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 September 30, 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	**95-3757924**
(State or other jurisdiction of incorporation or organization)	(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 November 5, 2004, there were 41,330,166 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 per share amounts)

	September 30, 2004	December 31, 2003
ASSETS		
Current assets:		
Cash and cash equivalents	$ 213,146	$ 203,305
Short-term investments available for sale	73,825	32,286
Accounts receivable, net	41,462	38,096
Prepaid expenses and other current assets	12,128	13,174
Deferred income taxes	3,551	3,551
Total current assets	344,112	290,412
Property, net	23,369	26,922
Long-term investments available for sale	15,883	12,672
Goodwill	26,184	26,170
Intangible assets, net	6,455	7,979
Deferred income taxes	23,081	23,001
Other assets	2,894	4,692
Total assets	$ 441,978	$ 391,848
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 7,931	$ 11,006
Accrued compensation and benefits	29,036	27,648
Customer deposits and advances	5,843	5,217
Unearned maintenance revenue	56,154	40,691
Other accrued liabilities	17,176	16,524
Total current liabilities	116,140	101,086
Unearned maintenance revenue and other liabilities	2,991	1,614
Commitments and contingencies (Note 11)		
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; 40,574,016 issued and 39,476,016 shares outstanding at September 30, 2004; and 38,906,640 shares issued and 37,808,640 shares outstanding at December 31, 2003	256,023	234,025
Retained earnings	76,615	64,098
Accumulated other comprehensive income	4,776	5,592
Treasury stock, at cost; 1,098,000 shares	(14,567)	(14,567)
Net stockholders' equity	322,847	289,148
Total liabilities and stockholders' equity	$ 441,978	$ 391,848

See accompanying notes to unaudited condensed consolidated financial statements.

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

	Three Months Ended September 30, 2004	Three Months Ended September 30, 2003	Nine Months Ended September 30, 2004	Nine Months Ended September 30, 2003
Revenue:				
Software	$ 35,447	$ 35,320	$ 109,475	$ 104,397
Customer support	47,510	41,907	139,852	123,063
Professional services and education	13,531	12,162	40,745	36,095
Total revenue	96,488	89,389	290,072	263,555
Costs:				
Software	3,835	3,800	10,486	10,416
Customer support	9,891	10,487	30,125	31,026
Professional services and education	11,404	10,586	33,396	32,001
Total cost of revenue	25,130	24,873	74,007	73,443
Gross Profit	71,358	64,516	216,065	190,112
Operating expenses:				
Sales and marketing	36,674	34,405	117,433	103,660
Research and development	19,664	19,049	59,469	58,031
General and administrative	8,509	8,241	27,136	24,393
Total operating expenses	64,847	61,695	204,038	186,084
Operating income	6,511	2,821	12,027	4,028
Other income, net	1,245	632	3,238	3,297
Income before income taxes	7,756	3,453	15,265	7,325
Provision for income taxes	1,396	967	2,748	2,051
Net income	$ 6,360	$ 2,486	$ 12,517	$ 5,274
Earnings per share:				
Basic	$ 0.16	$ 0.07	$ 0.32	$ 0.15
Diluted	$ 0.16	$ 0.06	$ 0.31	$ 0.14
Weighted-average shares outstanding:				
Basic	39,284	36,588	38,806	36,234
Diluted	40,495	38,494	40,793	37,471

See accompanying notes to unaudited condensed consolidated financial statements.

FILENET CORPORATION

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE OPERATIONS

(In thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Net income	$ 6,360	$ 2,486	$ 12,517	$ 5,274
Other comprehensive income (loss):				
Foreign currency translation adjustments	1,746	1,582	(644)	6,942
Unrealized gain (loss) on securities:				
Unrealized holding gain (loss), net of taxes	52	(23)	(172)	(61)
Total other comprehensive income (loss)	1,798	1,559	(816)	6,881
Comprehensive income	$ 8,158	$ 4,045	$ 11,701	$ 12,155

See accompanying notes to unaudited condensed consolidated financial statements.

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

	Nine Months Ended September 30,	
	2004	2003
Cash flows from operating activities:		
Net income	$ 12,517	$ 5,274
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	12,419	14,759
Loss on sale of property	403	14
Provision for doubtful accounts	136	52
Deferred income taxes	(80)	1,746
Stock option income tax benefit	-	2.129
Changes in operating assets and liabilities, net of the effects of acquisitions:		
Accounts receivable	(3,643)	2,871
Prepaid expenses and other current assets	888	2,423
Accounts payable	(3,041)	2,026
Accrued compensation and benefits	1,494	1,840
Customer deposits and advances	625	3,264
Unearned maintenance revenue	16,902	2,916
Income taxes payable	3,066	(1590)
Other	789	(1,931)
Net cash provided by operating activities	$ 42,475	$ 35,793
Cash flows from investing activities:		
Capital expenditures	(7,845)	(6,809)
Proceeds from sale of property	104	129
Cash paid for acquisition	-	(8,073)
Purchases of marketable securities	(84,822)	(81,354)
Proceeds from sales and maturities of marketable securities	39,065	77,805
Net cash used in investing activities	$ (53,498)	$ (18,302)
Cash flows from financing activities:		
Proceeds from issuance of common stock	21,543	9,485
Principal payments on lease obligation	-	(5)
Net cash provided by financing activities	$ 21,543	$ 9,480
Effect of exchange rate changes on cash and cash equivalents	(679)	5,146
Net increase in cash and cash equivalents	$ 9,841	$ 32,117
Cash and cash equivalents, beginning of year	203,305	130,154
Cash and cash equivalents, end of period	$ 213,146	$ 162,271
Supplemental cash flow information:		
Interest paid	$ 37	$ 36
Income taxes paid / (refunded)	$ (423)	$ 2,221

See Notes 4 and 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 and subsidiaries (the “Company” or “FileNet”) reflect all adjustments (consisting of normal recurring adjustments) necessary to present fairly the financial position of the Company at September 30, 2004, and the results of its operations, its comprehensive operations and its cash flows for the three and nine months ended September 30, 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.

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. The adoption of FIN 46R in 2004 has not had 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 has not had a material impact on the Company's consolidated financial statements.

In March 2004, The FASB issued EITF Issue No. 03-1 (EITF 03-1), "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments" which provides new guidance for assessing impairment losses on investments. Additionally, EITF 03-1 includes new disclosure requirements for investments that are deemed to be temporarily impaired. In September 2004, the FASB delayed the accounting provisions for EITF 03-1; however the disclosure requirements remain effective for annual periods ending after June 15, 2004. The Company will evaluate the impact of EITF 03-1 once final guidance is issued.

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 and nine months ended September 30, 2004 and 2003.

(In thousands, except per share amounts)	Three Months Ended September 30,				Nine Months Ended September 30,			
	2004		2003		2004		2003	
Net income, as reported	$	6,360	$	2,486	$	12,517	$	5,274
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects		(1,969)		(1,636)		(5,644)		(5,732)
Pro forma net income (loss)	$	4,391	$	850	$	6,873	$	(458)
Earnings (loss) per share:								
Basic earnings per share - as reported	$	0.16	$	0.07	$	0.32	$	0.15
Basic earnings (loss) per share - pro forma		0.11		0.02		0.18		(0.06)
Diluted earnings per share - as reported	$	0.16	$	0.06	$	0.31	$	0.14
Diluted earnings (loss) per share - pro forma		0.11		0.02		0.17		(0.06)

For purposes of computing proforma net income (loss), 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 estimates the 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 and Nine Months Ended September 30,	
	2004	2003
Expected life (in years)	5.28	5
Expected volatility	67%	63%
Risk free interest rates	3.5%	3.15%
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 provided technology and experience to expand the Company’s Enterprise Content Management (“ECM”) offering with electronic 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:

(In thousands)

Shana Corporation	April 2, 2003
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	(2,494)
Total purchase price	$ 9,011
Less cash acquired	(938)
Net cash paid	$ 8,073

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 was claimed resulting in deductible goodwill for U.S. tax purposes.

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. Goodwill and indefinite life intangibles are not amortized, but are reviewed at least annually for possible impairment. Intangible assets with definite lives must be amortized over their estimated useful lives. Goodwill is recorded at cost and is not amortized. Goodwill is tested for impairment at least annually and written down when impaired. Effective 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. The Company also periodically evaluates whether events and circumstances have occurred in between annual testing dates that indicate the carrying value of goodwill may not be recoverable. The Company performed an impairment analysis as of July 1, 2004 in accordance with SFAS 142. The results indicated there was no impairment of goodwill in any of the three reporting units. As of September 30, 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.

The following table presents the changes in goodwill by reporting segment during the nine months ended September 30, 2004:

(In thousands)			
Goodwill by Reporting Segment	*Balance at December 31, 2003*	*Foreign Currency Change*	*Balance at September 30, 2004*
Software	$ 15,144	$ 7	$ 15,151
Customer Support	5,858	3	5,861
Professional Services & Education	5,168	4	5,172
Total	$ 26,170	$ 14	$ 26,184

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.

Intangible assets subject to amortization consist of the following:

(in thousands)	September 30, 2004			December 31, 2003		
Intangible Assets	*Gross Asset*	*Accumulated Amortization*	*Net*	*Gross Asset*	*Accumulated Amortization*	*Net*
Acquired technology and other intangibles	$ 10,111	(3,795)	$ 6,316	$ 10,020	(2,272)	$ 7,748
Non-compete agreements	323	(184)	139	317	(90)	227
Patents	28	(28)	-	28	(24)	4
Total	$ 10,462	(4,007)	$ 6,455	$ 10,365	(2,386)	$ 7,979

Acquired technology and other intangibles are being amortized over a useful life of five years, and non-compete agreements are being amortized over three years. Amortization expense for intangible assets was $518,000 for the three months ended September 30, 2004 compared to $500,000 for the comparable period in 2003. Amortization expense for amortizing intangible assets was $1,558,000 for the nine months ended September 30, 2004 compared to $1,177,000 for the comparable period in 2003.

Estimated future amortization expense (assuming no foreign exchange effect) of purchased intangible assets as of September 30, 2004 is as follows:

(In thousands)	
Fiscal Year	**Amount**
(Remainder) 2004	$ 536
2005	2,111
2006	2,042
2007	1,451
2008	315
Thereafter	-
	$ 6,455

6. EARNINGS PER SHARE

Basic earnings per share is 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 and nine-month period ended September 30, 2004 were 2,780,900 and 1,371,049 shares, compared to 1,993,320 and 3,286,127 for the comparable periods in 2003. The following table sets forth the computation of basic and diluted earnings per share for the three and nine-month period ended September 30, 2004 and 2003:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In thousands, except per share amounts)	2004	2003	2004	2003
Net Income	$ 6,360	$ 2,486	$ 12,517	$ 5,274
Shares used in computing basic earnings per share	39,284	36,588	38,806	36,234
Dilutive effect of stock plans	1,211	1,906	1,987	1,237
Shares used in computing diluted earnings per share	40,495	38,494	40,793	37,471
Earnings per basic share	$ 0.16	$ 0.07	$ 0.32	$ 0.15
Earnings per diluted share	$ 0.16	$ 0.06	$ 0.31	$ 0.14

7. ACCUMULATED OTHER COMPREHENSIVE INCOME

Accumulated other comprehensive income, net of taxes, for the nine months ended September 30, 2004 is comprised of the following:

(In thousands)	Foreign Currency Translation Adjustment	Unrealized Holding Loss on Securities	Accumulated Other Comprehensive Income
Balance, December 31, 2003	$ 5,645	$ (53)	$ 5,592
Nine month period changes	(644)	(172)	(816)
Balance, September 30, 2004	$ 5,001	$ (225)	$ 4,776

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. There have been no new hardware sales; only spare parts and supplies. 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, the remaining portion of the previous 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 for the Company as a whole - 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 and nine months ended September 30, 2004 and 2003 are as follows:

(In thousands)	Three months ended September 30, 2004	Three months ended September 30, 2003	Nine months ended September 30, 2004	Nine months ended September 30, 2003
Software				
Revenue	$ 35,447	$ 35,320	$ 109,475	$ 104,397
Operating loss	(17,609)	(15,028)	(56,405)	(46,891)
Customer Support				
Revenue	$ 47,510	$ 41,907	$ 139,852	$ 123,063
Operating income	23,617	17,836	66,273	51,472
Professional Services and Education				
Revenue	$ 13,531	$ 12,162	$ 40,745	$ 36,095
Operating income (loss)	503	13	2,159	(553)
Total				
Revenue	$ 96,488	$ 89,389	$ 290,072	$ 263,555
Operating income	6,511	2,821	12,027	4,028

9. STOCK OPTIONS

The following is a summary of stock option transactions regarding all stock option plans for the three months ended September 30, 2004:

	Number of Options	Weighted Average Exercise Price
Balance, June 30, 2004	6,955,996	$ 18.08
Granted (weighted-average fair value of $10.75)	79,000	21.16
Exercised	(83,760)	11.85
Canceled	(36,718)	18.36
Balance, September 30, 2004	6,914,518	$ 18.26

The following table summarizes information concerning outstanding and exercisable stock options at September 30, 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	767,938	3.17	$ 7.98	764,416	$ 7.98
9.75 - 12.86	1,110,384	7.13	12.35	606,180	12.06
12.97 - 14.19	1,084,042	6.67	13.47	703,126	13.52
14.39 - 18.45	1,089,323	6.66	16.89	783,402	16.98
18.75 - 25.00	1,270,550	6.01	22.68	1,129,811	22.92
25.28 - 41.84	1,592,281	7.90	28.00	485,886	28.79
$ 1.39 - 41.84	6,914,518	6.52	$ 18.26	4,472,821	$ 17.00

10. ISSUANCE OF RESTRICTED STOCK

The Company awarded 25,000 shares of restricted stock to eight members of the research and development team on July 14, 2004. These shares of restricted stock vest at a rate of 25% annually over a four-year period and contain no accelerated vesting features. These shares were valued at $519,000 based on the July 14, 2004 closing price of $20.76 per share.

As previously reported, the Company awarded 132,500 shares of restricted stock to ten members of the senior management team on March 9, 2004. 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 were valued at approximately $3.6 million based on the March 9, 2004 closing price of $27.47 per share.

Both of these awards were made under the 2002 Incentive Award Plan. The grant value of the restricted stock award 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 on a straight-line basis over the vesting period. Recognition of expense may be accelerated if it becomes probable that certain performance targets will be achieved that trigger accelerated vesting for those shares that contain the acceleration feature. Approximately $218,205 and $452,161 of compensation expense was recognized in the three and nine-month periods ended September 30, 2004, respectively, for these restricted stock awards with no acceleration.

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 September 30, 2004 were as follows:

(In thousands)		
2004 (remaining 3 months)	$	3,216
2005		11,719
2006		11,132
2007		10,174
2008		8,950
2009		6,818
Thereafter		5,928
Total	$	57,937

Product Warranties

The Company provides a 90-day warranty for its software products against substantial nonconformance to the published documentation at time of delivery. 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 accrual for the nine months ended September 30, 2004 and 2003:

(In thousands)		**2004**		**2003**
Beginning balance at January 1	$	479	$	728
Additions		851		678
Deductions		(967)		(916)
Ending balance at September 30	$	363	$	490

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 and may also provide indemnification against legal claims that the Company's software products infringe certain third-party intellectual property rights. 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, payments by the Company under these agreements have been immaterial.

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 September 30, 2004. Approximately $1.5 million was issued in local currency in Europe and Asia, while the balance was issued in the United States. Approximately $0.4 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 September 30, 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

The Company is exposed to foreign exchange rate fluctuations due to intercompany accounts between the U.S. parent company and the foreign subsidiaries. The Company is also exposed to foreign exchange rate fluctuations as the financial statements of foreign subsidiaries are translated into U.S. dollars for consolidation purposes. The Company purchases foreign exchange contracts to mitigate the effect of exchange gains and losses on recorded foreign currency denominated monetary assets and liabilities. The Company does not use foreign exchange contracts for speculative or trading purposes. All outstanding forward contracts are marked-to-market on a monthly basis with gains and losses included in interest and other income, net. As of September 30, 2004, the Company had forward foreign exchange contracts outstanding totaling approximately $3.1 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 September 30, 2004.

13. INCOME TAXES

The Company's combined federal, state and foreign annual effective tax rate for the three months ended September 30, 2004 is 18% compared to 28% for the comparable period in 2003. The Company's combined federal, state and foreign annual effective tax rate for the nine months ended September 30, 2004 is 18% compared to 28% 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 with lower tax rates and reductions in the domestic deferred tax valuation allowance as net operating loss carryforwards were utilized. The decreased tax rate in the nine months ended September 30, 2004 was primarily due to the mix of income earned by domestic operations versus the foreign subsidiaries.

The Company is continually assessing the valuation allowance related to its deferred tax assets. As of September 30, 2004, the Company has a net tax deferred asset of approximately $26.6 million and valuation allowance of approximately $24.3 million. The Company will continue weighing various factors throughout the balance of 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 the Company's level of domestic profitability continue at the current rate, it would likely remove the entire valuation allowance associated with net operating loss carryforwards and other temporary differences by the end of 2004. A one-time, non-cash benefit would be realized by decreasing tax expense (causing an increase in earnings) by approximately $8.0 million to $11.0 million. Additionally, approximately $9.0 million of valuation allowance related to stock option deductions would be evaluated for potential reversal, which could be credited to additional paid in capital.

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 two payments in December 2003 and June 2004 of approximately $294,000 and $331,000, respectively, toward the principal loan balance of $1.9 million. As of September 30, 2004, the outstanding balance on the secured note receivable from Mr. Roberts is approximately $1.275 million and is included in other assets on the consolidated balance sheet. The accrued interest balance as of September 30, 2004 was approximately $36,248. Please reference Note 4 of the December 31, 2003 financial statements included in our Annual Report on Form 10-K 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

We develop, market, sell and support a software platform and framework for Enterprise Content Management. This platform, called FileNet P8, provides a flexible and scaleable framework for developing solutions, which allow our customers a competitive advantage by managing content throughout their organizations, and streamlining their business processes. Enterprise Content Management, or ECM, refers to the broad range of functions used by organizations of all types, including businesses and governmental agencies, to control and track the information, or content, that is important to the organization's operations, whether that information is used internally, such as sales data or product specifications, or externally, such as content provided to customers through a Web site. The content our software manages, commonly called unstructured content, includes, but is not limited to: Web pages, word processing documents, spreadsheets, HTML, XML, PDF, document images, email messages and other electronic content. Our software offers customers the ability to configure, design, build and deploy ECM solutions to meet the needs of their particular business or organization. These solutions allow customers to manage content throughout their organizations, automate and streamline their business processes, and provide the broad-spectrum of connectivity needed to support their critical and everyday decision-making.

We generate revenue by selling software licenses, delivering implementation and education services, and by providing technical support to our customers. Software revenue consists of fees earned from the licensing of our software products to our customers. Implementation and education services are sold on a fee for service basis, and technical support and software maintenance are generally provided pursuant to service contracts of a one-year duration. Annual fees for software technical support and software maintenance are generally received in advance and recognized as revenue over the duration of the contract. Since our operations are not capital or equipment intensive, and cost of goods sold is relatively small, employee compensation is the largest single operating expense for FileNet. Future profitability is contingent upon strategic investments in internally developed or acquired software technologies that are accepted by the market and result in software license and service revenue. This investment is the key factor in achieving our long-term business strategy.

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 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 products. 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 and 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 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. 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 we are not legally required to accept returns of non-defective products, we cannot guarantee that we will continue to experience the same return rates that we have in the past.

Goodwill. Goodwill is recorded at cost and is not amortized. Goodwill is tested for impairment at least annually and written down when impaired. Effective 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 in between annual testing dates that indicate the carrying value of goodwill may not be recoverable. We performed an impairment analysis as of July 1, 2004 in accordance with SFAS 142. The results indicated there was no impairment of goodwill in any of the three reporting units. As of September 30, 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 identified 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. Long-lived assets 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, which require significant estimates and judgments. 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 September 30, 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 balance of 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 domestic profitability continue at the current rate, we would likely remove the entire valuation allowance associated with net operating loss carryforwards and other temporary differences by the end of 2004. We would realize a one-time, non-cash benefit by decreasing our tax expense (causing an increase in earnings) by approximately $8.0 million to 11.0 million. Additionally, approximately $9.0 million of valuation allowance related to stock option deductions would be evaluated for potential reversal, which could be credited to additional paid in capital.

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

Results of Operations

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Revenue:				
Software	36.8 %	39.5 %	37.8 %	39.6 %
Customer support	49.2	46.9	48.2	46.7
Professional services and education	14.0	13.6	14.0	13.7
Total Revenue	100.0	100.0	100.0	100.0
Cost of revenue:				
Software	4.0	4.3	3.6	4.0
Customer support	10.3	11.7	10.4	11.8
Professional services and education	11.8	11.8	11.5	12.1
Total cost of revenue	26.1	27.8	25.5	27.9
Gross Profit	73.9	72.2	74.5	72.1
Operating expenses:				
Sales and marketing	38.0	38.5	40.5	39.3
Research and development	20.4	21.3	20.5	22.0
General and administrative	8.8	9.2	9.3	9.3
Total operating expenses	67.2	69.0	70.3	70.6
Operating income	6.7	3.2	4.2	1.5
Other income, net	1.3	0.7	1.1	1.3
Income before income tax	8.0 %	3.9 %	5.3 %	2.8 %

Revenue

As more fully discussed below, total revenue increased by 7.9% in the quarter ended September 30, 2004 compared to the same period in 2003 and increased 10.1% in the nine-month period ended September 30, 2004 compared to the same period in 2003. We believe this revenue growth is due to our customers placing importance on our products and services to improve their business processes and manage their unstructured content within their organizations. All three of our revenue segments showed growth year to year for the nine-month period ended September 30, 2004.

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

(In thousands)	Three Months Ended September 30, 2004	Three Months Ended September 30, 2003	% Increase/ decrease	Nine Months Ended September 30, 2004	Nine Months Ended September 30, 2003	% Increase/ decrease
$ Total Revenue						
Total United States Revenue	$ 64,532	$ 65,318	(1.2%)	$ 198,820	$ 182,483	9.0%
Europe, Middle East and Africa	23,366	18,601	25.6%	70,908	64,256	10.4%
Canada, Latin America and Asia	8,590	5,470	57.0%	20,344	16,816	21.0%
Total International Revenue	31,956	24,071	32.8%	91,252	81,072	12.6%
Total Revenue	$ 96,488	$ 89,389	7.9%	$ 290,072	$ 263,555	10.1%
% of Total Revenue						
United States Revenue	66.9 %	73.1 %		68.5 %	69.3 %	
International Revenue	33.1 %	26.9 %		31.5 %	30.7 %	
Total Revenue Contribution	100.0 %	100.0 %		100.0 %	100.0 %	

Revenue generated in the United States grew by 9.0% in the first nine months of 2004 compared to the same period in 2003 and decreased marginally by 1.2% in the third quarter of 2004 over the comparable prior year quarter. This increase during the nine-month period is primarily due to the increase in service revenue. The factors driving software license and service revenue growth will be more fully discussed in the *Revenue by Reporting Segment* section below. The revenue growth in the United States was complemented by increased international revenue in the three and nine-month periods of 2004 compared to the same quarter a year ago. International revenue represented approximately 31.5% of total revenue in the first nine months of 2004 compared to approximately 30.7% for the same nine months in 2003.

We believe that process improvement and content management requirements are global in nature and international customers also view our products as essential to solving their business and content problems. Revenue growth in the long term appears to be non-regional in nature, but is subject to periodic fluctuations. Furthermore, international revenues will be adversely affected if the U.S. dollar strengthens against certain major international currencies or if international economic conditions weaken.

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

	Three Months Ended September 30,			Nine Months Ended September 30,		
(*In thousands)*	2004	2003	% Increase / (decrease)	2004	2003	% Increase (decrease)
$ Total Revenue						
Software	$ 35,447	$ 35,320	0.4%	$ 109,475	$ 104,397	4.9%
Customer Support	47,510	41,907	13.4%	139,852	123,063	13.6%
Professional Services and Education	13,531	12,162	11.3%	40,745	36,095	12.9%
Total Revenue	$ 96,488	$ 89,389	7.9%	$ 290,072	$ 263,555	10.1%
% of Total Revenue						
Software	36.7%	39.5%	(2.8)	37.7%	39.6%	(1.9)
Customer Support	49.2%	46.9%	2.4	48.2%	46.7%	1.5
Professional Services and Education	14.1%	13.6%	0.4	14.1%	13.7%	0.4
Total Revenue Contribution	100.0%	100.0%		100.0%	100.0%	

Software. Software revenue consists of fees earned from the licensing of our software products to our customers. Demand was relatively stable for our products for the comparable three and nine-month periods in 2004 and 2003. As we have seen in prior quarters this year, fluctuation in buying patterns and the general market climate has affected our level of software sales quarter to quarter, creating an environment that is unpredictable. We believe this environment will continue in the near term. In the longer term we believe spending on enterprise content management and business process management software will be a priority as companies look to automate regulatory and compliance requirements. Additionally, we believe there will be increased demand for our ECM products driven by the need for large organizations to manage their unstructured content.

Customer Support. Customer support revenue consists of revenue from software maintenance contracts, time and material revenues and the sale of spare parts and supplies. Maintenance contracts entitle our customers to receive technical support, enhancements and upgrades to new versions of software releases if and when available. Time and material revenue is derived from services provided to the customer that are not included in their maintenance contract entitlements. Customer support revenue is generated from new maintenance contracts for current year software sales and from the renewal of existing maintenance contracts for previously sold software licenses on installed systems. Customer support revenue increased by 13.4% in the three-month period ended September 30, 2004 compared to the same period in 2003 and increased 13.6% in the nine-month period ended September 30, 2004 compared to the same period in 2003. We have historically experienced a high contract maintenance renewal rate and continue to see this same high level of renewal, but are continuing to encounter pricing pressures from our customers during contract negotiation and renewal. Accordingly, the rate of software revenue growth may not directly correlate to the same growth for customer support revenue experienced in the past.

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 11.3% in the three month period ended September 30, 2004 compared to the same period in 2003 and 12.9% in the nine-month period ended September 30, 2004 compared to the same period in 2003. Professional services revenue is dependent on the level and the nature of software sales in prior periods. Professional services revenue grows more rapidly when customers purchase new systems for a large scale implementation or purchase our FileNet P8 product to replace legacy systems, as opposed to existing customers purchasing add-on licenses for installed systems. The increase in professional services revenue we experienced in the first nine months of 2004 compared to the same period in 2003 was primarily attributable to an increased demand for consulting services to existing customers that migrated their custom applications to the new FileNet P8 platform. Based on software revenue sales for the past two quarters we do not believe the level of demand for professional services and education services will change significantly from current levels.

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 Ended September 30,			Nine Months Ended September 30,		
(*In thousands)*	2004	2003	% Increase/ (decrease)	2004	2003	% Increase/ (decrease)
$ Total Cost of Revenue						
Software	$ 3,835	$ 3,800	0.9%	$ 10,486	$ 10,416	0.7%
Customer Support	9,891	10,487	(5.7)%	30,125	31,026	(2.9)%
Professional Services and Education	11,404	10,586	7.7%	33,396	32,001	4.4%
Total Cost of Revenue	$ 25,130	$ 24,873	1.0%	$ 74,007	$ 73,443	0.8%
% Total Cost of Revenue						
Software	10.8%	10.8%	-	9.6%	10.0%	(0.4)
Customer Support	20.8%	25.0%	(4.2)	21.5%	25.2%	(3.7)
Professional Services and Education	84.3%	87.0%	(2.8)	82.0%	88.7%	(6.7)
Total Cost of Revenue as a % of Revenue	26.0%	27.8%		25.5%	25.3%	

Software. Cost of software revenue includes royalties paid to third parties for technology used in our products to enhance features and functionality, partner fees, amortization of acquired technology, media costs, and the cost to manufacture and distribute software. The cost of software revenue in absolute dollars increased minimally by 0.9% when comparing the three months ended September 30, 2004 to the same three months in 2003. The nine-month comparison for these two years resulted in a 0.7% increase. The cost of software revenue as a percent of software revenue was unchanged in the three month period comparison and decreased a small 0.4 percentage point in the nine-month period ended September 30, 2004, compared to the same period in 2003. While these costs will fluctuate period to period based on the mix of products sold containing third party product, our royalty costs have remained flat or decreased slightly due to more favorable royalty rates that have been negotiated during the renewal process over the past year. The volume of sales influenced by partners that requires a partner fee also fluctuates quarter to quarter. However, going forward we anticipate the cost of software revenue to remain at 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 compensation and benefits paid to customer support personnel, facility and technology infrastructure expenses in our call centers, supplies and spare parts. The cost of customer support revenue as a percent of customer support revenue decreased by 4.2 percentage points and 3.7 percentage points in the three and nine-month periods ended September 30, 2004 compared to the same periods in 2003. The cost of customer support revenue in absolute dollars also decreased in these comparable periods due to continuing cost containment programs. The reduction in cost of customer support revenue, as a percentage of the revenue is attributable to efficiencies in the delivery of technical support, which allows for increased revenue without a comparable increase in cost. We expect the cost of customer support revenue to remain fairly constant as a percent 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 2.8 percentage points and 6.7 percentage points in the three and nine-month periods ended September 30, 2004 as compared to the same periods in 2003. This decrease in cost of professional services and education revenue as a percent of professional services and education revenue is primarily attributable to higher professional services and education revenue in 2004 compared to 2003, together with lower costs associated with reduced employee headcount and lower variable employee compensation. 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, the level of revenue 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 Ended September 30,			Nine Months Ended September 30,		
(In thousands)	2004	2003	% Increase/ (decrease)	2004	2003	% Increase/ (decrease)
$ Total Operating Expenses						
Research and Development	$ 19,664	$ 19,049	3.2%	$ 59,469	$ 58,031	2.5%
Marketing and Sales	36,674	34,405	6.6%	117,433	103,660	13.3%
General and Administrative	8,509	8,241	3.3%	27,136	24,393	11.2%
Total Operating Expenses	$ 64,847	$ 61,695	5.1%	$ 204,038	$ 186,084	9.6%
% Total Operating Expenses						
Research and Development	20.4%	21.3%	(0.9)	20.5%	22.0%	(1.5)
Marketing and Sales	38.0%	38.5%	(0.5)	40.5%	39.3%	1.2
General and Administrative	8.8%	9.2%	(0.4)	9.4%	9.2%	0.1
Operating Expense as a % of Revenue	67.2%	69.0%		70.3%	70.6%	

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. We delivered version 3.0 of our FileNet P8 platform in the third quarter of 2004. Our efforts also focus on our product suites including Business Process Manager, Web Content Manager, Records Manager, Forms Manager, Team Collaboration Manager and other capabilities. We delivered our Records Manager suite in the third quarter of 2004 and plan the availability of Team Collaboration Manager suite during the fourth quarter of 2004.

Our research and development expense consists primarily of personnel costs for internal software development, third party contracted development resources, and related facilities costs. Research and development expense increased 3.2% and 2.5% in the three and nine-month periods ended September 30, 2004 compared to the same periods in 2003 due primarily to employee merit increases and increased offshore consulting expense. However, research and development expense decreased as a percent of revenue by 0.9 percentage points and 1.5 percentage points for the three and nine months ended September 30, 2004 compared to the same periods in 2003. This decrease is primarily attributable to increased revenue levels without a corresponding expense increase. Lower internal personnel and facility expense resulting from decreased headcount partially offset increased offshore development expense. The expense mix continues to change with lower internal personnel costs and higher offshore development expense. The number of internal research and development personnel was 430 on September 30, 2004 compared to 464 on September 30, 2003. We currently have 99 contract workers in India developing software compared to 62 one year ago.

We believe we will be able to further decrease our per-developer cost through the expanded 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 20% of revenue for the near term.

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 as a percent of revenue decreased by 0.5 percentage points and increased by 1.2 percentage points for the three and nine-months ended September 30, 2004 compared to the same period in 2003. In absolute dollars selling and marketing expense increased by 6.6% and 13.3% for the three and nine-month periods ended September 30, 2004 compared to 2003. Approximately $13.3 million, or 95%, of the year to date increase is attributable to organizational changes that resulted in higher salaries, higher variable compensation and associated benefits. We expect selling and marketing expense to remain at approximately 39% 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 as a percent of revenue decreased 0.4 percentage points and increased 0.1 percentage points in the three and nine-month periods ended September 30, 2004 compared to the same periods in 2003. In absolute dollars general and administrative expenses increased 3.3% and 11.2% in the three and nine-month periods ended September 30, 2004 compared to the same periods in 2003. The increases in general and administrative expense between the comparative periods are attributed to higher salary costs and benefits due to increased headcount and merit increases as well as increased legal and accounting fees associated with compliance to meet recently mandated corporate governance regulations. We expect general and administrative expense to remain at approximately 10% of revenue in the near-term.

Other Income, Net. Other income, net consists primarily of interest income earned on our cash and investments, and other items including realized foreign exchange gains and losses and interest expense. Other income, net of other expenses, was $1.2 million and $3.2 million for the three and nine-month periods ended September 30, 2004 compared to $0.6 million and $3.3 million during for the three and nine-month periods ended September 30, 2003. The weighted average interest rate earned on cash, cash equivalents and investments was 1.88% during the nine months ended September 30, 2004 compared to 1.35% for the same period in 2003.

Provision for Income Taxes. Our combined federal, state and foreign annual effective tax rate for the three and a nine-month period ended September 30, 2004 was 18%, compared to 28% for the comparable periods 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 with lower tax rates and reductions in our domestic deferred tax valuation allowance. The decreased tax rate in the three and nine-month period ended September 30, 2004 was primarily due to the mix of income earned by our domestic operations versus the foreign subsidiaries.

Liquidity and Capital Resources

At September 30, 2004, combined cash, cash equivalents and investments totaled $302.9 million, an increase of $54.6 million and $3.3 million from December 31, 2003 and June 30, 2004, respectively.

Cash provided by operating activities during the nine month period ended September 30, 2004 totaled $42.5 million and resulted primarily from: an increase in unearned maintenance revenue related to prepaid maintenance contracts of $16.9 million; depreciation and amortization expense of $12.4 million; and net income of $12.5 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 $21.5 million and was a result of proceeds received from the exercise of employee stock options and stock purchases under the employee stock purchase plan.

Net cash used in investing activities was $53.5 million comprised of $45.8 million for the purchase of marketable securities in excess of proceeds from the sales of marketable securities and $7.8 million for capital expenditures.

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. The adoption of FIN 46R in 2004 has not had 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 has not had a material impact on our consolidated financial statements.

In March 2004, The FASB issued EITF Issue No. 03-1 (EITF 03-1), “The Meaning of Other Than-Temporary Impairment and Its Application to Certain Investments” which provides new guidance for assessing impairment losses on investments. Additionally, EITF 03-1 includes new disclosure requirements for investments that are deemed to be temporarily impaired. In September 2004, the FASB delayed the accounting provisions for EITF 03-1; however the disclosure requirements remain effective for annual periods ending after June 15, 2004. We will evaluate the impact of EITF 03-1 once final guidance is issued.

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 quarterly 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:

- Information Technology 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 addition, large 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.

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 enterprise content management solutions market. 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, these markets may not continue to grow as we anticipate, or our products and solutions may not 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 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 product suites that we predict will address new markets include Records Manager and Team Collaboration Manager. The Records Manager Suite was released in the third quarter of 2004 and provides customers with the capability to systematically apply record management principles to content. The Team Collaboration Manager Suite that enables customers to initiate collaborative tasks at any point in a process is expected to be available in late 2004 or early 2005.

We may not be successful in developing, marketing and releasing new products or new versions of our products that respond to technological developments, evolving industry standards or changing customer requirements. We may also experience technical difficulties that could delay or prevent the successful development, introduction, sale and implementation 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 may 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. Announcements of currently planned or other new software products may 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 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 may not be successful in attracting and retaining such personnel in the future.

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

The limitation of liability provisions contained in our license agreements may not be effective as a result of existing or future federal, state or local laws or ordinances or unfavorable judicial decisions. Our license agreements with our customers typically contain provisions designed to limit our exposure to potential product liability claims. Although product liability claims to date have been immaterial, the sale and support of our products entails the risk of such claims, which could be substantial in light of our customers' use of such products in mission-critical applications. If a claimant brings a product liability claim against us, it could have a material adverse effect on our business, results of operations and financial condition. Even if our software is not at fault, we could suffer material expense and material diversion of management time in defending any such lawsuits.

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. 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. Our existing or future copyrights, trademarks, trade secrets, patents or other intellectual property rights may not 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 may not be able to redesign the infringing products to avoid further infringement or 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 BEA Systems Inc., EMC Corporation, ILOG 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. If we fail to maintain these relationships, or to establish new relationships in the future, it 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 111 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 September 30, 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 September 30, 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 $341,000 at September 30, 2004 and approximately $258,000 at September 30, 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 $681,000 at September 30, 2004 and approximately $515,000 at September 30, 2003.

The following table provides information about our investment portfolio at September 30, 2004:

(In thousands)	**Cost**	**Estimated Fair Value**
Debt Securities		
Due in one year or less:		
Short-term munis-taxable	$ 8,500	$ 8,500
Corporate	8,545	8,533
Governments/Agencies	57,009	56,792
Total due in one year	74,054	73,825
Due in one to three years:		
Corporate	2,087	2,079
Government/Agencies	13,860	13,804
Total due in three years	15,947	15,883
Grand total	$ 90,001	$ 89,708

Actual maturities may differ from contractual maturities because the issuer of the securities may have the right to repurchase such securities. We classify investments maturing in less than one year in current assets and investments maturing greater than one year are classified as long-term investments.

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 September 30, 2004, we had forward foreign exchange contracts outstanding totaling approximately $3.1 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 or loss is incurred when account balances denominated in a foreign currency are translated into U.S. dollars in accordance with FASB No. 52, or when investments are revalued to current fair market value in accordance with FASB No. 115. Our cumulative other comprehensive income and loss is due primarily to translation. The resulting gains or losses from translation are charged or credited to other comprehensive income and are accumulated and reported in the stockholders equity section of our consolidated balance sheet.

Other cumulative comprehensive income increased $1.8 million during the three-month period ended September 30, 2004 due to a temporary strengthening of the U.S. dollar to the Euro. However, cumulative other comprehensive income decreased by $0.8 million during the nine-month period ended September 30, 2004, due to the general weakening of the U.S. dollar to the Euro over this extended 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 and nine-month period ended September 30, 2004.

Item 4. Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports are 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 our management, including our 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 September 30, 2004, the end of the quarter covered by this report, an evaluation was carried out under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as required by SEC Rule 13a – 15(b). Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level. There has been no change in our internal controls over financial reporting during our most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting.

Section 404 of the Sarbanes-Oxley Act. We have made our Section 404 compliance project a top priority for the Company. However, the process is on going and we cannot provide assurance that a weakness requiring remediation will not be discovered and that such weakness, if discovered, can be remediated prior to the compliance date of December 31, 2004.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

See Note 11 to Consolidated Financial Statements.

Item 6. Exhibits

(a) Exhibits:
   1) The list of exhibits contained in the accompanying Index to Exhibits is herein incorporated by reference.

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

November 8, 2004	By:	*/s/ Sam M. Auriemma*
Date		Sam M. Auriemma, Executive Vice President and Chief Financial Officer (Principal Financial and Accounting Officer, Authorized Signatory)

Index to Exhibits

Exhibit No.	Exhibit Description
3.1*	Restated Certificate of Incorporation, as amended *(filed as Exhibit 3.1 to Registrant's Form S-4 filed on January 26, 1996; Registration No. 333-00676).*
3.1.1*	Certificate of Amendment of Restated Certificate of Incorporation *(filed as Exhibit 3.1.1 to Registrant's Form S-4 filed on January 26, 1996, Registration No. 333-00676).*
3.2*	Bylaws (*filed as Exhibit 3.2 of the Registrant's registration statement on Form S-1, Registration No. 33-15004).*
4.1*	Form of certificate evidencing Common Stock *(filed as Exhibit 4.1 to Registrant's registration statement on Form S-1, Registration No. 33-15004).*
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 *(filed as Exhibit 4.2 to Registrant's registration statement on Form S-4 filed on January 26, 1996; Registration No. 333-00676).*
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 *(filed as Exhibit 4.3 to Registrant's registration statement on Form 10-Q for the quarter ended September 30, 1998).*
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. *(filed as Exhibit 4.4 to Registrant's Annual Report on Form 10-K filed for the year ended December 31, 2001).*
10.2*+	Amended and Restated 1995 Stock Option Plan of FileNet (*filed as Exhibit 99.1 to Registrant's registration statement on Form S-8 filed on October 15, 2001; Registration No. 333-71598).*
10.2.1*+	Amendment to the 1995 Stock Option Plan approved by Registrant's Board of Directors dated May 7, 2003 *(filed as Exhibit 10.2.1 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003).*
10.2.2*+	Amended Form of 1995 Executive Officer Stock Option Agreement *(filed as Exhibit 10.2.2 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003).*
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 *(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)*, the first Amendment thereto *(filed as Exhibit 4(d) to the Registrant's registration statement on Form S-8, Registration No. 33-69920)*, and the Second Amendment thereto *(filed as Appendix A to the Registrant's Proxy Statement for the Registrant's 1994 Annual Meeting of Stockholders, filed on April 29, 1994).*
10.4*+	Non-Statutory Stock Option Agreement (with Notice of Grant of Stock Option and Special Addendum) between Registrant and Mr. Lee Roberts *(filed as Exhibit 99.17 to Registrant's registration statement on Form S-8 filed on August 20, 1997).*
10.6*+	Amended and Restated FileNet Corporation 1998 Employee Stock Purchase Plan (*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).*
10.7*+	FileNet Corporation International Employee Stock Purchase Plan (*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).*
10.8*	Lease between the Registrant and C. J. Segerstrom & Sons for the headquarters of the Company, dated September 1, 1999 *(filed as Exhibit 10.23 to Registrant's registration statement on Form 10-Q for the quarter ended September 30, 1999)*.
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 (*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*).
10.11*	Asset Purchase Agreement dated April 2, 2002 by and between 3565 Acquisition Corporation and eGrail, Inc. *(filed as Exhibit 10.1 to Registrant's Current Report on Form 8-K, filed on April 12, 2002).*
10.12*+	Secured Promissory Note between Registrant and Mr. Lee D. Roberts dated June 14, 2002 *(filed as Exhibit 10.12 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2002)*.

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).*
10.14.4*+	Amended and Restated 2002 Incentive Award Plan of FileNet Corporation, *(filed on April 1, 2004 as Appendix B of Registrant's Definitive Proxy Statement for its 2004 Annual Meeting of Stockholders).*
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*+	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).*
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.