
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 March 31, 2004

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 May 5, 2004, there were 38,940,147 shares of the Registrant's common stock outstanding.

FILENET CORPORATION
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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)

| | <u>March 31,</u> 2004 | <u>December 31,</u> 2003 |
|--|--------------------------|-----------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 238,327 | \$ 203,305 |
| Short-term investments available for sale | 33,674 | 32,286 |
| Accounts receivable, net | 33,340 | 38,096 |
| Prepaid expenses and other current assets | 13,511 | 13,174 |
| Deferred income taxes | <u>3,551</u> | <u>3,551</u> |
| Total current assets | 322,403 | 290,412 |
| Property, net | 25,810 | 26,922 |
| Long-term investments available for sale | 18,983 | 12,672 |
| Goodwill | 25,822 | 26,170 |
| Intangible assets, net | 7,315 | 7,979 |
| Deferred income taxes | 23,040 | 23,001 |
| Other assets | <u>4,032</u> | <u>4,692</u> |
| Total assets | <u>\$ 427,405</u> | <u>\$ 391,848</u> |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 10,207 | \$ 11,006 |
| Accrued compensation and benefits | 24,291 | 27,648 |
| Customer deposits and advances | 6,970 | 5,217 |
| Unearned maintenance revenue | 64,861 | 40,691 |
| Other accrued liabilities | <u>15,397</u> | <u>16,524</u> |
| Total current liabilities | 121,726 | 101,086 |
| Unearned maintenance revenue and other liabilities | 3,204 | 1,614 |
| 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; 39,811,824 issued and 38,713,824 shares outstanding at March 31, 2004; and 38,906,640 shares issued and 37,808,640 shares outstanding at December 31, 2003 | 244,252 | 234,025 |
| Retained earnings | 68,096 | 64,098 |
| Accumulated other comprehensive income | 4,694 | 5,592 |
| Treasury stock, at cost; 1,098,000 shares | <u>(14,567)</u> | <u>(14,567)</u> |
| Net stockholders' equity | <u>302,475</u> | <u>289,148</u> |
| Total liabilities and stockholders' equity | <u>\$ 427,405</u> | <u>\$ 391,848</u> |

See accompanying notes to unaudited condensed consolidated financial statements.

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

| | <u>Three Months Ended March 31,</u> | |
|--------------------------------------|-------------------------------------|-----------------|
| | <u>2004</u> | <u>2003</u> |
| Revenue: | | |
| Software | \$ 41,351 | \$ 35,522 |
| Customer support | 45,270 | 39,396 |
| Professional services and education | 12,877 | 12,131 |
| Total revenue | <u>99,498</u> | <u>87,049</u> |
| Costs: | | |
| Software | 3,523 | 3,008 |
| Customer support | 10,292 | 10,571 |
| Professional services and education | 10,838 | 11,080 |
| Total cost of revenue | <u>24,653</u> | <u>24,659</u> |
| Gross Profit | 74,845 | 62,390 |
| Operating expenses: | | |
| Sales & marketing | 41,561 | 34,399 |
| Research and development | 20,102 | 19,302 |
| General and administrative | 9,233 | 7,826 |
| Total operating expenses | <u>70,896</u> | <u>61,527</u> |
| Operating income | 3,949 | 863 |
| Other income, net | <u>927</u> | <u>1,045</u> |
| Income before income taxes | 4,876 | 1,908 |
| Provision for income taxes | <u>878</u> | <u>572</u> |
| Net income | <u>\$ 3,998</u> | <u>\$ 1,336</u> |
| Earnings per share: | | |
| Basic | \$ 0.10 | \$ 0.04 |
| Diluted | \$ 0.10 | \$ 0.04 |
| Weighted-average shares outstanding: | | |
| Basic | 38,280 | 35,942 |
| Diluted | 40,785 | 36,623 |

See accompanying notes to unaudited condensed consolidated financial statements.

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

| | Three Months Ended March 31, | |
|--|---------------------------------|----------|
| | 2004 | 2003 |
| Net income | \$ 3,998 | \$ 1,336 |
| Other comprehensive income (loss): | | |
| Foreign currency translation adjustments | (914) | 1,997 |
| Unrealized gain (loss) on securities: | | |
| Unrealized holding gain (loss) | 16 | (10) |
| Total other comprehensive income (loss) | (898) | 1,987 |
| Comprehensive income | \$ 3,100 | \$ 3,323 |

See accompanying notes to unaudited condensed consolidated financial statements.

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

| | Three Months Ended March 31, | |
|---|---------------------------------|------------|
| | 2004 | 2003 |
| Cash flows from operating activities: | | |
| Net income | \$ 3,998 | \$ 1,336 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 4,276 | 4,907 |
| Loss on sale of property | 4 | 37 |
| Provision for doubtful accounts | 6 | 18 |
| Deferred income taxes | (40) | (6) |
| Changes in operating assets and liabilities, net of the effects of acquisitions: | | |
| Accounts receivable | 4,551 | 4,653 |
| Prepaid expenses and other current assets | (411) | (975) |
| Accounts payable | (756) | (1,830) |
| Accrued compensation and benefits | (3,261) | 3,034 |
| Customer deposits and advances | 1,762 | 1,048 |
| Unearned maintenance revenue | 25,875 | 15,821 |
| Income taxes payable | 1,734 | (385) |
| Other | (2,578) | (972) |
| Net cash provided by operating activities | \$ 35,160 | \$ 26,686 |
| Cash flows from investing activities: | | |
| Capital expenditures | (2,726) | (2,507) |
| Proceeds from sale of property | 48 | 68 |
| Purchases of marketable securities | (24,910) | (28,020) |
| Proceeds from sales and maturities of marketable securities | 17,800 | 23,655 |
| Net cash used in investing activities | \$ (9,788) | \$ (6,804) |
| Cash flows from financing activities: | | |
| Proceeds from issuance of common stock | 10,178 | 530 |
| Net cash provided by financing activities | \$ 10,178 | \$ 530 |
| Effect of exchange rate changes on cash and cash equivalents | (528) | 1,755 |
| Net increase in cash and cash equivalents | 35,022 | 22,167 |
| Cash and cash equivalents, beginning of year | 203,305 | 130,154 |
| Cash and cash equivalents, end of period | 238,327 | 152,321 |
| Supplemental cash flow information: | | |
| Interest paid | 22 | 7 |
| Income taxes paid / (refunded) | \$ (950) | \$ 950 |

See Note No. 10 for additional non-cash disclosures.

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 March 31, 2004, the results of its operations, its comprehensive operations and its cash flows for the three months ended March 31, 2004 and 2003. 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, 2003 filed with the SEC on March 12, 2004. The results of operations for the interim periods are not necessarily indicative of the operating results for the year, or any other future period.

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

2. NEW ACCOUNTING PRONOUNCEMENTS

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. With respect to variable interest entities created before January 31, 2003, in December 2003 the FASB issued FIN 46R, which, among other things, revised the implementation date to the first fiscal years or interim periods ending after March 15, 2004, with the exception of Special Purpose Entities ("SPE"). The consolidated requirements apply to all SPE's in the first fiscal year or interim period ending after December 15, 2003. The Company has determined that it does not have any SPE's to which these interpretations apply and has adopted FIN 46R in the first quarter of 2004. The adoption of FIN 46R did not have a material impact on the Company's 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.

In November 2003, the FASB issued FASB Staff Position (FSP) No. 150-3 which deferred the effective dates for applying certain provisions of SFAS No. 150 related to mandatorily redeemable financial instruments of certain nonpublic entities and certain mandatorily redeemable noncontrolling interests for public and nonpublic entities.

For public entities, SFAS No. 150 is effective for mandatorily redeemable 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.

For mandatorily redeemable noncontrolling interests that would not have to be classified as liabilities by a subsidiary under the exception in paragraph 9 of SFAS No. 150, but would be classified as liabilities by the parent, the classification and measurement provisions of SFAS No. 150 are deferred indefinitely. For other mandatorily redeemable noncontrolling interests that were issued before November 5, 2003, the measurement provisions of SFAS No. 150 are deferred indefinitely. For those instruments, the measurement guidance for redeemable shares and noncontrolling interests in other literature shall apply during the deferral period.

SFAS No. 150 is to be implemented by reporting the cumulative effect of a change in accounting principle. The Company does not have financial instruments with characteristics of both debt and equity and therefore the adoption of SFAS No. 150 did not have a material impact on the Company's consolidated financial statements.

3. STOCK BASED COMPENSATION

The Company accounts for stock based awards to employees using the intrinsic value method in accordance with Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees." 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, Accounting for Stock Based Compensation", for the three months ended March 31, 2004 and 2003.

| <i>(In thousands, except per share amounts)</i> | Three Months Ended March 31, | |
|---|---------------------------------|-----------|
| | 2004 | 2003 |
| Net income, as reported | \$ 3,998 | \$ 1,336 |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (1,547) | (2,039) |
| Pro forma net income (loss) | 2,451 | (703) |
| Earnings per share: | | |
| Basic earnings per share - as reported | \$ 0.10 | \$ 0.04 |
| Basic earnings (loss) per share - pro forma | 0.06 | (0.02) |
| Diluted earnings per share - as reported | 0.10 | 0.04 |
| Diluted earnings (loss) per share - pro forma | \$ 0.06 | \$ (0.02) |

For purposes of computing proforma net income, the Company estimates 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 March 31, | |
|--------------------------|---------------------------------|-------|
| | 2004 | 2003 |
| Expected term (in years) | 5.39 | 5.0 |
| Expected volatility | 51% | 66% |
| Risk free interest rates | 3.07% | 3.61% |
| Expected dividend | 0% | 0% |

4. ACQUISITIONS

On April 2, 2003, the Company completed a stock purchase acquisition of 100% 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 consideration, less \$938,000 of acquired cash, plus \$184,000 in acquisition expenses and \$277,000 paid for Non-Compete Agreements.

In accordance with SFAS No. 141, “Business Combinations,” this acquisition was accounted for under the purchase method of accounting. The purchase price was allocated as follows:

| <u>Shana Corporation</u> | <u>(In thousands)</u> <u>April 2, 2003</u> |
|--|---|
| Net tangible assets | \$ 2,725 |
| Goodwill | 3,103 |
| Acquired technology | 4,000 |
| Technical manuals and design documents | 600 |
| Customer maintenance relationships | 800 |
| Non-Compete Agreements | 277 |
| Liabilities assumed | <u>(2,494)</u> |
| Total purchase price | \$ 9,011 |
| Less cash acquired | <u>(938)</u> |
| Net cash paid | <u>\$ 8,073</u> |

The Company allocated the purchase price for this acquisition 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 acquisition 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 in its 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.

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.

5. GOODWILL AND PURCHASED INTANGIBLE ASSETS

In acquisitions accounted for using the purchase method, goodwill is recorded as the difference, if any, between the aggregate consideration paid for an acquisition and the fair value of the net tangible and identified intangible assets acquired. SFAS No. 142 requires that amortization of goodwill and indefinite life intangibles be discontinued and replaced with periodic review and analysis for possible impairment. Intangible assets with definite lives must be amortized over their estimated useful lives.

The following table presents the changes in goodwill by reporting segment during the three months ended March 31, 2004:

(In thousands)

| <i>Goodwill by Reporting Segment</i> | <i>Balance at December 31, 2003</i> | <i>Foreign Currency Change</i> | <i>Balance at March 31, 2004</i> |
|---|---|--|--|
| Software | \$ 15,144 | \$ (203) | \$ 14,941 |
| Customer Support | 5,858 | (77) | 5,781 |
| Professional Services & Education | 5,168 | (68) | 5,100 |
| Total | \$ 26,170 | \$ (348) | \$ 25,822 |

Foreign currency change relates to the impact of translation on the portion of goodwill that was booked to the Company's Ireland and Canada subsidiaries.

Acquired technology, technical manuals and design documents, customer maintenance relationships, patents, and non-compete agreements are the Company's only intangible assets subject to amortization under Statement No. 142.

Changes in these assets are summarized as follows for the three months ended March 31, 2004:

(In thousands)

| <i>Intangible Assets</i> | <i>Balance at December 31, 2003</i> | <i>Amortized</i> | <i>Foreign Currency Change</i> | <i>Balance at March 31, 2004</i> |
|---|---|------------------|--|--|
| Acquired technology & other intangibles | \$ 7,748 | \$ (459) | \$ (167) | \$ 7,122 |
| Non-compete agreements | 227 | (28) | (6) | 193 |
| Patents | 4 | (3) | (1) | - |
| Total | \$ 7,979 | \$ (490) | \$ (174) | \$ 7,315 |

Acquired technology is being amortized over a useful life of five years, patents are being amortized over a useful life of two years and non-compete agreements are being amortized over three years. Amortization expense for amortizing intangible assets was \$527,000 for the three months ending March 31, 2004 compared to \$183,000 for the comparable period in 2003 (excluding foreign exchange effect). Estimated future amortization expense (excluding foreign exchange effect) of purchased intangible assets as of March 31, 2004 is as follows:

(In thousands)

| Fiscal Year | Amount |
|-------------------------|---------------|
| <i>(Remainder)</i> 2004 | \$ 1,566 |
| 2005 | 2,056 |
| 2006 | 1,989 |
| 2007 | 1,401 |
| 2008 | 303 |
| | \$ 7,315 |

6. 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, shares issuable under the employee stock purchase plan and restricted stock issued to key executive management using the treasury stock method. The number of anti-dilutive options excluded from the EPS calculation for the three months ended March 31, 2004 and 2003 were 2,505,000 and 681,000 shares, respectively. The following table sets forth the computation of basic and diluted earnings per share for the three months ended March 31, 2004 and 2003:

| <i>(In thousands, except per share amounts)</i> | Three Months Ended March 31, | |
|--|---------------------------------|---------------|
| | 2004 | 2003 |
| Net Income | \$ 3,998 | \$ 1,336 |
| Weighted average common shares outstanding | 38,313 | 35,942 |
| Weighted average common shares of unvested restricted stock* | (33) | - |
| Shares used in computing basic earnings per share | <u>38,280</u> | <u>35,942</u> |
| Earnings per basic share | \$.10 | \$.04 |
| Shares used in computing basic earnings per share | 38,280 | 35,942 |
| Dilutive effect of stock plans | 2,472 | 681 |
| Dilutive effect of weighted average common shares of unvested restricted stock | <u>33</u> | <u>-</u> |
| Shares used in computing diluted earnings per share | 40,785 | 36,623 |
| Earnings per diluted share | \$.10 | \$.04 |

* See Note 10 – Restricted Stock

7. ACCUMULATED OTHER COMPREHENSIVE INCOME

Accumulated other comprehensive income for the three months ended March 31, 2004 is comprised of the following:

| | <i>(In thousands)</i> | | |
|----------------------------|--|---|---|
| | Foreign Currency Translation Adjustment | Unrealized Holding Gain / (Loss) on Securities | Accumulated Other Comprehensive Income |
| Balance, December 31, 2003 | \$ 5,645 | \$ (53) | \$ 5,592 |
| Three month period changes | <u>(914)</u> | <u>16</u> | <u>(898)</u> |
| Balance, March 31, 2004 | \$ 4,731 | \$ (37) | \$ 4,694 |

8. OPERATING SEGMENT DATA

The Company has prepared operating 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 for which financial performance is assessed and resources allocated.

The Company's reportable operating segments effective January 1, 2004 include Software, Customer Support, and Professional Services and Education. The residual operating activity of the previously reported Hardware reporting segment has been combined with the Customer Support reporting segment. This combination is predicated on the reduced scale and change in the nature of on-going hardware operations. Prior year hardware amounts have been reclassified into customer service to conform to the new segment presentation.

The Software operating segment develops, markets, and sells a unified platform and framework for ECM software and solutions. The Customer Support segment provides after-sale support for software, as well as providing software upgrades, on a when and if available basis, under the Company's right to new versions program. The Customer Support segment also provides operating supplies and spare parts for the installed base of Optical Storage and Retrieval ("OSAR") libraries, previously the hardware business. The Professional Services and Education segment provides fee-based implementation and technical consulting services related to the Company's standard products and post-implementation training services.

The accounting policies of the Company's operating segments are the same as those described in Item 2 – Critical Accounting Policies and Estimates - except that the disaggregated 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. The Company evaluates performance based on stand-alone segment operating income. Because the Company does not evaluate performance based on the return on assets or on interest income at the operating segment level, assets and interest income are not tracked internally by segment. Therefore, such information is not presented.

Operating segments data for the three months ended March 31, 2004 and 2003 are as follows:

| | <i>(In thousands)</i> | |
|-------------------------------------|-----------------------|-----------|
| | Three months ended | |
| | March 31, | |
| | 2004 | 2003 |
| Software | | |
| Revenue | \$ 41,351 | \$ 35,522 |
| Operating loss | (16,066) | (14,747) |
| Customer Support | | |
| Revenue | \$ 45,270 | \$ 39,396 |
| Operating income | 19,747 | 16,585 |
| Professional Services and Education | | |
| Revenue | \$ 12,877 | \$ 12,131 |
| Operating income (loss) | 268 | (975) |
| Total: | | |
| Revenue | \$ 99,498 | \$ 87,049 |
| Operating income | 3,949 | 863 |

9. STOCK OPTIONS

The following is a summary of stock option transactions regarding all stock option plans for the three months ended March 31, 2004:

| | Number of Options | Weighted- Average Exercise Price |
|--|----------------------|--|
| Balance, December 31, 2003 | 7,642,743 | \$ 16.31 |
| Granted (weighted-average fair value of \$11.74) | 674,200 | 28.23 |
| Exercised | (772,684) | 13.18 |
| Canceled | (149,618) | 18.93 |
| Balance, March 31, 2004 | <u>7,394,641</u> | <u>\$ 17.68</u> |

The following table summarizes information concerning outstanding and exercisable stock options at March 31, 2004:

| 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 – 9.50 | 940,122 | 3.64 | \$ 8.01 | 934,527 | \$ 8.00 |
| 9.75 – 12.86 | 1,232,733 | 7.58 | 12.32 | 583,160 | 11.93 |
| 12.97 – 14.19 | 1,209,276 | 7.20 | 13.46 | 644,523 | 13.54 |
| 14.39 – 18.45 | 1,266,506 | 7.11 | 16.85 | 767,618 | 16.93 |
| 19.53 – 25.00 | 1,268,866 | 6.28 | 22.82 | 1,101,309 | 22.96 |
| 25.28 – 41.84 | 1,477,138 | 8.19 | 28.07 | 493,614 | 28.76 |
| \$ 1.39 – 41.84 | <u>7,394,641</u> | <u>6.84</u> | <u>\$ 17.68</u> | <u>4,524,751</u> | <u>\$ 16.72</u> |

10. ISSUANCE OF RESTRICTED STOCK

The Company awarded 132,500 shares of restricted stock to ten members of the senior management team on March 9, 2004. This award was made under the 2002 Incentive Award Plan. These shares of restricted stock vest December 31, 2008, and include a feature that allows the stock to vest on an accelerated basis provided certain performance targets are achieved.

These shares are valued at approximately \$3.6 million based on the March 9, 2004 closing price of \$27.47 per share. The grant value of \$3.6 million is recorded in the equity section of the balance sheet as an increase in common stock and a contra-equity offset to deferred compensation. Expense related to the shares is amortized over a five-year period on a straight-line basis. Additional recognition of expense may be accelerated if it becomes probable that certain performance targets are achieved that trigger vesting of the restricted shares. Approximately \$45,000 of compensation expense was recognized in the three months ended March 31, 2004.

11. 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 March 31, 2004 were as follows:

| | <i>(In thousands)</i> | |
|---------------------------|-----------------------|--------|
| 2004 (remaining 9 months) | \$ | 7,988 |
| 2005 | | 11,060 |
| 2006 | | 10,493 |
| 2007 | | 9,617 |
| 2008 | | 8,589 |
| 2009 | | 6,154 |
| Thereafter | | 938 |
| Total | \$ | 54,839 |

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 three months ended March 31, 2004 and 2003:

| <i>(In thousands)</i> | 2004 | | 2003 | |
|--------------------------------|-------------|-------|-------------|---------|
| Beginning balance at January 1 | \$ | 479 | \$ | 728 |
| Additions | | 329 | | 964 |
| Deductions | | (332) | | (1,213) |
| Ending balance at March 31 | \$ | 476 | \$ | 479 |

Guarantees and Indemnities

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.

In connection with certain facility leases and other performance guarantees, the Company has guaranteed payments on behalf of some of its domestic and foreign subsidiaries. To provide subsidiary guarantees, the Company obtains unsecured bank guarantees from local banks. These bank guarantees totaled an equivalent of approximately \$2.5 million as of March 31, 2004. Unsecured bank guarantees increased by \$1.2 million during the three months ended March 31, 2004 for performance guarantees related to workers compensation liability insurance and a company sponsored sales event to be held in April 2005. Approximately \$1.3 million was issued in local currency in Europe and Asia, while the balance was issued in the United States. Approximately \$0.6 million of the \$2.5 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.

The Company has not recorded a liability for the guarantees and indemnities described above in the accompanying consolidated balance sheet, as the estimated fair value of these items is de minimis. Also, 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 March 31, 2004 is disclosed in this item under the heading "Product Warranties."

Legal Proceedings

In the normal course of business, the Company is subject to ordinary routine litigation and claims incidental to its 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.

12. FOREIGN CURRENCY TRANSACTIONS

As of March 31, 2004, the Company had forward foreign exchange contracts outstanding totaling approximately \$5.1 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 March 31, 2004.

13. INCOME TAXES

The Company's combined federal, state and foreign annual effective tax rate for the three months ended March 31, 2004 is 18% compared to 30% for the comparable period in 2003. The provision for income taxes differs from the tax computed at the federal statutory income tax rate due primarily to earnings considered as permanently reinvested in foreign operations and reductions in the deferred tax valuation allowance. The decreased tax rate in the three months ended March 31, 2004 was primarily due to the mix of income earned by domestic operations versus the foreign subsidiaries, and the partial release of the valuation allowance against income from domestic operations as net operating loss carryforwards were utilized.

14. 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 for \$1.9 million to enable him to purchase a home in Orange County, California. The note bears interest at 2.89% per annum. On June 5, 2002, the Board approved the loan.

Mr. Roberts is current with all payments and obligations of this agreement. Mr. Roberts made two payments of \$37,000 in February 2003 and \$53,000 in February 2004 toward the accrued interest balance in accordance with the terms and conditions of the loan agreement. Mr. Roberts also made a payment in December 2003 of approximately \$294,000 toward the principal loan balance of \$1.9 million. As of March 31, 2004, FileNet has an outstanding secured note receivable balance from Mr. Roberts in the amount approximately of \$1.6 million that relates to the above-referenced loan and is included in other assets on the consolidated balance sheet. The accrued interest balance as of March 31, 2004 was approximately \$9,000. Please reference Note No, 4 of our December 31, 2003 Report 10-K filing for additional details of the terms and conditions of this loan.

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, 2003. 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, when such reports are available at the Securities and Exchange Commission Web site.

Overview

FileNet develops and markets software that helps our customers address their electronic content and business process management requirements. Electronic content is unstructured data with various object characteristics and attributes. Electronic or unstructured content includes, but is not limited to: Web content, forms, word documents and scanned images that are not easily managed by relational databases. We market these enterprise software solutions to primarily Global 2000 customers in the banking, insurance, government, utilities and telecom industries located in North America, Europe and Asia.

Software

The FileNet P8 architecture offers our customers enterprise-level scalability and flexibility to handle demanding content challenges, complex business processes, and integration to existing systems. The FileNet P8 architecture provides a framework for functional expansion to provide enhanced content and process management across an enterprise through five pre-packaged suites, each emphasizing a different aspect of the ECM solution set, with functions grouped in a logical order that are designed to meet a customer's individual ECM needs. Each suite can be implemented by a customer individually, but remains expandable to include all FileNet ECM capabilities. FileNet ECM solutions are designed to manage content; allowing organizations to capture, create, use, and activate that content in order to make decisions faster and bring control and consistency to business processes, to improve efficiency and address compliance requirements.

Services and Support

We operate service and support organizations on a global basis to provide both pre-sales and post-sales services to ensure successful implementation of our products and customer satisfaction. Due to the highly configurable nature of our products, many of our product sales are coupled with contracts for continuing support services. Our worldwide Customer Service and Support organization provides comprehensive support capabilities including electronic and real-time phone support and global call tracking for customers and partners on support programs. System engineers deliver support coverage on multiple platforms with 24-hour call handling. Our Web site offers the ability to open cases, search our knowledge base and review related status reports. Our manufacturing facilities in Costa Mesa, California and Dublin, Ireland, conduct software manufacturing and distribution, localization, integration, test and quality control.

Professional Services and Education

Our worldwide professional services organization provides consulting, development, architecture and other technical services and training services to our licensed customers and authorized ValueNet Partners and Global System Integrators. These services are provided through in-house employees and through a network of qualified partners. Our worldwide professional services organization offers a comprehensive methodology to architect, install, integrate, customize and deploy our solutions. These services range from the management of large-scale implementations of our products to prepackaged standard services such as software installation, but do not include modifications to the standard software. Our educational curriculum includes training courses for end users, application developers and system administrators through media-based and instructor-led training.

Research and Development

We have made and expect to continue to make substantial investments in research and development, primarily through internal and offshore development activities, third party licensing agreements and through technology acquisitions. Our development efforts focus on our unified FileNet P8 ECM architecture as we continue to develop and enhance our ECM capabilities. Additionally, we license and embed third party software that enhances the functionality of our products through a variety of agreements with the producers of this software.

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. Certain of these contracts relate to single elements and contain standard terms and conditions, while other agreements 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 not recognized until 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 using the residual method. 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 our 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. 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. Professional services are not required for the software to function. We do not make changes to the standard software code in the field.

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 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 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. Goodwill and other intangible assets with indefinite useful lives are tested for impairment at least annually and written down when impaired. On the first day of July of each year, goodwill is 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. We engaged an independent valuation firm to determine the business enterprise value for each of our three reporting units and to perform an impairment analysis as of July 1, 2003 in accordance with SFAS 142. The analysis indicated there was no impairment of goodwill in any of the three reporting units. As of March 31, 2004, there have been no indicators of impairment, and no impairment of goodwill has been recognized. If estimates change, a materially different impairment conclusion could result.

Long-Lived Assets. Property, plant and equipment and intangible assets 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 five 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. If impairment were indicated, we would be required to write the related assets down to their fair values. 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 (related to domestic operations) 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 we continue to generate profits and ultimately determine 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 temporary decrease to our effective tax rate and an increase to additional paid-in capital.

We are continually assessing the valuation allowance related to our deferred tax assets. As of March 31, 2004, we have a net tax deferred asset of approximately \$26.6 million and valuation allowance of approximately \$24.3 million. We will continue weighing various factors throughout the year to assess the need for any valuation allowance. Recoverability of the deferred tax assets is dependent on continued profitability from operations, as well as the geographic region generating the profits. Should our level of profitability continue as expected, we would likely remove the entire valuation allowance later in 2004. We would realize a one-time, non-cash benefit by decreasing our tax expense (causing an increase in earnings) by approximately \$10.0 million to \$12.0 million. Additionally, we would record a non-cash charge to increase additional reported paid-in-capital by approximately \$9.0 million.

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 March 31, | |
|-------------------------------------|---------------------------------|-------|
| | 2004 | 2003 |
| Revenue: | | |
| Software | 41.6% | 40.8% |
| Customer support | 45.5 | 45.3 |
| Professional services and education | 12.9 | 13.9 |
| Total revenue | 100.0 | 100.0 |
| Cost of revenue: | | |
| Software | 3.5 | 3.5 |
| Customer support | 10.4 | 12.1 |
| Professional services and education | 10.9 | 12.7 |
| Total cost of revenue | 24.8 | 28.3 |
| Gross Profit | 75.2 | 71.7 |
| Operating expenses: | | |
| Sales and marketing | 41.8 | 39.5 |
| Research and development | 20.2 | 22.2 |
| General and administrative | 9.2 | 9.0 |
| Total operating expenses | 71.2 | 70.7 |
| Operating income | 4.0 | 1.0 |
| Other income, net | 0.9 | 1.2 |
| Income before income tax | 4.9% | 2.2% |

Revenue

As more fully discussed below, total revenue increased by 14.3% in the quarter ended March 31, 2004 compared to the same period in 2003. The increase in total revenue during this period is primarily attributable to the increased demand for our software products and customer support. We believe that the demand for our software and services is due to an increase in the growth of unstructured content within our customer base. Our products enable customers to manage this content and use it in their business processes.

Revenue by Geography. The following table sets forth total revenue by geography and as a percentage of total revenue for the periods indicated:

Revenue by Geography

| | <i>(In thousands)</i> | | |
|------------------------------|-----------------------|-------------|----------------------------------|
| Three months ended March 31, | 2004 | 2003 | <i>% Increase / Decrease</i> |
| Total United States Revenue | \$ 68,000 | \$ 59,457 | 14.4% |
| Europe, Middle East & Africa | 25,317 | 22,134 | 14.4% |
| Canada, Latin America & Asia | 6,181 | 5,458 | 11.4% |
| Total International Revenue | 31,498 | 27,592 | 14.2% |
| Total Revenue | \$ 99,498 | \$ 87,049 | 14.3% |
| United States Revenue | 68.3% | 68.3% | - |
| International Revenue | 31.7% | 31.7% | - |
| Total Revenue Contribution | 100.0% | 100.0% | |

International revenue represented 31.7% of total revenue and increased at nearly the same rate as domestic revenue during this period as compared to the same period in 2003. We believe the same content management factors mentioned above drive international revenue growth and are not regional in nature. We expect international revenue to continue to represent a significant percentage of total revenue. However, international revenues will be adversely affected if the U.S. dollar strengthens against certain major international currencies or if international economic conditions remain relatively weak.

Revenue by Reporting Segment. The following table sets forth total revenue by reporting segment and as a percentage of total revenue for the periods indicated:

Revenue by Reporting Segment

| | <i>(In thousands)</i> | | |
|-------------------------------------|-----------------------|-------------|------------------------------------|
| Three months ending March 31, | 2004 | 2003 | <i>% Increase / (Decrease)</i> |
| Software | \$ 41,351 | \$ 35,522 | 16.4% |
| Customer Support | 45,270 | 39,396 | 14.9% |
| Professional Services and Education | 12,877 | 12,131 | 6.1% |
| Total Revenue | \$ 99,498 | \$ 87,049 | 14.3% |
| Software | 41.6% | 40.8% | .8% |
| Customer Support | 45.5% | 45.3% | .2% |
| Professional Services and Education | 12.9% | 13.9% | (1.0%) |
| Total Revenue Contribution | 100.0% | 100.0% | |

Software. Software revenue consists of fees earned from the licensing of our software products to our customers. Software revenue increased by 16.4% in the first three months of 2004 compared to the same period in 2003. The increase in software revenue during this period was primarily due to an increase in demand for enterprise content management solutions driven by the growth in unstructured content in our customer base. Customers in our key vertical industries of banking, insurance, government and telecom continued to purchase new systems and add-on licenses to existing systems to help them manage content and records. We believe IT spending on enterprise content management and business process management software will show steady improvement throughout 2004.

Customer Support. Customer support revenue consists of revenue from software maintenance contracts, “fee for service” revenues and the sale of Optical Storage and Retrieval (“OSAR”) libraries, spare parts and supplies. Maintenance contracts entitle our customers to receive technical support, enhancements and upgrades to new versions of software releases when and if available. Customer support revenue increased by 14.9% in the first three months ended March 31, 2004 compared to the same period in 2003. Customer support revenue is generated from new maintenance contracts for new system sales, and from the renewal of existing maintenance contracts for previously sold software licenses on installed systems. We have historically experienced a high contract maintenance renewal rate, but are continuing to experience pricing pressures from our customers during contract negotiation and renewal. Accordingly, the rate of software revenue growth may not directly translate into the same growth for customer support revenue.

Professional Services and Education. Professional services and education revenue is generated from consulting and implementation services to end users of our software products, technical consulting services provided to our resellers, and training services. No modifications are made to our standard base product code once the software has been sold. Professional services and education revenue increased by 6.1% in the three months ended March 31, 2004 compared to the same period in 2003. Increases in professional services revenue growth typically lags behind software revenue growth by 90 to 180 days as our customers implement their content management projects that include consulting and training services. Furthermore, professional services revenue is dependent on the level and the nature of software sales in prior periods. Professional services revenue grow more rapidly when new customers purchase new systems for a large-scale implementation - as opposed to existing customers purchasing add-on licenses for installed systems. A significant majority of our software sales during the last twelve months have been to existing customers. We believe we will experience a moderate, but steady improvement in professional services and education revenue during the balance of 2004 based on the software revenue trends we experienced during the last half of 2003 and the first quarter of 2004.

Cost of Revenue

Cost of Revenue by Reporting Segment. The following table sets forth total cost of revenue by reporting segment and as a percentage of revenue by reporting segment for the periods indicated:

Cost of Revenue by Reporting Segment

| Three months ending March 31, | 2004 | 2003 | (In thousands) |
|---|-----------|-----------|----------------------------|
| | | | % Increase / (Decrease) |
| Software | \$ 3,523 | \$ 3,008 | 17.1% |
| Customer Support | 10,292 | 10,570 | (2.6%) |
| Professional Services & Education | 10,838 | 11,081 | (2.2%) |
| Total Cost of Revenue | \$ 24,653 | \$ 24,659 | 0% |
| Software | 8.5% | 8.5% | 0% |
| Customer Support | 22.7% | 26.8% | (4.1%) |
| Professional Services & Education | 84.2% | 91.3% | (7.1%) |
| Total Cost of Revenue as a % of Revenue | 24.8% | 28.3% | (3.5%) |

Software. Cost of software revenue includes royalties paid to third parties for technology embedded in our products to enhance features and functionality, amortization of acquired technology, media costs, and the cost to manufacture and distribute software. The cost of software revenue as a percent of software revenue was unchanged in the three months ended March 31, 2004 compared to the same period in 2003. The increase in absolute cost of software revenue during this period is primarily due to an increase in royalty costs based on higher revenues and a higher mix of products sold that contain third party software products. This cost will fluctuate period to period based on the mix of products sold. The amortization of acquired technology resulting from the Shana acquisition in April 2003 is another cost element that has increased the absolute cost of software revenue. Going forward we anticipate cost of software revenue to increase slightly to approximately 10% of software revenue as we continue to integrate third-party technology with our products.

Customer Support. Cost of customer support revenue includes the cost of customer support personnel, facility and technology infrastructure expenses in our call centers, supplies and spare parts. The cost of customer support revenue in absolute dollars was relatively unchanged year over year. However, the cost of customer support revenue as a percent of customer support revenue decreased by 4.1% in the first three months ended March 31, 2004 compared to the same period in 2003. This reduction in cost of customer support revenue is attributable to efficiency improvements in the delivery of technical support, which allows for increased revenue without a comparable increase in expense. We expect the cost of customer support revenue to average approximately 25% of customer support revenue for the near future.

Professional Services and Education. Cost of professional services and education revenue consists primarily of the costs of professional services personnel, training personnel, and third-party contractors. The cost of professional services and education revenue, as a percent of professional services and education revenue, decreased by 7.1% in the first three months ended March 31, 2004 as compared to the same period in 2003. A reduced employee headcount and lower variable employee compensation contributed to maintaining reduced operating costs on slightly increased professional services and education revenue during the period. 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 internal and external service providers.

Operating Expenses

Total Operating Expenses. The following table sets forth total operating expense by function and as a percentage of total revenue for the periods indicated:

Operating Expenses

| Three months ending March 31, | 2004 | 2003 | % Increase / (Decrease) |
|-------------------------------------|-----------|-----------|----------------------------|
| Research & Development | \$ 20,102 | \$ 19,302 | 4.1% |
| Marketing & Sales | 41,561 | 34,399 | 20.8% |
| General & Administrative | 9,233 | 7,826 | 18.0% |
| Total Operating Expenses | \$ 70,896 | \$ 61,527 | 15.2% |
| Research & Development | 20.2% | 22.2% | (2.0%) |
| Marketing & Sales | 41.8% | 39.5% | 2.3% |
| General & Administrative | 9.3% | 9.0% | .3% |
| Operating Expense as a % of Revenue | 71.3% | 70.7% | .6% |

Research and Development. Our research and development efforts are focused on enhancing and maintaining our Enterprise Content Management capabilities within the FileNet P8 product line. These efforts focus on existing products and developing additional capabilities for our FileNet P8 platform and suites such as Business Process Management, Web Content Management, Records Management, Team Collaboration and other capabilities.

Our research and development expense consists primarily of personnel costs for software developers; third party contracted development efforts and related facilities costs. Research and development expense increased by 4.1% in the three months ended March 31, 2004 compared to the same period in 2003. The number of research and development personnel was 452 on March 31, 2004 compared to 455 on March 31, 2003.

The majority of the \$800,000 increase in research and development expenses during the three months ended March 31, 2004 compared to the same period in 2003 is attributable to increased offshore development expense partially offset by reduced internal employee expense. We currently have 91 contractors in India developing software compared to 35 contractors one year ago. We believe we will be able to lower our per-developer cost through the use of offshore resources, however in the near term, some duplicate expenses will be incurred as our development programs are transitioned to these offshore development resources. We believe that research and development expenditures, including compensation of technical personnel, are essential to maintaining our competitive position. We expect research and development expense to be at approximately 19% of revenue for 2004.

Selling and Marketing. We sell our products through a direct sales force and our indirect channel sales partners. The majority of our selling and marketing expense is salaries, benefits, sales commissions and other expenses related to the direct and indirect sales force, and personnel cost for marketing and market development programs. Selling and marketing expense increased by 20.8% or \$7.2 million, in the three months ended March 31, 2004 compared to the same period in 2003. Approximately \$5.2 million of the increase is attributable to higher salaries and benefits along with higher variable compensation generated by higher revenue. The total number of sales and marketing personnel increased by 25 employees, at a higher salary mix, from 557 to 582 when comparing March 31, 2004 to the same period in 2003. We expect selling and marketing expense to remain at approximately 41% of revenue in the near-term.

General and Administrative. Our general and administrative expense consists primarily of salaries, benefits, and other expenses related to personnel costs for finance, information technology, legal, human resources and general management and the cost of outside professional services. General and administrative expense increased 18% in the three months ended March 31, 2004 compared to the same period in 2003. The increase in general and administrative expense of \$1.4 million between the comparative periods reflects higher salary costs due to increased headcount as well as increased legal and accounting fees associated with recently mandated compliance regulations and cancellation of a facility lease. We expect general and administrative expense to remain at approximately 9% of revenue in the near-term.

Interest, Other Income and Expenses, 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 and interest expense. Other income, net of other expenses, was \$927,000 for the three months ended March 31, 2004 compared to \$1.0 million during the same period in 2003. The weighted average interest rate earned on cash, cash equivalents and investments was 1.36% during the three months ended March 31, 2004 compared to 1.48% for the same period in 2003.

Provision for Income Taxes. Our combined federal, state and foreign annual effective tax rate for the three months ended March 31, 2004 is 18% compared to 30% for the comparable period in 2003. The provision for income taxes differs from the tax computed at the federal statutory income tax rate due primarily to earnings considered as permanently reinvested in foreign operations and reductions in our deferred tax valuation allowance. The decreased tax rate in the three months ended March 31, 2004 was primarily due to the mix of income earned by our domestic operations versus the foreign subsidiaries, and the partial release of the valuation allowance against income from domestic operations as net operating loss carryforwards were utilized.

Liquidity and Capital Resources

At March 31, 2004, combined cash, cash equivalents and investments totaled \$291.0 million, an increase of \$42.7 million from December 31, 2003.

Cash provided by operating activities during the three months ended March 31, 2004 totaled \$35.2 million and resulted primarily from: an increase in unearned maintenance revenue related to prepaid maintenance contracts of \$25.9 million; a decrease in accounts receivable of \$2.9 million; depreciation and amortization expense of \$4.3 million; and net income of \$4.0 million. 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.

Cash provided by financing activities totaled \$10.2 million and was a result of proceeds received from the exercise of employee stock options and stock purchases under the employee stock purchase plan. Cash used in investing activities was \$9.8 million for the purchase of marketable securities.

Contractual cash obligations of significance include non-cancelable operating leases for our corporate offices, sales offices, development and manufacturing facilities and other equipment, some of which have renewal options and generally provide for escalation of the annual rental amount. (See Note No. 11 to the Notes to Unaudited Condensed Consolidated Financial Statements for additional details.)

We believe that our present cash balances together with internally generated funds 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 (expense) 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.

New Accounting Pronouncements

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. With respect to variable interest entities created before January 31, 2003, in December 2003 the FASB issued FIN 46R, which, among other things, revised the implementation date to the first fiscal years or interim periods ending after March 15, 2004, with the exception of Special Purpose Entities ("SPE"). The consolidated requirements apply to all SPE's in the first fiscal year or interim period ending after December 15, 2003. We have determined that we do not have any SPE's to which these interpretations apply; and have adopted FIN 46R in the first quarter of 2004. The adoption of FIN 46R did not 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.

In November 2003, the FASB issued FASB Staff Position (FSP) No. 150-3 which deferred the effective dates for applying certain provisions of SFAS No. 150 related to mandatorily redeemable financial instruments of certain nonpublic entities and certain mandatorily redeemable noncontrolling interests for public and nonpublic entities.

For public entities, SFAS No. 150 is effective for mandatorily redeemable 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.

For mandatorily redeemable noncontrolling interests that would not have to be classified as liabilities by a subsidiary under the exception in paragraph 9 of SFAS No. 150, but would be classified as liabilities by the parent, the classification and measurement provisions of SFAS No. 150 are deferred indefinitely. For other mandatorily redeemable noncontrolling interests that were issued before November 5, 2003, the measurement provisions of SFAS No. 150 are deferred indefinitely. For those instruments, the measurement guidance for redeemable shares and noncontrolling interests in other literature shall apply during the deferral period.

SFAS No. 150 is to be implemented by reporting the cumulative effect of a change in accounting principle. We do not have financial instruments with characteristics of both debt and equity and therefore, the adoption of SFAS No. 150 did not 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

Except for the historical information and discussions contained herein, statements contained in this Form 10-Q may constitute “forward looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. These statements are based on current expectations and assumptions that involve a number of risks, uncertainties and other factors that could cause actual results to differ materially from recent results or from our anticipated future results. We operate in a rapidly changing economic and technological environment that presents numerous risks. Prospective and existing investors are strongly urged to carefully consider the various cautionary statements and risks set forth in this annual report and our other public filings. Many of these risks are beyond our control and are driven by factors that we cannot predict. The following discussion highlights some of these risks:

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. 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. Consequently, our prior operating results should not necessarily be considered indicative of future operating results.

Factors that may cause our operating results to fluctuate, include, but are not limited to, the following:

- IT spending trends;
- 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;
- the length of our sales cycle;
- the level of software sales and price competition;
- the timing of new software introductions and software enhancements by us and our competitors; or,
- seasonality in technology purchases.

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 with the consolidation of the ECM market. 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.

Other competitive risks include, but are not limited to:

- We anticipate significant future consolidation as the software industry matures. Large well-established software firms like Oracle, IBM and Adobe may enter our market by adding content management features to their existing suite of products. In 2003, EMC Corporation, a data storage hardware company, acquired one of our competitors, Documentum. Other large, well-capitalized hardware firms may enter our market by acquiring our competitors to pursue revenue growth opportunities;
- Many of our competitors are also our distribution channel partners. For example, IBM competes with us in the content management market, but also implements our software solutions through its IBM Global Services business unit. Our customers may view this type of vertical integration of software development and system integration capabilities as a key competitive advantage.

Our inability to license future releases of technology from these competitive vendors could limit the technical capabilities of our products.

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 may not be able to compete effectively in our target markets. 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.

A significant portion 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. This contribution percentage will fluctuate quarter to quarter. 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 and requirements for localized products;
- reduced protection for intellectual property rights in certain countries;
- difficulties in staffing and maintaining foreign operations;
- difficulties in managing foreign distributors;
- multiple overlapping tax regimes;
- currency restrictions and currency exchange fluctuations;
- the burden of complying with a wide variety of complex foreign laws, regulations and treaties;
- spreading our management resources to cover multiple countries; or,
- longer collection cycles and higher risk of non-collection and bad debt expense.

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

The market for content management solutions may not grow as we anticipate, and may decline, and our products may not gain acceptance within this market, resulting in reduced revenue. Our future financial performance will depend primarily on the continued growth of the markets for our software products and services as well as our ability to capture a larger share of those markets. Our primary product offerings address the new and emerging market for content management solutions. This market is developing rapidly, and while we believe this market is growing and will continue to grow, particularly as new regulations are introduced that focus on controlling the flow of information within organizations to ensure compliance with disclosure and other obligations, there can be no assurance that these markets will continue to grow as we anticipate, or that our products and solutions will gain acceptance within these markets. If the markets we serve, particularly the market for enterprise content management solutions, fail to grow or grow more slowly than we currently anticipate, or if our products and solutions do not gain acceptance within these markets, our business, financial condition and operating results would be harmed.

We must execute on our strategy of offering a unified platform and framework for Enterprise Content Management that gains customer acceptance or our revenue may suffer. This strategy may require us to develop and maintain relations with technology partners. If we fail to successfully execute on our integrated product solution strategy or if we fail to maintain or establish relationships with technology partners, or if release dates of any future products or enhancements are delayed, or if these products or enhancements fail to achieve 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, either 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 business and operating results.

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. For example, two new products that we predict will address new markets will be made available in the second half of this year. Team Collaboration Manager suite that enables customers to initiate collaborative tasks at any point in a process and Records Manager Suite that systematically applies record management principles to content are both expected to be available in the second half of this year. We may not be successful in developing, marketing and releasing these new products or new versions of our products that respond to technological developments, evolving industry standards or changing customer requirements. We may also experience technical difficulties that could delay or prevent the successful development, introduction and sale of these products and enhancements. 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. In addition, our ability to generate revenues from the sale of customer support, education and professional services is substantially dependent on our ability to generate new sales of our software products.

We are dependent upon customers concentrated in a small number of industries. A significant decline in one of those industries could result in reduced revenue. Our customers are concentrated in the insurance, financial services, government, manufacturing, telecommunications and utilities industries. We may not be successful in obtaining significant new customers in different industry segments and we expect that sales of our products to a limited number of customers in a limited number of industry segments will continue to account for a large portion of our revenue in the future. If we are not successful at obtaining significant new customers or if a small number of customers cancel or delay their orders for our products, then we could fail to meet our revenue objectives. Consolidation within the financial services and insurance industry could further reduce our customers and future prospects. As many of our significant customers are concentrated in a small number of industry segments, if business conditions in one of those industry segments decline, then orders for our products from that segment may decrease, which could negatively impact our business, financial condition and operating results and cause the price of our common stock to fall.

We must devote substantial resources to software development, and we may not realize revenue from our development efforts for a substantial period of time. Introducing new products that rapidly address changing market demands requires a continued high level of investment in research and development. We expect to invest approximately 20% of annual revenue in research and development efforts in the near term. The majority of our investment in new and existing market opportunities must be made prior to our ability to generate revenue from these new opportunities. These investments of money and resources must be made based on our prediction of new products and services that the market needs and will accept. As a result, our operating results could be adversely affected if our predictions of market demand are incorrect and we are not able to realize the level of revenues we expect from new products or if that revenue is significantly delayed due to revenue recognition rules that require new products be tested in the market to validate pricing and acceptance.

We are increasing our use of third party software developers and may have difficulty enforcing or managing our agreements with them, which could delay new product introductions and reduce revenue. To help manage costs, we have contracted with third party software development companies overseas, particularly in India, where labor costs are lower, to perform an increasing portion of our software development and software localization work. As a result, we will become increasingly dependent on these third party developers for continued development and maintenance of several of our key products. If any of these third party developers were to terminate their relationship with us, our efforts to develop new products and improve existing products could be significantly delayed and our ability to provide product support to our customers could be impaired. In addition, since the majority of these third party developers are located outside the United States, our ability to enforce our agreements with them may be limited.

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.

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.

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; or
- 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.

Our business is highly automated for the execution of marketing, selling and technical support functions. We depend on the integrity of our information systems network connectivity to perform these business functions. Significant business interruption could occur at our Costa Mesa headquarters facility due to a natural disaster such as earthquake, which could cause a prolonged power outage and the inability for key personnel to perform their job functions.

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. Intellectual property rights often cannot be enforced without engaging in litigation, which involves devotion of significant resources, can divert management attention and has uncertain outcomes. 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, which could expose us to litigation and other costs. 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 to avoid further infringement or that we could obtain necessary licenses to use the infringed rights on acceptable terms, or 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 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. We would be unable to sell these products if we do not maintain these licenses, which would result in reduced revenue. 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.

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;
- 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;
- acquisitions in the past have been primarily cash based transactions. Future acquisitions may include stock, which could dilute EPS and possibly reduce shareholder value;
- we may not be able to hedge all foreign exchange risk due to the significant fluctuation of the Euro to the US Dollar and our ability to predict the mix of sales orders denominated in the Euro at the end of each fiscal quarter;
- reduced stock value may restrict our access to equity financing to fund further acquisitions using stock;
- industry analyst opinions may increase our stock price volatility and reduce shareholder value; 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.

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 76 days; 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 March 31, 2004 and 2003, 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 March 31, 2004 and 2003. 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 \$223,000 at March 31, 2004 and approximately \$286,000 at March 31, 2003. 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 \$446,000 at March 31, 2004 and approximately \$573,000 at March 31, 2003.

The following table provides information about our cash equivalents and our investment portfolio at March 31, 2004 (dollars in thousands):

| <i>(In thousands)</i> | Cost | Estimated Fair Value |
|----------------------------|------------------|-----------------------------|
| Debt Securities | | |
| Due in one year or less: | | |
| Short-term munis-taxable | \$ 6,286 | \$ 6,291 |
| Corporate | 13,358 | 13,357 |
| Governments/Agencies | 14,022 | 14,026 |
| Total due in one year | <u>33,666</u> | <u>33,674</u> |
| Due in one to three years: | | |
| Corporate | 2,157 | 2,155 |
| Government/Agencies | 16,821 | 16,828 |
| Total due in three years | <u>18,978</u> | <u>18,983</u> |
| Grand total | <u>\$ 52,644</u> | <u>\$ 52,657</u> |

Actual maturities may differ from contractual maturities because the issuer of the securities may have the right to repurchase such securities. We classify 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 March 31, 2004, we had forward foreign exchange contracts outstanding totaling approximately \$5.1 million in ten currencies. These contracts were opened on the last business day of the quarter and mature within three months.

Cumulative other comprehensive income decreased by \$898,000 for the three months ended March 31, 2004 due to unrealized foreign currency translation losses resulting from the weakening of the Euro against the U.S. dollar during the period.

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 three months ended March 31, 2004.

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 in reaching a reasonable level of assurance, management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As of March 31, 2004, 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 11 to Consolidated Financial Statements.

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

On April 22, 2004 FileNet furnished a report on Form 8-K under Item 12 announcing its financial results for the quarter ended March 31, 2004.

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

May 7, 2004

Date

By: /s/ Sam M. Auriemma

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

Index to Exhibits

| <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, 2001 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, 2001</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, 2001; 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 (<i>filed as Exhibit 10.2.1 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003</i>). |
| 10.2.2*+ | Amended Form of 1995 Executive Officer Stock Option Agreement (<i>filed as Exhibit 10.2.2 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003</i>). |
| 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>). |
| 10.6*+ | 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>). |
| 10.10*+ | Written Compensation Agreement and Non-Statutory Stock Option Agreement (with Notice of Grant of Stock Option and Special Addendum) 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, 2001; 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 (filed as Exhibit 10.13 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2002).
- 10.14*+ The 2002 Incentive Award Plan, as approved by stockholders at the Registrant's Annual Meeting on May 22, 2002, together with the forms of Incentive Option Agreement and Non-Qualified Stock Option Agreement for Independent Directors (filed as Exhibit 10.14 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2002).
- 10.14.1*+ Amended Form of 2002 Incentive Award Plan Incentive Option Agreement with Notice of Grant of Stock Option (filed as Exhibit 10.14.1 to Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2002).
- 10.14.2*+ Amended Form of 2002 Incentive Award Plan Non-Qualified Stock Option Agreement for Independent Directors with Notice of Grant of Stock Option (filed as Exhibit 10.14.2 to Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2002).
- 10.14.3*+ Amendment to the 2002 Incentive Award Plan dated May 7, 2003 (filed as Exhibit 10.14.3 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003).
- 10.15* Stock Purchase Agreement dated April 2, 2003 by and among Registrant, FileNet Nova Scotia Corporation, Shana Corporation and certain Sellers (filed as Exhibit 10.15 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003).
- 10.15.1* Escrow Agreement dated April 2, 2003 by and among FileNet Nova Scotia Corporation, certain Sellers and Bennett Jones LLP (filed as Exhibit 10.15.1 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003).
- 10.16*+ Amended and Restated Letter Agreement dated May 15, 2003 by and between Registrant and Lee D. Roberts, Chief Executive Officer (filed as Exhibit 10.16 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003).
- 10.17*+ Form of Amended and Restated Letter Agreement, dated May 15, 2003, by and between Registrant and the Chief Financial Officer and President (filed as Exhibit 10.17 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003)⁽¹⁾.
- 10.18*+ Form of Amended and Restated Letter Agreement by and among Registrant and certain Executive Officers (filed as Exhibit 10.18 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003)⁽²⁾.
- 10.19*+ CEO Severance Agreement together with Addendum II to Stock Option Agreement between Registrant and Mr. Lee D. Roberts (filed as Exhibit 10.19 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003).
- 10.20+ Non-Statutory Stock Option Agreement between Registrant and Mr. Kenneth F. Fitzpatrick.
- 10.21 Form of Restricted Stock Agreement between Registrant and certain Executive Officers (filed as Exhibit 10.21 to Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 2004).
- 14* Code of Conduct (filed as Exhibit 14 to Registrant's Annual Report on Form 10-K for the year ended December 31, 2003).
- 31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act
- 31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act
- 32.1 Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act
- 32.2 Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act

* 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, Ms. Katharina M. Mueller and Ms. Audrey N. Schaeffer. Mr. Kenneth F. Fitzpatrick entered in a Letter Agreement, dated September 2, 2003 on substantially the same terms and conditions.