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**FORM 10-Q**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

(Mark One)

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

For the quarterly period ended March 31, 2005

OR

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

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

Commission file number: 00-15997

**FILENET CORPORATION**

(Exact name of Registrant as specified in its charter)

**Delaware**

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

**95-3757924**

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

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

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

**(714) 327-3400**

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

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

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

As of May 9, 2005, there were 40,937,891 shares of the Registrant's common stock outstanding.

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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)*

	March 31, <b>2005</b>	December 31, <b>2004</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 235,113	\$ 123,217
Short-term investments available for sale	130,680	211,196
Accounts receivable, net	40,198	35,878
Prepaid expenses and other current assets	12,730	12,179
Deferred income taxes	3,681	3,681
Total current assets	422,402	386,151
Property, net	19,918	21,738
Long-term investments available for sale	9,585	14,256
Goodwill	26,896	27,268
Intangible assets, net	5,591	6,188
Deferred income taxes	36,063	36,028
Other assets	2,283	2,037
Total assets	\$ 522,738	\$ 493,666
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 14,153	\$ 13,868
Accrued compensation and benefits	27,443	33,674
Customer deposits and advances	8,484	9,007
Unearned maintenance revenue	71,552	47,145
Income tax payable	9,009	5,374
Other accrued liabilities	12,081	14,201
Total current liabilities	142,722	123,269
Unearned maintenance revenue and other liabilities	4,819	2,533
Commitments and contingencies (Note 10)		
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; 41,790,050 issued and 40,692,050 shares outstanding at March 31, 2005; and 41,690,989 shares issued and 40,592,982 shares outstanding at December 31, 2004	285,813	284,490
Deferred compensation	(6,122)	(6,530)
Retained earnings	101,784	93,512
Accumulated other comprehensive income	8,289	10,959
Treasury stock, at cost; 1,098,000 shares	(14,567)	(14,567)
Net stockholders' equity	375,197	367,864
Total liabilities and stockholders' equity	\$ 522,738	\$ 493,666

*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 March 31,	
	<b>2005</b>	<b>2004</b>
Revenue:		
Software	\$ 38,451	\$ 41,351
Customer support	48,333	45,270
Professional services and education	13,233	12,877
Total revenue	100,017	99,498
Costs:		
Software	2,370	3,523
Customer support	10,526	10,292
Professional services and education	10,384	10,838
Total cost of revenue	23,280	24,653
Gross Profit	76,737	74,845
Operating expenses:		
Sales and marketing	38,182	41,561
Research and development	18,630	20,102
General and administrative	9,227	9,233
Total operating expenses	66,039	70,896
Operating income	10,698	3,949
Other income, net	2,028	927
Income before income taxes	12,726	4,876
Provision for income taxes	4,454	878
Net income	\$ 8,272	\$ 3,998
Earnings per share:		
Basic	\$ 0.20	\$ 0.10
Diluted	\$ 0.20	\$ 0.10
Weighted-average shares outstanding:		
Basic	40,361	38,280
Diluted	41,706	40,785

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

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

	Three Months Ended March 31,	
	<b>2005</b>	<b>2004</b>
Net income	\$ 8,272	\$ 3,998
Other comprehensive loss:		
Foreign currency translation adjustments	(2,614)	(914)
Unrealized gain (loss) on securities:		
Unrealized holding gain (loss), net of taxes	(56)	16
Total other comprehensive loss	(2,670)	(898)
Comprehensive income	\$ 5,602	\$ 3,100

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

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

<i>Three months ended March 31,</i>	<b>2005</b>	<b>2004</b>
<b>Cash flows provided by operating activities:</b>		
Net income	\$ 8,272	\$ 3,998
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	3,840	4,276
Loss on sale of fixed assets	15	4
Provision for doubtful accounts and sales returns	299	6
Deferred income taxes	(35)	(40)
Changes in operating assets and liabilities:		
Accounts receivable	(5,223)	4,551
Prepaid expenses and other current assets	(1,193)	(411)
Accounts payable	492	(756)
Accrued compensation and benefits	(5,893)	(3,261)
Customer deposits and advances	(518)	1,762
Unearned maintenance revenue	27,122	25,875
Income taxes payable	3,582	1,734
Other	(1,426)	(1,774)
Net cash provided by operating activities	29,334	35,964
<b>Cash flows provided by (used in) investing activities:</b>		
Capital expenditures	(1,585)	(2,726)
Proceeds from sale of property	2	48
Purchases of marketable securities	(283,607)	(356,040)
Proceeds from sales and maturities of marketable securities	368,525	352,825
Net cash provided by (used in) investing activities	83,335	(5,893)
<b>Cash flows provided by financing activities:</b>		
Proceeds from issuance of common stock	1,323	10,178
Net cash provided by financing activities	1,323	10,178
Effect of exchange rate changes on cash and cash equivalents	(2,096)	(528)
Net increase in cash and cash equivalents	111,896	39,721
Cash and cash equivalents, beginning of period	123,217	100,605
Cash and cash equivalents, end of period	\$ 235,113	\$ 140,326
Supplemental cash flow information:		
Interest paid	\$ 1	\$ 22
Income taxes paid / (refunded)	\$ 892	\$ (950)

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

**FILENET CORPORATION**  
Notes To Condensed Consolidated Financial Statements  
(Unaudited)

1. BASIS OF PRESENTATION

The accompanying unaudited interim condensed consolidated financial statements of FileNet Corporation and subsidiaries (the "Company" or "FileNet") reflect all adjustments (consisting of normal recurring adjustments) necessary to present fairly the financial position of the Company at March 31, 2005, and the results of its operations, its comprehensive operations and its cash flows for the three months ended March 31, 2005 and 2004. 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, 2004 filed with the SEC on March 15, 2005. 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.** A portion of the Company's investments consist of auction rate securities that reset interest rates at auction intervals of 7, 28, 35 or 49 days. These securities are readily saleable at par value on the auction dates and the carrying value approximates fair value throughout the holding period. In prior years, auction rate securities that reset or matured in less than 90 days were included in cash equivalents. In December 2004, the Company determined such amounts should properly be classified as short-term investments. As a result, in its 2004 Form 10-K the Company reclassified these amounts for all periods presented. Additionally, the Company reclassified the accompanying statement of cash flows for the three months ended March 31, 2004 to remove the amounts from cash equivalents and record the net purchases or proceeds of auction rate securities as an investing activity.

2. NEW ACCOUNTING PRONOUNCEMENTS

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

In December 2004, the FASB revised Statement No. 123 (FAS 123R), "Share-Based Payment," which requires companies to expense the estimated fair value of employee stock options and similar awards based on the grant-date fair value of the award. The cost will be recognized over the period during which an employee is required to provide service in exchange for the award, usually the vesting period. The accounting provisions of FAS 123R will be effective as of the beginning of the first fiscal year that begins after June 15, 2005. The Company will adopt the provisions of FAS 123R on January 1, 2006 using a modified prospective application. Under the modified prospective application, FAS 123R will apply to new awards, unvested awards that are outstanding on the effective date and any awards that are subsequently modified or cancelled. Compensation expense for outstanding awards for which the requisite service had not been rendered as of the effective date will be recognized over the remaining service period using the

compensation cost calculated for pro forma disclosure purposes under FAS 123 (Note 3 Stock-Based Compensation). The Company is in the process of determining how the new method of valuing stock-based compensation as prescribed in FAS 123R will be applied to valuing stock-based awards granted after the effective date and the impact the recognition of compensation expense related to such awards will have on its financial statements.

### 3. STOCK BASED COMPENSATION

The Company currently 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 and net income per share on a pro forma basis had compensation cost for the Company's stock-based compensation plans been determined based on the provisions of SFAS No. 123, "Accounting for Stock Based Compensation", for the three months ended March 31, 2005 and 2004.

<i>(in thousands, except per share amounts)</i>	Three Months Ended March 31,	
	<u>2005</u>	<u>2004</u>
Net income, as reported	\$ 8,272	\$ 3,998
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	<u>(2,447)</u>	<u>(1,547)</u>
Pro forma net income	\$ 5,825	\$ 2,451
Earnings per share:		
Basic earnings per share - as reported	\$ 0.20	\$ 0.10
Basic earnings per share - pro forma	0.14	0.06
Diluted earnings per share - as reported	\$ 0.20	\$ 0.10
Diluted earnings per share - pro forma	0.14	0.06

For purposes of computing proforma net income, the Company estimates the fair value of each option grant and employee stock purchase plan right on the date of grant using the Black-Scholes option-pricing model. The Black-Scholes option-pricing model was developed for use in estimating the value of traded options that have no vesting restrictions and are fully transferable, while the options issued by the Company are subject to both vesting and restrictions on transfer. In addition, option-pricing models require input of highly subjective assumptions including the expected stock price volatility. The Company uses projected data for expected volatility and 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 March 31,	
	<u>2005</u>	<u>2004</u>
Expected life (in years)	5.52	5.39
Expected volatility	72%	51%
Risk free interest rates	3.87%	3.07%
Expected dividend	0%	0%



#### 4. GOODWILL AND OTHER INTANGIBLE ASSETS

The Company's business acquisitions have resulted in goodwill and other intangible assets. Goodwill is recorded at cost and is not amortized, but is tested for impairment at least annually and would be written down if impairment were determined. Effective the first day of July of each year, goodwill is tested for impairment by determining if the carrying value of each reporting unit exceeds its fair value. The Company's reporting units are consistent with the reportable segments identified in Note 7. The Company also periodically evaluates whether events and circumstances have occurred between annual testing dates that indicate the carrying value of goodwill may not be recoverable. An impairment analysis was performed as of July 1, 2004 in accordance with SFAS 142. The results indicated there was no impairment of goodwill in any of the three reporting units. As of March 31, 2005, there have been no indicators of impairment; therefore no interim impairment tests have been performed.

The following table presents the changes in goodwill by reporting segment during the three months ended March 31, 2005:

*(in thousands)*

	<i>Software</i>	<i>Customer Support</i>	<i>Professional Services and Education</i>	<i>Total</i>
Balance, December 31, 2004	\$ 15,826	\$ 6,003	\$ 5,439	\$ 27,268
Foreign currency effect	(216)	(82)	(74)	(372)
Balance, March 31, 2005	\$ 15,610	\$ 5,921	\$ 5,365	\$ 26,896

Foreign currency change relates to the impact of translation on the portion of goodwill that was recorded on the Company's foreign subsidiaries.

Identified intangible assets are recorded at cost less accumulated amortization. These assets are amortized using the straight-line method over estimated useful lives of 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. The Company evaluates these assets for impairment based on estimated undiscounted future cash flows from these assets. If the carrying value of the assets exceeds the estimated future undiscounted cash flows, a loss would be recorded for the excess of the asset's carrying value over the fair value. While the Company has not experienced impairment of intangible assets in prior periods, it cannot guarantee that there will not be impairment in the future. Intangible assets subject to amortization consist of the following:

*(in thousands)*

	<b>March 31, 2005</b>			<b>December 31, 2004</b>		
	<i>Gross Asset</i>	<i>Accumulated Amortization</i>	<i>Net</i>	<i>Gross Asset</i>	<i>Accumulated Amortization</i>	<i>Net</i>
Acquired technology and related intangibles	\$ 10,480	\$ (4,970)	\$ 5,510	\$ 10,571	\$ (4,496)	\$ 6,075
Non-compete agreements and patents	367	(286)	81	367	(254)	113
Total	\$ 10,847	\$ (5,256)	\$ 5,591	\$ 10,938	\$ (4,750)	\$ 6,188

Acquired technology and other intangibles are being amortized over a useful life of five years, and non-compete agreements are being amortized over three years. Patents were amortized over two years and are fully amortized. Amortization expense for intangible assets was \$553,000 for the three months ended March 31, 2005 compared to \$527,000 for the comparable period in 2004.

Estimated future amortization expense (assuming no foreign exchange effect) of purchased intangible assets as of March 31, 2005 is as follows:

<i>(in thousands)</i>	
<b>Fiscal Year</b>	<b>Amount</b>
<i>(Remainder)</i> 2005	\$ 1,633
2006	2,116
2007	1,513
2008	329
	<u>\$ 5,591</u>

## 5. EARNINGS PER SHARE

Basic earnings per share are computed by dividing net income for the period by the weighted-average number of common shares outstanding during the period. Diluted earnings per share is computed by dividing net income by the weighted-average number of common shares outstanding plus the dilutive effect of outstanding stock options, shares issuable under the employee stock purchase plan and restricted stock issued to key executive management using the treasury stock method. The number of anti-dilutive options excluded from the EPS calculation for the three months ended March 31, 2005 and 2004 were 1,345,145 and 2,505,000 shares, respectively. The following table sets forth the computation of basic and diluted earnings per share for the three months ended March 31, 2005 and 2004:

<i>(in thousands, except per share amounts)</i>	Three Months Ended March 31,	
	<b>2005</b>	<b>2004</b>
Net Income	\$ 8,272	\$ 3,998
Weighted average common shares outstanding	40,639	38,413
Unvested restricted stock	<u>(278)</u>	<u>(133)</u>
Shares used in computing basic earnings per share	40,361	38,280
Earnings per basic share	\$ 0.20	\$ 0.10
Shares used in computing basic earnings per share	40,361	38,280
Dilutive effect of stock plans	1,323	2,472
Dilutive effect of weighted average common shares of unvested restricted stock	<u>22</u>	<u>33</u>
Shares used in computing diluted earnings per share	41,706	40,785
Earnings per diluted share	\$ 0.20	\$ 0.10

6. ACCUMULATED OTHER COMPREHENSIVE INCOME

Accumulated other comprehensive income, net of taxes, for the three months ended March 31, 2005 is comprised of the following:

<i>(in thousands)</i>	<i>Foreign Currency Translation Adjustment</i>	<i>Unrealized Holding Loss on Securities</i>	<i>Accumulated Other Comprehensive Income</i>
Balance, December 31, 2004	\$ 11,235	\$ (276)	\$ 10,959
Three month period changes	<u>(2,614)</u>	<u>(56)</u>	<u>(2,670)</u>
Balance, March 31, 2005	<u>\$ 8,621</u>	<u>\$ (332)</u>	<u>\$ 8,289</u>

7. 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 include Software, Customer Support, and Professional Services and Education. The Software operating segment develops, markets, and sells a software platform and application framework for Enterprise Content Management and Business Process Management. 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 Professional Services and Education segment provides fee-based implementation and technical consulting services related to the Company's standard products and training services.

The accounting policies of the Company's operating segments are the same as those for the Company as a whole. The Company evaluates performance based on stand-alone segment gross profit. The Company does not separately allocate operating expenses to these segments, nor does it allocate specific assets to these segments. The Company does not evaluate performance based on the return on assets or on interest income at the operating segment level. Therefore, segment information reported includes only revenues, cost of revenues, and gross profit, as this information is the only information currently provided to the chief operating decision maker on a segment basis.

Operating segment data for the three months ended March 31, 2005 and 2004 is as follows:

<i>(in thousands)</i>	Three months ended March 31,	
	2005	2004
Software:		
Revenue	\$ 38,451	\$ 41,351
Cost of revenue	2,370	3,523
Gross profit	36,081	37,828
Customer Support:		
Revenue	\$ 48,333	\$ 45,270
Cost of revenue	10,526	10,292
Gross profit	37,807	34,978
Professional Services and Education:		
Revenue	\$ 13,233	\$ 12,877
Cost of revenue	10,384	10,838
Gross profit	2,849	2,039
Total		
Revenue	\$ 100,017	\$ 99,498
Cost of revenue	23,280	24,653
Gross profit	76,737	74,845

## 8. STOCK OPTIONS

The following is a summary of stock option transactions regarding all stock option plans for the three months ended March 31, 2005:

	<i>Number of Options</i>	<i>Weighted Average Exercise Price</i>
Balance, December 31, 2004	6,870,617	\$ 19.99
Granted (weighted-average fair value of \$13.11)	22,000	23.58
Exercised	(99,061)	13.35
Canceled	(103,719)	26.38
Balance, March 31, 2005	<u>6,689,837</u>	\$ 20.00

The following table summarizes information concerning outstanding and exercisable stock options at March 31, 2005:

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 - 12.86	1,401,516	5.35	\$ 10.99	1,037,972	\$ 10.40
12.97 - 16.35	1,117,119	6.24	13.94	812,590	13.90
16.54 - 23.47	1,436,527	6.24	19.87	1,243,331	19.98
23.88 - 26.66	1,125,129	7.32	25.73	521,568	24.74
26.75 - 28.19	1,333,754	8.85	27.77	277,355	27.82
28.42 - 41.84	275,792	4.38	30.09	250,718	30.13
\$ 1.39 - 41.84	6,689,837	6.68	\$ 20.00	4,143,534	\$ 18.13

#### 9. ISSUANCE OF RESTRICTED STOCK

The fair value of restricted stock awards is recorded in the equity section of the balance sheet as an increase in common stock and a contra-equity offset to deferred compensation. All restricted stock awards vest over time and certain awards include a feature that allows the stock to vest on an accelerated basis provided certain performance targets are achieved. Certain restricted stock awards are also subject to Change in Control Agreements and/or termination without cause provisions that could trigger accelerated vesting. Expense related to the shares is amortized on a straight-line basis over the vesting period. Recognition of expense may be accelerated if it becomes probable that certain performance targets will be achieved that trigger accelerated vesting for those shares that contain the acceleration feature. Approximately \$408,000 and \$45,500 of compensation expense was recognized for restricted stock awards in the three months ended March 31, 2005 and 2004, respectively.

#### 10. 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. Rental expense is recorded on a straight-line basis over the life of the lease and amounts related to deferred rent are recorded in other accrued liabilities on the consolidated balance sheet. Future annual minimum lease payments under all non-cancelable operating leases with an initial term in excess of one year as of March 31, 2005 were as follows:

<i>(in thousands)</i>	
2005 (remaining 9 months)	\$ 13,987
2006	13,461
2007	11,268
2008	9,786
2009	7,401
2010	6,310
Thereafter	3,029
<b>Total</b>	<b>\$ 65,242</b>

## **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 \$2.8 million as of March 31, 2005. Approximately \$1.4 million was issued in local currency in Europe and Asia, while the balance was issued in the United States. Approximately \$0.5 million of the \$2.8 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 fair value of such guarantees and indemnities is considered nominal.

## **Legal Proceedings**

In the normal course of business, the Company is subject to ordinary routine litigation and claims incidental to its business. The Company monitors and assesses the merits and risks of pending legal proceedings. While the results of litigation and claims cannot be predicted with certainty, based upon its current assessment the Company believes that the final outcome of existing legal proceedings will either be resolved in its favor or, if resolved against it, will not have a materially adverse effect on its consolidated results of operations or financial condition.

## **11. FOREIGN CURRENCY TRANSACTIONS**

The Company is exposed to foreign exchange rate fluctuations due to intercompany accounts between the U.S. parent company and the foreign subsidiaries. The Company is also exposed to foreign exchange rate fluctuations as the financial statements of foreign subsidiaries are translated into U.S. dollars for consolidation purposes. The Company purchases foreign exchange contracts to mitigate the effect of exchange gains and losses on recorded foreign currency denominated monetary assets and liabilities. The Company does not use foreign exchange contracts for speculative or trading purposes. All outstanding forward contracts are marked-to-market on a monthly basis with gains and losses included in other income (expense) in the consolidated statements of operations. The Company opens new hedge contracts each quarter that will mature within three months. The counterparties to these contracts are major financial institutions. The Company uses commercial rating agencies to evaluate the credit quality of the counterparties and does not anticipate nonperformance by any counterparties. The Company does not anticipate a material loss resulting from any credit risks related to any of these institutions.

## 12. INCOME TAXES

The Company's combined federal, state and foreign annual effective tax rate applied to the three months ended March 31, 2005 was 35% compared to 18% for the comparable period in 2004. The increased effective tax rate applied to the three months ended March 31, 2005 was primarily due to i) the mix of income earned by domestic operations versus the foreign subsidiaries, and ii) the absence of a valuation allowance reversal that benefited the Company's rate in 2004.

## 13. RELATED-PARTY-TRANSACTIONS

On June 5, 2002, the Compensation Committee of the Company's Board of Directors (the "Board") approved a loan to Mr. Roberts for \$1.9 million to enable him to purchase a home in Orange County, California. Mr. Roberts has repaid this loan in full as of December 10, 2004. Mr. Roberts made total payments of \$2,020,576 including \$120,576 in interest and \$1,900,000 in principal.

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

In addition to historical information 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 factors described under the heading "Risk Factors" and in other documents we file from time to time with the Securities and Exchange Commission. Our filings with the Securities and Exchange Commission, including our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to those filings, pursuant to Sections 13(a) and 15(d) of the Securities Exchange Act of 1934, are available free of charge at [www.filenet.com](http://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 for Enterprise Content and Business Process Management. This platform, called FileNet P8, provides a flexible and scaleable framework for developing solutions that provide our customers with the ability to manage content throughout their organizations, and streamline their business processes. Enterprise Content Management, or ECM, refers to the broad range of functions used by organizations of all types, including businesses and governmental agencies, to control and track the information, or content, that is important to the organization's operations, whether that information is used internally, such as sales contracts or product diagrams, or externally, such as content provided to customers through a Web site. The documents and 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.

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 provided pursuant to service contracts. Annual fees for software technical support and software maintenance are received in advance and recognized as revenue over the duration of the contract.

Our earnings results are highly sensitive to fluctuations in revenue. The nature of our cost structure is essentially fixed, with employee compensation and benefits being the single largest expense. These expenses represent more than 50% of our cost structure. Costs associated with variable compensation expense and third party royalty expenses fluctuate with revenue. Our future profitability is contingent upon revenue growth achieved through continued investments in internally developed or acquired software technologies that gain market acceptance.

### *Software*

The FileNet P8 platform provides our customers with enterprise-level software that is scalable and flexible to handle demanding content challenges and manage complex business processes. The FileNet P8 platform provides a framework for functional expansion to provide enhanced content and process management across an enterprise through FileNet's product suites; each emphasizing a different aspect of the ECM solution set, with functions designed to meet a customer's individual ECM or BPM needs. Each suite can be implemented by a customer individually, but remains expandable to include additional FileNet content and process management capabilities. Solutions and applications, built by third party partners or our customers using FileNet P8 software, are designed to manage documents and all forms of 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.

We license our ECM software to companies in the insurance, financial services, government, manufacturing, telecommunications and utilities industries, both directly to the end user and through partners. The growth in software license revenue is affected by the strength of general economic and business conditions, as well as the competitive position of our software products. Our enterprise software business is characterized by long sales cycles and timing of a few large software license transactions that can substantially affect our operating results. In the past several years the economy has shown slow growth in the software industry resulting in customer delays or limited spending for technology capital. The ability to meet regulatory and compliance requirements has become increasingly critical for large public enterprises in order to maintain proper documentation for all key transactions. We believe we are well positioned to grow our revenue through our software products that address our current and prospective customers' regulatory compliance and business process improvement requirements. However, we believe software revenue will continue to be affected by future economic conditions.

### *Customer Support*

We offer product support on a global basis to ensure successful implementation of our products and customer satisfaction. Our support offering also includes the right to new versions. Our 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 customers typically purchase support at the time they acquire new software licenses and renew their software license support contracts annually provided their systems are still in service. The growth of support revenue is influenced by the renewal rate of the existing customer base and the amount of new support contracts associated with the sale of new software licenses. We believe that our customer support



revenue will continue to grow as we sell more new software licenses and our customers continue to renew their product support contracts.

### *Professional Services and Education*

Our worldwide professional services organization provides consulting, implementation, development and other technical services and training services to our licensed customers and authorized ValueNet Partners. These services are provided by our internal employees and through a network of qualified service providers hired on a fee for service basis. Our professional services organization offers a comprehensive methodology to help our customers design, install, integrate, customize and deploy our products. These services range from the management of large-scale implementations of our products billed on a time and material basis to short-term fixed price services such as software installation and implementation packages, 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. The purpose of our education services is to allow our customers to further enhance the usability of our software products throughout their enterprise.

### *Research and Development*

We have made and expect to continue to make substantial investments in research and development, through internal and offshore development activities, third party licensing agreements and through technology acquisitions. Our development efforts focus on our FileNet P8 platform as we continue to develop and enhance our enterprise content and process management capabilities. Additionally, we license and embed third party software that is designed to expand the functionality of our products through a variety of agreements with the producers of this software and we intend to increase the number of third party licensing agreements. We expect research and development to remain a significant portion of our cost structure throughout 2005.

## **Critical Accounting Policies and Estimates**

The condensed consolidated financial statements of FileNet are prepared in conformity with accounting principles generally accepted in the United States of America. The condensed 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.

We continually evaluate our estimates and judgments, including those related to revenue recognition, valuation of intangible assets, reserves for bad debt and sales returns and income taxes. We base our estimates on historical and projected results that we believe are reasonable. These estimates form the basis for making judgments about the carrying values of assets and liabilities and by their nature, are subject to an inherent degree of uncertainty. Actual amounts could differ from our estimates and could have a significant adverse effect on our operating results and financial position. 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.*** The nature of our business commonly includes multiple elements in our arrangements and requires us to make judgments for determining the timing and the amount of revenue to recognize. These judgments include, but are not limited to, determining the allocation of revenue in multiple element arrangements based on vendor specific objective evidence and determining the creditworthiness of a customer to assess the probability of collection of a transaction.

We derive revenue from the following sources: (1) software, which includes software licenses, (2) customer support revenues, which include annual maintenance agreements, and (3) professional services, which include consulting, implementation and training services.

The provisions of Statement of Position No. 97-2, Software Revenue Recognition, issued by the American Institute of Certified Public Accountants, governs the basis for our software revenue recognition. Accordingly, software license revenue is recognized when: (1) we enter into a legally binding arrangement with a customer for the license of software; (2) we deliver the products; (3) customer payment is deemed fixed or determinable and free of contingencies or significant uncertainties; and (4) collection is probable. We must make judgments and estimates to determine whether or not the certainty of these elements has been met.

Our software license arrangements often include multiple elements that consist of software, post-contract customer support agreements and professional services such as consulting, implementation and training. We recognize revenue in multiple element arrangements using the residual method of revenue recognition in accordance with SOP 98-9. Under the residual method, the fair value of the undelivered elements is deferred and the remaining portion of the arrangement fee is allocated to the delivered elements and is recognized as revenue, assuming all other revenue recognition criteria have been met. If evidence of fair value for each undelivered element of the arrangement does not exist, all revenue from the arrangement is recognized when evidence of fair value is determined or when all elements of the arrangement are delivered.

Vendor specific objective evidence (“VSOE”) of fair value for customer support is determined by reference to the price our customers pay for such support when sold separately; that is, the renewal rates paid by our customers. Revenue from customer support contracts is recognized ratably over the term of the arrangement, which is typically 12 months. VSOE of fair value for professional services is based upon the established pricing and discounting practices for those services when sold separately. Historically, we have been able to establish VSOE for customer support and professional services, but we may modify our pricing practices in the future, which could result in changes in, or the inability to support, VSOE of fair value for these undelivered elements. If this occurs, our future revenue recognition for multi-element arrangements could differ significantly from our historical results. A majority of our professional service revenue is derived from time and materials based contracts that typically range from three months to one year in duration. Revenue is recognized on such contracts as time is incurred and approved by the customer. We also provide fixed price pre-packaged services that are one month or less in duration. Revenue from such short-term fixed price contracts is recognized upon completion of the work and customer acceptance. Short-term fixed-price contracts of a repetitive nature are more readily estimable than long-term contracts. Our ability to make judgments about revenue and cost for these types of contracts has in the past been accurate. We have limited exposure to cost overruns in professional service engagements as any additional services are pre-approved by our customers in time and material contracts and our fixed price contracts are normally very short term in nature and highly estimable.

We use judgment in assessing whether fees are fixed and determinable and probable of collection at the time of sale. Since customers who have previously deployed our products somewhere within their enterprise comprise approximately 90% of software sales, our ability to assess the credit-worthiness of a transaction is supported by the collection history we have with that customer. In the past our ability to judge the probability of collection has been highly accurate and we expect that this will continue. Our standard payment terms range from net 30 to net 90 days. Payments that are due within 90 days are deemed to be fixed or determinable based on our successful collection history on such arrangements. To the extent we elect to provide extended payment terms beyond 90 days for competitive or other reasons, revenue is recognized when the amounts become due. Historically, sales returns and bad debt write-offs have been insignificant and within management’s expectations. However, any adverse changes in these trends could impact the timing of revenue recognition in the future.

In addition to direct customer sales, we sell through third party channel partners. Our channel partners do not inventory our software products; rather, shipments are made only when the partner places an order for a specific end user. We require our channel partners to provide us with the name and address of all end users at the time an order is placed and, in many cases, we ship our products directly to the end user. Software license revenue from channel partners is recognized when an end user is identified, product is delivered either to a channel partner or to their designated end-user and all other revenue recognition criteria are met. As our channel partners only purchase our product for specific end users, we are not subject to channel inventory returns or price protection issues.

***Allowance for Doubtful Accounts and Sales Returns.*** We make judgments as to our ability to collect outstanding receivables and provide allowances for the portion of receivables when collection becomes doubtful. We perform an initial evaluation of 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. 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. Even though we have large transactions, these tend to be with large, well capitalized and credit worthy customers. We also maintain a sales returns allowance based on historical return rates. While we are not legally required to accept sales returns, we have done so on certain occasions for our customers. Product returns have historically been minimal and within our expectations. If we elect to accept a higher level of returns in the future for customer relations or other reasons, our results of operations could be materially affected. If the historical data we use to calculate the allowance for doubtful accounts or if estimates do not properly reflect future returns, then a change in the allowances would be made in the period in which such a determination is made and results of operations in that period could be materially affected.

***Goodwill and Other Intangible Assets.*** Our business acquisitions have resulted in goodwill and other intangible assets. Goodwill is recorded at cost and is not amortized, but is tested for impairment at least annually and would be written down if impairment were determined. 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. Our reporting units are consistent with the reportable segments identified in Note 7. We also periodically evaluate whether events and circumstances have occurred between annual testing dates that indicate the carrying value of goodwill may not be recoverable. We performed an impairment analysis as of July 1, 2004 in accordance with SFAS 142. The results indicated there was no impairment of goodwill in any of the three reporting units. As of March 31, 2005, there have been no indicators of impairment; therefore no interim impairment tests have been performed.

Identified intangible assets are recorded at cost less accumulated amortization. These assets are amortized using the straight-line method over estimated useful lives of 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 these assets for impairment based on estimated undiscounted future cash flows from these assets. If the carrying value of the assets exceeds the estimated future undiscounted cash flows, a loss would be recorded for the excess of the asset's carrying value over the fair value. While we have not experienced impairment of intangible assets in prior periods, we cannot guarantee that there will not be impairment in the future.

Determining the fair value of a reporting unit is judgmental in nature and involves the use of significant estimates and assumptions. These estimates and assumptions include revenue growth rates and operating margins used to calculate projected future cash flows, future economic and market conditions, and determination of appropriate market comparables. We base our fair value estimates on assumptions we

believe to be reasonable but that are unpredictable and uncertain. Actual future results may differ from those estimates. In addition, we make certain judgments and assumptions in allocating shared assets and liabilities to determine the carrying values for each of our reporting units. Future events, such as a significant decrease in our revenue, profitability or market capitalization, or a change in technology could cause us to conclude that impairment indicators exist and that goodwill or other intangible assets associated with our acquisitions are impaired. Any resulting impairment loss could have an adverse impact on our results of operations.

***Income Taxes.*** We exercise significant judgment in determining our income tax provision due to transactions, credits and calculations where the ultimate tax determination is uncertain. Uncertainties arise as a consequence of the actual source of taxable income between domestic and foreign locations, the outcome of tax audits and the ultimate utilization of tax credits. Although we believe our estimates are reasonable, the final tax determination could differ from our recorded income tax provision and accruals. In such case, we would adjust the income tax provision in the period in which the facts that give rise to the revision become known. These adjustments could have a material impact on our income tax provision and our net income for that period.

We recognize deferred income tax assets and liabilities based upon the differences between the financial statement carrying amounts and the tax bases of assets and liabilities. Such deferred income taxes primarily relate to the timing of the recognition of certain revenue items and the timing of the deductibility of certain reserves and accruals for income tax purposes. We regularly review the deferred tax assets for recoverability and establish a valuation allowance when it is more likely than not that some portion or all of the deferred tax assets will not be realized. In 2004 we concluded that the valuation allowance associated with domestic NOL's and other temporary differences should be fully reversed as a result of the cumulative domestic profits in recent years and future domestic projections. However, we could be required to record additional valuation allowance against the deferred tax assets if we are unable to generate sufficient future taxable income, fail to benefit from our tax planning strategies or if there is a material change in the actual effective tax rates or time periods within which the underlying timing differences become taxable or deductible. Increases in the valuation allowance could have a material adverse impact on our income tax provision and our net income. The remaining portion of the valuation allowance of \$15 million related to stock option deductions will result in an increase to additional paid in capital should the company generate sufficient taxable income in future years to utilize the net operating loss carryforwards recorded as a deferred tax asset.

## Results of Operations

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

	Three Months Ended March 31,	
	2005	2004
Revenue:		
Software	38.5 %	41.6 %
Customer support	48.3	45.5
Professional services and education	13.2	12.9
Total Revenue	100.0	100.0
Cost of revenue:		
Software	2.4	3.5
Customer support	10.5	10.4
Professional services and education	10.4	10.9
Total cost of revenue	23.3	24.8
Gross Profit	76.7	75.2
Operating expenses:		
Sales and marketing	38.2	41.8
Research and development	18.6	20.2
General and administrative	9.2	9.2
Total operating expenses	66.0	71.2
Operating income	10.7	4.0
Other income, net	2.0	0.9
Income before income tax	12.7 %	4.9 %

## Revenue

Total revenue in the quarter ended March 31, 2005 compared to the same period in 2004 was virtually unchanged with an increase of less than half a percentage point. Our software segment showed a 7.0% decline in revenue year over year. Fluctuation in software revenue is attributable to the timing of one or a few large enterprise transactions when comparing quarters. Revenue in our service segments increased when comparing the first quarter of 2005 to the first quarter of 2004. A high rate of renewal in our customer support segment and an increase in professional services and education revenue offset the decrease in software revenue.

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

## Revenue by Geography

<i>(in thousands)</i>	Three Months Ended March 31,		<i>% Increase/ decrease</i>
	2005	2004	
<b>\$ Total Revenue</b>			
Total United States Revenue	\$ 68,597	\$ 68,000	0.9%
Europe, Middle East and Africa	25,538	25,317	0.9%
Canada, Latin America and Asia	5,882	6,181	(4.8%)
Total International Revenue	<u>31,420</u>	<u>31,498</u>	(0.2%)
Total Revenue	\$ 100,017	\$ 99,498	0.5%
<b>% of Total Revenue</b>			
United States Revenue	68.6 %	68.3 %	
International Revenue	<u>31.4 %</u>	<u>31.7 %</u>	
Total Revenue Contribution	100.0 %	100.0 %	

Revenue generated in the United States grew by 0.9% in the first three months of 2005 compared to the same period in 2004. This increase during the three-month period is primarily due to the increase in service revenue. International revenue represented approximately 31.4% of total revenue in the first three months of 2005 compared to approximately 31.7% for the same three months in 2004. The factors driving software license and service revenue changes will be more fully discussed in the *Revenue by Reporting Segment* section below.

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

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

**Revenue by Reporting Segment**

<i>(in thousands)</i>	Three Months Ended March 31,		<i>% Increase / (decrease)</i>
	<b>2005</b>	<b>2004</b>	
<b>\$ Total Revenue</b>			
Software	\$ 38,451	\$ 41,351	(7.0%)
Customer Support	48,333	45,270	6.8%
Professional Services and Education	13,233	12,877	2.8%
Total Revenue	\$ 100,017	\$ 99,498	0.5%
<b>% of Total Revenue</b>			
Software	38.5%	41.6%	(3.1%)
Customer Support	48.3%	45.5%	2.8%
Professional Services and Education	13.2%	12.9%	0.3%
Total Revenue	100.0%	100.0%	
Contribution	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 7.0% in the three-month period ended March 31, 2005 compared to the same period in 2004. As we have seen in prior quarters, fluctuation in buying patterns and the number of large enterprise transactions that close in any particular quarter can affect our level of software sales quarter to quarter. One customer accounted for 9% of total revenue in the first quarter of 2004. There were no individually significant sales of this size in the first quarter of 2005, which accounts for the year-to-year decrease. This buying behavior creates an environment that is unpredictable and we believe this will continue in the near term. In the longer term we believe spending on enterprise content management and business process management software will be a priority as companies look to automate regulatory and compliance requirements. Additionally, we believe there will be increased demand for our ECM products driven by the need for large organizations to manage their unstructured content.

**Customer Support.** Customer support revenue consists of revenue from software maintenance contracts, time and material revenues and the sale of spare parts and supplies. Maintenance contracts entitle our customers to receive technical support, enhancements and upgrades to new versions of software releases when and if available. Time and material revenue is derived from services provided to the customer that are not included in their maintenance contract entitlements. Customer support revenue is generated from new maintenance contracts for current year software sales and from the renewal of existing maintenance contracts for previously sold software licenses on installed systems. Customer support revenue increased by 6.8% in the three-month period ended March 31, 2005 compared to the same period in 2004. We have historically experienced a high contract maintenance renewal rate and continue to see this same high level of renewal, but are continuing to encounter pricing pressures from our customers during contract negotiation and renewal. Accordingly, the rate of software revenue growth may not directly correlate to the same growth for customer support revenue experienced in the past.

**Professional Services and Education.** Professional services and education revenue is generated from consulting and implementation services to end users of our software products, technical consulting services provided to our resellers, and training services. No modifications are made to our standard base product code once the software has been sold. Professional services and education revenue increased by 2.8% in the three months ended March 31, 2005 compared to the same period in 2004. 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 and education revenue we experienced in the first three months of 2005 compared to the same period in 2004 was primarily attributable to the increase in P8 software license sales. Based on software revenue sales for the past year 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

(in thousands)	Three Months Ended March 31,		% Increase/ (decrease)
	2005	2004	
<b>\$ Total Cost of Revenue</b>			
Software	\$ 2,370	\$ 3,523	(32.7%)
Customer Support	10,526	10,292	2.3%
Professional Services and Education	10,384	10,838	(4.2%)
Total Cost of Revenue	\$ 23,280	\$ 24,653	(5.6%)
<b>% Total Cost of Revenue</b>			
Software	6.2%	8.5%	(2.3%)
Customer Support	21.8%	22.7%	(0.9%)
Professional Services and Education	78.5%	84.2%	(5.7%)
Total Cost of Revenue as a % of Revenue	23.3%	24.8%	(1.5%)

**Software.** Cost of software revenue includes royalties paid to third parties for technology used in our products to enhance features and functionality, referral fees, amortization of acquired technology, media costs, and the cost to manufacture and distribute software. The cost of software revenue in absolute dollars decreased by 32.7% when comparing the three months ended March 31, 2005 to the same three months in 2004. The cost of software revenue as a percent of software revenue decreased 2.3 percentage points in the three-month period comparison. Costs will fluctuate period to period based on the mix of products sold containing third party royalties and fees. A majority of the current quarter decrease is due to royalty costs being \$0.9 million less than the prior year quarter. However, we anticipate continuing to integrate third party technology with our software which could lower our margins in the future by several percentage points from current levels. Going forward we anticipate the cost of software revenue to be approximately 8%-10% of software revenue.



**Customer Support.** Cost of customer support revenue includes the cost of compensation and benefits paid to customer support personnel, facility and technology infrastructure expenses in our call centers, supplies and spare parts. The cost of customer support revenue as a percent of customer support revenue decreased by 0.7 percentage points in the three months ended March 31, 2005 compared to the same period in 2004. The cost of customer support revenue in absolute dollars increased \$0.2 million in these comparable periods due to minor increases in variable compensation, third-party maintenance and a variety of other expense items. The reduction in cost of customer support revenue, as a percentage of the revenue is attributable to efficiencies in the delivery of technical support, which allows for increased revenue without a comparable increase in cost. We expect the cost of customer support revenue to remain at approximately 21%-24% 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 5.7 percentage points in the three months ended March 31, 2005 as compared to the same period in 2004. This decrease in cost of professional services and education revenue as a percent of professional services and education revenue is primarily attributable to lower costs associated with reduced employee headcount resulting in \$0.5 million in lower benefit costs and lower variable employee compensation. In the near-term 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, but to average in a range between 80%-82% of revenue.

## 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

<i>(in thousands)</i>	Three Months Ended March 31,		% Increase/ (decrease)
	2005	2004	
<b>\$ Total Operating Expenses</b>			
Research and Development	\$ 18,630	\$ 20,102	(7.3%)
Marketing and Sales	38,182	41,561	(8.1%)
General and Administrative	9,227	9,233	(0.1%)
Total Operating Expenses	\$ 66,039	\$ 70,896	(6.9%)
<b>% Total Operating Expenses</b>			
Research and Development	18.6%	20.2%	(1.6%)
Marketing and Sales	38.2%	41.8%	(3.6%)
General and Administrative	9.2%	9.3%	(0.1%)
Operating Expense as a % of Revenue	66.0%	71.3%	(5.3%)

**Research and Development.** Our research and development efforts are focused on enhancing and maintaining our Enterprise Content Management capabilities. Our efforts focus on our product suites including Business Process Manager, Content Manager, Image Manager, Email Manager, Records Manager, Forms Manager, Team Collaboration Manager, Web Content Manager and other capabilities.

Our research and development expense consists primarily of personnel costs for internal software development; third party contracted development resources, and related facilities costs. Research and development expense decreased 7.3% in the three months ended March 31, 2005 compared to the same period in 2004 due primarily to lower internal personnel and facility expense of \$1.5 million resulting from decreased headcount. The number of internal research and development personnel was 401 on March 31, 2005 compared to 452 on March 31, 2004. We currently have 94 contract workers in India developing software compared to 99 one year ago. This reduction resulted in a decrease in research and development expense as a percent of revenue by 1.6 percentage points for the three months ended March 31, 2005 compared to the same period in 2004. Offshore development cost remained constant at approximately \$2.0 million for the comparable periods. We intend to modestly increase research and development headcount in the short term to invest in adding functionality to our FileNet P8 platform, increase support for industry standards, and extend the scalability, manageability, and openness of the FileNet P8 architecture. 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 range between 18%-20% of revenue assuming revenue growth in the near term.

**Selling and Marketing.** We sell our products through a direct sales force and our indirect channel sales partners. The majority of our selling and marketing expense is salaries, benefits, sales commissions and other expenses related to the direct and indirect sales force, and personnel cost for marketing and market development programs. Selling and marketing expense as a percent of revenue decreased by 3.6 percentage points for the three months ended March 31, 2005 compared to the same period in 2004. In absolute dollars selling and marketing expense decreased by 8.1% for the three months ended March 31, 2005 compared to the same period in 2004. Approximately \$1.9 million of the decrease in absolute dollars was attributable to reduced compensation and benefits resulting from lower headcount. Headcount was 534 as of March 31, 2005 compared to 582 as of March 31, 2004. Reduced spending in programs, travel, and the annual sales kickoff meeting held in the first quarter accounted for the balance of the decrease. We expect expense levels in future quarters to reflect incremental hiring in sales and increased marketing program expense related to lead generation and brand awareness and we expect selling and marketing expense to range between 38%-40% of revenue in the near-term.

**General and Administrative.** Our general and administrative expense consists primarily of salaries, benefits, and other expenses related to personnel costs for finance, information technology, legal, human resources and general management and the cost of outside professional services. General and administrative expense as a percent of revenue and in absolute dollars remained constant in the three months ended March 31, 2005 compared to the same period in 2004. We expect general and administrative expense to range between 8%-10% of revenue in the near-term.

**Other Income, Net.** Other income, net consists primarily of interest income earned on our cash and investments, and other items including realized foreign exchange gains and losses and interest expense. Other income, net of other expenses, was \$2.0 million for the three months ended March 31, 2005 compared to \$1.1 million during the three months ended March 31, 2004. Interest income increased \$0.9 million in the first quarter of 2005 compared to the first quarter in 2004. This increase is attributable to a higher cash balance and a higher weighted average interest rate earned on cash, cash equivalents and investments which was 2.44% during the three months ended March 31, 2005 compared to 1.48% for the same period in 2004.

***Provision for Income Taxes.*** Our combined federal, state and foreign annual effective tax rate applied to the three months ended March 31, 2005 was 35%, compared to 18% for the comparable period in 2004. The increased effective tax rate applied to the three months ended March 31, 2005 was primarily due to i) the mix of income earned by domestic operations versus the foreign subsidiaries, and ii) the absence of a valuation allowance reversal that benefited our rate in 2004.

### **Liquidity and Capital Resources**

As of March 31, 2005, cash and cash equivalents and investments were \$375.4 million, an increase of \$26.7 million from \$348.7 million at December 31, 2004. Cash, cash equivalents and investments include \$299.3 million in the United States and \$76.1 million held by our foreign subsidiaries. Cash and cash equivalents consist of high quality and highly liquid investments in short-term money market funds, United States government agency discount notes, and corporate notes. Cash equivalent investments include instruments with original maturities of 90 days or less. Short-term investments include investment instruments with maturities of greater than 90 days and less than 365 days as well as auction rate securities that reset interest rates at auction intervals ranging from 7, 28, 35, or 49 days. Long-term investments consist of high grade corporate and government securities with maturities greater than 12 months and less than three years.

Our two major sources of cash in the past two fiscal years have been cash generated from operations and cash generated from financing activities. The amount of these sources can fluctuate depending on operational activities and stock price as more fully discussed below. Cash flow from operations was \$29.3 million for the three months ended March 31, 2005 compared to \$36.0 million for the same three months in 2004. Cash provided by financing activities was \$1.3 million in the three months ended March 31, 2005 compared to \$10.2 million for the same period in 2004.

Net income is a primary source of cash from operating activities. Net income was \$8.3 million and \$4.0 million for the three months ended March 31, 2005 and 2004, respectively. Depreciation and amortization added to net income to provide cash from operating activities - although the amount has declined year to year due to tight budgetary control over capital spending. Depreciation and amortization was \$3.8 million in the first quarter of 2005 down from \$4.3 million in the first quarter of 2004. Our cash from operations is also impacted by changes in working capital accounts. Changes in accounts receivable and unearned revenue have typically had the largest impact on our cash flows. The days sales outstanding metric, which is calculated by dividing quarter-end accounts receivable by average daily sales for the quarter, was 36 days at March 31, 2005 compared to 30 days at of March 31, 2004. We attempt to structure our sales contracts to require a majority of payments in 30 days or less, and all payments in 90 days or less. To the extent that competitive pressures require us to extend our terms, it would result in a decrease to our operating cash flows. Our annual customer support agreements are typically prepaid at the beginning of the support period, resulting in a large cash inflow and a corresponding increase in unearned maintenance revenue. This has historically resulted in significant cash inflows in the first quarter, when the largest portion of our support agreements renews. This trend continued in the first quarter of 2005.

Net cash generated from investing activities was \$83.3 million compared to net cash used in investing activities of \$5.9 million in the three months ended March 31, 2005 and 2004, respectively. Capital spending has been fairly consistent and under tight budgetary control and accounted for net cash used of \$1.6 million in the first quarter of 2005 and \$2.7 million in the first quarter of 2004. We do not expect capital expenditure levels in 2005 to differ significantly from the level of the past year. Significant changes in cash from investing activities have resulted from the purchase and sale of investments. Excess cash from operations is invested in high quality debt instruments and securities, and the timing of purchases and maturities of investments could result in significant short-term fluctuations in net cash used or generated from investing activities. During the first quarter of 2005, most auction-rate securities were sold which resulted in an increase in cash and cash equivalents and at the same time generated the large increase from proceeds from the sale of marketable securities that is reflected in the first quarter of 2005. As we

continue to generate excess cash, we expect to invest such amounts in marketable securities and thus continue to show a net use of cash related to investing activities. However, based on the nature of our investment policy, all such investments are available in the short term if needed for any reason.

Net cash provided by financing activities results from the proceeds of common stock related to employee stock option plans and employee stock purchase plans. Cash generated from this activity was \$1.3 million for the three months ended March 31, 2005 compared to \$10.2 million for the same period in 2004. Stock prices unfavorably influenced this activity in the first quarter of 2005 with a lower stock price compared to the first quarter of 2004. When our stock price is greater than the exercise price of outstanding stock options, we expect to generate cash from option exercises.

The effect of exchange rate changes on cash and cash equivalents held in foreign currency had the effect of decreasing net cash in the two periods as the Euro and other currencies weakened against the dollar in those two quarters.

We have no borrowing arrangements as of March 31, 2005. We believe that our present cash balances, together with internally generated funds, will be sufficient to meet our working capital and capital expenditures throughout 2005. See “Risk Factors”.

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

In December 2004, the FASB revised Statement No. 123 (FAS 123R), “Share-Based Payment,” which requires companies to expense the estimated fair value of employee stock options and similar awards based on the grant-date fair value of the award. The cost will be recognized over the period during which an employee is required to provide service in exchange for the award, usually the vesting period. The accounting provisions of FAS 123R will be effective as of the beginning of the first fiscal year that begins after June 15, 2005. We will adopt the provisions of FAS 123R on January 1, 2006 using a modified prospective application. Under the modified prospective application, FAS 123R, will apply to new awards, unvested awards that are outstanding on the effective date and any awards that are subsequently modified or cancelled. Compensation expense for outstanding awards for which the requisite service had not been rendered as of the effective date will be recognized over the remaining service period using the

compensation cost calculated for pro forma disclosure purposes under FAS 123 (Note 3 Stock-Based Compensation). We are in the process of determining how the new method of valuing stock-based compensation as prescribed in FAS 123R will be applied to valuing stock-based awards granted after the effective date and the impact the recognition of compensation expense related to such awards will have on our 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:

- 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;
- information technology spending trends;
- the discretionary nature of our customers’ budget and purchase cycles and the absence of long-term customer purchase commitments;
- 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;
- general domestic and international economic and political conditions;
- seasonality in technology purchases, and
- a significant portion of our expenses are personnel related and fixed and cannot be adjusted quickly in response to actual or anticipated revenue trends.

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 EMC either have entered or may enter our market by adding content management features to their existing suite of products. In addition, large hardware or infrastructure 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.
- 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 partners;
- multiple overlapping tax regimes;
- currency restrictions and currency exchange fluctuations;
- the burden of complying with a wide variety of complex foreign laws, regulations and treaties;
- spreading our management resources to cover multiple countries; or,
- longer collection cycles and higher risk of non-collection and bad debt expense.

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

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

***We must develop and sell new products to keep up with rapid technological change in order to achieve future revenue growth and profitability.*** The market for our software and services is characterized by rapid technological developments, evolving industry standards, changes in customer requirements and frequent new product introductions and enhancements. Our ability to continue to sell products will be dependent upon our ability to continue to enhance our existing software and services offerings, develop and introduce, in a timely manner, new software products incorporating technological advances and respond to customer requirements. For example, three new product suites that we predict can address new markets include Records Manager, E-Mail Manager and Team Collaboration Manager. The Records Manager Suite was released in the third quarter of 2004 and provides customers with the capability to systematically apply records management principles to content. E-Mail Manager was released in late 2004 and allows organizations with large numbers of email users to effectively manage email content. The Team Collaboration Manager Suite was released during the first quarter of 2005 and is designed to enable customers to initiate collaborative tasks at any point in a process.

We may not be successful in developing, marketing and releasing new products or new versions of our products that respond to technological developments, evolving industry standards or changing customer requirements. We may also experience technical difficulties that could delay or prevent the successful development, introduction, sale and implementation of these products and enhancements. In the past, we have experienced delays in the release dates of enhancements and new releases to our products and we may experience significant future delays in product introduction. From time to time, our competitors or we may announce new software products, capabilities or technologies that have the potential to replace or shorten the life cycles of our existing software products. Announcements of currently planned or other new software products may cause customers to delay their purchasing decisions in anticipation of such software products, and such delays could have a material adverse effect on our sales. In addition, our ability to generate revenues from the sale of customer support, education and professional services is substantially dependent on our ability to generate new sales of our software products.

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

***We must devote substantial resources to software development, and we may not realize revenue from our development efforts for a substantial period of time.*** Introducing new products that rapidly address changing market demands requires a continued high level of investment in research and development. We expect to invest approximately 19% of annual revenue in research and development efforts in the near term. The majority of our investment in new and existing market opportunities is made prior to our ability to generate revenue from these new opportunities. These investments of money and resources are made based on our prediction of new products and services that we anticipate 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 a portion of our software development of specific products and software localization work. As a result, we will become increasingly dependent on these third party developers for continued development and support 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 or performance problems, 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 performance problems, 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 often contain undetected errors or performance problems that are discovered only after a product has been installed and used by customers. Errors or performance problems could cause delays in product introduction and shipments or could require design modifications, either of which could lead to a loss in or delay of revenue. These problems could cause a diversion of development resources, harm our reputation or result in increased service or warranty costs, or require the payment of monetary damages. While our license agreements with customers typically contain provisions designed to limit our exposure to potential product liability claims, it is possible that such limitation of liability provisions may not be effective under the laws of certain jurisdictions.



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

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

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

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

***Our business is highly automated for the execution of marketing, selling and technical support functions, and natural disasters that disable these systems could result in a disruption in our ability to transact business.*** We depend on the integrity of our information systems network connectivity to perform these business functions. While mitigating measures have been put in place, significant business interruption could occur at our Costa Mesa headquarters facility due to a natural disaster such as an 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 broaden the number of third party platforms with which our products are compatible and the loss of these relationships could harm our business.*** In order to broaden the number of third party platforms with which our products are compatible and thereby broaden the market opportunities for our products, we have established strategic relationships with a number of software and hardware platform vendors, including companies such as BEA Systems Inc., Hewlett-Packard Development Company LP, Network Appliance, Inc., Sun Microsystems and Veritas Software Corporation. We cannot assure that these companies will not reduce or discontinue their relationships with, or support of, FileNet and our products. If we fail to maintain these relationships, or to establish new relationships in the future, it could harm our business, financial condition and results of operations.

***We currently license certain software from third parties, including software that is integrated with internally developed software and used in our products to perform key functions. Also, certain of our products include publicly available software pursuant to open source license agreements. We would be unable to sell these products if we do not maintain these licenses, which would result in reduced revenue.*** In the past, we have had difficulty renewing certain licenses. The failure to continue to maintain these licenses would prohibit us from selling certain products until replacement functionality could be developed, licensed or acquired. 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, licensed, or acquired 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.

***In addition to our direct sales force, we depend on relationships with systems integrators, independent software vendors, and value added resellers to sell our products and services. The loss of a large strategic partner could affect our ability to sell in a specific segment of the market.*** We cannot assure that these channel partners will remain in business or continue to promote or sell our products or services. The loss or inability to maintain these channel partner relationships, or our failure to establish new channel partner relationships in the future, could harm our business, financial condition and results of operations.

***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 earnings per share 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 except for auction-rate securities that are considered as short term investments for any maturities less than 365 days. 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. The average maturity of our investment portfolio is 78 days; therefore, the movement of interest rates should not have a material impact on our balance sheet or income statement.

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.

At any time, a significant increase/decrease in interest rates will have an impact on the fair market value and interest earnings of our investment portfolio. We do not currently hedge this interest rate exposure. We have performed a sensitivity analysis as of March 31, 2005 and 2004, using a modeling technique that measures the change in the fair values arising from a hypothetical 50 basis points and 100 basis points adverse movement in the levels of interest rates across the entire yield curve, which are

representative of historical movements in the Federal Funds Rate with all other variables held constant. The analysis covers our investment and is based on the weighted-average maturity of our investments as of March 31, 2005 and 2004. 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 \$314,000 at March 31, 2005 and approximately \$223,000 at March 31, 2004. 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 \$629,000 at March 31, 2005 and approximately \$446,000 at March 31, 2004.

The following table provides information about our investment portfolio at March 31, 2005:

<i>(in thousands)</i>	<b>Cost</b>	<b>Unrealized Gain/(Loss)</b>	<b>Estimated Fair Value</b>
<b>Debt Securities</b>			
Due in one year or less:			
Short-term munis-taxable	\$ 7,500	\$ -	\$ 7,500
Corporate	7,091	(27)	7,064
Governments/Agencies	116,525	(409)	116,116
Total due in one year	131,116	(436)	130,680
Due in one to three years:			
Corporate			
Government/Agencies	9,687	(102)	9,585
Total due in three years	9,687	(102)	9,585
Grand total	<u>\$ 140,803</u>	<u>\$ (538)</u>	<u>\$ 140,265</u>

### **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 in an effort to hedge against the effects of fluctuating currency exchange rates on monetary assets and liabilities denominated in currencies other than the functional currency of the relevant entity (mainly in Europe and Asia Pacific). 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. Gains and losses on foreign exchange contracts are recognized in income in the same period as the gains and losses occur. Our forward contracts have an original maturity of three months. These contracts were closed on the last business day of the quarter ending March 31, 2005 and as such there were no outstanding forward contracts as of March 31, 2005.

Cumulative other comprehensive income decreased \$2.7 million during the three-month period ended March 31, 2005 due to unrealized foreign currency translation loss of \$2.6 million resulting from the weakening of the Euro against the U.S. dollar the first three months of 2005.

Management believes that inflation has not had a significant impact on the prices of our products, the cost of our materials, or our operating results for the three months ended March 31, 2005.

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

*Conclusion regarding the effectiveness of disclosure controls and procedures.* We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Securities Exchange Act of 1934 (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 March 31, 2005, 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 Securities Exchange Act of 1934 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.

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

## **PART II. OTHER INFORMATION**

#### **Item 1. Legal Proceedings**

See Note 10 to Condensed Consolidated Financial Statements.

#### **Item 6. Exhibits**

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

**SIGNATURE**

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

**FILENET CORPORATION**

May 10, 2005  
*Date*

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

## Index to Exhibits

<u>Exhibit No.</u>	<u>Exhibit Description</u>
3.1*	Restated Certificate of Incorporation, as amended ( <i>filed as Exhibit 3.1 to Registrant's Form S-4 filed on January 26, 1996; Registration No. 333-00676</i> ).
3.1.1*	Certificate of Amendment of Restated Certificate of Incorporation ( <i>filed as Exhibit 3.1.1 to Registrant's Form S-4 filed on January 26, 1996, Registration No. 333-00676</i> ).
3.2*	Bylaws ( <i>filed as Exhibit 3.2 of the Registrant's registration statement on Form S-1, Registration No. 33-15004</i> ).
4.1*	Form of certificate evidencing Common Stock ( <i>filed as Exhibit 4.1 to Registrant's registration statement on Form S-1, Registration No. 33-15004</i> ).
4.2*	Rights Agreement, dated as of November 4, 1988 between FileNet Corporation and the First National Bank of Boston, which includes the form of Rights Certificate as Exhibit A and the Summary of Rights to Purchase Common Shares as Exhibit B ( <i>filed as Exhibit 4.2 to Registrant's registration statement on Form S-4 filed on January 26, 1996; Registration No. 333-00676</i> ).
4.3*	Amendment One dated July 31, 1998 and Amendment Two dated November 9, 1998 to Rights Agreement dated as of November 4, 1988 between FileNet Corporation and BANKBOSTON, N.A. formerly known as The First National Bank of Boston ( <i>filed as Exhibit 4.3 to Registrant's registration statement on Form 10-Q for the quarter ended September 30, 1998</i> ).
4.4*	Amendment Three dated November 30, 2001 to Rights Agreement dated as of November 4, 1988 between FileNet Corporation and Equiserve Trust Company, N.A., successors to BANKBOSTON, N.A. ( <i>filed as Exhibit 4.4 to Registrant's Annual Report on Form 10-K filed for the year ended December 31, 2001</i> ).
10.2*+	Amended and Restated 1995 Stock Option Plan of FileNet ( <i>filed as Exhibit 99.1 to Registrant's registration statement on Form S-8 filed on October 15, 2001; Registration No. 333-71598</i> ).
10.2.1*+	Amendment to the 1995 Stock Option Plan approved by Registrant's Board of Directors dated May 7, 2003 ( <i>filed as Exhibit 10.2.1 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003</i> ).
10.2.2*+	Amended Form of 1995 Executive Officer Stock Option Agreement ( <i>filed as Exhibit 10.2.2 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003</i> ).
10.3*+	Second Amended and Restated 1986 Stock Option Plan of FileNet Corporation, together with the forms of Incentive Stock Option Agreement and Non-Qualified Stock Option Agreement ( <i>filed as Exhibits 4(a), 4(b) and 4(c), respectively, to the Registrant's registration statement on Form S-8, Registration No. 33-48499</i> ), the first Amendment thereto ( <i>filed as Exhibit 4(d) to the Registrant's registration statement on Form S-8, Registration No. 33-69920</i> ), and the Second Amendment thereto ( <i>filed as Appendix A to the Registrant's Proxy Statement for the Registrant's 1994 Annual Meeting of Stockholders, filed on April 29, 1994</i> ).
10.4*+	Non-Statutory Stock Option Agreement (with Notice of Grant of Stock Option and Special Addendum) between Registrant and Mr. Lee Roberts ( <i>filed as Exhibit 99.17 to Registrant's registration statement on Form S-8 filed on August 20, 1997</i> ).
10.6*+	Amended and Restated FileNet Corporation 1998 Employee Stock Purchase Plan ( <i>filed as Appendix B to Registrant's Definitive Proxy Statement on Schedule 14A, for the Registrant's 2002 Annual Meeting of Stockholders, filed on April 18, 2002</i> ).
10.6.1*+	Amendment No. 1 to the FileNet Corporation Amended and Restated 1998 Employee Stock Purchase Plan ( <i>filed as exhibit 10.6.1 to Registrant's Current Report of Form 8-K filed on April 11, 2005</i> ).
10.6.2*+	Revised Amendment No. 1 to the FileNet Corporation Amended and Restated 1998 Employee Stock Purchase Plan ( <i>filed as exhibit 10.6.2 to Registrant's Current Report of Form 8-K filed on April 21, 2005</i> ).
10.7*+	FileNet Corporation International Employee Stock Purchase Plan ( <i>filed as Appendix C to Registrant's Definitive Proxy Statement on Schedule 14A, for the Registrant's 2002 Annual Meeting of Stockholders, filed on April 18, 2002</i> ).
10.7.1*+	Amendment No. 1 to the FileNet Corporation Amended and Restated International Employee Stock Purchase Plan ( <i>filed as exhibit 10.7.1 to Registrant's Current Report of Form 8-K filed on April 11, 2005</i> ).
10.7.2*+	Revised Amendment No. 1 to the FileNet Corporation Amended and Restated International Employee Stock Purchase Plan ( <i>filed as exhibit 10.7.2 to Registrant's Current Report of Form 8-K filed on April 21, 2005</i> ).
10.8*	Lease between the Registrant and C. J. Segerstrom & Sons for the headquarters of the Company, dated September 1, 1999 ( <i>filed as Exhibit 10.23 to Registrant's registration statement on Form 10-Q for the quarter ended September 30, 1999</i> ).

10.10*+	Written Compensation Agreement and Non-Statutory Stock Option Agreement (with Notice of Grant of Stock Option and Special Addendum) between Registrant and Mr. Sam Auriemma (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) <sup>(1)</sup> .
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). <sup>(2)</sup>
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, William J. Kreidler, Chas W. Kunkelmann, Philip Rugani, Daniel S. Whelan, Franz X. Zihlmann, and Ms. Audrey N. Schaeffer. Amended and Restated Letter Agreement with substantially the same terms and conditions was entered into between Registrant and Philip C. Maynard dated August 30, 2004, and L. Kim Poindexter dated January 1, 2005.