FORM 10-Q

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

(Mark One)

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

For the quarterly period ended June 30, 2004

OR

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

For the transition period from ________ to ___________

Commission file number: 00-15997

FILENET CORPORATION
(Exact name of Registrant as specified in its charter)

Delaware	**95-3757924**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

3565 Harbor Boulevard, Costa Mesa, CA 92626
(Address of principal executive offices) (Zip code)

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

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark whether the Registrant is an accelerated filer as defined in Rule 12b-2 of the Securities Exchange Act of 1934:
Yes ☒ No ☐

As of August 5, 2004, there were 39,424,953 shares of the Registrant's common stock outstanding.

FILENET CORPORATION
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PART I. FINANCIAL INFORMATION

Item 1. Unaudited Condensed Consolidated Financial Statements

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

	June 30, 2004	December 31, 2003
ASSETS		
Current assets:		
Cash and cash equivalents	$ 224,172	$ 203,305
Short-term investments available for sale	57,790	32,286
Accounts receivable, net	33,821	38,096
Prepaid expenses and other current assets	12,879	13,174
Deferred income taxes	3,551	3,551
Total current assets	332,213	290,412
Property, net	25,597	26,922
Long-term investments available for sale	17,544	12,672
Goodwill	25,561	26,170
Intangible assets, net	6,679	7,979
Deferred income taxes	23,231	23,001
Other assets	3,260	4,692
Total assets	$ 434,085	$ 391,848
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 11,526	$ 11,006
Accrued compensation and benefits	23,456	27,648
Customer deposits and advances	6,742	5,217
Unearned maintenance revenue	60,288	40,691
Other accrued liabilities	15,455	16,524
Total current liabilities	117,467	101,086
Unearned maintenance revenue and other liabilities	3,208	1,614
Commitments and contingencies (Note 11)		
Stockholders' equity:		
Preferred stock - $0.10 par value; 7,000,000 shares authorized; none issued and outstanding		
Common stock - $0.01 par value; 100,000,000 shares authorized; 40,464,950 issued and 39,366,950 shares outstanding at June 30, 2004; and 38,906,640 shares issued and 37,808,640 shares outstanding at December 31, 2003	254,743	234,025
Retained earnings	70,255	64,098
Accumulated other comprehensive income	2,979	5,592
Treasury stock, at cost; 1,098,000 shares	(14,567)	(14,567)
Net stockholders' equity	313,410	289,148
Total liabilities and stockholders' equity	$ 434,085	$ 391,848

See accompanying notes to unaudited condensed consolidated financial statements.

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

	Three Months Ended June 30, 2004	Three Months Ended June 30, 2003	Six Months Ended June 30, 2004	Six Months Ended June 30, 2003
Revenue:				
Software	$ 32,677	$ 33,555	$ 74,028	$ 69,077
Customer support	47,072	41,760	92,342	81,156
Professional services and education	14,337	11,802	27,214	23,933
Total revenue	94,086	87,117	193,584	174,166
Costs:				
Software	3,128	3,608	6,651	6,616
Customer support	9,942	9,968	20,234	20,539
Professional services and education	11,154	10,335	21,992	21,415
Total cost of revenue	24,224	23,911	48,877	48,570
Gross Profit	69,862	63,206	144,707	125,596
Operating expenses:				
Sales and marketing	39,198	34,856	80,759	69,255
Research and development	19,703	19,680	39,805	38,982
General and administrative	9,394	8,326	18,627	16,152
Total operating expenses	68,295	62,862	139,191	124,389
Operating income	1,567	344	5,516	1,207
Other income, net	1,066	1,620	1,993	2,665
Income before income taxes	2,633	1,964	7,509	3,872
Provision for income taxes	474	512	1,352	1,084
Net income	$ 2,159	$ 1,452	$ 6,157	$ 2,788
Earnings per share:				
Basic	$ 0.06	$ 0.04	$ 0.16	$ 0.08
Diluted	$ 0.05	$ 0.04	$ 0.15	$ 0.08
Weighted-average shares outstanding:				
Basic	38,854	36,173	38,567	36,057
Diluted	41,099	37,296	40,942	36,960

See accompanying notes to unaudited condensed consolidated financial statements.

FILENET CORPORATION

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE OPERATIONS

(In thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Net income	$ 2,159	$ 1,452	$ 6,157	$ 2,788
Other comprehensive income (loss):				
Foreign currency translation adjustments	(1,474)	3,363	(2,388)	5,360
Unrealized losses on securities:				
Unrealized holding losses	(241)	(28)	(225)	(38)
Total other comprehensive income (loss)	(1,715)	3,335	(2,613)	5,322
Comprehensive income	$ 444	$ 4,787	$ 3,544	$ 8,110

See accompanying notes to unaudited condensed consolidated financial statements.

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

	Six Months Ended June 30,	
	2004	2003
Cash flows from operating activities:		
Net income	$ 6,157	$ 2,788
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	8,338	9,937
Loss on sale of property	12	28
Provision for doubtful accounts	31	26
Deferred income taxes	(230)	1,731
Changes in operating assets and liabilities, net of the effects of acquisitions:		
Accounts receivable	3,848	8,918
Prepaid expenses and other current assets	252	1,212
Accounts payable	606	(1,188)
Accrued compensation and benefits	(3,959)	1,633
Customer deposits and advances	1,540	(3,363)
Unearned maintenance revenue	21,536	9,965
Income taxes payable	2,127	(808)
Other	(1,127)	(2,628)
Net cash provided by operating activities	$ 39,131	$ 28,251
Cash flows from investing activities:		
Capital expenditures	(6,137)	(5,030)
Proceeds from sale of property	52	66
Note receivable	331	-
Cash paid for acquisition	-	(8,073)
Purchases of marketable securities	(60,904)	(60,199)
Proceeds from sales and maturities of marketable securities	29,715	64,305
Net cash used in investing activities	$ (36,943)	$ (8,931)
Cash flows from financing activities:		
Proceeds from issuance of common stock	20,481	4,187
Net cash provided by financing activities	$ 20,481	$ 4,187
Effect of exchange rate changes on cash and cash equivalents	(1,802)	3,669
Net increase in cash and cash equivalents	$ 20,867	$ 27,176
Cash and cash equivalents, beginning of year	203,305	130,154
Cash and cash equivalents, end of period	$ 224,172	$ 157,330
Supplemental cash flow information:		
Interest paid	$ 25	$ 32
Income taxes paid / (refunded)	$ (798)	$ 2,638

See Notes 4 and 10 for additional non-cash disclosures.

See accompanying notes to unaudited condensed consolidated financial statements.

FILENET CORPORATION
Notes To Condensed Consolidated Financial Statements
(Unaudited)

1. BASIS OF PRESENTATION

The accompanying unaudited interim condensed consolidated financial statements of FileNet Corporation (the "Company" or "FileNet") reflect all adjustments (consisting of normal recurring adjustments) necessary to present fairly the financial position of the Company at June 30, 2004, the results of its operations, its comprehensive operations and its cash flows for the three and six months ended June 30, 2004 and 2003. Certain information and footnote disclosures normally included in financial statements have been condensed or omitted pursuant to rules and regulations of the Securities and Exchange Commission (the "SEC"), although the Company believes that the disclosures in the condensed consolidated financial statements are adequate to ensure the information presented is not misleading. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto contained in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2003 filed with the SEC on March 12, 2004. The results of operations for the interim periods are not necessarily indicative of the operating results for the year, or any other future period.

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

2. NEW ACCOUNTING PRONOUNCEMENTS

In January 2003, the FASB issued FIN 46, "Consolidation of Variable Interest Entities." In general, a variable interest entity is a corporation, partnership, trust, or any other legal structure used for business purposes that either (a) does not have equity investors with voting rights or (b) has equity investors that do not provide sufficient financial resources for the entity to support its activities. FIN 46 requires a variable interest entity to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity's activities or entitled to receive a majority of the entity's residual returns or both. The consolidation requirements of FIN 46 apply immediately to variable interest entities created after January 31, 2003. With respect to variable interest entities created before January 31, 2003, in December 2003 the FASB issued FIN 46R, which, among other things, revised the implementation date to the first fiscal years or interim periods ending after March 15, 2004, with the exception of Special Purpose Entities ("SPE"). The consolidated requirements apply to all SPE's in the first fiscal year or interim period ending after December 15, 2003. The Company has determined that it does not have any SPE's to which these interpretations apply. The adoption of FIN 46R in 2004 has not had a material impact on the Company's consolidated financial statements.

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

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

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

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

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

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

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

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

3. STOCK BASED COMPENSATION

The Company accounts for stock based awards to employees using the intrinsic value method in accordance with Accounting Principles Board (APB) Opinion No. 25, “Accounting for Stock Issued to Employees.” The following table summarizes the Company’s net income (loss) and net income (loss) per share on a pro forma basis had compensation cost for the Company’s stock-based compensation plans been determined based on the provisions of SFAS No. 123, Accounting for Stock Based Compensation”, for the three and six months ended June 30, 2004 and 2003.

(In thousands, except per share amounts)	Three Months Ended June 30, 2004	Three Months Ended June 30, 2003	Six Months Ended June 30, 2004	Six Months Ended June 30, 2003
Net income, as reported	$ 2,159	$ 1,452	$ 6,157	$ 2,788
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(2,137)	(2,062)	(3,676)	(4,101)
Pro forma net income (loss)	$ 22	$ (610)	$ 2,481	$ (1,313)
Earnings (loss) per share:				
Basic earnings per share - as reported	$ .06	$ .04	$ .16	$ .08
Basic earnings (loss) per share - pro forma	.00	(.02)	.07	(.04)
Diluted earnings per share - as reported	.05	.04	.15	.08
Diluted earnings (loss) per share - pro forma	$ .00	$ (.02)	$ .06	$ (.04)

For purposes of computing proforma net income (loss), the Company estimates the fair value of each option grant and employee stock purchase plan right on the date of grant using the Black-Scholes option-pricing model. The Black-Scholes option-pricing model was developed for use in estimating the value of traded options that have no vesting restrictions and are fully transferable, while the options issued by the Company are subject to both vesting and restrictions on transfer. In addition, option-pricing models require input of highly subjective assumptions including the expected stock price volatility. The Company uses projected data for expected volatility and estimates the expected life of its stock options based upon historical data.

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

	Three Months Ended June 30, 2004	Three Months Ended June 30, 2003	Six Months Ended June 30, 2004	Six Months Ended June 30, 2003
Expected life (in years)	5.28	5.0	5.28	5.0
Expected volatility	67%	64%	51% - 67%	66%
Risk free interest rates	3.72%	3.31%	3.40%	3.56%
Expected dividend	0%	0%	0%	0%

4. ACQUISITIONS

On April 2, 2003, the Company completed a stock purchase acquisition of 100% of Shana Corporation (“Shana”), an electronic forms management company. This strategic acquisition provided technology and experience to expand the Company’s Electronic Content Management (“ECM”) offering with Enterprise Forms Management capability, which contributed to the purchase price and resulted in goodwill. The purchase price for the acquisition consisted of $8.55 million in cash consideration, less $938,000 of acquired cash, plus $184,000 in acquisition expenses and $277,000 paid for Non-Compete Agreements.

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

(In thousands)

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

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

The acquisition of Shana resulted in acquired technology, technical manuals and design documents, and customer maintenance relationships. Since Shana had recently completed Version 4.1 of its eForms product, there was no in-process research and development underway at the time of the acquisition. Shana's technology manuals and design documents are the "roadmaps" for the eForms technology and will be used by FileNet in its product development. Recurring maintenance revenues are expected and estimable for Shana's customers based on the older and newer versions of eForms technology. The acquired technology of $4.0 million, the technical manuals and design documents of $600,000, and the customer maintenance relationships of $800,000 were assigned a useful life of five years.

Although the goodwill stemming from the Shana stock purchase is non-deductible for Canadian tax purposes, a Section 338(g) election will result in the reduction of taxable income for U.S. tax purposes on this transaction by treating goodwill as tax deductible.

5. GOODWILL AND PURCHASED INTANGIBLE ASSETS

In acquisitions accounted for using the purchase method, goodwill is recorded as the difference, if any, between the aggregate consideration paid for an acquisition and the fair value of the net tangible and identified intangible assets acquired. Goodwill and indefinite life intangibles are not amortized, but are reviewed at least annually for possible impairment. Intangible assets with definite lives must be amortized over their estimated useful lives.

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

(In thousands) **Goodwill by Reporting Segment**		*Balance at December 31, 2003*		*Foreign Currency Change*		*Balance at June 30, 2004*
Software	$	15,144	$	(353)	$	14,791
Customer Support		5,858		(136)		5,722
Professional Services & Education		5,168		(120)		5,048
Total	$	26,170	$	(609)	$	25,561

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

Intangible assets subject to amortization consist of the following:

	June 30, 2004					December 31, 2003				
(In thousands) ***Intangible Assets***		*Gross Asset*	*Accumulated Amortization*		*Net*		*Gross Asset*	*Accumulated Amortization*		*Net*
Acquired technology and other intangibles	$	9,700	(3,181)	$	6,519	$	10,020	(2,272)	$	7,748
Non-compete agreements		304	(144)		160		317	(90)		227
Patents		28	(28)		-		28	(24)		4
Total	$	10,032	(3,353)	$	6,679	$	10,365	(2,386)	$	7,979

Acquired technology is being amortized over a useful life of five years, patents with a two year life are fully amortized and non-compete agreements are being amortized over three years. Amortization expense for intangible assets was $513,000 for the three months ended June 30, 2004 compared to $494,000 for the comparable period in 2003. Amortization expense for amortizing intangible assets was $1,040,000 for the six months ended June 30, 2004 compared to $677,000 for the comparable period in 2003.

Estimated future amortization expense (excluding foreign exchange effect) of purchased intangible assets as of June 30, 2004 is as follows:

(In thousands) **Fiscal Year**		**Amount**
(Remainder) 2004	$	1,028
2005		2,024
2006		1,958
2007		1,373
2008		296
	$	6,679

6. EARNINGS PER SHARE

Basic earnings per share is computed by dividing net income for the period by the weighted-average number of common shares outstanding during the period. Diluted earnings per share is computed by dividing net income by the weighted-average number of common shares outstanding plus the dilutive effect of outstanding stock options, shares issuable under the employee stock purchase plan and restricted stock issued to key executive management using the treasury stock method. The number of anti-dilutive options excluded from the EPS calculation for the three and six-month period ended June 30, 2004 were 2,245,812 and 2,375,506 shares, compared to 1,123,000 and 903,000 for the comparable periods in 2003. The following table sets forth the computation of basic and diluted earnings per share for the three and six-month period ended June 30, 2004 and 2003:

	Three Months Ended June 30,		Six Months Ended June 30,	
(In thousands, except per share amounts)	2004	2003	2004	2003
Net Income	$ 2,159	$ 1,452	$ 6,157	$ 2,788
Shares used in computing basic earnings per share	38,853	36,173	38,567	36,057
Dilutive effect of stock plans	2,246	1,123	2,375	903
Shares used in computing diluted earnings per share	41,099	37,296	40,942	36,960
Earnings per basic share	$ 0.06	$ 0.04	$ 0.16	$ 0.08
Earnings per diluted share	$ 0.05	$ 0.04	$ 0.15	$ 0.08

7. ACCUMULATED OTHER COMPREHENSIVE INCOME

Accumulated other comprehensive income for the six months ended June 30, 2004 is comprised of the following:

(In thousands)	Foreign Currency Translation Adjustment	Unrealized Holding Loss on Securities	Accumulated Other Comprehensive Income
Balance, December 31, 2003	$ 5,645	$ (53)	$ 5,592
Six month period changes	(2,388)	(225)	(2,613)
Balance, June 30, 2004	$ 3,257	$ (278)	$ 2,979

8. OPERATING SEGMENT DATA

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

The Company’s reportable operating segments effective January 1, 2004 include Software, Customer Support, and Professional Services and Education. The residual operating activity of the previously reported Hardware reporting segment has been combined with the Customer Support reporting segment. There have been no new hardware sales; only spare parts and supplies. Prior year hardware amounts have been reclassified into customer service to conform to the new segment presentation.

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

The accounting policies of the Company’s operating segments are the same as those described in Item 2 – Critical Accounting Policies and Estimates - except that the disaggregated financial results of the segments reflect allocation of certain functional expense categories consistent with the basis and manner in which Company management internally disaggregates financial information for the purpose of assisting in making internal operating decisions. The Company evaluates performance based on stand-alone segment operating income. Because the Company does not evaluate performance based on the return on assets or on interest income at the operating segment level, assets and interest income are not tracked internally by segment. Therefore, such information is not presented.

Operating segments data for the three and six months ended June 30, 2004 and 2003 are as follows:

	Three months ended June 30,		Six months ended June 30,	
(In thousands)	2004	2003	2004	2003
Software				
Revenue	$ 32,677	$ 33,555	$ 74,028	$ 69,077
Operating loss	(22,739)	(16,220)	(38,600)	(29,221)
Customer Support				
Revenue	$ 47,072	$ 41,760	$ 92,342	$ 81,156
Operating income	22,906	17,130	42,460	31,916
Professional Services and Education				
Revenue	$ 14,337	$ 11,802	$ 27,214	$ 23,933
Operating income (loss)	1400	(566)	1,656	(1,488)
Total				
Revenue	$ 94,086	$ 87,117	$ 193,584	$ 174,166
Operating income	1,567	344	5,516	1,207

9. STOCK OPTIONS

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

	Number of Options	Weighted Average Exercise Price
Balance, March 31, 2004	7,394,641	$ 17.68
Granted (weighted-average fair value of $13.91)	161,000	27.23
Exercised	(532,668)	14.22
Canceled	(66,977)	19.79
Balance, June 30, 2004	6,955,996	$ 18.08

The following table summarizes information concerning outstanding and exercisable stock options at June 30, 2004:

Options Outstanding				Options Exercisable	
Range of Exercise Price	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
$ 1.39 – 9.50	806,105	3.43	$ 8.01	801,524	$ 7.99
9.75 – 12.86	1,134,584	7.38	12.35	561,575	11.99
12.97 – 14.19	1,105,559	6.93	13.47	636,666	13.54
14.39 – 18.45	1,113,864	6.91	16.90	732,553	16.90
19.53 – 25.00	1,201,436	6.03	22.84	1,082,147	22.98
25.28 – 41.84	1,594,448	8.09	27.99	482,153	28.81
$ 1.39 – 41.84	6,955,996	6.72	$ 18.08	4,296,618	$ 16.97

10. ISSUANCE OF RESTRICTED STOCK

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

These shares were valued at approximately $3.6 million based on the March 9, 2004 closing price of $27.47 per share. The grant value of $3.6 million is recorded in the equity section of the balance sheet as an increase in common stock and a contra-equity offset to deferred compensation. Expense related to the shares is amortized on a straight-line basis through December 31, 2008. Recognition of expense may be accelerated if it becomes probable that certain performance targets will be achieved that trigger accelerated vesting of the restricted shares. Approximately $188,407 and $233,956 of compensation expense were recognized in the three and six-month periods ended June 30, 2004, with no acceleration.

11. COMMITMENTS AND CONTINGENCIES

Leases

The Company leases its corporate offices, sales offices, development and manufacturing facilities, and other equipment under non-cancelable operating leases, some of which have renewal options and generally provide for escalation of the annual rental amount. Amounts related to deferred rent are recorded in other accrued liabilities on the consolidated balance sheet. Future annual minimum lease payments under all non-cancelable operating leases with an initial term in excess of one year as of June 30, 2004 were as follows:

(In thousands)		
2004 (remaining 6 months)	$	6,295
2005		8,514
2006		10,882
2007		9,920
2008		8,670
2009		6,322
Thereafter		5,844
Total	$	56,447

Product Warranties

The Company provides a 90-day warranty for its software products against substantial nonconformance to the published documentation at time of delivery. For software products, the Company records the estimated cost of technical support during the warranty period. A provision for these estimated warranty costs is recorded at the time of sale or license. A small warranty is reserved for non-software products. If the Company were to experience an increase in warranty claims compared with historical experience, or costs of servicing warranty claims were greater than the expectations on which the accrual had been based, gross margins could be adversely affected.

The following table represents the warranty accrual for the six months ended June 30, 2004 and 2003:

(In thousands)		**2004**		**2003**
Beginning balance at January 1	$	479	$	728
Additions		578		396
Deductions		(693)		(636)
Ending balance at June 30	$	364	$	488

Guarantees and Indemnities

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

In connection with certain facility leases and other performance guarantees, the Company has guaranteed payments on behalf of some of its domestic and foreign subsidiaries. To provide subsidiary guarantees, the Company obtains unsecured bank guarantees from local banks. These bank guarantees totaled an equivalent of approximately $2.5 million as of June 30, 2004. Approximately $1.5 million was issued in local currency in Europe and Asia, while the balance was issued in the United States. Approximately $0.6 million of the $2.5 million is secured by cash deposit.

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

The Company has not recorded a liability for the guarantees and indemnities described above in the accompanying consolidated balance sheet, as the estimated fair value of these items is de minimis. Also, the maximum amount of potential future payments under such guarantees and indemnities is not determinable, other than as described above. The Company's product warranty liability as of June 30, 2004 is disclosed in this item under the heading "Product Warranties."

Legal Proceedings

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

12. FOREIGN CURRENCY TRANSACTIONS

As of June 30, 2004, the Company had forward foreign exchange contracts outstanding totaling approximately $1.4 million in 10 currencies. These contracts were opened on the last business day of the quarter and mature within three months. Accordingly, the fair value of such contracts is zero at June 30, 2004.

13. INCOME TAXES

The Company's combined federal, state and foreign annual effective tax rate for the three months ended June 30, 2004 is 18% compared to 26% for the comparable period in 2003. The Company's combined federal, state and foreign annual effective tax rate for the six months ended June 30, 2004 is 18% compared to 28% for the comparable period in 2003. The provision for income taxes differs from the tax computed at the federal statutory income tax rate due primarily to earnings considered as permanently reinvested in foreign operations with lower tax rates and reductions in the domestic deferred tax valuation allowance as net operating loss carryforwards were utilized. The decreased tax rate in six months ended June 30, 2004 was primarily due to the mix of income earned by domestic operations versus the foreign subsidiaries.

The Company is continually assessing the valuation allowance related to its deferred tax assets. As of June 30, 2004, the Company has a net tax deferred asset of approximately $26.6 million and valuation allowance of approximately $24.3 million. The Company will continue weighing various factors throughout the year to assess the need for any valuation allowance. Recoverability of the deferred tax assets is dependent on continued profitability from operations, as well as the geographic region generating the profits. Should the Company's level of domestic profitability continue at the current rate, it would likely remove the entire valuation allowance later in 2004. A one-time, non-cash benefit would be realized by decreasing tax expense (causing an increase in earnings) by approximately $7.0 million to $9.0 million. Additionally, a non-cash increase to additional paid-in-capital of approximately $9.0 million would be recorded.

14. RELATED-PARTY TRANSACTIONS

In July 2001, the Compensation Committee of the Company's Board of Directors (the "Board") entered into discussions with Lee Roberts, the Company's Chief Executive Officer, regarding a secured loan by the Company to Mr. Roberts for $1.9 million to enable him to purchase a home in Orange County, California. The note bears interest at 2.89% per annum. On June 5, 2002, the Board approved the loan.

Mr. Roberts is current with all payments and obligations of this agreement. Mr. Roberts made two payments, of $37,000 in February 2003 and $53,000 in February 2004, toward the accrued interest balance in accordance with the terms and conditions of the loan agreement. Mr. Roberts also made two payments in December 2003 and June 2004 of approximately $294,000 and $331,000, respectively, toward the principal loan balance of $1.9 million. As of June 30, 2004, the outstanding balance on the secured note receivable from Mr. Roberts is approximately $1.275 million and is included in other assets on the consolidated balance sheet. The accrued interest balance as of June 30, 2004 was approximately $22,000. Please reference Note No. 4 of our December 31, 2003 Report 10-K filing for additional details of the terms and conditions of this loan.

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

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 21E of the Securities and Exchange Act of 1934, as amended, and Section 27A of the Securities Act of 1933, as amended, and is subject to the safe harbors created by those sections. Words such as "anticipates," "expects," "intends," "plans," "believes," "seeks," "estimates," "may," "will" and variations of these words or similar expressions are intended to identify forward-looking statements. In addition, any statements that refer to expectations, projections or other characterizations of future events or circumstances, including any underlying assumptions, are forward-looking statements. These statements are not guarantees of future performance and are subject to risks, uncertainties and assumptions that are difficult to predict. Therefore, our actual results could differ materially and adversely from those expressed in any forward-looking statements as a result of various factors. We undertake no obligation to revise or publicly release the results of any revisions to these forward-looking statements. Readers should carefully review the risk factors described below under the heading "Risk Factors That May Affect Future Results" and in other documents we file from time to time with the Securities and Exchange Commission, including our Annual Report on Form 10-K for the fiscal year ended December 31, 2003. Our filings with the Securities and Exchange Commission, including our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to those filings, pursuant to Sections 13(a) and 15(d) of the Securities Exchange Act of 1934, are available free of charge at www.filenet.com, when such reports are available at the Securities and Exchange Commission Web site.

Overview

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, commonly called unstructured content, includes, but is not limited to: Web pages, word processing documents, spreadsheets, HTML, XML, PDF, document images, email messages and other electronic content. Our software offers customers the ability to configure, design, build and deploy ECM solutions to meet the needs of their particular business or organization. These solutions allow customers to manage content throughout their organizations, automate and streamline their business processes, and provide the broad-spectrum of connectivity needed to support their critical and everyday decision making.

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

Software

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

Services and Support

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

Professional Services and Education

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

Research and Development

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

Critical Accounting Policies and Estimates

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

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

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

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

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

Professional services revenue consists of consulting and implementation services provided to end users of our software products and technical consulting services provided to our resellers. Consulting engagements average from one to three months. Revenue from these services and from training classes is recognized as such services are delivered and accepted by the customer. Professional services are not required for the software to function. We do not make changes to the standard software code in the field.

Allowance for Doubtful Accounts and Sales Returns. We evaluate the creditworthiness of our customers prior to order fulfillment, and we perform ongoing credit evaluations of our customers to adjust credit limits based on payment history and the customer's current creditworthiness. We monitor collections from our customers and maintain an allowance for estimated credit losses that is based on historical experience and on specific customer collection issues. While credit losses have historically been within our expectations and the provisions established in our financial statements, we cannot guarantee that we will continue to experience the same credit loss rates that we have in the past. Since our revenue recognition policy requires customers to be creditworthy, our accounts receivable are based on customers whose payment is reasonably assured. Our accounts receivable are derived from sales to a wide variety of customers. We do not believe a change in liquidity of any one customer or our inability to collect from any one customer would have a material adverse impact on our consolidated financial position. Based on historical experience, we also maintain a sales return allowance for the estimated amount of returns. While product returns have historically been minimal and within our expectations and 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. Goodwill is recorded at cost and is not amortized. Goodwill is tested for impairment at least annually and written down when impaired. Effective the first day of July of each year, goodwill is tested for impairment by determining if the carrying value of each reporting unit exceeds its fair value. We also periodically evaluate whether events and circumstances have occurred in between annual testing dates that indicate the carrying value of goodwill may not be recoverable. We performed an impairment analysis as of July 1, 2003 in accordance with SFAS 142. The results indicated there was no impairment of goodwill in any of the three reporting units. As of June 30, 2004, there have been no indicators of impairment, and no impairment of goodwill has been recognized. If estimates change, a materially different impairment conclusion could result.

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

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

We are continually assessing the valuation allowance related to our deferred tax assets. As of June 30, 2004, we have a net tax deferred asset of approximately $26.8 million and valuation allowance of approximately $24.3 million. We will continue weighing various factors throughout the year to assess the need for any valuation allowance. Recoverability of the deferred tax assets is dependent on continued profitability from operations, as well as the geographic region generating the profits. Should our level of domestic profitability continue at the current rate, we would likely remove the entire valuation allowance later in 2004. We would realize a one-time, non-cash benefit by decreasing our tax expense (causing an increase in earnings) by approximately $7.0 million to $9.0 million. Additionally, we would record a non-cash increase to additional paid-in-capital of approximately $9.0 million.

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

Results of Operations

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

	Three Months Ended June 30,				Six Months Ended June 30,			
	2004		2003		2004		2003	
Revenue:								
Software	34.8	%	38.5	%	38.2	%	39.7	%
Customer support	50.0		48.0		47.7		46.6	
Professional services and education	15.2		13.5		14.1		13.7	
Total Revenue	100.0		100.0		100.0		100.0	
Cost of revenue:								
Software	3.3		4.1		3.4		3.8	
Customer support	10.5		11.4		10.4		11.8	
Professional services and education	11.9		11.9		11.4		12.3	
Total cost of revenue	25.7		27.4		25.2		27.9	
Gross Profit	74.3		72.6		74.8		72.1	
Operating expenses:								
Sales and marketing	41.7		40.0		41.7		39.8	
Research and development	20.9		22.6		20.6		22.4	
General and administrative	10.0		9.6		9.6		9.2	
Total operating expenses	72.6		72.2		71.9		71.4	
Operating income	1.7		.4		2.9		.7	
Other income, net	1.1		1.9		1.0		1.5	
Income before income tax	2.8	%	2.3	%	3.9	%	2.2	%

Revenue

As more fully discussed below, total revenue increased by 8.0% in the quarter ended June 30, 2004 compared to the same period in 2003 and increased 11.1% in the six-month period ended June 30, 2004 compared to the same period in 2003. We believe that the increase in total revenue is attributable to an increase in the growth of unstructured content within our customer base creating a demand for our products and services to manage this content and automate it for use in their business processes.

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

Revenue by Geography

	Three Months Ended June 30,			Six Months Ended June 30,		
(In thousands)	2004	2003	% Increase/ decrease	2004	2003	% Increase/ decrease
Total United States Revenue	$ 66,288	$ 57,708	14.9%	$ 134,288	$ 117,165	14.6%
Europe, Middle East and Africa	22,225	23,521	(5.5%)	47,542	45,655	4.1%
Canada, Latin America and Asia	5,573	5,888	(5.3%)	11,754	11,346	3.6%
Total International Revenue	27,798	29,409	(5.5%)	59,296	57,001	4.0%
Total Revenue	$ 94,086	$ 87,117	8.0%	$ 193,584	$ 174,166	11.1%
United States Revenue	70.5 %	66.2 %		69.4 %	67.3 %	
International Revenue	29.5 %	33.8 %		30.6 %	32.7 %	
Total Revenue Contribution	100.0 %	100.0 %		100.0 %	100.0 %	

Revenue generated in the United States grew by 14.6% in the first six months of 2004 compared to the same period in 2003 and by 14.9% in the second quarter of 2004 over the comparable prior year quarter. As more fully discussed below, this increase is primarily due to the increase in service revenue. The revenue growth in the United States was partially offset by reduced international revenue in the second quarter of 2004 compared to the same quarter a year ago. International revenue represented approximately 31% of total revenue in the first six months of 2004 compared to approximately 33% for the same six months in 2003. We believe the same content management factors mentioned above drive international revenue growth in the long term and are not regional in nature, but are subject to minor periodic fluctuations like those experienced in the second quarter of 2004. We expect international revenue to continue to represent a significant opportunity for us. However, international revenues will be adversely affected if the U.S. dollar strengthens against certain major international currencies or if international economic conditions weaken.

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

Revenue by Reporting Segment

(*In thousands*)	Three Months Ended June 30, 2004	Three Months Ended June 30, 2003	% Increase / (decrease)	Six Months Ended June 30, 2004	Six Months Ended June 30, 2003	% Increase (decrease)
Software	$ 32,677	$ 33,555	(2.6%)	$ 74,028	$ 69,077	7.2%
Customer Support	47,072	41,760	12.7%	92,342	81,156	13.8%
Professional Services and Education	14,337	11,802	21.5%	27,214	23,933	13.7%
Total Revenue	$ 94,086	87,117	8.0%	193,584	174,166	11.1%
Software	34.7%	38.5%	(3.8)%	38.2%	39.7%	(1.4)%
Customer Support	50.0%	47.9%	2.1%	47.7%	46.6%	1.1%
Professional Services and Education	15.3%	13.6%	1.7%	14.1%	13.7%	0.3%
Total Revenue Contribution	100.0%	100.0%		100.0%	100.0%	

Software. Software revenue consists of fees earned from the licensing of our software products to our customers. Software revenue decreased by 2.6% in the three-month period ended June 30, 2004, compared to the same period in 2003, primarily attributable to a small decrease in demand for our software products during the second quarter of 2004 and delays in some customer procurement cycles. However, due to higher software revenue in the first quarter of 2004, software revenue increased by 7.2% in the six-month period ended June 30, 2004 compared to the same period in 2003. We believe spending on enterprise content management and business process management software will be a priority in the near term, but is subject to customer buying patterns that can fluctuate. In the long-term we believe there will be increased demand for our ECM products that is driven by the need for large organizations to manage unstructured content.

Customer Support. Customer support revenue consists of revenue from software maintenance contracts, time and material revenues and the sale of Optical Storage and Retrieval ("OSAR") libraries, spare parts and supplies. Maintenance contracts entitle our customers to receive technical support, enhancements and upgrades to new versions of software releases when and if available. Customer support revenue increased by 12.7% in the three-month period ended June 30, 2004 compared to the same period in 2003 and increased 13.8% in the six-month period ended June 30, 2004 compared to the same period in 2003. Customer support revenue is generated from new maintenance contracts for new system sales and from the renewal of existing maintenance contracts for previously sold software licenses on installed systems. We have historically experienced a high contract maintenance renewal rate and continue to see this same high level of renewal, but are continuing to encounter pricing pressures from our customers during contract negotiation and renewal. Accordingly, the rate of software revenue growth may not directly result in the same growth for customer support revenue experienced in the past.

Professional Services and Education. Professional services and education revenue is generated from consulting and implementation services to end users of our software products, technical consulting services provided to our resellers, and training services. No modifications are made to our standard base product code once the software has been sold. Professional services and education revenue increased by 21.5% in the three month period ended June 30, 2004 compared to the same period in 2003 and 13.7% in the six-month period ended June 30, 2004 compared to the same period in 2003. Professional services revenue is dependent on the level and the nature of software sales in prior periods. Professional services revenue grows more rapidly when customers purchase new systems for a large scale implementation or purchase our FileNet P8 product to replace legacy systems, as opposed to existing customers purchasing add-on licenses for installed systems. The increase in professional services revenue we experienced in the first six months of 2004 compared to the same period in 2003 was primarily attributable to an increased demand for consulting services to existing customers that migrate their custom applications to the new FileNet P8 platform. Based on software revenue sales for the past two quarters we do not believe the level of demand for professional services and education services will change significantly from current levels.

Cost of Revenue

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

Cost of Revenue by Reporting Segment

	Three Months Ended June 30,			Six Months Ended June 30,		
(*In thousands)*	2004	2003	% Increase/ (decrease)	2004	2003	% Increase/ (decrease)
Software	$ 3,128	$ 3,608	(13.3)%	$ 6,651	$ 6,616	0.5%
Customer Support	9,942	9,968	(0.3)%	20,234	20,539	(1.5)%
Professional Services and Education	11,154	10,335	7.9%	21,992	21,415	2.7%
Total Cost of Revenue	$ 24,224	23,911	1.3%	48,877	48,570	0.6%
Software	9.6%	10.8%	(1.2)%	9.0%	9.6%	(0.6)%
Customer Support	21.1%	23.9%	(2.7)%	21.9%	25.3%	(3.4)%
Professional Services and Education	77.8%	87.6%	(9.8)%	80.8%	89.5%	(8.7)%
Total Cost of Revenue as a % of Revenue	25.7%	27.5%		25.2%	25.9%	

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 in absolute dollars decreased 13.3% when comparing the three months ended June 30, 2004 to the same three months in 2003 and the six month comparison for these two years resulted in a slight 0.5% increase. The cost of software revenue as a percent of software revenue decreased 1.2 percentage points and 0.6 percentage points in the three and six-month periods ended June 30, 2004, compared to the same periods in 2003. While these costs will fluctuate period to period based on the mix of products sold containing third party product, our royalty costs have decreased due to more favorable royalty rates that have been negotiated during the renewal process over the past year. However, going forward we anticipate the cost of software revenue to increase slightly to approximately 10% of software revenue as we continue to integrate third-party technology with our products.

Customer Support. Cost of customer support revenue includes the cost of customer support personnel, facility and technology infrastructure expenses in our call centers, supplies and spare parts. The cost of customer support revenue as a percent of customer support revenue decreased by 2.7 percentage points and 3.4 percentage points in the three and six-month periods ended June 30, 2004 compared to the same periods in 2003. The cost of customer support revenue in absolute dollars also decreased in these comparable periods. This reduction in cost of customer support revenue, as a percentage of the revenue and in absolute dollars is attributable to efficiency improvements in the delivery of technical support, which allows for increased revenue without a comparable increase in expense. We expect the cost of customer support revenue to remain fairly constant as a percent of customer support revenue for the near future.

Professional Services and Education. Cost of professional services and education revenue consists primarily of the costs of professional services personnel, training personnel, and third-party contractors. The cost of professional services and education revenue, as a percent of professional services and education revenue, decreased by 9.8 percentage points and 8.7 percentage points in the three and six-month periods ended June 30, 2004 as compared to the same periods in 2003. This decrease in cost of professional services and education revenue as a percent of professional services and education revenue is primarily attributable to higher professional services and education revenue in 2004 compared to 2003, along with lower costs associated with reduced employee headcount and lower variable employee compensation. We expect professional services and education costs as a percentage of professional services and education revenue to vary from period to period depending on the utilization rates of internal resources, the level of revenue and the mix between internal and external service providers.

Operating Expenses

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

Operating Expenses

	Three Months Ended June 30,			Six Months Ended June 30,		
(In thousands)	2004	2003	% Increase/ (decrease)	2004	2003	% Increase/ (decrease)
Research and Development	$ 19,703	$ 19,680	0.1%	$ 39,805	$ 38,982	2.1%
Marketing and Sales	39,198	34,856	12.5%	80,759	69,255	16.6%
General and Administrative	9,394	8,326	12.8%	18,627	16,152	15.3%
Total Operating Expenses	$ 68,295	$ 62,862	8.6%	$ 139,191	$ 124,389	11.9%
Research and Development	20.9%	22.6%	(1.6)%	20.6%	22.4%	(1.8)%
Marketing and Sales	41.7%	40.0%	1.7%	41.7%	39.8%	2.0%
General and Administrative	10.0%	9.6%	0.4%	9.6%	9.3%	0.3%
Operating Expense as a % of Revenue	72.6%	72.2%		71.9%	71.4%	

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 our FileNet P8 platform and suites such as Business Process Management, Web Content Management, Records Management, Team Collaboration and other capabilities.

Our research and development expense consists primarily of personnel costs for internal software developers; third party contracted development resources and related facilities costs. Research and development expense was approximately the same in the three and six-month periods ended June 30, 2004 compared to the same periods in 2003. However, this quarter the expense mix changed with lower internal personnel costs and higher offshore development expense. The number of internal research and development personnel was 446 on June 30, 2004 compared to 472 on June 30, 2003. We currently have 94 contract workers in India developing software compared to 48 one year ago.

Research and development expense decreased as a percent of revenue by 1.6 percentage points and 1.8 percentage points for the three and six months ended June 30, 2004 compared to the same periods in 2003. This decrease is primarily attributable to increased revenue levels without a corresponding expense increase due to lower internal personnel and facility expense resulting from the decreased headcount that more than offset the increased offshore development expense. We believe we will be able to further decrease our per-developer cost through the expanded use of offshore resources, however in the near term, some duplicate expenses will be incurred as our development programs are transitioned to these offshore development resources. We believe that research and development expenditures, including compensation of technical personnel, are essential to maintaining our competitive position. We expect research and development expense to be at approximately 20% of revenue for the near term.

Selling and Marketing. We sell our products through a direct sales force and our indirect channel sales partners. The majority of our selling and marketing expense is salaries, benefits, sales commissions and other expenses related to the direct and indirect sales force, and personnel cost for marketing and market development programs. Selling and marketing expense as a percent of revenue increased by 1.7 percentage points and 2.0 percentage points for the three and six-months ended June 30, 2004 compared to the same period in 2003. In absolute dollars selling and marketing expense increased by 12.5% and 16.5% for the three and six-months ended June 30, 2004. Approximately $9.3 million of the year to date increase is attributable to organizational changes that resulted in higher salaries, higher variable compensation and associated benefits. Additionally, we experienced higher travel expense and we granted merit increases in 2004. We expect selling and marketing expense to remain at approximately 41% of revenue in the near-term.

General and Administrative. Our general and administrative expense consists primarily of salaries, benefits, and other expenses related to personnel costs for finance, information technology, legal, human resources and general management and the cost of outside professional services. General and administrative expense as a percent of revenue increased 0.4 percentage points and 0.3 percentage points in the three and six-month periods ended June 30, 2004 compared to the same periods in 2003. In absolute dollars general and administrative expenses increased 12.8% and 15.3% in the three and six-month periods ended June 30, 2004 compared to the same periods in 2003. The increases in general and administrative expense between the comparative periods reflects higher salary costs and benefits due to increased headcount as well as increased legal and accounting fees associated with compliance to recently mandated corporate governance regulations. We expect general and administrative expense to remain at approximately 10% of revenue in the near-term.

Other Income, Net. Other income, net consists primarily of interest income earned on our cash and investments, and other items including foreign exchange gains and losses and interest expense. Other income, net of other expenses, was $1,066,500 and $1,993,500 for the three and six-month periods ended June 30, 2004 compared to $1,619,500 and $2,664,900 during for the three and six-month periods ended June 30, 2003. We experienced a foreign exchange gain of approximately $748,000 in the second quarter of 2003 that did not reoccur in 2004. The weighted average interest rate earned on cash, cash equivalents and investments was 1.60% during the six months ended June 30, 2004 compared to 1.43% for the same period in 2003.

Provision for Income Taxes. Our combined federal, state and foreign annual effective tax rate for the three and six-month periods ended June 30, 2004 is 18% compared to 26% and 28% for the comparable periods in 2003. The provision for income taxes differs from the tax computed at the federal statutory income tax rate due primarily to earnings considered as permanently reinvested in foreign operations with lower tax rates and reductions in our domestic deferred tax valuation allowance. The decreased tax rate in the three and six-month period ended June 30, 2004 was primarily due to the mix of income earned by our domestic operations versus the foreign subsidiaries.

Liquidity and Capital Resources

At June 30, 2004, combined cash, cash equivalents and investments totaled $299.5 million, an increase of $51.3 million and $8.5 million from December 31, 2003 and March 31, 2004, respectively.

Cash provided by operating activities during the six month period ended June 30, 2004 totaled $39.1 million and resulted primarily from: an increase in unearned maintenance revenue related to prepaid maintenance contracts of $21.5 million; a decrease in customer receivables of $3.8 million; depreciation and amortization expense of $8.3 million; and net income of $6.2 million. The increase in unearned maintenance revenue is primarily the result of the growth in our base of annual support contracts resulting from new customer sales and sales of additional products to the existing base. Additionally, a significant number of maintenance contracts renew early in the year and are amortized ratably throughout the year resulting in a lower balance in unearned maintenance by December 31.

Cash provided by financing activities totaled $20.5 million and was a result of proceeds received from the exercise of employee stock options and stock purchases under the employee stock purchase plan.

Net cash used in investing activities was $36.9 million comprised of $31.2 million for the purchase of marketable securities in excess of proceeds and $6.1 million for capital expenditures.

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

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

Other Financial Instruments

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

New Accounting Pronouncements

In January 2003, the FASB issued FIN 46, "Consolidation of Variable Interest Entities." In general, a variable interest entity is a corporation, partnership, trust, or any other legal structure used for business purposes that either (a) does not have equity investors with voting rights or (b) has equity investors that do not provide sufficient financial resources for the entity to support its activities. FIN 46 requires a variable interest entity to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity's activities or entitled to receive a majority of the entity's residual returns or both. The consolidation requirements of FIN 46 apply immediately to variable interest entities created after January 31, 2003. With respect to variable interest entities created before January 31, 2003, in December 2003 the FASB issued FIN 46R, which, among other things, revised the implementation date to the first fiscal years or interim periods ending after March 15, 2004, with the exception of Special Purpose Entities ("SPE"). The consolidated requirements apply to all SPE's in the first fiscal year or interim period ending after December 15, 2003. We have determined that we do not have any SPE's to which these interpretations apply. The adoption of FIN 46R in 2004 has not had a material impact on our consolidated financial statements.

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

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

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

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

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

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

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

SFAS No. 150 is to be implemented by reporting the cumulative effect of a change in accounting principle. We do not have financial instruments with characteristics of both debt and equity and therefore, the adoption of SFAS No. 150 has not had a material impact on our consolidated financial statements.

Other Matters

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

Risk Factors That May Affect Future Results

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

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

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

- Information Technology spending trends;
- general domestic and international economic and political conditions;
- the discretionary nature of our customers' budget and purchase cycles and the absence of long-term customer purchase commitments;
- the tendency to realize a substantial percentage of our revenue in the last weeks, or even days, of each quarter;
- the potential for delays or deferrals of customer orders;
- the size, complexity and timing of individual transactions;
- the length of our sales cycle;
- the level of software sales and price competition;
- the timing of new software introductions and software enhancements by us and our competitors; or,
- seasonality in technology purchases.

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

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

Other competitive risks include, but are not limited to:

- We anticipate significant future consolidation as the software industry matures. Large well-established software firms like Oracle, IBM and Adobe may enter our market by adding content management features to their existing suite of products. In addition, large hardware firms may enter our market by acquiring our competitors to pursue revenue growth opportunities;

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

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

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

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

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

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

The market for content management solutions may not grow as we anticipate, and may decline, and our products may not gain acceptance within this market, resulting in reduced revenue. Our future financial performance will depend primarily on the continued growth of the markets for our software products and services as well as our ability to capture a larger share of those markets. Our primary product offerings address the content management solutions market. This market is developing rapidly, and while we believe this market is growing and will continue to grow, particularly as new regulations are introduced that focus on controlling the flow of information within organizations to ensure compliance with disclosure and other obligations, these markets may not continue to grow as we anticipate, or 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.

We must develop and sell new products to keep up with rapid technological change in order to achieve future revenue growth and profitability. The market for our software and services is characterized by rapid technological developments, evolving industry standards, changes in customer requirements and frequent new product introductions and enhancements. Our ability to continue to sell products will be dependent upon our ability to continue to enhance our existing software and services offerings, develop and introduce, in a timely manner, new software products incorporating technological advances and respond to customer requirements. For example, two new products that we predict will address new markets will be made available in the second half of this year. Team Collaboration Manager Suite that enables customers to initiate collaborative tasks at any point in a process and Records Manager Suite that systematically applies record management principles to content are both expected to be available in the second half of this year. We may not be successful in developing, marketing and releasing these new products or new versions of our products that respond to technological developments, evolving industry standards or changing customer requirements. We may also experience technical difficulties that could delay or prevent the successful development, introduction and sale of these products and enhancements. In the past, we have experienced delays in the release dates of enhancements and new releases to our products and we may experience significant future delays in product introduction. From time to time, our competitors or we may announce new software products, capabilities or technologies that have the potential to replace or shorten the life cycles of our existing software products. Announcements of currently planned or other new software products may cause customers to delay their purchasing decisions in anticipation of such software products, and such delays could have a material adverse effect on our sales. In addition, our ability to generate revenues from the sale of customer support, education and professional services is substantially dependent on our ability to generate new sales of our software products.

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

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

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

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

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

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

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

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

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

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

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

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

We depend on certain strategic relationships in order to license third-party products and revenue related to these products could be at risk if we were unable to maintain these relationships. In order to expand the distribution of our products and broaden our product offerings, we have established strategic relationships with a number of indirect channel partners and other consultants that provide marketing and sales opportunities for us. We have entered into key formal and informal agreements with other companies such as 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. If we fail 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 3. Quantitative and Qualitative Disclosures About Market Risk

Interest Rate Risk

Our exposure to market rate risk for changes in interest rates relates primarily to our investment portfolio. We have not used derivative financial instruments in our investment portfolio. We place our investments with high-quality issuers and, by policy, limit the amount of credit exposure to any one issuer. We protect and preserve our invested funds by limiting default, market and reinvestment risk. Our investments in marketable securities consist primarily of high-grade corporate and government securities with maturities of less than three years. Investments purchased with an original maturity of three months or less are considered to be cash equivalents. We classify all of our investments as available-for-sale. Available-for-sale securities are carried at fair value, with unrealized gains and losses, net of tax, reported in a separate component of stockholders' equity. Average maturity of our investment portfolio is 105 days; therefore, the movement of interest rates should not have a material impact on our balance sheet or income statement.

At any time, a significant increase/decrease in interest rates will have an impact on the fair market value and interest earnings of our investment portfolio. We do not currently hedge this interest rate exposure. We have performed a sensitivity analysis as of June 30, 2004 and 2003, using a modeling technique that measures the change in the fair values arising from a hypothetical 50 basis points and 100 basis points adverse movement in the levels of interest rates across the entire yield curve, which are representative of historical movements in the Federal Funds Rate with all other variables held constant. The analysis covers our investment and is based on the weighted-average maturity of our investments as of June 30, 2004 and 2003. The sensitivity analysis indicated that a hypothetical 50 basis points adverse movement in interest rates would result in a loss in the fair values of our investment instruments of approximately $323,000 at June 30, 2004 and approximately $249,000 at June 30, 2003. Similarly a hypothetical 100 basis points adverse movement in interest rates would result in a loss in the fair values of our investments of approximately $646,000 at June 30, 2004 and approximately $498,000 at June 30, 2003.

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

(In thousands)	Cost	Estimated Fair Value
Debt Securities		
Due in one year or less:		
Short-term munis-taxable	$ 2,500	$ 2,500
Corporate	15,089	15,049
Governments/Agencies	40,412	40,241
Total due in one year	58,001	57,790
Due in one to three years:		
Government/Agencies	17,710	17,544
Total due in three years	17,710	17,544
Grand total	$ 75,711	$ 75,334

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

Foreign Currency Fluctuations and Inflation

Our performance can be affected by changes in foreign currency values relative to the U.S. dollar in relation to our revenue and operating expenses. We have entered into forward foreign exchange contracts primarily to hedge amounts due from and the net assets of selected subsidiaries denominated in foreign currencies (mainly in Europe and Asia Pacific) against fluctuations in exchange rates. We have not entered into forward foreign exchange contracts for speculative or trading purposes. Our accounting policies for these contracts are based on our designation of the contracts as hedging transactions. The criteria we use for designating a contract as a hedge include the contract's effectiveness in risk reduction and one-to-one matching of derivative instruments to underlying transactions. Gains and losses on foreign exchange contracts are recognized in income in the same period as gains and losses on the underlying transactions. If an underlying hedged transaction were terminated earlier than initially anticipated, the offsetting gain or loss on the related forward foreign exchange contract would be recognized in income in the same period. In addition, since we enter into forward contracts only as a hedge, any change in currency rates would not result in any material net gain or loss, as any gain or loss on the underlying foreign currency denominated balance would be offset by the gain or loss on the forward contract. Our forward contracts generally have an original maturity of three months. As of June 30, 2004, we had forward foreign exchange contracts outstanding totaling approximately $1.4 million in ten currencies. These contracts were opened on the last business day of the quarter and mature within three months.

Cumulative other comprehensive income decreased by $1.7 million and $2.6 million for the three and six-month period ended June 30, 2004 due to unrealized foreign currency translation losses resulting from the weakening of the Euro against the U.S. dollar during the period.

Management believes that inflation has not had a significant impact on the prices of our products, the cost of our materials, or our operating results for the three and six-month period ended June 30, 2004.

Item 4. Controls and Procedures

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

As of June 30, 2004, the end of the quarter covered by this report, an evaluation was carried out under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as required by SEC Rule 13a – 15(b). Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level.

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

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

See Note 11 to Consolidated Financial Statements.

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

(a) We held our 2004 Annual Meeting of Stockholders at 9:00 a.m. on May 7, 2004, in Costa Mesa, California.

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

Nominee	Affirmative Votes	Votes Withheld
L. George Klaus	33,724,578	1,968,962
William P. Lyons	33,070,456	2,623,084
Lee D. Roberts	34,048,575	1,644,965
John C. Savage	33,721,603	1,971,937
Roger S. Siboni	32,958,270	2,735,270
Theodore J. Smith	25,734,661	9,958,879

(c) Our stockholders were asked to approve an amendment and restatement of our 2002 Incentive Award Plan which (i) increases the number of shares of Common Stock available for issuance there under by an additional 2,000,000 shares, from 2,800,000 to 4,800,000 shares; (ii) increases the number shares that may be awarded as Restricted Stock, Restricted Stock Units, Deferred Stock, Performance Awards and Stock Payments from 140,000 shares to 700,000 shares, an increase of 560,000 shares; (iii) increases the number of shares automatically granted annually to independent directors from 7,000 to 10,000 shares; and (iv) establishes a termination date for the Plan of February 24, 2014.

This proposal was approved in accordance with the following vote of stockholders:

Votes For	Votes Against	Abstentions
20,215,589	10,077,309	27,865

Our stockholders were asked to ratify the appointment of Deloitte & Touche LLP as our independent accountants for the fiscal year ending December 31, 2004. This proposal was approved in accordance with the following vote of stockholders:

Votes For	Votes Against	Abstentions
35,017,179	656,257	20,104

Item 6. Exhibits and Reports on Form 8-K

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

(b) Reports on Form 8-K:
1) On July 7, 2004 FileNet furnished a report on Form 8-K under Item 12 announcing its preliminary financial results for the quarter ended June 30, 2004.

2) On July 19, 2004 FileNet furnished a report on Form 8-K under Item 12 announcing its financial results for the quarter ended June 30, 2004.

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

FILENET CORPORATION

August 6, 2004	By:	*/s/ Sam M. Auriemma*
Date		Sam M. Auriemma, Executive Vice President and Chief Financial Officer (Principal Financial and Accounting Officer, Authorized Signatory)

Index to Exhibits

Exhibit No.	Exhibit Description
3.1*	Restated Certificate of Incorporation, as amended *(filed as Exhibit 3.1 to Registrant's Form S-4 filed on January 26, 1996; Registration No. 333-00676).*
3.1.1*	Certificate of Amendment of Restated Certificate of Incorporation *(filed as Exhibit 3.1.1 to Registrant's Form S-4 filed on January 26, 1996, Registration No. 333-00676).*
3.2*	Bylaws (*filed as Exhibit 3.2 of the Registrant's registration statement on Form S-1, Registration No. 33-15004).*
4.1*	Form of certificate evidencing Common Stock *(filed as Exhibit 4.1 to Registrant's registration statement on Form S-1, Registration No. 33-15004).*
4.2*	Rights Agreement, dated as of November 4, 1988 between FileNet Corporation and the First National Bank of Boston, which includes the form of Rights Certificate as Exhibit A and the Summary of Rights to Purchase Common Shares as Exhibit B *(filed as Exhibit 4.2 to Registrant's registration statement on Form S-4 filed on January 26, 1996; Registration No. 333-00676).*
4.3*	Amendment One dated July 31, 1998 and Amendment Two dated November 9, 1998 to Rights Agreement dated as of November 4, 1988 between FileNet Corporation and BANKBOSTON, N.A. formerly known as The First National Bank of Boston *(filed as Exhibit 4.3 to Registrant's registration statement on Form 10-Q for the quarter ended September 30, 1998).*
4.4*	Amendment Three dated November 30, 2001 to Rights Agreement dated as of November 4, 1988 between FileNet Corporation and Equiserve Trust Company, N.A., successors to BANKBOSTON, N.A. *(filed as Exhibit 4.4 to Registrant's Annual Report on Form 10-K filed for the year ended December 31, 2001).*
10.2*+	Amended and Restated 1995 Stock Option Plan of FileNet (*filed as Exhibit 99.1 to Registrant's registration statement on Form S-8 filed on October 15, 2001; Registration No. 333-71598).*
10.2.1*+	Amendment to the 1995 Stock Option Plan approved by Registrant's Board of Directors dated May 7, 2003 *(filed as Exhibit 10.2.1 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003).*
10.2.2*+	Amended Form of 1995 Executive Officer Stock Option Agreement *(filed as Exhibit 10.2.2 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003).*
10.3*+	Second Amended and Restated 1986 Stock Option Plan of FileNet Corporation, together with the forms of Incentive Stock Option Agreement and Non-Qualified Stock Option Agreement *(filed as Exhibits 4(a), 4(b) and 4(c), respectively, to the Registrant's registration statement on Form S-8, Registration No. 33-48499)*, the first Amendment thereto *(filed as Exhibit 4(d) to the Registrant's registration statement on Form S-8, Registration No. 33-69920)*, and the Second Amendment thereto *(filed as Appendix A to the Registrant's Proxy Statement for the Registrant's 1994 Annual Meeting of Stockholders, filed on April 29, 1994).*
10.4*+	Non-Statutory Stock Option Agreement (with Notice of Grant of Stock Option and Special Addendum) between Registrant and Mr. Lee Roberts *(filed as Exhibit 99.17 to Registrant's registration statement on Form S-8 filed on August 20, 1997).*
10.6*+	Amended and Restated FileNet Corporation 1998 Employee Stock Purchase Plan (*filed as Appendix B to Registrant's Definitive Proxy Statement on Schedule 14A, for the Registrant's 2002 Annual Meeting of Stockholders, filed on April 18, 2002).*
10.7*+	FileNet Corporation International Employee Stock Purchase Plan (*filed as Appendix C to Registrant's Definitive Proxy Statement on Schedule 14A, for the Registrant's 2002 Annual Meeting of Stockholders, filed on April 18, 2002).*
10.8*	Lease between the Registrant and C. J. Segerstrom & Sons for the headquarters of the Company, dated September 1, 1999 *(filed as Exhibit 10.23 to Registrant's registration statement on Form 10-Q for the quarter ended September 30, 1999)*.
10.10*+	Written Compensation Agreement and Non-Statutory Stock Option Agreement (with Notice of Grant of Stock Option and Special Addendum) between Registrant and Mr. Sam Auriemma (*filed as Exhibit 99.1 and 99.2 to Registrant's registration statement on Form S-8, filed on April 20, 2001; Registration No. 333-59274*).
10.11*	Asset Purchase Agreement dated April 2, 2002 by and between 3565 Acquisition Corporation and eGrail, Inc. *(filed as Exhibit 10.1 to Registrant's Current Report on Form 8-K, filed on April 12, 2002).*
10.12*+	Secured Promissory Note between Registrant and Mr. Lee D. Roberts dated June 14, 2002 *(filed as Exhibit 10.12 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2002)*.

10.13*+	Option Exchange Agreement between Registrant and Mr. Ron L. Ercanbrack, dated May 22, 2002, together with form of Incentive Stock Option Agreement and Grant Notice *(filed as Exhibit 10.13 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2002).*
10.14*+	The 2002 Incentive Award Plan, as approved by stockholders at the Registrant's Annual Meeting on May 22, 2002, together with the forms of Incentive Option Agreement and Non-Qualified Stock Option Agreement for Independent Directors *(filed as Exhibit 10.14 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2002)*.
10.14.1*+	Amended Form of 2002 Incentive Award Plan Incentive Option Agreement with Notice of Grant of Stock Option *(filed as Exhibit 10.14.1 to Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2002).*
10.14.2*+	Amended Form of 2002 Incentive Award Plan Non-Qualified Stock Option Agreement for Independent Directors with Notice of Grant of Stock Option *(filed as Exhibit 10.14.2 to Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2002).*
10.14.3*+	Amendment to the 2002 Incentive Award Plan dated May 7, 2003 *(filed as Exhibit 10.14.3 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003).*
10.14.4*+	Amended and Restated 2002 Incentive Award Plan of FileNet Corporation, *(filed on April 1, 2004 as Appendix B of Registrant's Definitive Proxy Statement for its 2004 Annual Meeting of Stockholders).*
10.15*	Stock Purchase Agreement dated April 2, 2003 by and among Registrant, FileNet Nova Scotia Corporation, Shana Corporation and certain Sellers *(filed as Exhibit 10.15 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003).*
10.15.1*	Escrow Agreement dated April 2, 2003 by and among FileNet Nova Scotia Corporation, certain Sellers and Bennett Jones LLP *(filed as Exhibit 10.15.1 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003).*
10.16*+	Amended and Restated Letter Agreement dated May 15, 2003 by and between Registrant and Lee D. Roberts, Chief Executive Officer *(filed as Exhibit 10.16 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003).*
10.17*+	Form of Amended and Restated Letter Agreement, dated May 15, 2003, by and between Registrant and the Chief Financial Officer and President *(filed as Exhibit 10.17 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003)* (1).
10.18*+	Form of Amended and Restated Letter Agreement by and among Registrant and certain Executive Officers *(filed as Exhibit 10.18 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003)* (2).
10.19*+	CEO Severance Agreement together with Addendum II to Stock Option Agreement between Registrant and Mr. Lee D. Roberts *(filed as Exhibit 10.19 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003).*
10.20*+	Form of Restricted Stock Agreement between Registrant and certain Executive Officers (*filed as Exhibit 10.21 to Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 2004).*
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act.
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act.
32.1	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act.
32.2	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act.

** Incorporated herein by reference* *+ Management contract, compensatory plan or arrangement*

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

(2) Amended and Restated Letter Agreement, dated May 15, 2003 was entered into by and between Registrant and Messrs. Martyn D. Christian, David D. Despard, Frederick P. Dillon, Karl J. Doyle, Michael W. Harris, William J. Kreidler, Chas W. Kunkelmann, Philip Rugani, Daniel S. Whelan, Franz X. Zihlmann, Ms. Katharina M. Mueller and Ms. Audrey N. Schaeffer. Mr. Kenneth F. Fitzpatrick entered in a Letter Agreement, dated September 2, 2003 on substantially the same terms and conditions.