UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

(Mark One)

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2003

OR

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

For the transition period for _____________ to _______________.

Commission File No. 0-15997

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, California	**92626**
(Address of principal executive offices)	**(Zip Code)**

Registrant's telephone number, including area code: (714) 327-3400

Securities Registered Pursuant to Section 12(b) of the Act: None

Securities Registered Pursuant to Section 12(g) of the Act: Common Stock, $0.01 par value

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 disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [√]

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 [ ]

Based on the closing sale price as of June 30, 2003 the aggregate market value of the 36,323,178 shares of the common stock of the Registrant held by non-affiliates of the Registrant on such date was $653,853,204. For purposes of such calculation, only executive officers, board members and beneficial owners of more than 10% of our outstanding common stock are deemed to be affiliates.

The number of shares outstanding of the Registrant's common stock was 38,535,087 at March 12, 2004.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's definitive proxy statement, to be delivered in connection with the Registrant's 2004 Annual Meeting of Stockholders, are incorporated by reference into Part III of this Report.

FILENET CORPORATION

2003 ANNUAL REPORT ON FORM 10-K
For the Year Ended December 31, 2003

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Forward-Looking Statements

In addition to historical information, this Annual Report on Form 10-K contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 21E of the Securities 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. These forward-looking statements involve risks and uncertainties, including those discussed herein and in the notes to our financial statements for the year ended December 31, 2003, certain sections of which are incorporated herein by reference as set forth in Items 7 and 8 of this report. The actual results that we achieve may differ materially from any forward-looking statements, which reflect management's opinions only as of the date hereof. We undertake no obligation to revise or publicly release the results of any revisions to these forward-looking statements. Readers should carefully review the section entitled "Risk Factors" and other documents we file from time to time with the Securities and Exchange Commission. Our business, financial condition, operating results and prospects can be impacted by a number of factors, including but not limited to those set forth in the section entitled "Risk Factors" and elsewhere in this report, any one of which could cause our actual results to differ materially from recent results or from our anticipated future results.

PART I

Item 1. *Business*

FileNet Corporation ("FileNet") was incorporated on July 30, 1982. We develop, market, sell and support a software platform and framework for Enterprise Content Management. 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 includes, but is not limited to: Web pages, word processing documents, spreadsheets, HTML, XML, PDF, document images, email messages and other electronic content. ECM also refers to processing, communicating and gathering information within the organization and from third parties, such as processing payments or applications for services. 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 operate globally and sell our products and services to our customers through a direct sales force, system integrators, resellers and value added distributors. We invest significantly in product development to improve our existing products and to increase our product offerings. We also offer professional services for the implementation of these software solutions, as well as 24 hours a day, 7 days a week technical support and services to our customers on a global basis.

Available Information

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.

Fiscal 2003 Developments and Strategy

During fiscal 2003, we focused our development efforts on enhancing and integrating the capabilities of our FileNet P8 architecture and bringing this architecture to market. FileNet P8 provides our customers with the ability to easily configure, design, build and deploy a variety of ECM solutions to meet a broad range of content management and business process management needs within a single scalable framework. Also during the year, we acquired the technology of the Shana Corporation and ramped-up our third party offshore development efforts. The Shana acquisition brought us advanced eForms management technology. Offshore development augments our current development capacity with a low cost and high quality alternative to internal development.

During fiscal 2002, we acquired the technology of eGrail, which brought us advanced Web content management technology. During fiscal 2000, we acquired the technology of Application Partners Incorporated, which brought us eService applications technology.

With the introduction of the FileNet P8 ECM architecture in early 2003, we provide the following capabilities:

- a unified architecture for content types;
- unified object oriented Application Programming Interfaces to facilitate rapid application development;
- common user and management interface across the entire architecture;
- portal integration to leverage a customer's existing applications;
- connectivity to customer enterprise applications via an Enterprise Application Integration capability and FileNet Virtual Content Management, which provides the ability to interact with external content and events; and
- enhanced Business Process Management capabilities including process simulation and analytics allowing customers to optimize business processes on a real-time basis.

We have packaged our ECM capabilities into five FileNet suites that include the Business Process Manager, Content Manager, Web Content Manager, Image Manager and Forms Manager. Each suite provides specific functionality to meet customer requirements. When our customers purchase a FileNet ECM solution they have the ability to add-on additional FileNet capabilities as needed, allowing them flexibility to acquire only the functionality they need. The integration of the suites allows for a lower total cost of ownership by reducing support costs and application development times.

We intend to continue to leverage our development capabilities and substantial worldwide distribution and service network to deliver on our unified platform strategy. We also intend to continue our strategy of investing in product enhancements, new product developments, new partnerships, and strategic acquisitions.

Markets and Customers

We believe the FileNet P8 architecture offers our customers the ability to scale their ECM solutions to the enterprise-level and offers the flexibility to manage demanding content challenges, complex business processes, and integration with an organization's existing systems. The FileNet P8 architecture is designed to provide our customers with a way to manage their enterprise content, which can provide greater process control and consistency throughout the enterprise.

Our customers include many of the Global 2000 organizations and are typically those enterprises and government agencies that have complex business processes that capture, manage, store, and share large volumes of digital content. As of December 31, 2003, our software has been licensed to more than 4,000 customers worldwide.

Our software solutions are effective for a variety of applications such as mortgage loan servicing, customer relationship management, insurance claims processing, regulatory compliance, accounts payable and receivable, and for any business operation that processes significant amounts of electronic information or content in their day-to-day operations. Additionally, our software products can address ad hoc business processes at the enterprise, departmental, and workgroup levels to improve overall enterprise productivity, and can integrate with industry-standard productivity and enterprise applications such as Lotus Notes, Microsoft Office, SAP, Siebel, and others.

We market our products in more than 90 countries around the world through a direct sales force and through our ValueNet business partner program. The ValueNet program brings together value-added resellers, independent software vendors, system integrators, consultants and service providers to deliver a broad range of solutions and services to our customers worldwide. Furthermore, our strategic alliances with other industry leaders contribute to our efforts in product development, customer satisfaction, and worldwide market penetration. More than 250 firms operate under the ValueNet program and combine our software products with industry-specific, value-added services and applications to provide turnkey ECM solutions for customers. Our FileNet ECM solutions are applicable in a variety of industries, however our key vertical markets are insurance, financial services, government, manufacturing, telecommunications, and utilities.

Using our standard software products, customers generally build applications that address their particular needs. Very often these applications can involve a significant change in the way a customer operates. Consequently, our sales cycle, or the time from initial customer contact to completed product sale, can be lengthy, and our quarterly sales typically include a mix of medium sized sales with a smaller number of large orders. We typically ship our products within a short period of time after acceptance of orders, which is common in the computer software industry.

Our global customer support operation offers software maintenance and technical support services for our products worldwide. These technical support programs offer a wide range of services including the right to new versions of our software, extended phone support coverage, on-site technical consultants, a technical account management program, and software development kit support.

Our professional services operation offers business and technical consulting services and training to both end-users of our products and to ValueNet partners on our standard software products. These professional services are marketed by our direct sales force and through the ValueNet business partner program, with a focus on FileNet centric enterprise system implementation and the delivery of ECM applications.

Industry Segments and Geographic Information

For the purposes of Statement of Financial Accounting Standards ("SFAS") No. 131, "Disclosures About Segments of an Enterprise and Related Information," we have provided a breakdown of our sales, operating results and other information using the management approach in Note 16 of the "Notes to Consolidated Financial Statements" under Item 8, "Financial Statements and Supplementary Data." Using the management approach, our principle reportable operating segments include Software, Customer Support, Professional Services and Education, and Hardware. A summary of our sales by geographic location is incorporated herein by reference in Note 16 of the "Notes to Consolidated Financial Statements" under Item 8, "Financial Statements and Supplementary Data."

Software Products and Solutions

FileNet P8

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

FileNet Suites

Business Process Manager

FileNet Business Process Manager is an ECM solution that is designed to help organizations increase process performance, reduce cycle times, and improve productivity by managing the flow of work through automating, streamlining, and optimizing complex processes associated with business operations. The operations of many businesses involve gathering information and making decisions based on that information, and many of these decisions, or the steps leading up to them, can be automated to increase efficiency and create a more standardized approach to these decisions throughout the business organization. Examples of customer business processes that may benefit from our Business Process Manager solution include: insurance companies that have automated policy underwriting and claims processing decisions, financial services companies that have streamlined the loan origination and servicing processes, and government agencies that have automated case management and tax processing functions. The Business Process Manager can provide an interface for gathering necessary information and either make decisions based on automated criteria or direct that information to the appropriate decision-maker in an efficient and consistent basis. Additionally, the Business Process Manager suite provides real-time and historical tracking of processes combined with analysis and simulation capabilities allowing customers to optimize their processes. This product is standards based, flexible and can be customized to a wide range of industry requirements.

Content Manager

FileNet Content Manager is an ECM solution that combines content management with process management capabilities to help organizations manage complex documents to control, share, and access critical business information. Content Manager is designed to assist with all steps in the content life cycle, from creation and tracking to storing and controlling access to relevant information. It activates content by allowing an organization to make content available to the right place at the right time - to support the business decision-making process at any level in the organization. The Content Manager's secure and scalable environment integrates directly with desktop and business applications so business users can collaborate on the creation and management of content, while controlling access as necessary.

Web Content Manager

FileNet Web Content Manager is designed to combine easy-to-use Web site development capabilities with integrated process capabilities for managing the creation, approval and publication of Web content and complex documents to multiple Web sites, in multiple formats, and in multiple languages. The Web Content Manager allows centralized control of Web site content and appearance while allowing particular content to be directly created and updated by organization members without specialized Web expertise, through the use of controlled templates and other tools. Web Content Manager can control large amounts of dynamic Web content across globally distributed sites and provides integrated process management capabilities to help ensure secure and accurate Web content publication.

Image Manager

FileNet Image Manager is designed to be highly scalable and provides rapid access for end-users to fixed objects, or content that is not intended to be modified, such as scanned documents, faxes, email and rich media. It is designed to securely and permanently store large volumes of critical business information and to safeguard critical content from disaster and misuse while making it more accessible to thousands of users. Among other applications, FileNet Image Manager has been used by organizations such as municipal court systems to scan, track and provide access to important case documents.

Forms Manager

FileNet Forms Manager is designed to provide customers the ability to design, deploy and process electronic forms (eForms) across their enterprise. FileNet Forms Manager enables customers to transform cumbersome paper forms into fully interactive eForms that directly connect to their business applications.

FileNet Forms Manager provides a rich and intuitive design environment that enables general business users to create, deploy and process eForms and associated data without extensive Web development or JavaScript experience. FileNet Forms Manager integrates with a customer’s existing infrastructure to enable forms to be widely accessible by supporting a variety of operating systems and browsers. It enables users to view forms in a business process and supports digital signatures and tracking for audit trails to help in meeting regulatory compliance requirements.

FileNet ECM Technology

The FileNet P8 architecture includes the following technology for aiding in the development of ECM solutions:

Content Engine provides software services for managing content and other business-related data, collectively referred to as objects. In addition to managing documents and any customer defined objects, the Content Engine manages a broad range of enterprise content including workflow definitions, stored searches, publishing templates, entry templates, Web content management templates, analytics reports, and simulation scenarios.

Process Engine is the component for design, execution and tracking of processes. It manages processes and their associations with documents, data, and lifecycle information residing in the Content Engine. It also tracks and records the status of work in progress. The Process Engine drives processes, associates information, manages work-to-do, sends notifications, sets milestones, provides reporting and tracking capabilities, and provides the most up-to-date information to all participants.

Enterprise Application Integration provides connectors for integrating process and content with enterprise applications. In addition, FileNet offers an optional EAI server through an OEM agreement for IBM Websphere InterChange Server, Adaptors and Collaborations. The connectors provided by FileNet provide integration with enterprise applications such as SAP R/3, Siebel, and Clarify as well as technologies such as XML, Web Service, JMS, and MQSeries.

FileNet P8 Workplace is an end-user application that provides a Web-based interface to FileNet P8. It is designed to allow users to locate business content, initiate new transactions, check status and track a wide variety of processes and information across multiple storage locations or systems. A customizable environment, FileNet P8 Workplace is designed to enable employees, partners and customers to manage work processes through a simple interface.

Content Provider for FileNet P8 Workplace provides virtual content management ("VCM") access to content stored in third party repositories including content management repositories from IBM, EMC/Documentum, and OpenText among others, through the FileNet P8 Workplace. It is designed to eliminate the need for custom integrations, which can be expensive, time consuming and require ongoing maintenance for customers. FileNet's VCM capabilities are provided as a result of a reseller business agreement with FileNet partner, Venetica.

Web Content Manager ("WCM") is an application that provides Web content management capabilities that leverage the core content and process management capabilities provided in the platform.

Java2 Platform Enterprise Edition ("J2EE") Support provides J2EE application components and system components that operate in J2EE Platform Products (application servers) such as BEA WebLogic and IBM WebSphere. In addition, FileNet applications leverage the J2EE application model to build multi-tier applications that deliver the scalability, accessibility, and manageability required by enterprise applications.

Web Application Toolkit provides a framework for developing web applications that run in a J2EE environment. The toolkit is used by several FileNet P8 applications, including Workplace, Solution Templates, and the Web Content Manager.

Image Services Resource Adapter ("ISRA") is designed to enable organizations to connect content stored in the FileNet Image Manager's Image Services repository to custom J2EE applications. The ISRA delivers the functionality required to access Image Services content within a J2EE Web application. It was specifically designed for Image Services customers who have standardized on a Java development and implementation environment for Web applications.

Portal Integrations provide commonly required content and process functionality within 3rd party portal products. FileNet provides portal integration for BEA WebLogic, IBM WebSphere and mySAP portals. Additionally, customers and partners can create their own portlets using FileNet's Java Application Programming Interfaces. In addition, FileNet distributes the source code for the portlets so that customers and partners can modify and extend the capabilities if desired.

Solution Templates are a set of predefined objects and processes for use in developing industry specific solutions. Built on the FileNet P8 architecture, a Solution Template provides working code that can be configured and extended to build complete applications. A Solution Template is not a turnkey application; rather, it can be thought of as an application development template. By providing much of the application's core infrastructure, it can reduce the length of the solution development and deployment cycle.

Stand-Alone Products

In addition to the FileNet P8 product suites and development tools the following FileNet software products are available to our customers as stand-alone products that provide some of the functionality available through the full FileNet P8 architecture, and were formally available under the Panagon and/or Brightspire brands.

FileNet eProcess Services is a Web browser-based process management product. eProcess Services enables an organization to create and manage high-volume, mission-critical automated business processes in a dynamic Web environment. Our Web-based user interface, built-in eProcess applications, Web server components, and XML architecture provide scalable connectivity of business processes for employees, business partners, and customers.

FileNet Web Services combines a full-featured, Web browser-based client system that allows access to content without the need to locally download information or content. FileNet Web Services also combines a comprehensive Web-based application development tool kit, and Web server components, and is designed to support complex and mission critical ECM and Business Process Management activities. This application provides a complete set of content management functionality, allowing users to check in, check out, search and browse, share, revise, and change properties for content stored in a FileNet repository, all from a Web browser.

FileNet Content Services is a repository for creating, accessing, managing, securing, and updating electronic documents and content. Content Services is designed to allow a business to manage enterprise content from creation, to secure delivery, to revision and re-use.

FileNet WorkFlo Services is FileNet's eProcess workflow engine. WorkFlo Services, combined with eProcess Services, is designed to enable customers to automate and access critical business processes and associated content. WorkFlo Services can be used to create applications that reflect the way business processes are performed within the particular customer's organization, and is a critical enabling technology for the automation of business processes via the Web. It allows organizations to control and modify their work processes to meet their evolving needs, and integrates the flow of information between software applications within a company's business processes. WorkFlo Services supports multiple client, server and applications development environments, such as Java and COM, and integrates with leading business process re-engineering products for reduced implementation time.

FileNet Integrated Document Management ("IDM") Desktop is a Microsoft Windows client software application designed to allow users to view, manage, revise, share, and distribute content across an enterprise for ad hoc or mission critical use. IDM Desktop allows users to manage content directly from within Microsoft Office and Lotus Notes applications.

FileNet Image Services is an image and object server designed to allow businesses to manage the high-speed acquisition, distribution, and access of content and objects of all types.

FileNet Report Manager is an online statement and report management system. Report Manager is designed to allow organizations the ability to capture, store and access legacy print data streams within ECM applications by storing, accessing, mining, and analyzing computer-generated reports, statements and forms.

FileNet Capture addresses document and content capture needs. Available in high-volume Capture Professional or small department Capture Desktop versions, Capture is designed to acquire digital and paper-based content into FileNet ECM repositories for enterprise-wide use and online access.

FileNet Application Connector for SAP software is a document and data archiving application certified by SAP, designed for use with the SAP R/3 Enterprise Resource Planning ("ERP") application suite.

Hardware

We also manufacture and market an Optical Storage And Retrieval ("OSAR") library product based on 12-inch, 30 gigabyte, and optical disk technology for storage management of business critical content. Hardware is no longer a strategic focus for the Company.

Services, Support, and Manufacturing

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.

Support programs may be customized and enhanced with optional fee-based services. These options include after hours phone coverage, on-site technical consultants to assist with upgrades and FileNet product installations, and FileNet Software Development Kit support for development teams building applications using our products.

Our manufacturing facilities in Costa Mesa, California and Dublin, Ireland, conduct software manufacturing and distribution, localization, integration, test and quality control.

Professional Services and Education

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

Research and Development

We have made and expect to continue to make substantial investments in research and development, primarily through internal and offshore development activities, third party licensing agreements and through technology acquisitions. Our development efforts focus on our unified FileNet

P8 ECM architecture as we continue to develop and enhance our ECM capabilities. Additionally, we license and embed third party software that enhances the functionality of our products through a variety of agreements with the producers of this software. Expenditures for research and development were $77.0 million; $71.7 million and $68.8 million for the years ended December 31, 2003, 2002, and 2001, respectively.

We expect to continue to look for technology acquisitions that offer us additional product know-how or domain knowledge where appropriate and will continue to embed third party technology that enhances our product line. We intend to continue to invest significantly in internal and offshore development with a focus on developing new functionality in Enterprise Content Management and Business Process Management technology that provide a richer competitive product offering to our customers.

Competition

The market for our products is highly competitive and competition will continue to intensify as the ECM market consolidates. We compete with a large number of Enterprise Content Management, Web content management, business process management, workflow, document imaging, and electronic document management companies. IBM is the largest company that competes directly with FileNet in the content and process management market. Documentum, a key competitor in the Content Management market, was acquired by the EMC Corporation, a large storage technology company, during 2003. EMC becomes a FileNet competitor offering both content management and storage management capabilities. Numerous smaller software vendors also compete in each product area. We also experience competition from systems integrators who configure hardware and software into customized systems.

Large infrastructure vendors such as Oracle Corporation and Microsoft Corporation have developed products or plan to offer products in the content management market. Software vendors such as Tibco Software, Inc., Savvion, Inc. and Pegasystems, Inc., each with a different core product foundation, have approached the business process management market from their individual market segments and may compete more intensely with us in the future. It is also possible that new competitors or alliances among competitors may emerge and rapidly acquire significant market share. We also expect that competition will increase as a result of software industry consolidations.

We believe that the principal competitive factors affecting the market for our software products and services include vendor and product reputation; product quality, performance and price; the availability of software products on multiple platforms; product scalability; product integration with other enterprise applications; software functionality and features; software ease of use; and the quality of professional services, customer support services and training. The relative importance of each of these factors depends upon the specific customer involved.

Certain of our competitors and potential competitors may have greater resources, larger sales and marketing teams, broader product lines and more experience developing software than we do. Increased competition may result in price reductions, reduced gross margins and loss of market share, any of which could have a material adverse effect on our business, financial condition or results of operations.

Trademarks

FileNet, WorkFlo Services, ValueNet, OSAR, Watermark, Panagon, Acenza, Brightspire, Document Warehouse, and FileNet Workgroup are trademarks or registered trademarks of FileNet Corporation that may be referenced in this Form 10K. All other brands or product names are trademarks of their respective companies.

Patents and Licenses

As of December 31, 2003, FileNet Corporation has four issued and seven pending U.S. patents. Our subsidiary, 3565 Acquisition LLC, has one issued U.S. patent and one pending U.S. patent application. Another subsidiary, Shana Corporation, has one issued U.S. patent and two pending U.S. patent applications. We have applied for and may in the future apply for patent protection in foreign countries.

We have also entered into non-exclusive license arrangements with a number of organizations, including IBM, Verity, Stellent and Oracle that permit our resellers and us to grant sublicenses and provide support to end-users of our systems to use software developed by these third party vendors.

Employees

As of December 31, 2003 we had 1,720 full-time employees, of which 456 were employed in research and development; 436 in sales; 113 in marketing; 210 in education and professional services; 261 in customer support; 68 in operations; and 176 in administration. No employees are represented by labor unions, and we have never experienced a work stoppage. We believe that we enjoy good employee relations.

Risk Factors

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

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

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

- IT spending trends;
- general domestic and international economic and political conditions;
- the discretionary nature of our customers’ budget and purchase cycles and the absence of long-term customer purchase commitments;
- the tendency to realize a substantial percentage of our revenue in the last weeks, or even days, of each quarter;
- the potential for delays or deferrals of customer orders;

- the size, complexity and timing of individual transactions;
- the length of our sales cycle;
- the level of software sales and price competition;
- the timing of new software introductions and software enhancements by us and our competitors; or,
- seasonality in technology purchases.

The decision to implement our products is subject to each customer's resources and budget availability. Our quarterly sales generally include a mix of medium sized orders, along with several large individual orders, and as a result, the loss or delay of an individual large order could have a significant impact on our quarterly operating results and revenue. Our operating expenses are based on projected revenue trends and are generally fixed. Therefore, any shortfall from projected revenue may cause significant fluctuations in operating results from quarter to quarter. As a result of these factors, revenue and operating results for any quarter are subject to fluctuations and are not predictable with any significant degree of accuracy. Therefore, we believe that period-to-period comparisons of our results of operations should not be relied upon as indications of future performance. Moreover, such factors could cause our operating results in a given quarter to be below the expectations of public market analysts and investors. In either case, the price of our common stock could decline materially.

The markets in which we operate are highly competitive and we cannot be sure that we will be able to continue to compete effectively, which could result in lost market share and reduced revenue. The markets we serve are highly competitive and we expect competition to intensify with the consolidation of the ECM market. We have multiple competitors and there may be future competitors, some of which have or may have substantially greater sales, marketing, development and financial resources. As a consequence, our present or future competitors may be able to develop software products comparable or superior to those offered by us, offer lower priced products or adapt more quickly than we do to new technologies or evolving customer requirements.

Other competitive risks include, but are not limited to:

- We anticipate significant future consolidation as the software industry matures. Large well-established software firms like Oracle, IBM and Adobe may enter our market by adding content management features to their existing suite of products. In 2003, EMC Corporation, a data storage hardware company, acquired one of our competitors, Documentum. Other large, well-capitalized hardware firms may enter our market by acquiring our competitors to pursue revenue growth opportunities;

- Many of our competitors are also our distribution channel partners. For example, IBM competes with us in the content management market, but also implements our software solutions through its IBM Global Services business unit. This type of vertical integration of software development and system integration capabilities may be viewed by our customers as a key competitive advantage;

- Some of our competitors are also our key technology suppliers. For example, IBM's Crossworlds business unit supplies a key technology for our business process management software. Our inability to license future releases of key technology from these competitive vendors could limit the technical capabilities of our products.

We cannot predict new competitors entering our market through acquisitions or other alliances. In order to be successful in the future, we must respond to technological change, customer requirements and competitors' current software products and innovations. We may not be able to compete effectively in our target markets. In addition, current and potential competitors have established or may establish cooperative relationships among themselves or with third parties to increase the ability of their products to address the needs of the markets we serve. Accordingly, it is possible that new competitors or alliances among competitors may emerge and rapidly acquire significant market share. Increased competition may result in price reductions, reduced gross margins and loss of market share that could result in reduced revenue.

A significant portion of our revenue is derived internationally and we are subject to many risks internationally, which could put our revenue at risk. Historically, we have derived approximately 28% of our total revenue from international sales through our worldwide network of subsidiaries and channel partners. International business is subject to certain risks including, but not limited to, the following:

- political and economic instability;
- tariffs and trade barriers;
- varying technical standards and requirements for localized products;
- reduced protection for intellectual property rights in certain countries;
- difficulties in staffing and maintaining foreign operations;
- difficulties in managing foreign distributors;
- multiple overlapping tax regimes;
- currency restrictions and currency exchange fluctuations;
- the burden of complying with a wide variety of complex foreign laws, regulations and treaties;
- spreading our management resources to cover multiple countries; or,
- longer collection cycles and higher risk of non-collection and bad debt expense.

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

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

We must execute on our strategy of offering a unified platform and framework for Enterprise Content Management that gains customer acceptance or our revenue may suffer. This strategy may require us to develop and maintain relations with technology partners. If we fail to successfully execute on our integrated product solution strategy or if we fail to maintain or establish relationships with technology partners, or if release dates of any future products or enhancements are delayed, or if these products or enhancements fail to achieve market acceptance when released, our business operating results and financial condition could be materially harmed. In the past, we have experienced delays in the release dates of enhancements and new releases to our products and we cannot assure that we will not experience significant future delays in product introduction. From time to time, either our competitors or we may announce new software products, capabilities or technologies that have the potential to replace or shorten the life cycles of our existing software products. We cannot assure that announcements of currently planned or other new software products will not cause customers to delay their purchasing decisions in anticipation of such software products, and such delays could have a material adverse effect on our business and operating results.

We must develop and sell new products to keep up with rapid technological change in order to achieve future revenue growth and profitability. The market for our software and services is characterized by rapid technological developments, evolving industry standards, changes in customer requirements and frequent new product introductions and enhancements. Our ability to continue to sell products will be dependent upon our ability to continue to enhance our existing software and services offerings, develop and introduce, in a timely manner, new software products incorporating technological advances and respond to customer requirements. 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 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 and sale of these products and enhancements. In the past, we have experienced delays in the release dates of enhancements and new releases to our products and we cannot assure that we will not experience significant future delays in product introduction. From time to time, our competitors or we may announce new software products, capabilities or technologies that have the potential to replace or shorten the life cycles of our existing software products. We cannot assure that announcements of currently planned or other new software products will not cause customers to delay their purchasing decisions in anticipation of such software products, and such delays could have a material adverse effect on our sales.

We are dependent upon customers concentrated in a small number of industries. A significant decline in one of those industries could result in reduced revenue. Our customers are concentrated in the insurance, financial services, government, manufacturing, telecommunications and utilities industries. We may not be successful in obtaining significant new customers in different industry segments and we expect that sales of our products to a limited number of customers in a limited number of industry segments will continue to account for a large portion of our revenue in the future. If we are not successful at obtaining significant new customers or if a small number of customers cancel or delay their orders for our products, then our business and our prospects could be harmed. 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. Our research and development expenses were $77.0 million, or 21% of total revenue, for 2003 and $ 71.7 million, or 21% of total revenue, for 2002. 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.

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

We must retain and attract key executives and personnel who are essential to our business, which could result in increased personnel expenses. Our success depends to a significant degree upon the continued contributions of our key management, as well as other marketing, technical and operational personnel. The loss of the services of one or more key employees could have a material adverse effect on our operating results. We do not have employment agreements with any of the members of our United States-based senior management. We do have employment contracts with members of our international management that commit them to a notification period.

We believe our future success will depend in large part upon our ability to attract and retain additional highly skilled management, technical, marketing, product development and operational personnel and consultants. There is competition for such personnel; particularly software developers, professional services consultants and other technical personnel. We cannot assure that in the future we will be successful in attracting and retaining such personnel.

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

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

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

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

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

Protection of our intellectual property and other proprietary rights is limited, which could result in the use of our technology by competitors or other third parties. There is risk of third-party claims of infringement, which could expose us to litigation and other costs. Our success depends, in part, on our ability to protect our proprietary rights to the technologies used in our principal products. We rely on a combination of copyrights, trademarks, trade secrets, patents, confidentiality procedures and contractual provisions to protect our proprietary rights in our software products. We cannot assure that our existing or future copyrights, trademarks, trade secrets, patents or other intellectual property rights will have sufficient scope or strength to provide meaningful protection or a commercial advantage to us. Intellectual property rights often cannot be enforced without engaging in litigation, which involves devotion of significant resources, can divert management attention and has uncertain outcomes. In addition, the laws of some foreign countries do not protect our proprietary rights to the same extent, as do the laws of the United States. Any inability to protect our intellectual property may harm our business and competitive position.

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

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

We currently license certain software from third parties, including software that is integrated with internally developed software and used in our products to perform key functions. We would be unable to sell theses 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 2. *Properties*

We currently lease 300,238 square feet of office, development and manufacturing space in Costa Mesa, California and 91,128 square feet of office and development space in Kirkland, Washington. In addition, we lease 24,500 square feet of office and manufacturing space in Dublin, Ireland and 10,000 square feet of office and development space in Edmonton, Alberta, Canada. We also lease sales and support offices in 29 locations in the United States, 18 locations in Europe, 3 locations in Australia, 2 other locations in Canada, and 4 locations in Asia. We believe that the Costa Mesa, Dublin, Kirkland and Edmonton facilities will be adequate for our anticipated development and manufacturing needs through 2004.

Item 3. *Legal Proceedings*

In the normal course of business, we are subject to ordinary routine litigation and claims incidental to our business. While the results of litigation and claims cannot be predicted with certainty, we believe that the final outcome of existing litigation and claims matters will not have a materially adverse effect on our consolidated results of operations or financial conditions.

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

No matters were submitted to a vote of security holders during the fourth quarter of the fiscal year ended December 31, 2003.

PART II

Item 5. ***Market for the Registrant's Common Stock and Related Stockholder Matters***

Our common stock is traded on the NASDAQ National Market under the symbol "FILE". The following are the high and low sale prices from January 1, 2002 through December 31, 2003, as reported by NASDAQ:

	High	*Low*
Year Ended December 31, 2003		
4th Quarter	$ 27.75	$ 19.50
3rd Quarter	22.65	15.00
2nd Quarter	19.65	10.19
1st Quarter	14.18	10.39
Year ended December 31, 2002		
4th Quarter	$ 14.23	$ 8.64
3rd Quarter	15.50	10.09
2nd Quarter	17.98	11.35
1st Quarter	23.10	16.01

The closing price of our common stock at December 31, 2003 was $27.08. As of March 12, 2004 we estimate that there will be approximately 475 stockholders of record on March 16, 2004 (record date for 2004 Annual Meeting of Stockholders).

We have not paid any dividends on our common stock. We currently intend to retain earnings for use in our business and do not anticipate paying cash dividends in the foreseeable future.

Item 6. Selected Financial Data

The following table summarizes selected financial data and should be read in conjunction with our consolidated financial statements and the notes thereto, and Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations. The selected consolidated statements of operations and balance sheet data as of and for each of the five years in the period ended December 31, 2003 have been derived from our audited financial statements.

(In thousands, except per share amounts)

Fiscal Years Ended December 31,	**2003**	**2002**	**2001**	**2000**	**1999**
Consolidated statements of operations data:					
Revenue:					
Software	$ 149,214	$ 132,508	$ 119,014	$ 204,872	$ 183,316
Service	212,833	206,806	201,568	174,291	148,162
Hardware	2,458	7,703	14,028	21,199	16,630
Total revenue	364,505	347,017	334,610	400,362	348,108
Cost of revenue:					
Cost of software revenue	13,800	10,565	7,522	14,643	16,986
Cost of service revenue	81,462	89,016	102,292	101,976	86,377
Cost of hardware revenue	3,669	5,995	10,211	13,559	9,078
Total cost of revenue	98,931	105,576	120,025	130,178	112,441
Gross profit	265,574	241,441	214,585	270,184	235,667
Operating expenses:					
Research and development	77,050	71,735	68,838	57,914	54,307
Selling and marketing	144,975	132,109	136,124	135,513	133,374
General and administrative	32,466	31,656	33,381	29,428	24,356
Restructuring and in-process research and development	-	400	-	2,984	-
Total operating expenses	254,491	235,900	238,343	225,839	212,037
Operating income (loss)	11,083	5,541	(23,758)	44,345	23,630
Other income, net	4,084	5,209	2,503	5,406	3,409
Income (loss) before income taxes	15,167	10,750	(21,255)	49,751	27,039
Provision (benefit) for income taxes	4,247	2,478	(4,633)	11,204	7,362
Net income (loss)	$ 10,920	$ 8,272	$ (16,622)	$ 38,547	$ 19,677
Earnings (loss) per share:					
Basic	$ 0.30	$ 0.23	$ (0.47)	$ 1.13	$ 0.61
Diluted	$ 0.29	$ 0.23	$ (0.47)	$ 1.05	$ 0.59
Weighted average shares outstanding:					
Basic	36,532	35,590	35,117	34,155	32,125
Diluted	38,089	36,709	35,117	36,765	33,360
Consolidated balance sheet data:					
Working capital	$ 189,326	$ 135,302	$ 144,750	$ 155,483	$ 101,777
Total assets	391,848	328,036	301,639	324,093	243,398
Stockholders' equity	289,148	238,905	215,825	224,957	150,458

***Note**: Service revenue and costs include both Customer Support and Professional Services and Education. Certain reclassifications have been made to the prior years' selected financial data to conform to the current year's presentation. In November 2001, the FASB announced Emerging Issues Task Force ("EITF") Topic No. D-103, "Income Statement Characterization of Reimbursements Received for Out-of-Pocket Expense Incurred." The EITF required companies to characterize reimbursements received for out-of-pocket expenses as revenues in the statement of operations. Application of this EITF required that comparative financial statements for prior periods be reclassified to comply with the guidance. We adopted this EITF as of January 1, 2002 and have reclassified our prior-period, consolidated financial statements to conform to this EITF.*

Item 7. *Management's Discussion and Analysis of Financial Condition and Results of Operations*

This Annual Report on Form 10-K 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 factors described under the heading "Risk Factors" and in other documents we file from time to time with the Securities and Exchange Commission. 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.

Critical Accounting Policies and Estimates

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

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

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

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

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

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

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

The following table represents the account balances for these provisions and the changes for each of the periods presented. Deductions to these provisions are the result of customer bad debt write-offs or product returns. Additions to the provision are based on estimated credit losses related to specific customer collection issues and are also based on historical experience.

(In thousands)

	Balance at Beginning of Period	*Additions Charged to Revenue and Expenses*	*Deductions*	*Balance at End of Period*
Year ended December 31, 2003:				
Allowance for doubtful accounts and sales returns	$ 4,232	$ 653	$ 968	$ 3,917
Year ended December 31, 2002:				
Allowance for doubtful accounts and sales returns	$ 3,567	$ 1,752	$ 1,087	$ 4,232
Year ended December 31, 2001:				
Allowance for doubtful accounts and sales returns	$ 5,518	$ 1,482	$ 3,433	$ 3,567

We do not believe a change in liquidity of any one customer or our inability to collect from any one customer would have a material adverse impact on our consolidated financial position. Based on historical experience, we also maintain a sales return allowance for the estimated amount of returns. While product returns have historically been minimal and within our expectations and the allowances established by us, we cannot guarantee that we will continue to experience the same return rates that we have in the past.

Goodwill and Other Intangible Assets. Goodwill is recorded at cost and is not amortized. In June 2001, the FASB issued SFAS No. 142, "Goodwill and Other Intangible Assets," which we adopted January 1, 2002. SFAS No. 142 requires that goodwill and other intangible assets with indefinite useful lives no longer be amortized, but instead be tested for impairment at least annually and written down when impaired. On the first day of July of each year, goodwill is tested for impairment by determining if the carrying value of each reporting unit exceeds its fair value. We also periodically evaluate whether events and circumstances have occurred which indicate that the carrying value of goodwill may not be recoverable. We engaged an independent valuation firm to determine the business enterprise value for each of our three reporting units and to perform an impairment analysis as of July 1, 2003 in accordance with SFAS 142. The analysis indicated there was no impairment of goodwill in any of the three reporting units. As of December 31, 2003, no impairment of goodwill has been recognized. If estimates change, a materially different impairment conclusion could result.

Long-Lived Assets. Property, plant and equipment, intangible assets, and capitalized software costs are recorded at cost less accumulated depreciation or amortization. They are amortized using the straight-line method over estimated useful lives of generally three to five years. The determination of useful lives and whether or not these assets are impaired involves judgment and are reviewed for impairment whenever events or circumstances indicate that the carrying amount of such assets may not be recoverable. We evaluate the carrying value of long-lived assets and certain identifiable intangible assets for impairment of value based on undiscounted future cash flows resulting from the use of the asset and its eventual disposition. 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. The Company is currently assessing its valuation allowance related to our deferred tax assets. As of December 31, 2003, we have a net tax deferred asset of approximately $26.6 million and valuation allowance of approximately $24.3 million. We will continue weighing various factors throughout the year to assess the need for any valuation allowance. Recoverability of the deferred tax assets is dependent on continued profitability from operations. Should our level of profitability continue as expected, we would likely remove the entire valuation allowance in 2004. We would realize a one-time, non-cash benefit by decreasing our tax expense (causing an increase in earnings) by approximately $10.0 million to $14.0 million. Additionally, we would record a non-cash charge to increase additional reported paid-in-capital by approximately $9.0 million.

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

Overview

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

We have experienced a turbulent business environment during the last three years. During this period we have witnessed dramatically reduced spending on information technology. Only during the last half of 2003 have we seen accelerated spending on information technology from our customers. We derive approximately seventy two percent of our revenue from the United States market and approximately twenty eight percent from international markets. The U.S. economy is showing early indications of moderate expansion while growth in Europe remains sluggish. Growth in Asia is expanding rapidly - but represents a much smaller base of business for us compared to the United States market. We operate in an international economy and are subject to the inherent risks of foreign exchange, regulatory compliance, intellectual property infringement and interest rate risk. We believe the electronic content management market will out-perform average information technology spending based on industry analysts’ opinions and our own customers’ statements regarding their IT investment priorities in the next several years.

There was a significant consolidation in the electronic content management market space during 2003. Several competitors that previously offered only point solutions to specific content management problems now provide a suite of solutions rendering them as more viable competitors to us. These competitors must now integrate these various point solutions, based on several different technologies, into an application that a prospective customer could consider deploying on an enterprise-wide basis. We have taken a different approach by focusing primarily on internal development to provide an integrated solution. We have, however, acquired certain specific third party technologies that enhance our products’ capabilities. For example, we acquired and integrated Web content and electronic forms technologies into our FileNet P8 framework during 2002 and 2003.

We face several challenges in executing our strategy of growth and profitability in the future. Our strategy is to:

- Leverage the investment we have made in research and development through increased software license sales,
- Continue to sell our software to customers who will deploy multiple applications across their enterprises based on the FileNet P8 architecture,
- Manage our research and development expenditures through a balanced approach of internal development, offshore development, and third party licensing and technology acquisitions,
- Increase our marketing and sales productivity to effectively and efficiently address each vertical market and each account segment, and
- Maintain high customer satisfaction levels to ensure continued renewal of maintenance contracts.

We believe we are well positioned for continued growth and profitability if we can execute our business strategy.

Results Of Operations

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

		(As a percentage of total revenue)	
December 31,	**2003**	**2002**	**2001**
Revenue:			
Software	40.9%	38.2%	35.6%
Customer support	45.2	43.2	39.6
Professional services and education	13.2	16.4	20.6
Hardware	0.7	2.2	4.2
Total revenue	100.0	100.0	100.0
Cost of revenue:			
Software	3.8	3.1	2.2
Customer support	10.7	11.1	12.7
Professional services and education	11.6	14.5	17.9
Hardware	1.0	1.7	3.1
Total cost of revenue	27.1	30.4	35.9
Gross profit	72.9	69.6	64.1
Operating expenses:			
Research and development	21.1	20.8	20.6
Selling and marketing	39.8	38.1	40.6
General and administrative	8.9	9.1	10.0
Total operating expenses	69.8	68.0	71.2
Operating income (loss)	3.1	1.6	(7.1)
Other income, net	1.1	1.5	0.7
Income (loss) before tax	4.2%	3.1%	(6.4)%

Revenue

As more fully discussed below, total revenue increased by 5.0% in 2003 compared to 2002 and by 3.7% in 2002 compared to 2001. The increase in total revenue during both of these periods is primarily attributable to an increase in demand for our software products as well as the growth in customer support revenue partially offset by lower professional services and hardware revenue.

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)

Year ended December 31,	**2003**	*% Increase/ decrease*	**2002**	*% Increase/ decrease*	**2001**
Total United States Revenue	$ 257,100	2.2%	$ 251,447	2.7%	$ 244,902
Europe	83,817	7.5%	77,953	8.1%	72,117
Asia / Pacific	12,171	22.7%	9,916	24.4%	7,968
Canada	7,971	42.8%	5,581	(17.8%)	6,787
Other	3,446	62.5%	2,120	(25.2%)	2,836
Total International Revenue	107,405	12.4%	95,570	6.5%	89,708
Total Revenue	$ 364,505	5.0%	$ 347,017	3.7%	$ 334,610
United States Revenue	71%		72%		73%
International Revenue	29%		28%		27%
Total Revenue Contribution	100%		100%		100%

International revenue represents approximately 29% of total revenue and grew more rapidly than domestic revenue in both 2003 and 2002. Europe is our largest international market and total revenues in Europe grew by 16% during the period from 2001 to 2003. Asia is a much smaller market, but produced revenue growth of 53% during the period from 2001 to 2003. We made significant investments in the Asia Pacific region to support the revenue growth that we believe will continue to increase in countries such as China and India. We expect international revenue to continue to represent a significant percentage of total revenue. However, international revenues will be adversely affected if the U.S. dollar strengthens against certain major international currencies or if international economic conditions remain relatively weak.

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

Revenue by Reporting Segment

(In thousands)

Year ended December 31,	**2003**	*% Increase / (Decrease)*	**2002**	*%Increase / (Decrease)*	**2001**
Software	$ 149,214	12.6%	$ 132,508	11.3%	$ 119,014
Customer Support	164,772	10.0	149,847	13.2	132,382
Professional Services and Education	48,061	(15.6)	56,959	(17.7)	69,186
Hardware	2,458	(68.0)	7,703	(45.1)	14,028
Total Revenue	$ 364,505	5.0%	$ 347,017	3.7%	$ 334,610
Software	40.9%		38.2%		35.6%
Customer Support	45.2		43.2		39.6
Professional Services and Education	13.2		16.4		20.6
Hardware	.7		2.2		4.2
Total Revenue Contribution	100.0%		100.0%		100.0%

Software. Software revenue consists of fees earned from the licensing of our software products to our customers. Software revenue increased by 12.6% in 2003 compared to 2002, and by 11.3% in 2002 compared to 2001. The increase in software revenue during both periods was primarily due to an increase in demand for enterprise content management and business process management solutions. Additionally, our existing customers primarily drove this demand in our key vertical industries of banking, insurance and government. We saw these customers increase usage of existing applications and new applications of our software. We believe the IT spending environment improved during the past two fiscal years and more significantly during the last half of 2003 as we experienced the return of larger software deployments by some of our customers. We believe these trends will continue in 2004 with a moderate, but steady improvement in IT spending on enterprise content management and business process management software.

Customer Support. Customer support revenue consists of revenue from software maintenance contracts, “fee for service” revenues and the sale of spare parts and supplies. Maintenance contracts entitle our customers to receive technical support, bug fixes and upgrades to new versions of software releases when and if available. Customer support revenue increased by 10.0% in 2003 compared to 2002 and by 13.2% in 2002 compared to 2001. These increases in customer support revenue reflect an increase in our overall customer installed base combined with a high rate of renewal in the existing customer base. Customer support revenue is directly related to the sale of software licenses in prior periods. Customer support revenue grew more slowly in both 2003 and 2002 compared to the growth rate in previous years as a result of reduced software sales growth in 2001 and 2002 and software support pricing pressure. A prolonged economic slowdown negatively affects the growth rate of customer support revenue as this revenue stream is directly related to software revenue growth over time. However, we believe we will continue to experience a high rate of renewal on maintenance contracts, as our customers tend to deploy mission critical applications using our software to manage content.

Professional Services and Education. Professional services and education revenue is generated primarily 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 are generally performed on a time and material basis. Professional services and education revenue decreased by 15.6% in 2003 compared to 2002 and by 17.7% in 2002 compared to 2001. The decrease during the last two years is reflective of the economic slow down that began in 2001, resulting in fewer and smaller consulting engagements and increased pricing pressures. Professional services revenue and education revenue is dependent on the level and the nature of software sales in prior years - particularly new customer sales. Professional services revenue was strong in 2001 as a result of strong software sales in 2000 to new customers. However, with the decline in software revenue in 2001, professional services revenue in 2002 started to decrease and this trend continued into 2003. Another contributing factor to the decrease in professional services revenue for the past two years is that software revenue has been characterized by repeat purchases for additional software licenses that do not require large-scale professional services engagements. We believe we will experience a moderate, but steady improvement in professional services and education revenue in 2004 based on the software revenue trends we experienced during the last half of 2003.

Hardware. Hardware revenue is generated primarily from the sale of our 12-inch OSAR libraries. Hardware revenue decreased by 68.1% in 2003 compared to 2002 and by 45.1% in 2002 compared to 2001. The decline in hardware revenue reflects that hardware is not a strategic focus for us.

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 total cost of revenue by reporting segment for the periods indicated:

Cost of Revenue by Reporting Segment

(*In thousands)*

Year ended December 31,	**2003**	*% Increase/ (Decrease)*	**2002**	*% Increase/ (Decrease)*	**2001**
Software	$ 13,800	30.6%	$ 10,565	40.5%	$ 7,522
Customer Support	39,116	1.3	38,608	(8.9)	42,396
Professional Services & Education	42,346	(16.0)	50,408	(15.8)	59,896
Hardware	3,669	(38.8)	5,995	(41.3)	10,211
Total Cost of Revenue	$ 98,931	(6.3)%	$ 105,576	(12.0)%	$ 120,025
Software	9.2%		8.0%		6.3%
Customer Support	23.7		25.8		32.0
Professional Services & Education	88.1		88.5		86.6
Hardware	115.0		77.8		72.8
Total Cost of Revenue as a % of Segment Revenue	27.1%		30.4%		35.9%

Software. Cost of software revenue includes royalties paid to third parties for technology embedded in our products to enhance features and functionality, amortization of acquired technology, media costs, and the cost to manufacture and distribute software. The cost of software revenue as a percent of software revenue increased by 1.2% in 2003 compared to 2002 and by 1.7% in 2002 compared to 2001. The increase in cost of software revenue during both periods is primarily the result of an increase in royalty costs due to increased utilization of new third party software products and the amortization of acquired technology resulting from the eGrail acquisition in April 2002 and the Shana acquisition in April 2002. Going forward we anticipate cost of software revenue to be approximately 10% of cost of revenue as we continue to integrate third-party technology with our products.

Customer Support. Cost of customer support revenue includes the cost of customer support personnel, facility and technology infrastructure expenses in our call centers, supplies and spare parts. The cost of customer support revenue as a percent of customer support revenue decreased by 2.0% in 2003 compared to 2002 and by 6.2% in 2002 compared to 2001. These reductions in cost of customer support revenue are attributable to employee reductions and efficiency improvements in the delivery of technical support. We expect the cost of customer support revenue to remain at approximately 25% of customer support revenue for the near future.

Professional Services and Education. Cost of professional services and education revenue consists primarily of the costs of professional services personnel, training personnel, and third-party contractors. The cost of professional services and education revenue, as a percent of professional services and education revenue, decreased by 0.4% in 2003 compared to 2002 and increased by 1.9% in 2002 compared to 2001. The reduction in the use of external third party independent consultants and lower variable compensation for internal employees contributed to maintaining essentially flat operating costs as a percent of professional services and education revenue during both periods. We expect professional services and education costs as a percentage of professional services and education revenue to vary from period to period depending on the utilization rates of internal resources and the mix between internal and external service providers.

Hardware*.* Cost of hardware revenue includes the cost of assembling our OSAR library products, the cost of hardware integration personnel, warranty costs and distribution costs. The cost of hardware revenue decreased by 38.8% in 2003 compared to 2002 and decreased by 41.3% in 2002 compared to 2001. The year-to-year decreases in absolute dollars are directly related to decreased hardware revenue. Hardware cost as a percent of hardware revenue has not decreased proportionally because fixed costs have not decreased at the same rate as hardware revenue. Hardware is no longer a strategic focus for us.

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

Year ended December 31,	**2003**	*% Increase / (Decrease)*	**2002**	*% Increase / (Decrease)*	**2001**
Research & Development	$ 77,050	7.4%	$ 71,735	4.2%	$ 68,838
Marketing & Sales	144,975	9.7	132,109	(2.9)	136,124
General & Administrative	32,466	2.6	31,656	(5.2)	33,381
In-process R&D	-		400		-
Total Operating Expenses	$ 254,491	7.9%	$ 235,900	(1.0)%	$ 238,343
Research & Development	21.1%		20.8%		20.6%
Marketing & Sales	39.8		38.1		40.6
General & Administrative	8.9		9.1		10.0
Operating Expense as a % of Revenue	69.8%		68.0%		71.2%

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

We seek to achieve our development objectives through both internal and external resources, and by obtaining third party technology to enhance product capabilities through licensing agreements and acquisitions. During 2002 we initiated a program involving offshore development in lower labor cost countries. During 2003 we expanded this offshore development effort to include both product sustainment and product development activities. During 2003 we acquired Shana to integrate their electronics forms capabilities into our products. During 2002 we acquired eGrail to integrate their web content management capabilities into our products. (See Note 3 to the Notes to the Consolidated Financial Statements.)

Our research and development expense consists primarily of personnel costs for software developers; third party contracted development efforts and related facilities costs. Research and development expense increased by 7.4% in 2003 compared to 2002 and by 4.2% in 2002 compared to 2001. The number of research and development personnel was 456 in 2003, 430 in 2002 and 425 in 2001.

The majority of the $5.3 million increase in research and development expenses from 2002 to 2003 is attributable to the acquisition of Shana, the full year cost of the eGrail development team, extensive investment development efforts to enhance content management with new capabilities and increased offshore development expense. Increased numbers of internal employees resulted in higher compensation, benefits and relocation costs related to the integration of the eGrail and Shana acquisitions in April of 2002 and 2003, respectively. The majority of the $2.9 million increase in research and development expenses from 2001 to 2002 is primarily attributable to the acquisition of eGrail that resulted in additional facility and employee expenses. This acquisition resulted in an increase in compensation expense primarily due to increased numbers of personnel as well as an increase in consulting costs due to the expanded use of contractors.

We intend to complement internal development with offshore development as well as with third-party software through OEM agreements and may execute additional technology acquisitions. Over time, we believe we will be able to lower our per developer cost through the use of offshore resources. However, in the near term, some duplicate expenses will be incurred as our development programs are transitioned to offshore developers. Offshore development costs for the 12 months ended December 31, 2003 was $3.1 million compared to $1.3 million for 2002. 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 21% of revenue in the near-term.

Selling and Marketing. We sell our products through a direct sales force and our indirect channel sales partners. Our selling and marketing expense consists primarily of salaries, benefits, sales commissions and other expenses related to the direct and indirect sales force and personnel cost for marketing and market development programs.

Selling and marketing expense increased by 9.7% in 2003 compared to 2002 and decreased by 2.9% in 2002 compared to 2001. The number of sales and marketing employees was 549 in 2003 compared to 541 in 2002. Marketing personnel increased by 30 employees while sales personnel decreased by 22 employees, yielding the net increase of 8 employees during 2003. This shift in sales and marketing capacity was predicated on our customer engagement initiative, which we implemented in

2002 and 2003. This initiative prescribed a smaller direct sales force, increased channel partner business and increased marketing personnel with deep vertical industry knowledge and demand generation capabilities.

The increase in sales and marketing expense of $12.9 million reflects a higher salary mix as well as higher variable compensation associated with higher revenue in 2003 compared to 2002. Personnel related expenses including salaries and benefits increased $4.6 million year over year. Higher software revenue in 2003 resulted in higher commission expense of $3.4 million. Travel, training, recruitment and marketing programs related to the FileNet P8 product release in 2003 accounted for the balance of the increase. The decrease in absolute dollars from 2001 to 2002 was primarily due to a 54% reduction in recruitment expenses, as well as a 10% reduction in sales commission expense. Charges in 2001 for severance of $2.9 million related to workforce reductions and $218,000 for facility consolidation costs, primarily in sales, also contributed to the higher costs in 2001 compared to 2002 and led to reduced costs in 2002.

We expect selling and marketing expense to remain at approximately 40% of revenue in the near-term.

General and Administrative. Our general and administrative expense consists primarily of salaries, benefits, and other expenses related to personnel costs for finance, information technology, legal, human resources and general management; and the cost of outside professional services.

General and administrative expense increased slightly by 2.6% in 2003 compared to 2002 and decreased by 5.2% in 2002 compared to 2001. General and administrative expenses remained relatively stable when comparing 2003 to 2002 and 2001 - primarily as a result of expense controls.

We expect general and administrative expense to remain at approximately 9% of revenue in the near-term.

Purchased In-Process Research and Development. There was no in-process research and development expense associated with our April 2003 acquisition of Shana. Our eGrail acquisition in April 2002 of certain assets and certain liabilities of eGrail resulted in an allocation of $400,000 to in-process research and development. The allocation was determined through established valuation techniques in the high-technology industry by an independent third-party appraiser. In-process research and development was expensed upon acquisition because technological feasibility had not been established and no future alternative uses existed. New product development underway at eGrail at the time of the acquisition included the next generation of their Web Content Management product that was in the early stages of design and only 5% complete at the date of the acquisition. The cost to complete the project was estimated at approximately $3.0 million to occur over a twelve-month period. However, actual costs upon 100% completion at March 31, 2003 were $4.7 million. There was no in-process research and development expense during 2001.

Amortization of Goodwill. There was no amortization of goodwill expense during 2003 and 2002 as we ceased amortizing goodwill and assembled workforce beginning January 1, 2002 based on the adoption of SFAS No. 142. In connection with our acquisition of certain assets from API on May 18, 2000, the purchase price amount allocated to goodwill of $14.6 million was being amortized in operating expenses over a useful life of five years and assembled workforce of $386,000 was being amortized over a useful life of three years. Assembled workforce no longer meets the definition of a separately identified intangible asset under the provisions of SFAS No. 141, "Business Combinations," and the un-amortized balance of $182,000 at December 31, 2001 was reclassified as goodwill at January 1, 2002. SFAS No. 142 was also effective for business combinations that occurred after June 30, 2001. Accordingly, goodwill of $5.8 million that was recorded in April 2002 in connection with the eGrail acquisition and goodwill of $3.6 million that was recorded in April 2003 in connection with the Shana acquisition is not amortized.

SFAS No. 142 requires that goodwill and other intangible assets with indefinite useful lives no longer be amortized, but instead be tested for impairment at least annually and written down when impaired. In accordance with this standard, we do not amortize goodwill and indefinite life intangible assets but evaluate their carrying value annually or when events or circumstances indicate that their carrying value may be impaired. As of 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 engaged an independent valuation firm to determine the business enterprise value for each of our three reporting units and to perform an impairment analysis as of July 1, 2003 in accordance with SFAS 142. The analysis indicated there was no impairment of goodwill in any of the three reporting units. As of December 31, 2003, no impairment of goodwill has been recognized. If estimates change, a materially different impairment conclusion could result.

Amortization of Purchased Intangible Assets. The April 2002 purchase of eGrail assets resulted in intangible assets comprised of acquired technology of $3.3 million and patents of $24,000, with assigned useful lives of five years and two years, respectively. The April 2003 purchase of Shana resulted in $5.7 million of intangible assets; comprised of acquired technology of $4.0 million, customer maintenance relationships of $800,000, technology manuals and design documents of $600,000 and non-compete agreements of $277,000. All intangible assets for the Shana acquisition were assigned a useful life of five years. Non-compete agreements with former executives of Shana were assigned a useful life of between two and three years. We determined that these assets were not impaired at December 31, 2003. Amortization of patents are reported as research and development expense, amortization of non-compete agreements are reported as general and administrative expense, while acquired technology, customer maintenance relationships and technical manuals and design documents are reported as cost of revenue.

Interest, Other Income and Expenses, Net. Other income, net consists primarily of interest income earned on our cash and cash equivalents, short and long-term investments, and other items including foreign exchange gains and losses and interest expense. Other income, net of other expenses, was $4.1 million in 2003, $5.2 million in 2002 and $2.5 million in 2001. The decrease in 2003 from 2002 of $1.1 million was primarily attributable to a lower net foreign exchange gain of approximately $700,000 due to a significant weakening of the dollar against the Euro in 2003, and reduced interest income of approximately $400,000 due to a lower weighted-average interest rate in 2003 compared to 2002. The weighted average interest rate earned on cash, cash equivalents and investments was 1.39% in 2003, 1.98% in 2002 and 2.49% in 2001. Other expense in 2001 included a $3.5 million litigation settlement charge.

Provision for Income Taxes. The provision for income taxes was $4.2 million in 2003, compared to $2.5 million in 2002, and a benefit of $4.6 million in 2001. The effective tax rate was 28%, 23% and (22%) for the years ended December 31, 2003, 2002 and 2001, respectively. The increased tax rate in 2003 was primarily due to the mix of income earned between the domestic group versus the foreign subsidiaries. As of December 31, 2003, we have a net tax deferred asset (related to domestic operations) of approximately $26.6 million and a valuation allowance of approximately $24.3 million. The Company is currently assessing its valuation allowance related to our deferred tax assets. Recoverability of the deferred tax assets is dependent on continued profitability from operations. Should our level of profitability continue as expected, we would likely remove the entire valuation allowance in 2004. We would realize a one-time, non-cash benefit by decreasing our tax expense (causing an increase in earnings) by approximately $10.0 million to $14.0 million. Additionally, we would record a non-cash charge to increase additional reported paid in capital by approximately $9.0 million.

Liquidity And Capital Resources

As of December 31, 2003, cash and cash equivalents, and investments were $248.3 million, an increase of $63.1 million from $185.2 million at December 31, 2002.

Cash provided by operating activities in 2003 was $52.2 million and resulted primarily from depreciation and amortization of $19.4 million, net income of $10.9 million, decreased accounts receivable of $8.8 million and increased accrued compensation and benefits of $5.3 million. The days sales outstanding metric decreased to thirty-six days by December 31, 2003 from forty-seven days at December 31, 2002 due to strong collections. Accrued compensation and benefits increased due to increased variable compensation associated with higher revenue. Cash used in investing activities in 2003 was $10.3 million and resulted primarily from $9.2 million for capital expenditures, and an $8.1 million cash purchase related to the Shana acquisition in April 2003, partially offset by $ 6.5 million net proceeds from the sale of marketable securities. Financing activities provided cash of $21.3 million primarily from the proceeds of the issuance of common stock upon exercise of employee stock options under the stock option and stock purchase plans.

Cash provided by operating activities in 2002 was $21.4 million and resulted primarily from net income of $8.3 million, and depreciation and amortization of $21.6 million. These were partially offset by increased accounts receivable of $7.8 million resulting from increased revenue in the fourth quarter of 2002 compared to 2001, an increase of $3.4 million in prepaid expenses such as prepaid insurance due to higher insurance premiums in 2002 and increases in prepaid royalty related to the addition of new third party licensing agreements in 2002, and a decrease in income tax payable of $4.0 million. Cash used in investing activities in 2002 included $10.8 million for capital expenditures, a $1.9 million note receivable from an officer, and a $9.4 million cash purchase related to the eGrail acquisition in April 2002, partially offset by $12.0 million net proceeds from the sale of marketable securities. Financing activities provided cash of $4.7 million primarily from the proceeds of the issuance of common stock upon exercise of employee stock options under the stock option and stock purchase plans.

Cash provided by operating activities in 2001 was $42.5 million and resulted primarily from a substantial decrease in accounts receivable of $51.1 million due to decreased revenue and strong collections in the fourth quarter, depreciation and amortization expense of $24.4 million, and increases in unearned maintenance of $9.8 million related to prepaid maintenance contracts, partially offset by a net loss of $16.6 million, decreases in accounts payable of $8.2 million resulting from reduced spending, decreases in accrued compensation and benefits of $8.1 million primarily due to a reduction in bonuses, and a reduction in federal income tax payable of $5.6 million. Cash used for investing activities in 2001 was $41.9 million consisting primarily of capital expenditures of $14.1 million and net purchases of marketable securities of $28.1 million. Cash provided by financing activities in 2001 was $7.8 million consisting primarily of proceeds from the issuance of common stock upon exercise of employee stock options under our stock option and stock purchase plans and income tax benefit from exercised stock options.

Our capital expenditures were $9.2 million in 2003, $10.8 million in 2002 and $14.1 million in 2001. Our primary capital expenditures during these years were for research and development equipment, demonstration and training equipment, enhancements to our internal network and business systems, leasehold improvements on leased property, and furniture. Spending was significantly reduced in an effort to contain expenses while the company experienced reduced revenues from the downturn in the economy and reduced information technology spending during the period 2001 to 2003. We anticipate capital expenditures of approximately $12.0 million in 2004. We have no long-term debt at December 31, 2003.

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

Our principal sources of short and long-term liquidity consist of existing cash balances and funds generated from future operations. We had total cash and investments of $248.3 million at December 31, 2003, compared to $185.2 million at December 31, 2002. We regularly review our cash funding requirements and attempt to meet our cash requirements through a combination of cash on hand and cash provided by operations. Our ability to increase revenues and generate profits is subject to numerous risks and uncertainties and any significant decrease in our revenues or profitability could reduce our operating cash flows and erode our existing cash balances. During 2001, 2002 and continuing into 2003 lower capital spending in the IT sector resulted in lower revenue for us. While the economy showed signs of improved IT spending during the last two quarters of 2003, no assurances can be given that this trend will continue or that we will continue to be able to generate positive operating cash flows or that we will continue to maintain or grow our existing cash balances. We believe that our present cash balances, together with internally generated funds, will be sufficient to meet our working capital and capital expenditures throughout 2004. See “Risk Factors”.

Commitments. We lease certain of our facilities under noncancelable operating lease arrangements that expire at various dates through 2013. We have certain royalty commitments associated with licensing of third party products that require minimum payments or contractual prepayments. We have contract commitments associated with third party development agreements. The following table summarizes future minimum payments for these obligations as of December 31, 2003:

(In thousands)

	Payments Due by Period				
	Total	2004	2005-2006	2007-2008	Thereafter
Contractual obligations:					
Operating leases	$ 57,186	$ 12,518	$ 20,606	$ 17,514	$ 6,548
Third party licensing contracts	2,130	2,130	-	-	-
Third party development contracts	2,140	1,127	1,013	-	-
Total contractual cash obligations	$ 61,456	$ 15,775	$ 21,619	$ 17,514	$ 6,548

We have bank guarantees issued in local currencies in Europe and Asia as discussed in Note 18 of the Notes to Consolidated Financial Statements. The following table summarizes future minimum commercial commitments for these obligations as of December 31, 2003:

(In thousands)

	Amount of Commitment Expiration Per Period				
Other commercial commitments:	Total Amounts Committed	2004	2005-2006	2007-2008	Thereafter
Secured and unsecured bank guarantees	$ 1,627,657	$ 355,756	$ 924,736	$ 23,465	$ 323,700
Total commercial commitments	$ 1,627,657	$ 355,756	$ 924,736	$ 23,465	$ 323,700

OTHER MATTERS

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

Impact of Recently Issued Accounting Pronouncements

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

In June 2001, the FASB issued SFAS No. 142, "Goodwill and Other Intangible Assets," which we adopted January 1, 2002. SFAS No. 142 requires that goodwill and other intangible assets with indefinite useful lives no longer be amortized, but instead be tested for impairment at least annually and written down when impaired. SFAS No. 142 requires purchased intangible assets other than goodwill to be amortized over their useful lives, unless these lives are determined to be indefinite. In accordance with this standard, we do not amortize goodwill and indefinite life intangible assets but evaluate their carrying value annually or when events or circumstances indicate that their carrying value may be impaired. As of 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 engaged an independent valuation firm to assist us in determining the business enterprise value for each of our three reporting units and to perform an impairment analysis as of July 1, 2003 in accordance with SFAS 142. The analysis indicated there was no impairment of goodwill in any of the three reporting units. As of December 31, 2003, no impairment of goodwill has been recognized. If estimates change, a materially different impairment conclusion could result.

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

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

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

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

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; we will adopt FIN 46R in the first quarter of 2004. We believe the adoption of FIN 46R will not have a material impact on our consolidated financial statements.

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

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

- a financial instrument issued in the form of shares that is mandatorily redeemable and embodies an unconditional obligation that requires the issuer to redeem it by transferring its assets at a specified or determinable date or upon an event that is certain to occur;

- a financial instrument, other than an outstanding share, that embodies an obligation to repurchase the issuer's equity shares, or is indexed to such an obligation, and requires the issuer to settle the obligation by transferring assets; and

- a financial instrument that embodies an unconditional obligation that the issuer must settle by issuing a variable number of its equity shares if the monetary value of the obligation is based solely or predominantly on (1) a fixed monetary amount, (2) variations in something other than the fair value of the issuer's equity shares, or (3) variations inversely related to changes in the fair value of the issuer's equity shares.

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

For public entities, SFAS No. 150 is effective for mandatorily redeemable financial instruments entered into or modified after May 31, 2003 and is effective for all other financial instruments as of the first interim period beginning after June 15, 2003.

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

SFAS No. 150 is to be implemented by reporting the cumulative effect of a change in accounting principle. We do not believe the adoption of SFAS No. 150 will have a material impact on our consolidated financial statements.

Inflation. Management believes that inflation has not had a significant impact on the price of our products, the cost of our materials, or our operating results for any of the three years ended December 31, 2003.

Item 7a. *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 2.8 months; therefore, the movement of interest rates should not have a material impact on our balance sheet or income statement.

At any time, a significant increase/decrease in interest rates will have an impact on the fair market value and interest earnings of our investment portfolio. We do not currently hedge this interest rate exposure. We have performed a sensitivity analysis as of December 31, 2003 and 2002, using a modeling technique that measures the change in the fair values arising from a hypothetical 50 basis points and 100 basis points adverse movement in the levels of interest rates across the entire yield curve, which are representative of historical movements in the Federal Funds Rate with all other variables held constant. The analysis covers our investment and is based on the weighted-average maturity of our investments as of December 31, 2003 and 2002. The sensitivity analysis indicated that a hypothetical 50 basis points adverse movement in interest rates would result in a loss in the fair values of our investment instruments of approximately $194,000 at December 31, 2003 and approximately $231,000 at December 31, 2002. Similarly a hypothetical 100 basis points adverse movement in interest rates would result in a loss in the fair values of our investments of approximately $388,000 at December 31, 2003 and approximately $460,000 at December 31, 2002.

The following table provides information about our investment portfolio at December 31, 2003:

(In thousands)

	Cost	Estimated Fair Value
Debt Securities		
Due in one year or less:		
Short-term munis-taxable	$ 8,313	$ 8,324
Corporate	8,442	8,440
Governments/Agencies	15,526	15,522
Total due in one year	32,281	32,286
Due in one to three years:		
Corporate	2,189	2,182
Government/Agencies	10,500	10,490
Total due in one to three years	12,689	12,672
Grand total	$ 44,970	$ 44,958

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

Foreign Currency Fluctuations

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 December 31, 2003, we had forward foreign exchange contracts outstanding totaling approximately $185,000 in ten currencies. These contracts were opened on the last business day of the quarter and mature within three months.

Cumulative other comprehensive income increased from a loss of $6.4 million in 2002, to a gain of $5.6 million at the end of 2003, due primarily to $12.0 million of unrealized foreign currency translation gains resulting from the strengthening of the Euro against the U.S. dollar during 2003.

Item 8. *Financial Statements and Supplementary Data*

The consolidated financial statements for the years ended December 31, 2003, 2002 and 2001 are incorporated herein by reference and submitted as a separate section of this Form 10-K. (See Item 15).

Item 9. *Changes in and Disagreements with Accountants on Accounting and Financial Disclosure*

None.

Item 9a. *Controls and Procedures*

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

As of December 31, 2003, the end of the period covered by this report, an evaluation was carried out under the supervision and with the participation of the Company’s management, including the Company’s Chief Executive Officer and the Company’s Chief Financial Officer, of the effectiveness of the design and operation of the Company’s disclosure controls and procedures as required by SEC Rule 13a – 15(b). Based on the foregoing, the Company’s Chief Executive Officer and Chief Financial Officer concluded that the Company’s disclosure controls and procedures were effective at the reasonable assurance level.

There has been no change in the Company’s internal controls over financial reporting during the Company’s most recent fiscal quarter and year ending December 31, 2003 that has materially affected, or is reasonably likely to materially affect, the Company’s internal controls over financial reporting.

PART III

Item 10. *Directors and Executive Officers of the Registrant*

We hereby incorporate by reference the information appearing under the caption “Election of Directors,” under the caption “Executive Officers of the Company,” under the caption “Section 16(a) Beneficial Ownership Reporting Compliance” and under the caption “Code of Ethics” of our definitive Proxy Statement for our 2004 Annual Meeting to be filed with the Securities and Exchange Commission.

Item 11. *Executive Compensation*

We hereby incorporate by reference the information appearing under the caption “Executive Compensation” and under the caption “Election of Directors” of our definitive Proxy Statement for our 2004 Annual Meeting to be filed with the Securities and Exchange Commission.

Item 12. *Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters*

We hereby incorporate by reference the information appearing under the caption “Voting Securities and Principal Holders Thereof” and “Equity Compensation Plans” of our definitive Proxy Statement for our 2004 Annual Meeting to be filed with the Securities and Exchange Commission.

Item 13. *Certain Relationships and Related Transactions*

We hereby incorporate by reference the information appearing under the caption “Related Party Transactions” of our definitive Proxy Statement for our 2004 Annual Meeting to be filed with the Securities and Exchange Commission.

Item 14. *Principal Accountant Fees and Services*

We hereby incorporate by reference the information appearing under the caption “Fees Billed to Us by Deloitte & Touche in 2003” of our definitive Proxy Statement for our 2004 Annual Meeting to be filed with the Securities and Exchange Commission.

PART IV

Item 15. ***Exhibits, Financial Statement Schedule, and Reports on Form 8-K***

(a) Independent Auditors' Report, Financial Statements and Financial Statement Schedule

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(b) Reports on Form 8-K

No reports on Form 8-K were filed during the fourth quarter ended December 31, 2003.

(c) Exhibits

The following exhibits are filed herewith or incorporated by reference:

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).*
10.1*	Second Amended and Restated Credit Agreement (Multi-currency) by and between the Registrant and Bank of America National Trust and Savings Association dated June 30, 1999, effective June 30, 1999 *(filed as Exhibit 10.1 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 1999)* as amended by a Waiver and First Amendment to Credit Agreement dated as of June 29, 2001 and by a letter amendment dated as of April 5, 2002.
10.1.1*	Waiver and First Amendment to Credit Agreement (Multi-currency) by and among the Registrant and Bank of America, N.A., formerly known as Bank of America National Trust and Savings Association, dated June 29, 2001, effective June 29, *2001 (filed as Exhibit 10.1 to Registrant's Annual Report on Form 10-K filed for the year ended December 31, 2001).*
10.1.2*	Letter amendment dated as of April 5, 2002 and Third Amendment to Credit Agreement (Multi-currency) by and between the Registrant and Bank of America, N.A., dated as of June 28, 2002 *(filed as Exhibit 10.1.2 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2002).*
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).*

10.5*+ Non-Statutory Stock Option Agreement (with Notice of Grant of Stock Option and Special Addendum) between Registrant and Mr. Ron *Ercanbrack (filed as Exhibit 99.19 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)*.

10.9* Asset Purchase Agreement between the Registrant and Application Partners, Inc. dated May 18, 2000 (*filed as Exhibit 10.24 to Registrant's Form 10-Q for the quarter ended June 30, 2000*).

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).*

10.15* Stock Purchase Agreement dated April 2, 2003 by and among Registrant, FileNet Nova Scotia Corporation, Shana Corporation and certain Sellers *(filed as Exhibit 10.15 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003).*

10.15.1* Escrow Agreement dated April 2, 2003 by and among FileNet Nova Scotia Corporation, certain Sellers and Bennett Jones LLP *(filed as Exhibit 10.15.1 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003).*

10.16*+ Amended and Restated Letter Agreement dated May 15, 2003 by and between Registrant and Lee D. Roberts, Chief Executive Officer *(filed as Exhibit 10.16+ to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003).*

10.17*+ Form of Amended and Restated Letter Agreement, dated May 15, 2003, by and between Registrant and the Chief Financial Officer and President *(filed as Exhibit 10.17 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003)* (1).

10.18*+ Form of Amended and Restated Letter Agreement by and among Registrant and certain Executive Officers *(filed as Exhibit 10.18 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003).* (2)

10.19*+	CEO Severance Agreement together with Addendum II to Stock Option Agreement between Registrant and Mr. Lee D. Roberts *(filed as Exhibit 10.19 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003).*
10.20+	Non-Statutory Stock Option Agreement between Registrant and Mr. Kenneth F. Fitzpatrick.
14	Code of Conduct
21.1	List of subsidiaries of Registrant (*filed as FileNet Corporation Subsidiary Information*).
23.1	Independent Auditors' consent
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.

SIGNATURES

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

Date: March 12, 2004	By:	/s/ ***Lee D. Roberts*** Lee D. Roberts Chief Executive Officer and Chairman of the Board

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

DATE	SIGNATURE AND TITLE
March 12, 2004	***/s/ Lee D. Roberts*** Lee D. Roberts Chief Executive Officer and Chairman of the Board (Principal Executive Officer)
March 12, 2004	***/s/ Sam M. Auriemma*** Sam M Auriemma, Chief Financial Officer and Senior Vice President, Finance (Principal Financial and Accounting Officer)
March 12, 2004	***/s/ Theodore J. Smith*** Theodore J. Smith Director
March 12, 2004	***/s/ L. George Klaus*** L. George Klaus Director
March 12, 2004	***/s/ William P. Lyons*** William P. Lyons Director
March 12, 2004	***/s/ John C. Savage*** John C. Savage Director
March 12, 2004	***/s/ Roger S. Siboni*** Roger S. Siboni Director

Index to Consolidated Financial Statements

As required under Item 8, Financial Statements and Supplementary Data, FileNet Corporation's consolidated financial statements are provided in this separate section as follows:

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INDEPENDENT AUDITORS' REPORT

To the Stockholders and the Board of Directors of
FileNet Corporation:

We have audited the accompanying consolidated balance sheets of FileNet Corporation and its subsidiaries (the Company) as of December 31, 2003 and 2002, and the related consolidated statements of operations, comprehensive operations, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2003. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of FileNet Corporation and its subsidiaries as of December 31, 2003 and 2002, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 2 to the consolidated financial statements, the Company changed its method of accounting for goodwill and other intangible assets as a result of adopting Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets*, effective January 1, 2002.

/s/ Deloitte & Touche LLP

Deloitte & Touche LLP
Costa Mesa, California
February 24, 2004

CONSOLIDATED BALANCE SHEETS

ASSETS

(In thousands, except share and per share amounts)

December 31,	**2003**	**2002**
Current assets**:**		
Cash and cash equivalents	$ 203,305	$ 130,154
Short-term investments	32,286	29,188
Accounts receivable, net of allowances for doubtful accounts and sales returns of $3,917 and $4,232 at December 31, 2003 and 2002, respectively	38,096	44,839
Inventories, net	528	2,568
Prepaid expenses and other current assets	12,646	13,317
Deferred income taxes	3,551	802
Total current assets	290,412	220,868
Property, net	26,922	34,641
Long-term investments	12,672	25,864
Goodwill	26,170	16,907
Intangible assets, net of accumulated amortization of $1,842 and $544 at December 31, 2003 and 2002, respectively	7,979	3,029
Deferred income taxes	23,001	21,792
Other assets	4,692	4,935
Total assets	$ 391,848	$ 328,036

LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities**:**		
Accounts payable	$ 11,006	$ 7,706
Accrued compensation and benefits	27,648	20,729
Customer deposits and advances	5,217	2,962
Unearned maintenance revenue	40,691	38,945
Other accrued liabilities	16,524	15,224
Total current liabilities	101,086	85,566
Unearned maintenance revenue	1,614	3,565
Commitments and contingencies (Notes 10, 17 and 18)		
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; 38,906,640 shares issued and 37,808,640 shares outstanding at December 31, 2003; and 37,014,512 shares issued and 35,916,512 shares outstanding at December 31, 2002	234,025	206,676
Retained earnings	64,098	53,178
Accumulated other comprehensive income (loss)	5,592	(6,382)
	303,715	253,472
Treasury stock, at cost; 1,098,000 shares at December 31, 2003 and 2002	(14,567)	(14,567)
Net stockholders’ equity	289,148	238,905
Total liabilities and stockholders' equity	$ 391,848	$ 328,036

See accompanying Notes to Consolidated Financial Statements

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except share and per share amounts)			
Year Ended December 31,	**2003**	**2002**	**2001**
Revenue:			
Software	$ 149,214	$ 132,508	$ 119,014
Customer support	164,772	149,847	132,382
Professional services and education	48,061	56,959	69,186
Hardware	2,458	7,703	14,028
Total revenue	364,505	347,017	334,610
Cost of revenue:			
Cost of software revenue	13,800	10,565	7,522
Cost of customer support revenue	39,116	38,608	42,396
Cost of professional services and education revenue	42,346	50,408	59,896
Cost of hardware revenue	3,669	5,995	10,211
Total cost of revenues	98,931	105,576	120,025
Gross profit	265,574	241,441	214,585
Operating expenses:			
Research and development	77,050	71,735	68,838
Selling and marketing	144,975	132,109	136,124
General and administrative	32,466	31,656	33,381
In-process research and development	-	400	-
Total operating expenses	254,491	235,900	238,343
Operating income (loss)	11,083	5,541	(23,758)
Other income, net	4,084	5,209	2,503
Income (loss) before income taxes	15,167	10,750	(21,255)
Provision (benefit) for income taxes	4,247	2,478	(4,633)
Net income (loss)	$ 10,920	$ 8,272	$ (16,622)
Earnings (loss) per share:			
Basic	$ .30	$ .23	$ (0.47)
Diluted	$ .29	$ .23	$ (0.47)
Weighted average shares outstanding:			
Basic	36,532	35,590	35,117
Diluted	38,089	36,709	35,117

See accompanying Notes to Consolidated Financial Statements

CONSOLIDATED STATEMENTS OF COMPREHENSIVE OPERATIONS

(In thousands)

Year Ended December 31,	**2003**	**2002**	**2001**
Net income (loss)	$ 10,920	$ 8,272	$ (16,622)
Other comprehensive income (loss):			
Foreign currency translation adjustments	12,093	7,631	(3,056)
Unrealized holding gains (losses) on available-for-sale securities, net of tax	(119)	27	77
Other comprehensive income (loss)	11,974	7,658	(2,979)
Comprehensive income (loss)	$ 22,894	$ 15,930	$ (19,601)

See accompanying Notes to Consolidated Financial Statements

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

(In thousands)

	Common Stock Shares	*Common Stock Amount*	*Retained Earnings*	*Accumulated Other Comprehensive Operations*	*Treasury Stock Shares*	*Treasury Stock Amount*	*Total*
Balances at January 1, 2001	35,941	$ 189,057	$ 61,528	$ (11,061)	(1,098)	$ (14,567)	$ 224,957
Stock options exercised	486	4,722					4,722
Stock option income tax benefit		1,749					1,749
Common stock issued under the Employee Qualified Stock Purchase Plan	339	3,998					3,998
Cancelled and retired escrow shares issued in business combinations	(376)						
Foreign currency translation adjustment				(3,056)			(3,056)
Net (loss)			(16,622)				(16,622)
Unrealized holding gains on available-for-sale-securities				77			77
Balances at December 31, 2001	36,390	$ 199,526	$ 44,906	$ (14,040)	(1,098)	$ (14,567)	$ 215,825
Stock options exercised	286	2,753					2,753
Stock option income tax benefit		685					685
Common stock issued under the Employee Qualified Stock Purchase Plan	339	3,712					3,712
Foreign currency translation adjustment				7,631			7,631
Net income			8,272				8,272
Unrealized holding gains on available-for-sale-securities				27			27
Balances at December 31, 2002	37, 015	$ 206,676	$ 53,178	$ (6,382)	(1,098)	$ (14,567)	$ 238,905
Stock options exercised	1,553	17,569					17,569
Stock option income tax benefit		5,865					5,865
Common stock issued under the Employee Qualified Stock Purchase Plan	339	3,788					3,788
Foreign currency translation adjustment				12,093			12,093
Net income			10,920				10,920
Unrealized holding gains on available-for-sale-securities				(119)			(119)
Non-employee stock compensation valuation		127					127
Balances at December 31, 2003	38,907	$ 234,025	$ 64,098	$ 5,592	(1,098)	$ (14,567)	$ 289,148

See accompanying Notes to Consolidated Financial Statements

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

Year Ended December 31,	2003	2002	2001
Cash flows provided by operating activities:			
Net income (loss)	$ 10,920	$ 8,272	$ (16,622)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Purchased in-process research and development	-	400	-
Depreciation and amortization	19,378	21,588	24,349
Loss on sale of fixed assets	27	47	264
Provision for doubtful accounts and sales returns	653	1,752	1,482
Deferred income taxes	(3,956)	1,629	(8,286)
Stock option income tax benefit	5,865	685	1,749
Changes in operating assets and liabilities net of effects of acquisitions:			
Accounts receivable	8,835	(7,818)	51,128
Inventories	2,075	425	405
Prepaid expenses and other current assets	1,648	(3,425)	185
Accounts payable	2,325	(940)	(8,236)
Accrued compensation and benefits	5,309	2,101	(8,119)
Customer deposits and advances	2,198	(1,895)	2,936
Unearned maintenance revenue	(2,276)	4,651	9,842
Income taxes payable	2,349	(3,966)	(5,559)
Other assets and liabilities	(3,183)	(2,066)	(3,044)
Net cash provided by operating activities	52,167	21,440	42,474
Cash flows used for investing activities:			
Capital expenditures	(9,177)	(10,825)	(14,075)
Proceeds from sale of property	135	66	329
Note receivable	294	(1,900)	-
Cash paid for acquisitions, net of cash acquired	(8,073)	(9,359)	-
Purchases of investments	(87,768)	(134,528)	(148,570)
Proceeds from sales and maturities of investments	94,305	146,571	120,433
Net cash used in investing activities	(10,284)	(9,975)	(41,883)
Cash flows provided by financing activities:			
Proceeds from issuance of common stock	21,357	6,465	8,720
Principal payments on capital lease obligations	(16)	(1,799)	(935)
Net cash provided by financing activities	21,341	4,666	7,785
Effect of exchange rate changes on cash and cash equivalents	9,927	6,521	(2,371)
Net increase in cash and cash equivalents	73,151	22,652	6,005
Cash and cash equivalents, beginning of year	130,154	107,502	101,497
Cash and cash equivalents, end of year	$ 203,305	$ 130,154	$ 107,502
Supplemental cash flow information:			
Interest paid	$ 48	$ 100	$ 92
Income taxes paid	$ 3,050	$ 4,301	$ 7,045
See Note 13 for non-cash investing and financing activities			

See accompanying Notes to Consolidated Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 ***Nature of Operations***

FileNet Corporation ("FileNet" or "the Company") develops, markets, sells and supports a unified platform and framework for Enterprise Content Management ("ECM") software and solutions that delivers capabilities in a tightly integrated and synchronized offering. The Company markets its products to a broad range of industries in more than 90 countries through a global sales, service and support organization, including its ValueNet business partner program of resellers, system integrators and application developers.

Note 2 ***Summary of Significant Accounting Policies***

Basis of Presentation. The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All intercompany balances and transactions have been eliminated.

Use of Estimates. 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 and disclosure of contingent liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Estimates are used for, but not limited to, the accounting for the allowance for doubtful accounts and sales returns, inventory allowances, warranty costs, contingencies and taxes.

Foreign Currency Translation. The Company measures the financial statements of its foreign subsidiaries using the local currency as the functional currency. Assets and liabilities of these subsidiaries are translated at the exchange rate on the balance sheet date. Revenues, costs and expenses are translated at the rates of exchange prevailing during the year. Translation adjustments resulting from this process are included in stockholders' equity. Gains and losses from foreign currency transactions are included in other income, net. Transaction gains and losses incurred during the years ended December 31, 2003, 2002 and 2001 were a gain of approximately $700,000, a gain of $1.5 million, and a loss of approximately $13,000, respectively.

Cash Equivalents. Investments purchased with an original maturity of three months or less are considered to be cash equivalents and are stated at cost, which approximates fair value. Cash equivalents generally consist of cash, time deposits, commercial paper, U.S. government and U.S. government agencies instruments, money market funds and other money market instruments. The Company invests its excess cash only in investment AAA grade money market instruments from companies in a variety of industries and, therefore, believes that it bears minimal principal risk.

Investments. The Company's investments consist of marketable securities, primarily high-grade corporate and government securities with maturities of less than three years. The Company classifies all of its 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 (Note 7).

Other Financial Instruments. The Company enters into forward foreign exchange contracts as a hedge against the effects of fluctuating currency exchange rates on monetary assets and liabilities denominated in currencies other than the functional currency of the relevant entity. The Company is exposed to market risk on the forward foreign exchange contracts as a result of changes in foreign exchange rates; however, the market risk should be offset by changes in the valuation of the underlying exposures. 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 in the consolidated statements of operations. These contracts mature every three months at the end of each quarter. The Company opens 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. The Company uses commercial rating agencies to evaluate the credit quality of the counterparties and does not anticipate nonperformance by any counterparties. The Company does not anticipate a material loss resulting from credit risks related to any of these institutions (Note 19).

In June 1998, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities." SFAS No. 133 as amended, is effective for fiscal years beginning after June 15, 2000. SFAS No. 133, as amended, established accounting and reporting standards for derivative instruments including certain derivative instruments embedded in other contracts that were not formerly considered derivatives and may now meet the definition of a derivative. Additionally, this standard required the Company to record all derivatives on the balance sheet at fair value. For derivatives that qualify for hedge accounting, changes in the fair value of derivatives are offset by the change in fair value of the hedged assets, liabilities, or firm commitments as appropriate for cash flow and fair value hedges. The Company adopted this standard effective January 1, 2001, and it has had no significant effect on the Company's consolidated results of operations, financial position, or cash flows.

Fair Value of Financial Instruments. The recorded amounts of financial assets and liabilities at December 31, 2003 and 2002, approximate fair value due to the relatively short period of time between origination of the instruments and their expected realization.

Accounts Receivable. The Company evaluates the creditworthiness of its customers prior to order fulfillment and regularly adjusts credit limits based upon ongoing credit evaluations of a customer's payment history and current creditworthiness. An allowance for estimated credit losses is maintained and such losses have been within management's expectations and the provisions established.

Inventories. Inventories are stated at the lower of first-in, first-out, cost, or market (Note 8). The Company regularly monitors inventories for excess or obsolete items and makes any necessary adjustments at each balance sheet date.

Property. Property is stated at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the related assets, generally three to five years. Leasehold improvements are amortized over the shorter of the estimated useful lives of the improvements or the term of the related lease (Note 9).

Long-Lived Assets. The Company accounts for the impairment and disposition of long-lived assets in accordance with SFAS No. 144, "Accounting for Impairment or Disposal of Long-Lived Assets," which the Company adopted effective January 1, 2002. In accordance with SFAS No. 144, long-lived assets are reviewed for events or changes in circumstances that indicate that their carrying value may not be recoverable. Based on the Company's most recent analysis, the Company believes there is no impairment at December 31, 2003.

Change in Accounting for Goodwill. Prior to the adoption of SFAS No. 142, "Goodwill and Other Intangible Assets," goodwill arising from our API acquisition that took place on May 18, 2000, was amortized on a straight-line basis over five years and assembled workforce was amortized on a straight-line basis over three years (Note 3). The Company adopted SFAS No. 142 on January 1, 2002. As a result, assembled workforce no longer meets the definition of a separately identified intangible asset under the provisions of SFAS No. 142, and the un-amortized balance of $182,000 was reclassified as goodwill at January 1, 2002. In accordance with this Standard, the Company ceased amortizing the goodwill balance of $10.1 million from its 2000 acquisition of Applications Partner, Inc. as of January 1, 2002 and there were no other indefinite life intangible assets as of January 1, 2002. Goodwill of $5.8 million resulting from the acquisition of eGrail in April 2002 and goodwill of $3.1 million resulting from the acquisition of Shana in April 2003 is also not being amortized.

In accordance with SFAS No. 142, the Company is required to perform a two-step transitional impairment review each year. Step one of this review determines whether the fair value of each reporting unit is less than its carrying amount as of the measurement date. In the event that the fair value of each reporting unit was less than the carrying amount, the step two of the test would be required to determine if the carrying value of goodwill exceeded the implied value. The Company engaged an independent valuation firm to assist management in determining the business enterprise value for each of its reporting segments and to perform an impairment analysis as of July 1, 2003 in accordance with SFAS 142. The analysis indicated there was no impairment of goodwill in any of the reporting segments. As of December 31, 2003, no impairment of goodwill has been recognized. If estimates change, a materially different impairment conclusion could result.

Summarized below are the effects on net income (loss) per share data if the Company had followed the non-amortization provisions of SFAS No.142 for all periods presented (in thousands, except per share amounts):

Year ended December 31,	**2003**	**2002**	**2001**
Net income (loss):			
As reported	$ 10,920	$ 8,272	$ (16,622)
Add: goodwill and assembled workforce amortization, net of taxes	-	-	1,619
Adjusted net income (loss)	$ 10,920	$ 8,272	$ (15,003)
Basic net income (loss) per share:			
As reported	$ 0.30	$ 0.23	$ (0.47)
Add: goodwill and assembled workforce amortization, net of taxes	-	-	0.04
Adjusted basic net income (loss) per share	$ 0.30	$ 0.23	$ (0.43)
Diluted net income (loss) per share:			
As reported	$ 0.29	$ 0.23	$ (0.47)
Add: goodwill and assembled workforce amortization, net of taxes	-	-	0.04
Adjusted diluted net income (loss) per share	$ 0.29	$ 0.23	$ (0.43)

Intangible Assets. The acquisition of eGrail in April 2002 and Shana in April 2003 resulted in intangible assets. Acquired technology, technical manuals and design documents, and customer relationships were assigned a useful life of five years and amortized on a straight-line basis as a cost of software revenue. Non-compete agreements have a useful life of three years and are amortized on a straight-line basis as a cost of software revenue. Patents were assigned a useful life of two years and amortized on a straight-line basis as an operating expense.

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

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

For arrangements with multiple elements, we allocate revenue to each element of a transaction based upon its fair value as determined in reliance on vendor specific objective evidence. This evidence of fair value for all elements of an arrangement is based on the normal pricing and discounting practices for those products and services when sold separately. If fair value of any undelivered element cannot be determined objectively, the Company defers 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 the Company's software, as well as software upgrades under its 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. The Company does not make changes to the standard software code in the field. Revenue from these services and from training classes is recognized as such services are delivered and accepted by the customer. Revenue and cost is recognized using the percentage-of-completion method for fixed-price consulting contracts. However, revenue and profit are subject to revision as the contract progresses and anticipated losses on fixed-price professional services contracts are recognized in the period when they become known.

Product Warranty. The Company provides a 90-day warranty for its software products against substantial non-conformance to the published documentation at the time of delivery and hardware products against defects in materials and workmanship. A provision for estimated warranty costs is recorded at the time of sale or license and the related liability is periodically adjusted to reflect actual experience (Note 11).

Research and Development. The Company expenses 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 software is substantially completed concurrently with the establishment of technological feasibility.

Income Taxes. The provision for incomes taxes is determined in accordance with SFAS No. 109, "Accounting for Income Taxes." Deferred tax assets and liabilities arise from temporary differences between the tax bases of assets and liabilities and their reported amounts in the consolidated financial statements that will result in taxable or deductible amounts in future years. A valuation allowance is established to reduce deferred tax assets if it is more likely than not that such deferred tax assets will not be realized (Note 15).

Earnings (Loss) Per Share. Basic earnings (loss) per share is computed using the weighted average number of common shares outstanding during the reporting period. Diluted earnings per share is computed using the weighted average number of common shares outstanding plus the dilutive effect of outstanding stock options and shares issuable under the employee stock purchase plan using the treasury stock method. Diluted loss per share excludes these adjustments, as the impact would be antidilutive (Note 5).

Supplier Concentrations. Hardware is no longer a strategic reporting segment for the Company. The dependence on suppliers is limited to Optical Storage and Retrieval (OSAR) devices that generate minimal revenue to the Company.

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." No stock-based compensation expense was recorded in the consolidated statements of operations for the years ended December 31, 2003, 2002 and 2001.

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:"

(In thousands, except per share amounts)

December 31,		**2003**		**2002**		**2001**
Net income (loss), as reported	$	10,920	$	8,272	$	(16,622)
Deduct: Total stock-based employee compensation expense determined under fair value based method For all awards, net of related tax effects		(7,429)		(8,735)		(12,381)
Pro forma net income (loss)	$	3,491	$	(463)	$	(29,003)
Earnings per share:						
Basic earnings (loss) per share – as reported	$	0.30	$	0.23	$	(0.47)
Basic earnings (loss) per share – pro forma	$	0.10	$	(0.01)	$	(0.83)
Diluted earnings (loss) per share - as reported	$	0.29	$	0.23	$	(0.47)
Diluted earnings (loss) per share – pro forma	$	0.09	$	(0.01)	$	(0.83)

The fair value of each option grant was estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions used for grants in 2003, 2002 and 2001:

	2003	**2002**	**2001**
Expected volatility	58%	68%	78%
Risk-free interest rates	1.63% - 4.76%	2.0% to 4.61%	3.6% to 5.3%
Expected life from vest date (years)	1	1	1
Dividend	0%	0%	0%

Pro forma compensation cost of shares issued under the Employee Qualified Stock Purchase Plan is measured based on the discount from market value on the date of purchase in accordance with SFAS No. 123.

Recently Issued Accounting Pronouncements

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

In June 2001, the FASB issued SFAS No. 142, “Goodwill and Other Intangible Assets,” which we adopted January 1, 2002. SFAS No. 142 requires that goodwill and other intangible assets with indefinite useful lives no longer be amortized, but instead be tested for impairment at least annually and written down when impaired. SFAS No. 142 requires purchased intangible assets other than goodwill to be amortized over their useful lives, unless these lives are determined to be indefinite. In accordance with this standard, the Company does not amortize goodwill and indefinite life intangible assets but evaluates their carrying value annually or when events or circumstances indicate that their carrying value may be impaired. As of the first day of July of each year, goodwill is tested for impairment by determining if the carrying value of each reporting segment exceeds its fair value. The Company engaged an independent valuation firm to determine the business enterprise value for each of our reporting units and to perform an impairment analysis as of July 1, 2003 in accordance with SFAS 142. The analysis indicated there was no impairment of goodwill in any of the reporting units. As of December 31, 2003, no impairment of goodwill has been recognized. If estimates change, a materially different impairment conclusion could result.

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

In July 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities," which addresses financial accounting and reporting for costs associated with exit or disposal activities and supersedes EITF Issue 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a

Restructuring)." SFAS No. 146 requires that costs associated with exit or disposal activities be recognized when they are incurred rather than at the date of a commitment to an exit or disposal plan. SFAS No. 146 also establishes that the liability should initially be measured and recorded at fair value. The Company adopted the provisions of SFAS No. 146 for exit or disposal activities initiated after December 31, 2002. The adoption of this standard did not have a material impact on the Company's consolidated financial statements.

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

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

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. As the Company has determined that it does not have any SPE's to which these interpretations apply, the Company will adopt FIN 46R in the first quarter of 2004. The Company believes the adoption of FIN 46R will not have a material impact on its consolidated financial statements.

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

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

- a financial instrument issued in the form of shares that is mandatorily redeemable and embodies an unconditional obligation that requires the issuer to redeem it by transferring its assets at a specified or determinable date or upon an event that is certain to occur;

- a financial instrument, other than an outstanding share, that embodies an obligation to repurchase the issuer's equity shares, or is indexed to such an obligation, and requires the issuer to settle the obligation by transferring assets; and

- a financial instrument that embodies an unconditional obligation that the issuer must settle by issuing a variable number of its equity shares if the monetary value of the obligation is based solely or predominantly on (1) a fixed monetary amount, (2) variations in something other than the fair value of the issuer's equity shares, or (3) variations inversely related to changes in the fair value of the issuer's equity shares.

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

For public entities, SFAS No. 150 is effective for mandatorily redeemable financial instruments entered into or modified after May 31, 2003 and is effective for all other financial instruments as of the first interim period beginning after June 15, 2003.

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

SFAS No. 150 is to be implemented by reporting the cumulative effect of a change in accounting principle. The Company does not believe the adoption of SFAS No. 150 will have a material impact on its consolidated financial statements.

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

Note 3 ***Acquisitions***

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

On April 2, 2003, the Company completed a stock purchase acquisition of Shana Corporation (“Shana”), an electronic forms management company. This strategic acquisition provides technology and experience to expand the Company’s ECM offering with Enterprise Forms Management capability, which contributed to the purchase price and resulted in goodwill. The purchase price for the acquisition consisted of $8.55 million in cash 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,” these acquisitions were accounted for under the purchase method of accounting. The purchase price was allocated as follows:

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

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

The valuation of the eGrail assets included $400,000 of in-process research and development, which was expensed upon acquisition because technological feasibility had not been established and no future alternative uses existed. New product development underway at eGrail at the time of the acquisition included the next generation of their WCM product that was in the early stages of design and only 5% complete at the date of the acquisition. The cost to complete the project was estimated at approximately $3.0 million to occur over a 12-month period. As of March 31, 2003 the project was 100% complete and the Company incurred approximately $4.8 million of research and development expenses related to the project. The acquired technology of $3.3 million was assigned a useful life of five years and patents of $24,000 were assigned a useful life of two years. The remaining purchase price of $6.0 million was primarily allocated to tangible assets and goodwill. Goodwill of $5.8 million was tax deductible for this asset purchase.

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. The remaining purchase price of $3.6 million was allocated primarily to goodwill.

In accordance with SFAS No. 142, goodwill for both the eGrail and Shana acquisitions will not be amortized and was reviewed for impairment as part of the annual analysis performed in July 2003. (See Note 4.) Goodwill from these acquisitions was not impaired at December 31, 2003. Although the goodwill stemming from the Shana stock purchase is non-deductible for Canadian tax purposes, a Section 338(g) election will result in the reduction of taxable income for U.S. tax purposes on this transaction. Goodwill is tax deductible for the eGrail asset purchase.

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

(in thousands)

December 31,	**2003 Actual**	**2002 Pro Forma**
Revenue	$ 364,505	$ 347,769
Net income	10,920	6,425
Earnings per share:		
Basic	$ 0.30	$ 0.18
Diluted	$ 0.29	$ 0.17

Note 4 *Related-Party Transactions*

In July 2001, the Compensation Committee of the Company's Board of Directors ("the Board") entered into discussions with Lee Roberts, the Company's Chief Executive Officer, regarding a secured loan by the Company to Mr. Roberts to enable him to purchase a home in Orange County, California. In July 2001, the Compensation Committee forwarded its recommendation to the Board to approve, in principle, a secured loan, in the amount of $1.2 million to Mr. Roberts. In September 2001, the Compensation Committee approved, in principle, an increase in the previously requested loan amount to $1.9 million, subject to review of final loan documents and approval of the Board. In May 2002, the Compensation Committee reviewed proposed loan documentation for a secured loan to Mr. Roberts and forwarded its recommendation to the Board to approve the loan on the terms set forth in the loan documents. The loan documents provided that the loan would be secured by the real estate purchased by Mr. Roberts. Subsequently, on June 5, 2002, the Board approved the loan documents and the loan. The loan to Mr. Roberts is permitted under Section 13 of the Securities Exchange Act of 1934, as amended by Section 402 of the Sarbanes-Oxley Act on July 30, 2002, because it was outstanding on July 30, 2002. However, its terms cannot be renewed or materially modified in the future. The note bears interest at

2.89% per annum. Accrued interest on the principal balance of this note is payable annually beginning February 15, 2003 and on each February 15th thereafter until the entire principal balance becomes due. The entire outstanding principal balance of this note and any accrued interest is due and payable at the earliest of (a) June 7, 2005, (b) one year after termination of Mr. Roberts' employment by the Company, or (c) ninety (90) days after voluntary termination of employment by Mr. Roberts. Imputed interest for the difference between the stated interest rate of the note and a fair value interest rate of 7% was recorded as compensation expense and a discount that is being amortized over the term of the note to interest income using the effective interest method.

Mr. Roberts made a payment in February 2003 of approximately $37,000 toward the accrued interest balance in accordance with the terms and conditions of the loan agreement. Mr. Roberts also made a payment in December 2003 of approximately $294,000 toward the principal loan balance of $1.9 million. As of December 31, 2003, FileNet has an outstanding secured note receivable balance from Mr. Roberts in the amount approximately of $1.6 million that relates to the above-referenced loan and is included in other assets on the consolidated balance sheet. The accrued interest balance as of December 31, 2003 was approximately $48,000.

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

Note 5 *Earnings (Loss) Per Share*

The following table is a reconciliation of the earnings (loss) and share amounts used in the calculation of basic earnings (loss) per share and diluted earnings (loss) per share.

(In thousands, except per share amounts)

	Net Income (loss)	***Shares***	***Per Share Amount***
Year ended December 31, 2003:			
Basic earnings per share	$ 10,920	36,532	$ 0.30
Effect of dilutive stock options	-	1,557	
Diluted earnings per share	$ 10,920	38,089	$ 0.29
Year ended December 31, 2002:			
Basic (loss) per share	$ 8,272	35,590	$ 0.23
Effect of dilutive stock options	-	1,119	
Diluted (loss) per share	$ 8,272	36,709	$ 0.23
Year ended December 31, 2001:			
Basic earnings per share	$ (16,622)	35,117	$ (0.47)
*Effect of dilutive stock options	-	-	
Diluted earnings per share	$ (16,622)	35,117	$ (0.47)

***Note - Options to purchase 3,284,849 shares of common stock in fiscal 2001 were outstanding during the year but were not included in the computation of diluted income per share as their effect was antidilutive (See Note 14).**

Note 6 ***Accumulated Other Comprehensive Operations***

Accumulated other comprehensive operations for each of the three years in the period ended December 31 are comprised of the following:

	Foreign Currency Translation Adjustment	*Unrealized Holding Gains (Losses)*	*(In thousands) Accumulated Other Comprehensive Operations*
Balance, December 31, 2003	$ 5,646	$ (53)	$ 5,592
Current Period Changes	12,093	(119)	11,974
Balance, December 31, 2002	(6,448)	66	(6,382)
Current Period Changes	7,631	27	7,658
Balance, December 31, 2001	(14,079)	39	(14,040)
Current Period Changes	(3,056)	77	(2,979)
Balance, January 1, 2001	$ (11,023)	$ (38)	$ (11,061)

Note 7 ***Investment Securities Available for Sale***

The Company's 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. The following table summarizes investment securities available for sale as of December 31:

Investment securities available for sale:	**2003**	**2002** *(In thousands)*
Cost	$ 44,970	$ 54,945
Gross unrealized gains	-	107
Gross unrealized losses	(12)	-
Estimated fair value	$ 44,958	$ 55,052

There were no significant realized gains or losses for the years ended December 31, 2003, 2002 and 2001. Unrealized holding gains and losses on investments, net of tax, are included in accumulated other comprehensive operations in stockholders' equity at December 31, 2003 and 2002, and were a $53,000 loss and a $66,000 gain, respectively. The change year over year was an unrealized loss of $119,000, net of tax.

The contractual maturities of investments at December 31, 2003 and 2002 are shown below. Actual maturities may differ from contractual maturities because the issuer of the securities may have the right to repurchase such securities. The Company classifies short-term investments in current assets, as all such investments are available for current operations.

(In thousands)

	2003		2002	
	Cost	*Estimated Fair Value*	*Cost*	*Estimated Fair Value*
Debt Securities				
Due in one year or less:				
Short-term munis-taxable	$ 8,313	$ 8,324	$ 4,227	$ 4,232
Commercial paper	-	-	-	-
Corporate	8,442	8,440	4,659	4,681
Governments/Agencies	15,526	15,522	20,244	20,275
Total	32,281	32,286	29,130	29,188
Due in one to three years:				
Short-term munis-taxable	-	-	2,315	2,329
Commercial paper	-	-	-	-
Corporate	2,189	2,182	-	-
Government/Agencies	10,500	10,490	23,500	23,535
Total	12,689	12,672	25,815	25,864
Grand Total	$ 44,970	$ 44,958	$ 54,945	$ 55,052

Note 8 *Inventories*

Inventories consisted of the following at December 31:

(In thousands)

	2003	2002
Raw materials	$ 102	$ 1,538
Work-in-process	-	979
Finished goods	426	51
Total	$ 528	$ 2,568

Note 9 *Property*

Property consisted of the following at December 31:

(In thousands)

	2003	2002
Machinery, equipment and software	$ 127,265	$ 118,723
Furniture and fixtures	14,350	13,213
Leasehold improvements	24,344	23,416
Total property	165,959	155,352
Less accumulated depreciation and amortization	(139,037)	(120,711)
Property, net	$ 26,922	$ 34,641

Note 10 ***Leases and Commitments***

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.

Expenses related to operating leases were $13.8 million, $16.0 million and $17.5 million for the years ended December 31, 2003, 2002 and 2001, respectively. The following table summarizes future minimum lease payments required under operating leases at December 31, 2003:

	(In thousands)
2004	$ 12,518
2005	10,579
2006	10,027
2007	9,282
2008	8,232
Thereafter	6,548
Total	$ 57,186

The Company continues to invest in technology equipment and software for research and development and for information systems infrastructure and telecommunications. These investments have been funded through operating leases, capital leases and cash purchases. In July 2001, the Company converted its outstanding leases associated with these investments into an eighteen-month capital lease with a value of $2.6 million. No future lease commitments are required under this lease at December 31, 2003.

The Company licenses certain software from third parties with contractual arrangements that require future payment obligations. These obligations were $2.1 million, $3.8 million and $3.4 million at December 31, 2003, 2002 and 2001, respectively, and were due the following year. The Company entered into a development contract with a third party vendor during 2003. The obligation was $2.1 million at December 31, 2003.

Note 11 ***Product Warranty***

The Company provides a 90-day warranty for its hardware products against defects in materials and workmanship and for its software products against substantial nonconformance to the published documentation at time of delivery. For hardware products the Company accrues warranty costs based on historical trends in product return rates and the expected material and labor costs to provide warranty services. For software products, the Company records the estimated cost of technical support during the warranty period. A provision for these estimated warranty costs is recorded at the time of sale or license. If the Company were to experience an increase in warranty claims compared with our historical experience, or costs of servicing warranty claims were greater than the expectations on which the accrual had been based, gross margins could be adversely affected.

The following table represents the warranty activity and balances for the periods shown (in thousands):

	Balance at Beginning of Period	*Additions*	*Deductions*	*Balance at End of Period*
Year ended December 31, 2003:				
Warranty reserves	$ 728	964	1,213	$ 479
Year ended December 31, 2002:				
Warranty reserves	772	1,146	1,190	728
Year ended December 31, 2001:				
Warranty reserves	$ 764	1,801	1,793	$ 772

Note 12 ***Goodwill and Purchased Intangible Assets***

In acquisitions accounted for using the purchase method, goodwill is recorded as the difference, if any, between the aggregate consideration paid for an acquisition and the fair value of the net tangible and identified intangible assets acquired. SFAS No. 142 requires that amortization of goodwill and indefinite life intangibles be discontinued and replaced with periodic review and analysis of goodwill for possible impairment. Intangible assets with definite lives must be amortized over their estimated useful lives. On January 1, 2002 the Company adopted SFAS No. 142, and as a result, goodwill is no longer amortized. Summarized below are the effects on net income (loss) per share data if the Company had followed the non-amortization provisions of SFAS No.142 for all periods presented (in thousands, except per share amounts):

Year ended December 31,	**2003**	**2002**	**2001**
Net income (loss):			
As reported	$ 10,920	$ 8,272	$ (16,622)
Add: goodwill and assembled workforce amortization, net of taxes	-	-	1,619
Adjusted net income (loss)	$ 10,920	$ 8,272	$ (15,003)
Basic net income (loss) per share:			
As reported	$ 0.30	$ 0.23	$ (0.47)
Add: goodwill and assembled workforce amortization, net of taxes	-	-	0.04
Adjusted basic net income (loss) per share	$ 0.30	$ 0.23	$ (0.43)
Diluted net income (loss) per share:			
As reported	$ 0.29	$ 0.23	$ (0.47)
Add: goodwill and assembled workforce amortization, net of taxes	-	-	0.04
Adjusted diluted net income (loss) per share	$ 0.29	$ 0.23	$ (0.43)

A portion of goodwill and intangible assets were allocated to the Company's Ireland subsidiary and therefore the following tables reflect amounts resulting from foreign exchange translation.

The following table presents the changes in goodwill by reporting segment during 2003, 2002 and 2001*(in thousands):*

	Balance at Beginning of Period	*Acquired*	*Amortized*	*Adjustments*	*Foreign Currency Gain*	*Balance at End of Period*
Year ended December 31, 2003:	**$ 16,907**	**$ 3,103**	**$ -**	**$ 4,132**	**$ 2,028**	**$ 26,170**
Software	9,187	2,070	-	2,756	1,177	15,190
Customer Support	3,962	580	-	773	446	5,761
Professional Services & Education	3,758	453	-	603	405	5,219
Year ended December 31, 2002:	**$ 9,953**	**$ 5,793**	**$ -**	**$ 182**	**$ 979**	**$ 16,907**
Software	4,914	3,654	-	90	529	9,187
Customer Support	3,271	406	-	60	225	3,962
Professional Services & Education	1,768	1,733	-	32	225	3,758
Year ended December 31, 2001:	**$ 13,146**	**$ -**	**$ (3,193)**	**$ -**	**$ -**	**$ 9,953**

Goodwill acquired during 2003 was due to the Shana acquisition in April 2003. Adjustments to goodwill in 2003 included $1.7 million for the write-off of a prepaid royalty and the recognition of a $2.3 million deferred tax asset. Prior to the Shana acquisition, FileNet licensed the eForms technology from Shana under an agreement that resulted in a prepaid royalty. The remaining balance of this prepaid royalty fee was considered additional investment in Shana and was allocated to goodwill. A deferred tax asset was recorded under purchase accounting for the estimated future tax effects of the identified intangibles with a corresponding entry to goodwill of $1.7 million. A portion of the Shana goodwill was allocated to the Company's subsidiaries in Ireland and Canada resulting in foreign currency gain and loss exposure. Goodwill acquired during 2002 was due to the eGrail acquisition in April 2002. Adjustments to goodwill in 2002 included a reclassification of the assembled workforce intangible to goodwill at January 1, 2002 as a result of the adoption of SFAS 142. A portion of the eGrail goodwill was booked to the Company's subsidiaries in Ireland resulting in foreign currency gain and loss exposure. Goodwill acquired in 2000 due to the API acquisition amortized by approximately $3.1 million during 2001 before the Company adopted SFAS 142 on January 1, 2002. All goodwill due to the API acquisition was allocated to the U.S. subsidiary.

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

These assets were recorded in connection with the April 2002 eGrail acquisition and the April 2003 Shana acquisition, and are comprised of the following as of December 31, 2003 *(in thousands):*

	Balance at Beginning of Period	*Acquired*	*Amortized*	*Foreign Currency Gain*	*Balance at End of Period*
Total year ended December 31, 2003:	**$ 3,029**	**$ 5,677**	**$ (1,842)**	**$ 1,115**	**$ 7,979**
Acquired technology & other intangibles	3,015	5,400	(1,739)	1,072	7,748
Non-compete agreements	-	277	(90)	40	227
Patents	14	-	(13)	3	4
Total year ended December 31, 2002:	**$ -**	**$ 3,325**	**$ (544)**	**$ 248**	**$ 3,029**
Acquired technology & other intangibles	-	3,300	(532)	247	3,015
Non-compete agreements	-	-	-	-	-
Patents	-	25	(12)	1	14
Total year ended December 31, 2001:	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**

Acquired technology is being amortized over a useful life of five years, patents are being amortized over a useful life of two years and non-compete agreements are being amortized over three years. Amortization expense for amortizing intangible assets was $1,695,000 for 2003 and $523,000 for 2002 (excluding foreign exchange effect). Estimated future amortization expense (excluding foreign exchange effect) of purchased intangible assets as of December 31, 2003 is as follows *(in thousands):*

Fiscal Year	**Amount**
2004	$ 2,128
2005	2,091
2006	2,023
2007	1,428
2008	309
Thereafter	-
	$ 7,979

Note 13 ***Borrowing Arrangements***

On June 27, 2003 the Company's $5.0 million multi-currency revolving line of credit expired in accordance with its terms and was not renewed because the cost of carrying the line did not justify the level of usage. The Company believes it will be able to meet escrow needs through existing bank relationships in the United States and internationally.

Note 14 *Stockholders' Equity*

Shareholder Rights Plan. In October 1988, the Company declared a dividend of one common stock purchase right for each outstanding share of common stock. A right may be exercised under certain circumstances to purchase one share of common stock at an exercise price of $87.50, subject to certain anti-dilution adjustments. The rights become exercisable if and when a person (or group of affiliated or associated persons) acquire 15% or more of FileNet's outstanding common stock, or announces an offer that would result in such person acquiring 15% or more of FileNet's common stock. After the rights become exercisable, each right will entitle its holder to buy a number of shares of FileNet's common stock having a market value of twice the exercise price of the rights. After the rights become exercisable, if FileNet is a party to certain merger or business combination transactions or transfers 50% or more of its assets or earnings power (as defined), each right will entitle its holder to buy a number of shares of common stock of the acquiring or surviving entity having a market value of twice the exercise price of the right. The rights expire November 17, 2008 and may be redeemed by FileNet at one cent per right at any time up to ten days after a person has announced that they have acquired 15% or more of FileNet's common stock.

Treasury Stock. In 1997, the Board of Directors authorized, subject to certain business and market conditions, the purchase of up to $10.0 million of the Company's outstanding common stock. During the year ended December 31, 1997, the number of shares purchased under this authorization was 420,000 shares at an aggregate cost of $5.6 million. During the first quarter of 1998, the Company repurchased 278,000 shares of its common stock at an aggregate cost of $4.4 million, thereby completing the stock repurchase program.

Employee Stock Purchase Plans. In May 1998, FileNet adopted the 1998 Employee Stock Purchase Plan and the International Employee Stock Purchase Plan (the "Purchase Plans"). A total of 300,000 shares were authorized to be added to the remaining share reserve under the predecessor 1988 Employee Qualified Stock Purchase Plan so that the total share reserve for the Purchase Plans would be no more than 400,000 shares. In May 2001, shareholders approved adding an additional 300,000 shares to the reserve. In addition, in May 2002, shareholders approved an additional 1,100,000 shares to the reserve. Under the terms of the Purchase Plans, common stock may be offered in successive six-month offering periods to eligible employees of the Company at 85% of the market price of the common stock at the beginning or end of the offering period, whichever is lower. The Purchase Plans cover substantially all employees of the Company. Eligible employees may elect to have a portion of their salary withheld for the purpose of making purchases under the Purchase Plans. Each participant is limited in any plan year to the acquisition of that number of shares that have an aggregate fair market value of not more than $25,000. There are no charges or credits to income in connection with the Purchase Plans. At December 31, 2003, $846,378 had been withheld from employees' salaries pursuant to the Purchase Plans for the current offering period, which expires on April 30, 2004. At December 31, 2003, approximately 795,198 shares remained available for future issuance.

Stock Option Plans. In April 1986, the Company adopted the 1986 Stock Option Plan (the "1986 Plan"). Under the amended terms of the 1986 Plan, options to purchase 6,500,000 shares of the Company's common stock were reserved for issuance to employees, officers and directors. Options to purchase 18,110 common shares were exercisable under the 1986 Plan at December 31, 2003. In May 1995, the 1986 Plan was terminated as to future grants and the remaining reserve of 140,098 shares was transferred into the 1995 Stock Option Plan ("1995 Plan"). Outstanding options under the 1986 Plan will continue to be governed by the provisions of agreements evidencing those grants. No common shares remain available for future grants under the 1986 Plan. Options granted under the 1986 Plan were either incentive stock options or nonqualified stock options and became exercisable in 20% annual installments beginning one year after the date of grant and expire no later than ten years plus one day from the date of grant. The exercise price of the incentive stock options and nonqualified options were not to be less than 100% and 85%, respectively, of the fair market value of the Company's common stock at the date of grant. To the extent any outstanding options under the 1986 Plan terminate or expire prior to exercise, the shares subject to those unexercised options will be available for subsequent option grant pursuant to the provisions of the 1995 Plan.

In May 1995, the Company adopted the 1995 Plan. Under the amended terms of the 1995 Plan, options to purchase 8,350,000 shares of the Company's common stock were reserved for issuance to employees, officers and directors. This reserve was added to the 140,098 shares of common stock transferred from the 1986 Plan. Options granted under the 1995 Plan's Discretionary Option Grant Program for employees and the Automatic Option Grant Program for directors have an exercise price per share of 100% of the fair market value per share on the grant date and become exercisable in 25% annual installments beginning one year from the date of grant. On October 21, 1999, the Plan's Discretionary Option Program was amended to change the vesting schedule of all options granted from that date forward to vest twenty-five percent (25%) of the option shares after twelve (12) months of service from the grant date and the balance of the options to vest in thirty-six (36) successive equal monthly installments upon completion of each additional month of service thereafter. On May 7, 2003, the Plan was amended to prohibit, without prior stockholder approval, the repricing, replacement or regranting through cancellation or lowering the option exercise price of any outstanding options granted under the Plan. As of December 31, 2003, 4,223,003 options were exercisable under the 1995 Plan.

Prior to their merger with FileNet in March 1996 and August 1995, respectively, Saros and Watermark Software, Inc. had adopted stock option plans. The Company assumed the Saros Plan and the Watermark Plan and outstanding options were converted into options to purchase an aggregate of 975,976 shares of FileNet common stock. Outstanding options under these plans will continue to be governed by the provisions of the agreements evidencing those grants. To the extent any of those outstanding options terminate or expire prior to exercise, the shares subject to those unexercised options will not be available for subsequent option grant. At December 31, 2003, a total of 2,977 options were outstanding and exercisable under the Saros Plan. No shares remain outstanding or exercisable under the Watermark Plan.

Future grants to non-employee directors are to be granted under the provisions of the 1995 Plan or the 2002 Incentive Award Plan. On May 15, 1998, the shareholders approved an amendment to the 1995 Plan for the Automatic Option Grant Program to non-employee directors to increase the initial option to purchase 25,000 shares of FileNet common stock at fair market value on the date of grant and an additional 7,000 shares of FileNet common stock at fair market value on the date of grant every year following the initial grant, provided such person continued to be a director at such time.

In August 1997, the Company filed a Form S-8 with the Securities and Exchange Commission registering a Non-Statutory Stock Option Grant of 600,000 shares, dated May 22, 1997, to the Company's current Chief Executive Officer and a Non-Statutory Stock Option Grant of 160,000 shares, dated June 18, 1997, to the Company's current President. In April 2001, the Company filed a Form S-8 with the Securities and Exchange Commission registering a Non-Statutory Stock Option Grant of 140,000 shares, dated September 13, 2000, to the Company's current Chief Financial Officer. Such grants were in accordance with employment agreements entered into by the Company and the grantees. In September 2003, the Company's Chief Marketing Officer was granted a Non-Statutory Stock Option Grant of 100,000 shares. (These options were subsequently cancelled in March 2004 upon the termination of employment of the Chief Marketing Officer.) The non-statutory options granted prior to October 21, 1999 have an exercise price per share of 100% of the fair market value per share on the date of grant and vest in 25% installments beginning one year from the date of grant and will expire no later than ten years from the date of grant. The non-statutory options granted after October 21, 1999 have an exercise price per share of 100% of the fair market value per share on the date of grant and vest in installments with 25% exercisable after twelve months of service and the balance exercisable in thirty-six (36) successive equal monthly installments upon completion of each additional month of service thereafter and will expire no later than ten years after the grant date. As of December 31, 2003, 459,532 options were exercisable related to these Non-Statutory Stock Option Grants and 414,218 had been exercised to date.

In May 2002, the Company adopted the 2002 Incentive Award Plan (the “2002 Plan”). Under the terms of the 2002 Plan, options to purchase 1,400,000 shares of the Company’s common stock were reserved for issuance to key employees, consultants and independent directors, of which only 140,000 shares may be issued as restricted stock. In May 2003, stockholders approved an additional 1,400,000 shares to the reserve. Options granted under the 2002 Plan for independent directors, consultants and key employees have an exercise price per share of 100% of the fair market value per share on the grant date. Options for key employees and consultants become exercisable as to 25% of the option shares after twelve months of service from the grant date and the balance of the options in thirty-six (36) successive equal monthly installments upon completion of each additional month of service thereafter. Options for independent directors become exercisable as to 25% per year on each of the first, second, third and fourth anniversary provided the director continues as an independent director on each such anniversary. Additionally, on May 7, 2003, the Plan was amended to prohibit, without prior stockholder approval, the re-pricing, replacement or re-granting through cancellation or lowering the option exercise price of any outstanding options granted under the Plan. As of December 31, 2003, 281,693 options were exercisable under the 2002 Plan.

Information regarding all stock option plans is as follows:

	Number of Options	*Weighted Average Exercise Price*
Balances, January 1, 2001	6,356,092	$ 14.64
Granted (weighted average fair value of $9.30)	2,442,985	16.88
Exercised	(485,270)	9.74
Cancelled	(303,354)	16.45
Balances, December 31, 2001	8,010,453	$ 15.56
Granted (weighted average fair value of $7.02)	1,559,230	13.63
Exercised	(286,114)	9.56
Cancelled	(577,253)	21.42
Balances, December 31, 2002	8,706,316	$ 15.12
Granted (weighted average fair value of $9.33)	799,100	19.97
Exercised	(1,552,892)	11.31
Cancelled	(309,811)	17.21
Balances, December 31, 2003	7,642,713	$ 16.32

The following table summarizes information concerning currently outstanding and exercisable options:

	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 to $ 9.00	1,106,956	3.84	$ 7.96	1,106,706	$ 7.96
$ 9.17 to $ 12.86	1,478,378	7.51	12.06	712,799	11.41
$ 12.97 to $ 14.19	1,374,288	7.39	13.47	698,056	13.56
$ 14.39 to $ 18.45	1,399,093	7.30	16.80	824,038	16.85
$ 19.53 to $ 23.94	1,363,854	6.76	22.50	1,062,763	22.76
$ 24.88 to $ 41.84	920,144	6.91	27.60	580,953	28.15
$ 1.39 to $ 41.84	7,642,713	6.71	$ 16.32	4,985,315	$ 16.21

The Company accounts for its stock-based compensation plans in accordance with APB No. 25 and related interpretations. Stock-based compensation expense was recorded for only one non-employee contractor working in the United Kingdom during 2003. No stock-based compensation expense was recorded in the consolidated statements of operations for the years ended December 31, 2002 and 2001, respectively.

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:"

(In thousands, except per share amounts)	**2003**	**2002**	**2001**
Net income (loss), as reported	$ 10,920	$ 8,272	$ (16,622)
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(7,429)	(8,735)	(12,381)
Pro forma net income (loss)	$ 3,491	$ (463)	$ (29,003)
Earnings per share:			
Basic earnings (loss) per share - as reported	$ .30	$ 0.23	$ (0.47)
Basic earnings (loss) per share – pro forma	$ .10	$ (0.01)	$ (0.83)
Diluted earnings (loss) per share - as reported	$ .29	$ 0.23	$ (0.47)
Diluted earnings (loss) per share – pro forma	$ .09	$ (0.01)	$ (0.83)

The fair value of each option grant was estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions used for grants in 2003, 2002 and 2001:

	2003	2002	2001
Volatility Factor	58%	68%	78%
Risk-free Interest Date	1.63% - 4.76%	2.0% - 4.60%	3.6% - 5.3%
Expected Life from Vest Date (years)	1	1	1
Dividend	0%	0%	0%

Pro forma compensation cost of shares issued under the Employee Qualified Stock Purchase Plan is measured based on the discount from market value on the date of purchase in accordance with SFAS No. 123.

Retirement of Shares. In September 2001, 375,700 shares were cancelled and retired as part of a litigation settlement (Note 17).

Note 15 *Income Taxes*

The provision for income taxes at December 31, 2003, 2002 and 2001 consists of the following:

(In thousands)

Year ended December 31,	**2003**	**2002**	**2001**
Current:			
Federal	$ 7,428	$ (2,126)	$ (324)
State	885	235	1,261
Foreign	1,825	2,740	2,716
Deferred:			
Federal	(4,520)	1,276	(4,550)
State	(1,371)	353	(3,736)
Foreign	-	-	-
Total provision (benefit)	$ 4,247	$ 2,478	$ (4,633)

Income (loss) before income taxes consists of the following components:

(In thousands)

Year ended December 31,	**2003**	**2002**	**2001**
United States	$ 9,272	$ (307)	$ (17,442)
Foreign	5,895	11,057	(3,813)
Total	$ 15,167	$ 10,750	$ (21,255)

A reconciliation of the provision (benefit) for income taxes at the federal statutory rate compared to the Company's effective tax rate is as follows:

Year ended December 31,	**2003**	**2002**	**2001**
Income taxes (benefit), at statutory federal rate	35%	35%	(35)%
State taxes (benefit), net of federal benefit	(2)	3	(7)
Tax rate differential on foreign earnings	(1)	(10)	13
Change in valuation allowance	-	-	6
R&D Credit	(7)	(7)	(3)
Other	3	2	4
Total	28%	23%	(22)%

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. The income tax effects of these temporary differences representing significant portions of the deferred taxes at December 31, 2003 and 2002 are as follows:

(In thousands)

Year ended December 31,	**2003**	**2002**
Deferred taxes:		
Loss carryforwards	$ 20,254	$ 23,391
Tax credit carryforwards	15,980	11,408
Accrued expenses	3,608	3,321
Sales returns and allowance reserves	405	405
Deferred revenue	10,209	4,035
Depreciable assets and amortizable assets	4,060	5,996
Other	(3,667)	(2,122)
Total	50,849	46,434
Valuation allowance	(24,297)	(23,840)
Net deferred tax asset	$ 26,552	$ 22,594

The Company maintains a valuation allowance against the domestic portion of the deferred tax asset due to uncertainty regarding the future realization and after weighing all available evidence. The net increase (decrease) in the total valuation allowance was $457,000, $(844,000) and $1,316,000 during 2003, 2002 and 2001, respectively. As of December 31, 2003, the Company has a net tax deferred asset of approximately $26.6 million and a valuation allowance of approximately $24.3 million. The Company will continue weighing various factors throughout the year to assess the need for any valuation allowance. Recoverability of the deferred tax assets is dependent on continued profitability from operations. Should the Company's level of profitability continue as expected, it would likely remove the entire valuation allowance in 2004. The Company would realize a one-time, non-cash benefit by decreasing its tax expense (causing an increase in earnings) by approximately $10.0 million to $14.0 million. Additionally, the Company would record a non-cash charge to increase additional reported paid-in capital by approximately $9.0 million.

The net deferred asset at December 31, 2003, includes a $2.3 million deferred tax liability recorded in the purchase accounting entries for the April 2003 Shana stock acquisition.

The Company has $50.1 million domestic federal net operating loss carryforwards that can be utilized to reduce future taxable income. Any unutilized net operating loss carryforward will begin expiring in 2013. The Company has $15.9 million tax credit carryforwards that will begin expiring in 2004.

At December 31, 2003, the Company had French, Canadian, Irish, Swedish and Austrian tax loss carryforwards relating to its foreign subsidiary operations that total approximately $4.2 million that will begin expiring in 2005.

No provision has been made for federal or state income taxes on the unremitted earnings of the Company's foreign subsidiaries (cumulative $63.7 million at December 31, 2003) since the Company plans to indefinitely reinvest all such earnings offshore. At December 31, 2003, the unrecognized deferred tax liability for these earnings was approximately $24.4 million.

Note 16 *Operating Segment and Geographic Information*

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 include Software, Hardware, Customer Support, and Professional Services and Education. The Software operating segment develops, markets, and sells a unified platform and framework for ECM software and solutions. The Hardware operating segment manufactures and markets the Company's line of OSAR libraries. The Customer Support segment provides after-sale support for software, as well as providing software upgrades under the Company's right to new versions program. The Professional Services and Education segment provides fee-based implementation and technical consulting services related to the Company's standard products and post-implementation training services.

The accounting policies of the Company's operating segments are the same as those described in Note 2 - Summary of Significant Accounting Policies - 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 segment data for the three years ended December 31, 2003, was as follows:

(In thousands)

	Software	Customer Support	Professional Services and Education	Hardware	Consolidated
Year Ended December 31, 2003					
Revenue	$ 149,214	$ 164,772	$ 48,061	$ 2,458	$ 364,505
Depreciation and amortization	10,725	5,724	2,827	102	19,378
Operating (loss) income	(58,409)	70,780	(542)	(746)	11,083
Assets	-	-	-	-	391,848
Capital expenditures	5,196	2,844	1,107	30	9,177
Year Ended December 31, 2002					
Revenue	$ 132,508	$ 149,847	$ 56,959	$ 7,703	$ 347,017
Depreciation and amortization	10,215	7,527	3,550	296	21,588
Operating (loss) income	(51,413)	60,258	(3,212)	(92)	5,541
Assets	-	-	-	-	328,036
Capital expenditures	5,146	3,881	1,601	197	10,825
Year Ended December 31, 2001					
Revenue	$ 119,014	$ 132,382	$ 69,186	$ 14,028	$ 334,610
Depreciation and amortization	10,835	8,540	4,377	597	24,349
Operating income	(59,296)	39,336	(3,259)	(539)	(23,758)
Assets	-	-	-	-	301,639
Capital expenditures	7,077	4,161	2,477	360	14,075

Revenue is attributed to geographic areas based on the location of the entity to which the products or services were sold. The operation in Ireland functions as a manufacturing and service center for non-United States and non-Latin America customers. An allocation of its assets among the geographic segments is not prepared for management reporting. All other geographic locations include South America, the Middle East and Africa. Information concerning principal geographic areas in which the Company operates was as follows:

(In thousands)

Year ended December 31,	**2003**		**2002**		**2001**	
	Revenue	*Assets*	*Revenue*	*Assets*	*Revenue*	*Assets*
North America:						
United States	$ 257,100	$ 283,073	$ 251,447	$ 251,928	$ 244,902	$ 234,408
Canada	7,971	22,627	5,581	5,398	6,787	6,143
Total North America	265,071	305,700	257,028	257,326	251,689	240,551
Europe:						
France	6,166	2,111	6,593	2,086	7,800	1,753
Germany	29,074	6,985	22,174	3,632	19,565	5,920
United Kingdom	18,930	20,810	22,950	18,145	16,851	18,275
Ireland	-	39,742	-	37,114	-	26,925
Other Europe	29,647	5,954	26,236	4,902	27,901	5,320
Total Europe	83,817	75,602	77,953	65,879	72,117	58,193
Asia Pacific	12,171	10,546	9,916	4,831	7,968	2,895
All other	3,446	-	2,120	-	2,836	-
Totals	$ 364,505	$ 391,848	$ 347,017	$ 328,036	$ 334,610	$ 301,639

Note 17 *Litigation*

In October 1994, Wang Laboratories, Inc. (“Wang”) filed a complaint in the United States District Court for the District of Massachusetts alleging that the Company was infringing five patents held by Wang (the “FileNet Case”). On June 23, 1995, Wang amended its complaint to include an additional related patent. On July 2, 1996, Wang filed a complaint in the same court alleging that Watermark Software Inc., a former wholly owned subsidiary of FileNet that was merged with the Company, was infringing three patents held by Wang (the “Watermark Case”). On October 9, 1996, Wang withdrew its claim in the FileNet Case that one of the patents it initially asserted was infringed.

On January 8, 1997, the court stayed the Watermark Case, subject to limited exceptions for certain discovery. The products at issue in the Watermark Case were phased out as of December 31, 1999. In March 1997, Eastman Kodak Company purchased the Wang imaging business unit that had responsibility for this litigation. On July 30, 1997, the court permitted Eastman Software and Kodak Limited of England to be substituted in the FileNet Case in place of Wang. On April 24, 2001, the court permitted Eastman Software and Kodak Limited to be substituted in the Watermark case in place of Wang.

On August 10, 2000, Eastman Kodak Company, Eastman Software and eiStream WMS, Inc. (“eiStream”) entered into an Asset Purchase and Sale Agreement (“APA”), under which eiStream acquired some, but not all, of the assets of Eastman Software.

Effective June 30, 2001, the Company and Eastman Kodak Company, the parent of Eastman Software, entered into an agreement that settled the FileNet Case. In accordance with that settlement agreement, the parties filed on July 5, 2001, a stipulation dismissing the FileNet Case.

On September 19, 2001, eiStream filed a complaint against Eastman Kodak Company and Eastman Software in the United States District Court for the district of Dallas County (the “eiStream Case”). eiStream sought, among other things, a declaratory judgment that pursuant to the terms of the APA, eiStream owns the Watermark Case and has the right to pursue claims in the Watermark Case regarding Watermark products sold prior to the phase out in December 1999 and that Eastman Kodak Company was required to obtain eiStream’s consent prior to settling the FileNet Case.

On October 15, 2001, Eastman Kodak Company filed its answer to eiStream’s complaint in which Eastman Kodak Company claimed ownership of the Watermark Case, denied that the APA gave eiStream ownership of the Watermark Case, and stated that eiStream’s claim that its consent was necessary prior to settling the FileNet Case was barred by principles of equitable estoppel.

Also on October 15, 2001, Eastman Kodak Company moved to abate the eiStream Case because the previously filed Watermark Case raises issues inherently related with issues raised in the eiStream Case and because certain necessary and indispensable parties were not properly joined in the eiStream Case.

On October 31, 2001, Eastman Kodak Company moved for leave to amend the original complaint filed in the Watermark Case to add eiStream as a party, to add the correct Eastman Kodak Company entities as plaintiffs and to add a declaratory judgment count seeking a judgment that Eastman Kodak Company, not eiStream, owns the Watermark Case.

In November 2001, Eastman Kodak Company and eiStream amended the APA and resolved all their disputes regarding Eastman Kodak Company’s right to settle the FileNet Case and the Watermark Case. Effective November 15, 2001, eiStream agreed that the June 30, 2001 agreement between the

Company and Eastman Kodak Company which settled the FileNet Case is in accordance with the APA, as amended, and that the Company and Eastman Kodak Company may dismiss the Watermark Case with prejudice.

Effective November 15, 2001, the Company and Eastman Kodak Company entered into an agreement that settled the Watermark Case. In accordance with that settlement agreement and the amended APA between Eastman Kodak Company and eiStream, the parties to the Watermark Case filed on November 16, 2001 a stipulation dismissing that case with prejudice. A stipulation of non-suit with prejudice was filed in the eiStream Case on November 19, 2001.

Subsequent to December 31, 1998, the former shareholders of Saros Corporation, a former wholly owned subsidiary of FileNet that was merged with the Company, filed a demand for mandatory arbitration to release approximately 375,700 shares of the Company's stock which were held in escrow pursuant to the Agreement and Plan of Merger dated January 17, 1996 among FileNET Corporation, FileNet Acquisition Corporation and Saros Corporation and for damages. The Company and the agent for the former Saros Shareholders ("Shareholders' Agent") had agreed to mediate the matter, but the Shareholders' Agent cancelled the mediation prior to the scheduled date and renewed the demand for mandatory arbitration. A binding arbitration proceeding took place during the period March 5, 2001 through March 23, 2001. On April 24, 2001 the arbitrators issued an interim decision denying all claims asserted by the Shareholders' Agent against the Company, sustaining all claims asserted by the Company, and awarding all of the shares of stock held in escrow to the Company. On June 7, 2001 the arbitrators issued a final award that reiterated the principal rulings set forth in the interim decision and awarded all of the stock held in the escrow to the Company. The final award further determined that the escrowed shares provide the exclusive source for the Company's recovery of its attorneys' fees and costs from the former stockholders of Saros. These shares were cancelled and retired when the Company received the certificates from the escrow agent in September 2001.

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

Note 18 *Guarantees and Indemnifications*

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

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

In connection with certain facility leases and other performance guarantees, the Company has guaranteed payments on behalf of some of its subsidiaries. To provide subsidiary guarantees, the Company obtains unsecured bank guarantees from local banks. These bank guarantees totaled an equivalent of approximately $1.6 million issued in local currency in Europe and Asia as of December 31, 2003. Approximately $587,000 of the $1.6 million is secured by cash deposit. Furthermore, the Company has signed an indemnity letter as a performance guarantee to a certain customer in Europe in local currency equivalent to $180,000 as of December 31, 2003.

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 and the maximum amount of potential future payments under such guarantees and indemnities is not determinable, other than as described above. The Company's product warranty liability as of December 31, 2003 is disclosed in this footnote under the heading "Product Warranties."

Note 19 *Other Financial Instruments*

The Company enters into forward foreign exchange contracts on the last business day of each quarter - all maturing in three months.

The following table summarizes the notional amounts of the Company's foreign currency agreements entered into on December 31, 2003 and 2002:

At December 31,	**2003**		**2002**	
	Notional Amount Purchased	*Notional Amount Sold*	*Notional Amount Purchased*	*Notional Amount Sold*
European	$ 17,907,065	$ 11,888,699	$ 16,721,200	$ 4,128,147
Australian	-	116,072	47,149	-
Asian	1,791,763	-	1,648,157	-
Canadian	-	7,878,703	574,604	-
Total	$ 19,698,828	$ 19,883,474	$ 18,991,110	$ 4,128,147

The following table summarizes the amounts due to (from) the Company for realized gains (losses) on the Company's foreign exchange contracts closed on December 31, 2003 and 2002 that were $656,210 and $952,917, respectively. The actual settlement with the banks occurs in January of the following year.

At December 31,	**2003**	**2002**
European	$ 984,788	$ 962,247
Australian	(16,573)	(12,531)
Asian	5,800	8,747
Canadian	(317,805)	(5,546)
Total	$ 656,210	$ 952,917

Note 20 *Quarterly Financial Information (Unaudited)*

The following table sets forth selected unaudited quarterly information for the Company's last eight fiscal quarters. This information has been prepared on the same basis as the Consolidated Financial Statements and all necessary adjustments (which consisted only of normal recurring adjustments) have been included in the amounts stated below to present fairly the results of such periods when read in conjunction with the Consolidated Financial Statements and related notes included elsewhere herein.

(In thousands, except per share amounts)

	First Quarter	*Second Quarter*	*Third Quarter*	*Fourth Quarter*	*Fiscal Year*
Year ended December 31, 2003:					
Revenue	$ 87,049	$ 87,117	$ 89,389	$ 100,950	$ 364,505
Gross profit	62,390	63,206	64,516	75,462	265,574
Income before income taxes	1,908	1,964	3,453	7,842	15,167
Net income	1,336	1,452	2,486	5,646	10,920
Basic earnings per share	0 .04	0.04	0.07	0.15	0.30
Diluted earnings per share	0 .04	0.04	0.06	0.14	0.29
Year ended December 31, 2002:					
Revenue	$ 86,241	$ 88,227	$ 83,102	$ 89,447	$ 347,017
Gross profit	58,692	60,974	58,316	63,459	241,441
Income (loss) before income taxes	1,818	2,205	1,804	4,923	10,750
Net income (loss)	1,364	1,734	1,389	3,785	8,272
Basic earnings (loss) per share	0.04	0.05	0.04	0.11	0.23
Diluted earnings (loss) per share	0.04	0.05	0.04	0.10	0.23

Note 21 *Subsequent Events*

The Company awarded 560,800 stock options with an option price of $28.19 to 301 employees during Q1 2004. This grant was made under the 2002 Incentive Award Plan. These shares vest over a four-year period and will be reported in accordance with APB 25 and FASB 123. This transaction is unaudited. The Company also awarded 132,500 shares of restricted stock to ten members of the senior management team during the first quarter of 2004 under the 2002 Incentive Award Plan. These shares of restricted stock vest over five years after the grant date and include a feature that allows the stock to vest on an accelerated basis provided certain performance targets are achieved. These restricted stock awards will be reported in accordance with ABP 25 and FASB 123. This transaction is unaudited.

INDEPENDENT AUDITORS' REPORT ON SCHEDULE

Stockholders and the Board of Directors
FileNet Corporation
Costa Mesa, California

We have audited the consolidated balance sheets of FileNet Corporation and its subsidiaries (the Company) as of December 31, 2003 and 2002, and the related consolidated statements of operations, comprehensive operations, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2003, and have issued our report thereon dated February 24, 2004 (which report expresses an unqualified opinion and includes an explanatory paragraph referring to a change in method of accounting for goodwill and other intangible assets in 2002). Such consolidated financial statements and reports are included elsewhere in this Form 10-K. Our audits also included the financial statement schedule of FileNet Corporation and its subsidiaries, listed in Item 15. This consolidated financial statement schedule is the responsibility of the Company's management. Our responsibility is to express an opinion based on our audits. In our opinion, such consolidated financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

/s/ Deloitte & Touche LLP

Deloitte & Touche LLP
Costa Mesa, California
February 24, 2004

SCHEDULE II

VALUATION AND QUALIFYING ACCOUNTS AND RESERVES

(In thousands)

	Balance at Beginning of Period	*Additions Charged to Revenue and Expenses*	*Deductions*	*Balance at End of Period*
Year ended December 31, 2003:				
Inventory reserves	$ 301	547	598	$ 250
Allowance for doubtful accounts and sales returns	$ 4,232	653	968	$ 3,917
Year ended December 31, 2002:				
Inventory reserves	$ 188	139	26	$ 301
Allowance for doubtful accounts and sales returns	$ 3,567	1,752	1,087	$ 4,232
Year ended December 31, 2001:				
Inventory reserves	$ 234	26	72	$ 188
Allowance for doubtful accounts and sales returns	$ 5,518	1,482	3,433	$ 3,567