financing activities totaled \$4.2 million and was a result of proceeds received from the exercise of employee stock options and stock purchases under the employee stock purchase plan.

We had a \$5.0 million multi-currency revolving line of credit. On June 27, 2003, this credit facility expired in accordance with its terms and was not renewed because the cost of carrying the line did not justify the level of usage. We believe we will be able to meet our bank guarantee needs through our existing bank relationships in the United States and internationally.

Contractual cash obligations of significance include operating leases for our corporate offices, sales offices, development and manufacturing facilities, and other equipment under non-cancelable operating leases, some of which have renewal options and generally provide for escalation of the annual rental amount. (See Note 9 to the Notes to Unaudited Condensed Consolidated Financial Statements for additional details.)

We believe that our present cash balances together with internally generated funds and credit lines will be sufficient to meet our working capital and capital expenditure needs for at least the next 12 months.

## **Other Financial Instruments**

We conduct business on a global basis in several currencies. Accordingly, we are exposed to movements in foreign currency exchange rates. We enter into forward foreign exchange contracts to minimize the short-term impact of currency fluctuations on monetary assets and liabilities denominated in currencies other than the functional currency of the relevant entity. We do not enter into foreign exchange forward contracts for trading purposes. Gains and losses on these contracts, which equal the difference between the forward contract rate and the prevailing market spot rate at the time of valuation, are recognized as other income in the consolidated statements of operations. We open new hedge contracts on the last business day of each quarter that will mature at the end of the following quarter. The counterparties to these contracts are major financial institutions. We use commercial rating agencies to evaluate the credit quality of the counterparties and do not anticipate nonperformance by any counterparties. We do not anticipate a material loss resulting from any credit risks related to any of these institutions.

## **Recently Adopted Accounting Pronouncements**

In June 2001, the FASB issued SFAS No. 141, "Business Combinations," which was effective immediately. SFAS No. 141 requires that the purchase method of accounting be used for all business combinations initiated after June 30, 2001 and it eliminated the pooling-of-interests method. The adoption of this standard did not have a significant impact on our consolidated financial statements. Our April 2002 acquisition of certain assets and certain liabilities of eGrail, Inc. and our April 2003 acquisition of Shana Corporation were accounted for in compliance with this pronouncement (See Note 3 for details).

In June 2001, the FASB issued SFAS No. 142, "Goodwill and Other Intangible Assets," which we adopted January 1, 2002. SFAS No. 142 requires that goodwill and other intangible assets with indefinite useful lives no longer be amortized, but instead be tested for impairment at least annually and written down when impaired. SFAS No. 142 requires purchased intangible assets other than goodwill to be amortized over their useful lives, unless these lives are determined to be indefinite. In accordance with this standard, we do not amortize goodwill and indefinite life intangible assets but evaluate their carrying value annually or when events or circumstances indicate that their carrying value may be impaired. On the first day of July of each year, goodwill will be tested for impairment by determining if the carrying value of each reporting unit exceeds its fair value. As of June 30, 2003, no impairment of goodwill has been recognized. If estimates change, a materially different impairment conclusion could result.

In August 2001, the FASB issued SFAS No. 144, "Accounting for Impairment or Disposal of Long-Lived Assets." This statement addresses financial accounting and reporting for the impairment of long-lived assets and for the disposal of long-lived assets and discontinued operations. SFAS No. 144 superseded SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of," and is effective for fiscal years beginning after December 15, 2001. The adoption of this standard did not have a material impact on our consolidated financial position and results of operations.

In July 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities," which addresses financial accounting and reporting for costs associated with exit or disposal activities and supersedes EITF Issue 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)." SFAS No. 146 requires that costs associated with exit or disposal activities be recognized when they are incurred rather than at the date of a commitment to an exit or disposal plan. SFAS No. 146 also establishes that the liability should initially be measured and recorded at fair value. We adopted the provisions of SFAS No. 146 for exit or disposal activities initiated after December 31, 2002. The adoption of this standard did not have a material impact on our consolidated financial position and results of operations.

In November 2002, the FASB issued FIN 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees and Indebtedness of Others," an interpretation of FASB Statement Nos. 5, 57 and 107, and rescission of FIN 34, "Disclosure of Indirect Guarantees of Indebtedness of Others." FIN 45 elaborates on the disclosures to be made by the guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. It also requires that a guarantor recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. The provisions related to recognizing a liability at inception of the guarantee for the fair value of the guarantor's obligations does not apply to product warranties or to guarantees accounted for as derivatives. The initial recognition and measurement provisions of this interpretation are applicable on a prospective basis to guarantees issued or modified after December 31, 2002, while the disclosure requirements are effective for financial statements for interim or annual periods ending after December 15, 2002. The adoption of the recognition of provisions of FIN 45 in the three and six months ended June 30, 2003 did not have a

material impact on our consolidated results of operations or financial position.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation Transition and Disclosure," an amendment of SFAS No. 123. This statement amends SFAS No. 123, "Accounting for Stock-Based Compensation," to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, this statement amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The transition guidance and annual disclosure provisions of SFAS No. 148 are effective for fiscal years ending after December 15, 2002. The interim disclosure provisions are effective for financial reports containing financial statements for interim periods beginning after December 15, 2002. The adoption of SFAS No. 148 did not have a material impact on our consolidated results of operations or financial position.

In January 2003, the FASB issued FIN 46, "Consolidation of Variable Interest Entities." In general, a variable interest entity is a corporation, partnership, trust, or any other legal structure used for business purposes that either (a) does not have equity investors with voting rights or (b) has equity investors that do not provide sufficient financial resources for the entity to support its activities. FIN 46 requires a variable interest entity to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity's activities or entitled to receive a majority of the entity's residual returns or both. The consolidation requirements of FIN 46 apply immediately to variable interest entities created after January 31, 2003. The consolidation requirements apply to older entities in the first fiscal year or interim period beginning after June 15, 2003. Certain of the disclosure requirements apply in all financial statements issued after January 31, 2003, regardless of when the variable interest entity was established. We do not have any variable interest entities as of June 30, 2003. The adoption of FIN 46 did not have a material impact on our consolidated results of operations or our financial position.

In April 2003, FASB issued SFAS No. 149, "Amendment of Statement No. 133 on Derivative Instruments and Hedging Activities." SFAS No. 149 (1) clarifies under what circumstances a contract with an initial net investment meets the characteristic of a derivative discussed in paragraph 6(b) of Statement No. 133, (2) clarifies when a derivative contains a financing component, (3) amends the definition of an underlying derivative to conform it to language used in FIN 45, and (4) amends certain other existing pronouncements, which will collectively result in more consistent reporting of contracts as either derivatives or hybrid instruments. SFAS No. 149 is effective for contracts and hedging relationships entered into or modified after June 30, 2003. We do not believe that the adoption of SFAS No. 149 will have a material impact on our consolidated financial statements.

In May 2003, FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both debt and equity and requires an issuer to classify the following instruments as liabilities in its balance sheet:

- a financial instrument issued in the form of shares that is mandatorily redeemable and embodies an unconditional obligation that requires the issuer to redeem it by transferring its assets at a specified or determinable date or upon an event that is certain to occur;
- a financial instrument, other than an outstanding share, that embodies an obligation to repurchase the issuer's equity shares, or is indexed to such an obligation, and requires the issuer to settle the obligation by transferring assets; and
- a financial instrument that embodies an unconditional obligation that the issuer must settle by issuing a variable number of its equity shares if the monetary value of the obligation is based solely or predominantly on (1) a fixed monetary amount, (2) variations in something other than the fair value of the issuer's equity shares, or (3) variations inversely related to changes in the fair value of the issuer's equity shares.

SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003 and is effective for all other financial instruments as of the first interim period beginning after June 15, 2003. SFAS No. 150 is to be implemented by reporting the cumulative effect of a change in accounting principle. We do not expect the adoption of SFAS No. 150 to have a material impact on our consolidated financial statements.

## **Other Matters**

***Environmental Matters.*** We are not aware of any issues related to environmental matters that have, or are expected to have, a material affect on our business.

## **Risk Factors That May Affect Future Results**

Our business, financial condition, operating results and prospects can be impacted by a number of factors, including but not limited to those set forth below and elsewhere in this report, any one of which could cause our actual results to differ materially from recent results or from our anticipated future results. Factors that may affect our business, financial condition and results of operations include:

***Our quarterly operating results may fluctuate in future periods and are not predictable and, as a result, we may fail to meet expectations of investors and analysts, causing our stock price to fluctuate or decline.*** Prior operating results should not necessarily be considered indicative of future operating results. Our operating results have fluctuated in the past and we anticipate our future operating results will continue to fluctuate due to many factors, some of which are largely beyond our control.

These factors include, but are not limited to, the following:

- the industry-wide slow down in IT spending;
- general domestic and international economic and political conditions;
- the discretionary nature of our customers' budget and purchase cycles and the absence of long-term customer purchase commitments;
- the tendency to realize a substantial percentage of our revenue in the last weeks, or even days, of each quarter;
- the potential for delays or deferrals of customer orders;
- the size, complexity and timing of individual transactions;
- changes in foreign currency exchange rates;
- the length of our sales cycle;
- variations in the productivity of our sales force;
- the level of software product sold and price competition;
- the timing of new software introductions and software enhancements by us and our competitors;
- the mix of sales by products, software, services and distribution channels;
- project overruns associated with fixed price contracts;
- acquisitions by us and our competitors;
- our ability to develop and market new software products and control costs;
- the quality of our customer support; or
- the level of international sales.

The decision to implement our products is subject to each customer's resources and budget availability. Our quarterly sales generally include a mix of medium sized orders, along with several large individual orders, and as a result, the loss or delay of an individual large order could have a significant impact on our quarterly operating results and revenue. Our operating expenses are based on projected revenue trends



and are generally fixed. Therefore, any shortfall from projected revenue may cause significant fluctuations in operating results from quarter to quarter. As a result of these factors, revenue and operating results for any quarter are subject to fluctuations and are not predictable with any significant degree of accuracy. Therefore, we believe that period-to-period comparisons of our results of operations should not be relied upon as indications of future performance. Moreover, such factors could cause our operating results in a given quarter to be below the expectations of public market analysts and investors. In either case, the price of our common stock could decline materially.

***The markets in which we operate are highly competitive and we cannot be sure that we will be able to continue to compete effectively, which could result in lost market share and reduced revenue.*** The markets we serve are highly competitive and we expect competition to intensify. Our future financial performance will depend primarily on the continued growth of the markets for our software products and services as well as the purchase of our products by customers in these markets. If the markets we serve fail to grow or grow more slowly than we currently anticipate, our business, financial condition and operating results would be harmed. These intensely competitive markets can change rapidly. We have multiple competitors and there may be future competitors, some of which have or may have substantially greater sales, marketing, development and financial resources. As a consequence, our present or future competitors may be able to develop software products comparable or superior to those offered by us, offer lower priced products or adapt more quickly than we do to new technologies or evolving customer requirements. We cannot predict new competitors entering our market through acquisitions or other alliances. In order to be successful in the future, we must respond to technological change, customer requirements and competitors' current software products and innovations. We cannot assure that we will be able to continue to compete effectively in our target markets or that future competition will not have a material adverse effect on our business, financial condition or results of operations. In addition, current and potential competitors have established or may establish cooperative relationships among themselves or with third parties to increase the ability of their products to address the needs of the markets we serve. Accordingly, it is possible that new competitors or alliances among competitors may emerge and rapidly acquire significant market share. Increased competition may result in price reductions, reduced gross margins and loss of market share that could result in reduced revenue.

***We must develop and sell new products to keep up with rapid technological change in order to achieve future revenue growth and profitability.*** The market for our software and services is characterized by rapid technological developments, evolving industry standards, changes in customer requirements and frequent new product introductions and enhancements. Our ability to continue to sell products will be dependent upon our ability to continue to enhance our existing software and services offerings, develop and introduce, in a timely manner, new software products incorporating technological advances and respond to customer requirements. Our future success also depends, in part, on our ability to execute on our strategy of delivering a unified platform and framework for Enterprise Content Management. This strategy requires us to make long-term investments and commit significant resources based on our prediction of new products and services that the market needs and will accept. Our strategy also requires us to develop and maintain relations with technology partners. We may not be successful in maintaining these relationships or in developing, marketing and releasing new products or new versions of our products that respond to technological developments, evolving industry standards or changing customer requirements. We may also experience difficulties that could delay or prevent the successful development, introduction and sale of these products and enhancements. In addition, these products and enhancements may not adequately meet the requirements of the marketplace and may not achieve any significant degree of market acceptance. If we fail to successfully maintain or establish relationships with technology partners or to execute on our integrated product solution strategy, or if release dates of any future products or enhancements are delayed, or if these products or enhancements fail to achieve our prediction of market acceptance when released, our business operating results and financial condition could be materially harmed. In the past, we have experienced delays in the release dates of enhancements and new releases to our products and we cannot assure that we will not experience significant future delays in product introduction. From time to time, our competitors or we may announce new software products, capabilities or technologies that have the potential to replace or shorten the life cycles of our existing software products. We cannot assure that announcements of currently planned or

other new software products will not cause customers to delay their purchasing decisions in anticipation of such software products, and such delays could have a material adverse effect on our sales.

***We must effectively manage our new product and services transitions or our revenue may suffer.*** If we do not make an effective transition from existing products and services to our FileNet P8 architecture, our revenue may be seriously harmed. Among the factors that make a smooth transition difficult are delays in development, variations in pricing, delays in customer purchases in anticipation of new introductions and customer demand for the new offerings. If we incur delays in customer purchases or do not accurately estimate the market effects of new introductions, future demand for our products and services and our revenue may be seriously harmed.

***Protection of our intellectual property and other proprietary rights is limited, which could result in the use of our technology by competitors or other third parties. There is risk of third-party claims of infringement, which could expose us to litigation and other costs.*** Our success depends, in part, on our ability to protect our proprietary rights to the technologies used in our principal products. We rely on a combination of copyrights, trademarks, trade secrets, patents, confidentiality procedures and contractual provisions to protect our proprietary rights in our software products. We cannot assure that our existing or future copyrights, trademarks, trade secrets, patents or other intellectual property rights will have sufficient scope or strength to provide meaningful protection or a commercial advantage to us. In addition, the laws of some foreign countries do not protect our proprietary rights to the same extent as do the laws of the United States. Any inability to protect our intellectual property may harm our business and competitive position.

***We may, from time to time, be notified that we are infringing certain patent or intellectual property rights of others.*** While there are no material actions currently pending against us for infringement of patent or other proprietary rights of third parties, we cannot assure that third parties will not initiate infringement actions against us in the future. Combinations of technology acquired through past or future acquisitions and our technology will create new software products and technology that also may give rise to claims of infringement. Infringement actions can result in substantial costs and diversion of resources, regardless of the merits of the actions. If we were found to infringe upon the rights of others, we cannot assure that we could redesign the infringing products or could obtain licenses on acceptable terms, if at all. Additionally, significant damages for past infringement could be assessed or future litigation relative to any such licenses or usage could occur. An adverse disposition of any claims or the advent of litigation arising out of any claims of infringement could result in significant costs or reduce our ability to market any affected products.

***We depend on certain strategic relationships in order to license third-party products and revenue related to these products could be at risk if we were unable to maintain these relationships.*** In order to expand the distribution of our products and broaden our product offerings, we have established strategic relationships with a number of indirect channel partners and other consultants that provide marketing and sales opportunities for us. We have entered into key formal and informal agreements with other companies such as IBM CrossWorlds, Microsoft Corporation, SAP AG, Siebel Systems Inc, Sun Microsystems, Inc., BEA Systems Inc., EMC Corporation, ILOG Corporation, Arbortext, Inc., Venetica Corporation and Verity, Inc. Certain of these agreements have minimum purchase requirements and/or require prepayments which usage is limited to a specific timeframe, while others do not have minimum purchase requirements and/or are cancelable at will. We cannot assure that these companies will not reduce or discontinue their relationships with, or support of, FileNet and our products. Our failure to maintain these relationships, or to establish new relationships in the future, could harm our business, financial condition and results of operations.

***We currently license certain software from third parties, including software that is integrated with internally developed software and used in our products to perform key functions.*** In the past, we have had difficulty renewing certain licenses. The failure to continue to maintain these licenses would prohibit us from selling certain products. We cannot assure that such third parties will remain in business, that they will continue to support their software products or that their software products will continue to be available to us on acceptable terms. The loss or inability to maintain any of these software licenses could result in shipment delays or reductions in software shipments until equivalent software can be developed, identified, licensed, and integrated. In addition, it is possible that as a consequence of a merger or acquisition transaction involving

one of these third parties, certain restrictions could be imposed on our business that had not been imposed prior to the transaction. This could adversely affect our sales.

***We must retain and attract key executives and personnel who are essential to our business, which could result in increased personnel expenses.*** Our success depends to a significant degree upon the continued contributions of our key management, as well as other marketing, technical and operational personnel. The loss of the services of one or more key employees could have a material adverse effect on our operating results. We do not have employment agreements with any of the members of our United States-based senior management. We do have employment contracts with members of our international management that commit them to a notification period. We believe our future success will depend in large part upon our ability to attract and retain additional highly skilled management, technical, marketing, product development and operational personnel and consultants. There is competition for such personnel; particularly software developers, professional services consultants and other technical personnel. We cannot assure that in the future we will be successful in attracting and retaining such personnel.

***A significant percent of our revenue is derived internationally and we are subject to many risks internationally, which could put our revenue at risk.*** Historically, we have derived approximately 30% of our total revenue from international sales through our worldwide network of subsidiaries and channel partners. International business is subject to certain risks including, but not limited to, the following:

- political and economic instability;
- tariffs and trade barriers;
- varying technical standards;
- reduced protection for intellectual property rights in certain countries;
- difficulties in staffing and maintaining foreign operations;
- difficulties in managing foreign distributors;
- varying requirements for localized products;
- potentially adverse tax consequences;
- currency restrictions and currency exchange fluctuations including those related to the Euro;
- the burden of complying with a wide variety of complex foreign laws, regulations and treaties;
- the possibility of difficulties in collecting accounts receivable; and
- longer accounts receivable cycles and financial instability among customers.

Any of these factors could reduce the amount of revenue we realize from our international operations in the future.

***If our products contain errors, we could incur unplanned expenses and delays that could result in reduced revenue, lower profits, and harmful publicity.*** Software, services and products, as complex as those we sell, are susceptible to errors or failures, especially when first introduced or deployed. Our software products are often intended for use in applications that are critical to a customer's business. As a result, our customers may rely on the effective performance of our software to a greater extent than the market for software products generally. Despite internal testing and testing by current and potential customers, new products or enhancements may contain undetected errors or performance problems that are discovered only after a product has been installed and used by customers. Errors or performance problems could cause delays in product introduction and shipments or could require design modifications, either of which could lead to a loss in or delay of revenue. These problems could cause a diversion of development resources, harm our reputation or result in increased service or warranty costs, or require the payment of monetary damages. While our license agreements with customers typically contain provisions designed to limit our exposure to potential product liability claims, it is possible that such limitation of liability provisions may not be effective under the laws of certain jurisdictions.

***Our stock price has been and may continue to be volatile causing fluctuations in the market price of our stock, which would impact shareholder value.*** The trading price of our common stock has fluctuated in the past and is subject to significant fluctuations in response to the following factors, among others, some of which are beyond our control:

- variations in quarterly operating results;
- fluctuations in our order levels;
- changes in earnings estimates by analysts;
- announcements of technological innovations or new products or product enhancements by us or our competitors;
- key management changes;
- changes in accounting regulations;
- changes in joint marketing and development programs;
- developments relating to patents or other intellectual property rights or disputes;
- developments in our relationships with our customers, resellers and suppliers;
- our announcements of significant contracts, acquisitions, strategic partnerships or joint ventures;
- general conditions in the software and computer industries;
- fluctuations in general stock market prices and volume, which are particularly common among highly volatile securities of Internet and software companies; and
- other general economic and political conditions.

In recent years, the stock market, in general, has experienced extreme price and volume fluctuations that have affected the market price for many companies in industries similar to ours. Some of these fluctuations have been unrelated to the operating performance of the affected companies. These market fluctuations may decrease the market price of our common stock in the future.

***Acquisitions of companies or technologies may result in disruptions to our business and diversion of management attention, which could cause our financial performance to suffer.*** As part of our business strategy, we frequently evaluate strategic acquisition opportunities. For example we recently completed the acquisitions of eGrail and Shana. We anticipate that our future growth may depend in part on our ability to identify and acquire complementary businesses, technologies or product lines. Acquisitions involve significant risks and could divert management's attention from the day-to-day operations of our ongoing business. Additionally, such acquisitions may include numerous other risks, including, but not limited to, the following:

- difficulties in the integration of the operations, products and personnel of the acquired companies;
- the incurrence of debt;
- liabilities and risks that are not known or identifiable at the time of the acquisition;
- difficulties in retaining the acquired company's customer base;
- valuations of acquired assets or businesses that are less than expected; and
- the potential loss of key personnel of the acquired company.

If we fail to successfully manage future acquisitions or fully integrate future acquired businesses, products or technologies with our existing operations, we may not receive the intended benefits of the acquisitions and such acquisitions may harm our business and financial results.

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

#### Interest Rate Risk

Our exposure to market rate risk for changes in interest rates relates primarily to our investment portfolio. We have not used derivative financial instruments in our investment portfolio. We place our investments with high-quality issuers and, by policy, limit the amount of credit exposure to any one issuer. We protect and preserve our invested funds by limiting default, market and reinvestment risk. Our investments in marketable securities consist primarily of high-grade corporate and government securities with maturities of less than three years. Investments purchased with an original maturity of three months or less are considered to be cash equivalents. We classify all of our investments as available-for-sale. Available-for-sale securities are carried at fair value, with unrealized gains and losses, net of tax, reported in a separate component of stockholders' equity. Average maturity of our investment portfolio is 4.2 months; therefore, the movement of interest rates should not have a material impact on our balance sheet or income statement.

At any time, a significant increase/decrease in interest rates will have an impact on the fair market value and interest earnings of our investment portfolio. We do not currently hedge this interest rate exposure. We have performed a sensitivity analysis as of June 30, 2003 and 2002, using a modeling technique that measures the change in the fair values arising from a hypothetical 50 basis points and 100 basis points adverse movement in the levels of interest rates across the entire yield curve, which are representative of historical movements in the Federal Funds Rate with all other variables held constant. The analysis covers our investment and is based on the weighted-average maturity of our investments as of June 30, 2003 and 2002. The sensitivity analysis indicated that a hypothetical 50 basis points adverse movement in interest rates would result in a loss in the fair values of our investment instruments of approximately \$249,000 at June 30, 2003 and approximately \$280,000 at June 30, 2002. Similarly a hypothetical 100 basis points adverse movement in interest rates would result in a loss in the fair values of our investments of approximately \$498,000 at June 30, 2003 and approximately \$559,000 at June 30, 2002.

The following table provides information about our cash and cash equivalents and our investment portfolio at June 30, 2003 (dollars in thousands):

<i>(In thousands)</i>	Cost	Estimated Fair Value
Debt Securities		
Due in one year or less:		
Short-term munis-taxable	\$ 5,997	\$ 6,010
Corporate	10,664	10,681
Governments/Agencies	9,000	9,003
Total due in one year	25,661	25,694
Due in one to three years:		
Taxable munis	1,047	1,057
Corporate	2,255	2,243
Government/Agencies	19,500	19,514
Total due in three years	22,802	22,814
Grand total	\$ 48,463	\$ 48,507

Actual maturities may differ from contractual maturities because the issuer of the securities may have the right to repurchase such securities. The Company classifies short-term investments in current assets, as all such investments are available for current operations.

### **Foreign Currency Fluctuations and Inflation**

Our performance can be affected by changes in foreign currency values relative to the U.S. dollar in relation to our revenue and operating expenses. We have entered into forward foreign exchange contracts primarily to hedge amounts due from and the net assets of selected subsidiaries denominated in foreign currencies (mainly in Europe and Asia Pacific) against fluctuations in exchange rates. We have not entered into forward foreign exchange contracts for speculative or trading purposes. Our accounting policies for these contracts are based on our designation of the contracts as hedging transactions. The criteria we use for designating a contract as a hedge include the contract's effectiveness in risk reduction and one-to-one matching of derivative instruments to underlying transactions. Gains and losses on foreign exchange contracts are recognized in income in the same period as gains and losses on the underlying transactions. If an underlying hedged transaction were terminated earlier than initially anticipated, the offsetting gain or loss on the related forward foreign exchange contract would be recognized in income in the same period. In addition, since we enter into forward contracts only as a hedge, any change in currency rates would not result in any material net gain or loss, as any gain or loss on the underlying foreign currency denominated balance would be offset by the gain or loss on the forward contract. Our forward contracts generally have an original maturity of three months. As of June 30, 2003, we had forward foreign exchange contracts outstanding totaling approximately \$2.1 million in ten currencies. These contracts were opened on the last business day of the quarter and mature within three months.

Cumulative other comprehensive loss decreased by \$5.0 million for the six months ended June 30, 2003 due to unrealized foreign currency translation gains resulting from the strengthening of the Euro against the U.S. dollar during the first half of 2003.

Management believes that inflation has not had a significant impact on the prices of our products, the cost of our materials, or our operating results for the six months ended June 30, 2003.

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

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Company's Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and that such information is accumulated and communicated to the Company's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As of June 30, 2003, the end of the quarter covered by this report, an evaluation was carried out under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and the Company's Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as required by SEC Rule 13a – 15(b). Based on the foregoing, the Company's Chief Executive Officer and Chief Financial Officer concluded that, the Company's disclosure controls and procedures were effective at the reasonable assurance level.

There has been no change in the Company's internal controls over financial reporting during the Company's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal controls over financial reporting.

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

See Note 10 to Consolidated Financial Statements.

### Item 4. Submission of Matters to a Vote

(a) The 2003 Annual Meeting of Stockholders of the Company was held at 9:00 a.m. on May 7, 2003, in Costa Mesa, California.

(b) At the annual meeting, the following six individuals were elected to the Company's Board of Directors, constituting all members of the Board of Directors:

Nominee	Affirmative Votes	Votes Withheld
L. George Klaus	31,665,441	2,050,045
William P. Lyons	30,694,550	3,020,936
Lee D. Roberts	32,210,595	1,504,891
John C. Savage	31,273,510	2,441,976
Roger S. Siboni	32,143,365	1,572,121
Theodore J. Smith	24,592,546	9,122,940

(c) The Company's stockholders were asked to approve an amendment to the Company's 2002 Incentive Award Plan to increase the number of shares of Common Stock available for issuance there under by an additional 1,400,000 shares. This proposal was approved in accordance with the following vote of stockholders:

Votes For	Votes Against	Abstentions
24,532,286	9,134,985	48,215

(d) The Company's stockholders were asked to ratify the Company's appointment of Deloitte & Touche LLP as independent accountants of the Company for the fiscal year ending December 31, 2003. This proposal was approved in accordance with the following vote of stockholders:

Votes For	Votes Against	Abstentions
33,332,939	328,069	54,478

**Item 6. Exhibits and Reports on Form 8-K****(a) Exhibits**

The list of exhibits contained in the accompanying Index to Exhibits is herein incorporated by reference.

**(b) Reports on Form 8-K**

No reports on Form 8-K were filed in the quarter ended June 30, 2003.



## **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.

### **FILENET CORPORATION**

August 13, 2003

*Date*

By: /s/ Sam M. Auriemma.

Sam M. Auriemma, Senior Vice President  
(Principal Financial and Accounting Officer, Authorized Signatory  
and Chief Financial Officer)

## Index to Exhibits

The following exhibits are filed herewith or incorporated by reference:

<u>Exhibit No.</u>	<u>Exhibit Description</u>
3.1*	Restated Certificate of Incorporation, as amended ( <i>filed as Exhibit 3.1 to Registrant's Form S-4 filed on January 26, 1996; Registration No. 333-00676</i> ).
3.1.1*	Certificate of Amendment of Restated Certificate of Incorporation ( <i>filed as Exhibit 3.1.1 to Registrant's Form S-4 filed on January 26, 1996, Registration No. 333-00676</i> ).
3.2*	Bylaws ( <i>filed as Exhibit 3.2 of the Registrant's registration statement on Form S-1, Registration No. 33-15004</i> ).
4.1*	Form of certificate evidencing Common Stock ( <i>filed as Exhibit 4.1 to Registrant's registration statement on Form S-1, Registration No. 33-15004</i> ).
4.2*	Rights Agreement, dated as of November 4, 1988 between FileNet Corporation and the First National Bank of Boston, which includes the form of Rights Certificate as Exhibit A and the Summary of Rights to Purchase Common Shares as Exhibit B ( <i>filed as Exhibit 4.2 to Registrant's registration statement on Form S-4 filed on January 26, 1996; Registration No. 333-00676</i> ).
4.3*	Amendment One dated July 31, 1998 and Amendment Two dated November 9, 1998 to Rights Agreement dated as of November 4, 1988 between FileNet Corporation and BANKBOSTON, N.A. formerly known as The First National Bank of Boston ( <i>filed as Exhibit 4.3 to Registrant's registration statement on Form 10-Q for the quarter ended September 30, 1998</i> ).
4.4*	Amendment Three dated November 30, 2002 to Rights Agreement dated as of November 4, 1988 between FileNet Corporation and Equiserve Trust Company, N.A., successors to BANKBOSTON, N.A. ( <i>filed as Exhibit 4.4 to Registrant's Annual Report on Form 10-K filed for the year ended December 31, 2002</i> ).
10.1*	Second Amended and Restated Credit Agreement (Multi-currency) by and between the Registrant and Bank of America National Trust and Savings Association dated June 30, 1999, effective June 30, 1999 ( <i>filed as Exhibit 10.1 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 1999</i> ) as amended by a Waiver and First Amendment to Credit Agreement dated as of June 29, 2002 and by a letter amendment dated as of April 5, 2002.
10.1.1*	Letter amendment dated as of April 5, 2002 and Third Amendment to Credit Agreement (Multi-currency) by and between the Registrant and Bank of America, N.A., dated as of June 28, 2002 ( <i>filed as Exhibit 10.1.2 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2002</i> ).
10.1.2*	Waiver and First Amendment to Credit Agreement (Multi-currency) by and among the Registrant and Bank of America, N.A., formerly known as Bank of America National Trust and Savings Association, dated June 29, 2002, effective June 29, 2002 ( <i>filed as Exhibit 10/1 to Registrant's Annual Report on Form 10-K filed for the year ended December 31, 2002</i> ).
10.2*+	Amended and Restated 1995 Stock Option Plan of FileNet ( <i>filed as Exhibit 99.1 to Registrant's registration statement on Form S-8 filed on October 15, 2002; Registration No. 333-71598</i> ).
10.2.1+	Amendment to the 1995 Stock Option Plan approved by Registrant's Board of Directors dated May 7, 2003.
10.2.2+	Amended Form of 1995 Executive Officer Stock Option Agreement
10.3*+	Second Amended and Restated 1986 Stock Option Plan of FileNet Corporation, together with the forms of Incentive Stock Option Agreement and Non-Qualified Stock Option Agreement ( <i>filed as Exhibits 4(a), 4(b) and 4(c), respectively, to the Registrant's registration statement on Form S-8, Registration No. 33-48499</i> ), the first Amendment thereto ( <i>filed as Exhibit 4(d) to the Registrant's registration statement on Form S-8, Registration No. 33-69920</i> ), and the Second Amendment thereto ( <i>filed as Appendix A to the Registrant's Proxy Statement for the Registrant's 1994 Annual Meeting of Stockholders, filed on April 29, 1994</i> ).
10.4*+	Non-Statutory Stock Option Agreement (with Notice of Grant of Stock Option and Special Addendum) between Registrant and Mr. Lee Roberts ( <i>filed as Exhibit 99.17 to Registrant's registration statement on Form S-8 filed on August 20, 1997</i> ).
10.5*+	Non-Statutory Stock Option Agreement (with Notice of Grant of Stock Option and Special Addendum) between Registrant and Mr. Ron Ercanbrack ( <i>filed as Exhibit 99.19 to Registrant's registration statement on Form S-8 filed on August 20, 1997</i> ).
10.6*+	Amended and Restated FileNet Corporation 1998 Employee Stock Purchase Plan ( <i>filed as Appendix B to Registrant's Definitive Proxy Statement on Schedule 14A, for the Registrant's 2002 Annual Meeting of Stockholders, filed on April 18, 2002</i> ).

10.7*+	FileNet Corporation International Employee Stock Purchase Plan ( <i>filed as Appendix C to Registrant's Definitive Proxy Statement on Schedule 14A, for the Registrant's 2002 Annual Meeting of Stockholders, filed on April 18, 2002</i> ).
10.8*	Lease between the Registrant and C. J. Segerstrom & Sons for the headquarters of the Company, dated September 1, 1999 ( <i>filed as Exhibit 10.23 to Registrant's registration statement on Form 10-Q for the quarter ended September 30, 1999</i> ).
10.9*	Asset Purchase Agreement between the Registrant and Application Partners, Inc. dated May 18, 2000 ( <i>filed as Exhibit 10.24 to Registrant's Form 10-Q for the quarter ended June 30, 2000</i> ).
10.10*+	Written Compensation Agreement and Non-Statutory Stock Option Agreement (with Notice of Grant of Stock Option) between Registrant and Mr. Sam Auriemma ( <i>filed as Exhibit 99.1 and 99.2 to Registrant's registration statement on Form S-8, filed on April 20, 2002; Registration No. 333-59274</i> ).
10.11*	Asset Purchase Agreement dated April 2, 2002 by and between 3565 Acquisition Corporation and eGrail, Inc. ( <i>filed as Exhibit 10.1 to Registrant's Current Report on Form 8-K, filed on April 12, 2002</i> ).
10.12*+	Secured Promissory Note between Registrant and Mr. Lee D. Roberts dated June 14, 2002 ( <i>filed as Exhibit 10.12 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2002</i> ).
10.13*+	Option Exchange Agreement between Registrant and Mr. Ron L. Ercanbrack, dated May 22, 2002, together with form of Incentive Stock Option Agreement and Grant Notice ( <i>filed as Exhibit 10.13 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2002</i> ).
10.14*+	The 2002 Incentive Award Plan, as approved by stockholders at the Registrant's Annual Meeting on May 22, 2002, ( <i>filed as Exhibit 10.14 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2002</i> ).
10.14.1*+	Form of 2002 Incentive Award Plan Incentive Option Agreement with Notice of Grant of Stock Option ( <i>filed as Exhibit 10.14.1 to Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2002</i> ).
10.14.2*+	Form of 2002 Incentive Award Plan Non-Qualified Stock Option Agreement for Independent Directors with Notice of Grant of Stock Option ( <i>filed as Exhibit 10.14.2 to Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2002</i> ).
10.14.3+	Amendment to the 2002 Incentive Award Plan dated May 7, 2003.
10.15	Stock Purchase Agreement dated April 2, 2003 by and among Registrant, FileNet Nova Scotia Corporation, Shana Corporation and certain Sellers.
10.15.1	Escrow Agreement dated April 2, 2003 by and among FileNet Nova Scotia Corporation, certain Sellers and Bennett Jones LLP.
10.16+	Amended and Restated Letter Agreement dated May 15, 2003 by and between Registrant and Lee D. Roberts, Chief Executive Officer.
10.17+	Form of Amended and Restated Letter Agreement, dated May 15, 2003, by and between Registrant and the Chief Financial Officer and President <sup>(1)</sup> .
10.18+	Form of Amended and Restated Letter Agreement by and among Registrant and certain Executive Officers <sup>(2)</sup> .
10.19+	CEO Severance Agreement together with Addendum II to Stock Option Agreement between Registrant and Mr. Lee D. Roberts.
31.1	Certification of Chief Executive Officer
31.2	Certification of Chief Financial Officer
32.1	Certification of Chief Executive Officer
32.2	Certification of Chief Financial Officer

\* Incorporated herein by reference

+ Management contract, compensatory plan or arrangement

(1) Amended and Restated Letter Agreement, dated May 15, 2003 was entered into by and between Registrant and Messrs. Sam Auriemma, Chief Financial Officer and Ron L. Ercanbrack, President

(2) Amended and Restated Letter Agreement, dated May 15, 2003 was entered into by and between Registrant and Messrs. Martyn D. Christian, David D. Despard, Frederick P. Dillon, Karl J. Doyle, Michael W. Harris, William J. Kreidler, Chas W. Kunkelmann, , Philip Rugani, Daniel S. Whelan, Franz X. Zihlmann, and Ms.Katharina M. Mueller.