ZIX CORP
Form 10-Q/A
August 09, 2004

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q/A

(Mark One)

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

For the quarterly period ended March 31, 2004

o **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: 0-17995

ZIX CORPORATION

(Exact Name of Registrant as Specified in its Charter)

Texas	**75-2216818**
(State of Incorporation)	**(I.R.S. Employer Identification Number)**

2711 North Haskell Avenue
Suite 2300, LB 36
Dallas, Texas 75204-2960
(Address of Principal Executive Offices)

(214) 370-2000
(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 þ No o

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes þ No o

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Class	Outstanding at April 30, 2004
Common Stock, par value $.01 per share	**31,727,909**

Purpose of Amendment

This Form 10-Q/A is being filed for the purpose of amending Items 1 and 2 of Part I of Form 10-Q as of March 31, 2004 filed on May 10, 2004 to reflect the restatement of the Company s Condensed Consolidated Financial Statements, as discussed in Note 6 thereto, and other information related to such restated Condensed Consolidated Financial Statements. All information in the Form 10-Q/A is as of March 31, 2004 and does not reflect any subsequent information or events other than such changes.

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PART I-FINANCIAL INFORMATION

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ZIX CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except share data)

(Unaudited)

	March 31, 2004	December 31, 2003
	(as restated, see Note 6)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 19,325	$ 6,599
Marketable securities	4,758	7,253
Receivables, net	504	359
Other current assets	1,524	1,147
Total current assets	26,111	15,358
Property and equipment, net	4,638	3,151
Intangible assets, net	5,881	3,589
Goodwill	9,119	4,321
	$ 45,749	$ 26,419
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$ 4,666	$ 3,738
Deferred revenue	4,351	4,066
Customer deposit	1,000	
Total current liabilities	10,017	7,804
Deferred revenue non-current	1,130	696
Customer deposit non-current	3,000	
Promissory note payable	1,580	
Commitments and contingencies		
Stockholders equity:		
Preferred stock, $1 par value, 10,000,000 shares authorized; none issued and outstanding		
Common stock, $.01 par value, 175,000,000 shares authorized; 33,186,291 issued and 30,859,110 outstanding in 2004 and 31,155,646 issued and 28,828,465 outstanding in 2003	332	312

Additional capital	253,608	230,580
Unearned stock-based compensation	(33)	(26)
Treasury stock, at cost; 2,327,181 common shares	(11,507)	(11,507)
Accumulated deficit	(212,378)	(201,440)
Total stockholders equity	30,022	17,919
	$ 45,749	$ 26,419

See accompanying notes.

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ZIX CORPORATION

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

(Unaudited)

	Three Months Ended March 31	
	2004	**2003**
	(as restated, see Note 6)	
Revenues:		
Services	$ 2,516	$ 639
Software sales	327	
	2,843	639
Cost of revenues	(3,174)	(1,760)
Research and development expenses	(2,845)	(1,204)
Selling, general and administrative expenses	(7,806)	(4,523)
Investment and other income	58	41
Interest expense	(55)	
Realized and unrealized gain on investments	70	
Loss before income taxes	(10,909)	(6,807)
Income taxes	(29)	(24)
Net loss	$(10,938)	$ (6,831)
Basic and diluted loss per common share	$ (0.36)	$ (0.36)
Weighted average common shares outstanding	30,200	20,570

See accompanying notes.

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ZIX CORPORATION

CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY
(In thousands, except share data)
(as restated, Note 6)
(Unaudited)

	Stockholders Equity						
	Common Stock		Additional Capital	Unearned Stock-Based Compensation	Treasury Stock	Accumulated Deficit	Total Stockholders Equity
	Shares	Amount					
Balance, December 31, 2003	31,155,646	$ 312	$ 230,580	$ (26)	$ (11,507)	$ (201,440)	$ 17,919
Exercise of stock options and warrants for cash	1,403,647	14	10,971				10,985
Common stock issued for purchase of MyDocOnline	583,411	6	9,031				9,031
Warrants assigned to promissory note payable			1,475				1,475
Common stock issued in lieu of cash compensation	43,587		588				588
Non-cash compensation related to stock options			942				942
Unearned stock-based compensation for service providers			40	(40)			
Amortization of unearned stock-based compensation				33			33
Other			(19)				(19)
Net loss						(10,938)	(10,938)
Balance, March 31, 2004	33,186,291	$ 332	$ 253,608	$ (33)	$ (11,507)	$ (212,378)	$ 30,022

See accompanying notes.

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ZIX CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

(Unaudited)

	Three Months Ended March 31	
	2004	**2003**
	(as restated, see Note 6)	
Cash flows from operating activities:		
Net loss	$(10,938)	$(6,831)
Adjustments to reconcile net loss to net cash used by operating activities:		
Depreciation and amortization	1,554	917
Non-cash compensation related to stock options	942	187
Common stock issued in lieu of cash compensation	588	
Amortization of stock-based compensation	33	
Recovery of investment in Maptuit Corporation	(70)	
Changes in assets and liabilities, excluding acquisitions of businesses:		
Other assets	(168)	1,279
Customer deposit	4,000	
Other liabilities	1,118	456
Net cash used by operating activities	(2,941)	(3,992)
Cash flows from investing activities:		
Purchases of property and equipment, net	(883)	(576)
Purchases of marketable securities	(2,485)	
Sales and maturities of marketable securities	4,980	4,981
Cash received from Maptuit Corporation	70	
Net cash provided by investing activities	1,682	4,405
Cash flows from financing activities:		
Proceeds from exercise of stock options or warrants	10,985	334
Promissory note payable	3,000	
Net cash provided by financing activities	13,985	334
Increase in cash and cash equivalents	12,726	747
Cash and cash equivalents, beginning of period	6,599	7,586

Cash and cash equivalents, end of period	$ 19,325	$ 8,333

See accompanying notes.

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ZIX CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Basis of Presentation

General

The accompanying financial statements of Zix Corporation, which should be read in conjunction with the audited consolidated financial statements included in the Company s 2003 Annual Report to Shareholders on Form 10-K, are unaudited but have been prepared in the ordinary course of business for the purpose of providing information with respect to the interim periods. The Condensed Consolidated Balance Sheet at December 31, 2003 was derived from the audited Consolidated Balance Sheet at that date which is not presented herein. Management of the Company believes that all adjustments necessary for a fair presentation for such periods have been included and are of a normal recurring nature. The results of operations for the three-month period ended March 31, 2004 are not necessarily indicative of the results to be expected for the full year.

The Company operates in a single industry segment, providing solutions that protect, manage and deliver sensitive electronic information. These solutions are grouped into two categories: Communications Protection and Care Delivery Solutions. By offering two comprehensive sets of products and services, the Company protects organizations from viruses and spam, provides the management tools needed for Web access control and policy-driven email encryption, and provides care delivery solutions for e-prescribing, e-lab results, online doctor visits and e-consulting that enable physicians to leverage technology for better patient care.

In 1999, the Company began developing and marketing products and services that bring privacy, security and convenience to Internet users. ZixMail® is a desktop solution for encrypting and securely delivering email. The Company did not begin to charge for the use of ZixMail until the first quarter of 2001. In 2002, the Company began offering additional products. ZixVPM® (Virtual Private Messenger) is an e-messaging gateway solution that provides company-wide privacy protection for inbound and outbound email communications. ZixAuditor® is an assessment service used to analyze email traffic patterns and monitor compliance with corporate and regulatory policies. ZixPort provides a secure Web-messaging portal. In 2003, the Company introduced ZixWorks , a suite of fully managed hosted services that enables users to send email securely and that protects organizations from viruses, spam, inappropriate content and electronic attack.

In July 2003, the Company acquired substantially all of the operating assets and the business of PocketScript, LLC (PocketScript), a privately-held development stage enterprise that provided electronic prescription solutions for the healthcare industry. This acquisition enabled the Company to expand its services into care delivery, specifically, the e-prescription marketplace.

In September 2003, the Company acquired substantially all of the operating assets and the business of Elron Software, Inc. (Elron Software), a majority-owned subsidiary of Elron Electronic Industries Ltd. and a provider of anti-spam, email content filtering and Web filtering solutions. This acquisition enabled the Company to add a feature set to its anti-spam, anti-virus, and email content filtering services while expanding its offerings to include Web filtering. All of these solutions can now be offered on-premise, fully hosted, or co-sourced (meaning a shared service offering).

In January 2004, the Company acquired substantially all of the operating assets and the business of MyDocOnline, Inc. (MyDocOnline), a subsidiary of Aventis Pharmaceuticals, Inc., the North American pharmaceuticals business of Aventis SA. MyDocOnline offers a variety of Internet-based healthcare services and is a provider of secure Web-based communications, disease management, and laboratory information solutions. Through the acquisition, the Company acquired a fully developed product and an installed base of physicians using the products.

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Operating in emerging markets involves risks and uncertainties, and there are no assurances that the Company will be successful in its efforts. Successful growth of an early stage enterprise is costly and highly competitive. The Company s growth depends on the timely development and market acceptance of its products and services. In 2003 and the three month period ended March 31, 2004, the Company has incurred significant operating losses and the use of cash resources has continued at a substantial level. The Company anticipates further operating losses in 2004. At March 31, 2004, the Company s cash and marketable securities totaled $24,083,000. The Company s future cash requirements depend primarily on the timing and magnitude of cash flows generated from new customer orders. Subsequent to quarter end, through April 30, 2004, as a result of the exercise of stock options and warrants, the Company s liquidity improved as it received proceeds of $9,338,000 in exchange for 868,486 shares of the Company s common stock. On April 30, 2004, there are currently exercisable warrants and stock options, with an exercise price per share of $10.00 or less, to acquire approximately 3,864,000 shares of the Company s common stock, at an average price of approximately $5.31 per share, which if exercised would result in a significant level of additional new funding for the Company. Cash flows will also be impacted by capital expenditure requirements, resources devoted to the additional development of products and services and resources devoted to sales and marketing. The Company may need to raise additional funds in the future to sustain its operations or initiate reductions in operating expenses, or both. The Company will continue to consider various capital funding alternatives to strengthen its financial position. These capital funding alternatives could involve one or more types of equity securities, including convertible debt, common or convertible preferred stock and warrants to acquire common or preferred stock. Such equity securities could be issued at or below the then-prevailing market price for shares of the Company s common stock. The Company currently has no existing credit facilities. There can be no assurances that the Company will be able to raise additional capital on satisfactory terms if and when needed.

Receivables, net

Receivables, net consists of the following:

	March 31, 2004	December 31, 2003
Gross accounts receivable	$ 3,213,000	$ 2,306,000
Allowance for doubtful accounts	(96,000)	(93,000)
Deferred revenue	(2,613,000)	(1,854,000)
Receivables, net	$ 504,000	$ 359,000

The reduction for deferred revenue represents future customer service or maintenance obligations that have been billed to the customer but remain unpaid as of the date indicated. Deferred revenue on the Company s condensed consolidated balance sheets represents future customer service or maintenance obligations that have been billed and collected as of the respective balance sheet date.

Intangible Assets

At March 31, 2004, the Company s intangible assets, subject to amortization, were comprised of the following, which resulted from the third quarter 2003 acquisitions of PocketScript and Elron Software and the first quarter 2004 acquisition of MyDocOnline:

	March 31, 2004			December 31, 2003		
	Gross Carrying Amount, at Cost	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount, at Cost	Accumulated Amortization	Net Carrying Amount
Developed technology	$4,320,000	$559,000	$3,761,000	$2,269,000	$289,000	$1,980,000
Customer contracts and relationships	1,994,000	222,000	1,772,000	1,336,000	111,000	1,225,000
Trademarks and trade names	432,000	84,000	348,000	432,000	48,000	384,000
Total	$6,746,000	$865,000	$5,881,000	$4,037,000	$448,000	$3,589,000

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Amortization expense relating to intangible assets subject to amortization totaled $417,000 in the first quarter 2004. The estimated amortization expense for the remainder of 2004 and each of the next five years is as follows:

Nine months ended December 31, 2004	$1,413,000
2005	1,885,000
2006	1,547,000
2007	701,000
2008	310,000
2009	25,000

Stock Compensation

As permitted by Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation (SFAS 123), the Company accounts for stock-based compensation plans under the provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25) and related interpretations. SFAS 123 encourages adoption of a fair-value based method for valuing the cost of stock-based compensation; however, it allows companies to continue to use the intrinsic value method under APB 25 and disclose pro forma results and earnings per share in accordance with SFAS 123. Had compensation cost for the Company s stock-based compensation been determined consistent with the fair value method of SFAS 123, the Company s net loss and loss per common share would have been as follows:

	Three Months ended March 31,	
	2004	**2003**
Net loss, as reported	$(10,938,000)	$(6,831,000)
Add stock compensation expense recorded under the intrinsic value method	942,000	
Deduct pro forma stock compensation expense computed under the fair value method	(2,622,000)	(1,431,000)
Pro forma net loss	$(12,618,000)	$(8,262,000)
Basic and diluted loss per common share:		
As reported	$ (0.36)	$ (0.36)
Pro forma	$ (0.42)	$ (0.43)

Loss per common share

The amounts presented for basic and diluted loss per common share in the accompanying statements of operations have been computed by dividing the losses applicable to common stock by the weighted average number of common shares outstanding. A reconciliation of the numerator of basic and diluted net loss per share is provided as follows:

	Three Months ended March 31,	
	2004	**2003**
Net loss before preferred stock dividends	$(10,938,000)	$ (6,831,000)
Accretion of preferred stock dividend		(494,000)
Net loss attributable to common stock	$(10,938,000)	$ (7,325,000)
Basic and diluted loss per common share	$ (0.36)	$ (0.36)
Weighted average common shares		
Weighted average common shares outstanding basic and diluted	30,200,000	20,570,000

The two presentations are equal in amounts because the assumed exercise of common stock equivalents would be anti-dilutive, because a net loss was reported for each period. The accretion of preferred stock dividends shown above pertain to the Series A and Series B convertible preferred stocks, which were issued and outstanding during that period. Common stock equivalents that have been excluded from the computation of diluted loss per common share consist of the following:

	Three Months ended March 31,	
	2004	**2003**
Stock options	6,294,000	6,989,000
Warrants	3,365,000	4,158,000
Convertible preferred stock		1,858,000
	9,659,000	13,005,000

Total common stock equivalents excluded		

2. Business Acquisitions and Related Transactions

MyDocOnline, Inc.

On January 30, 2004, the Company acquired substantially all of the operating assets and the business and assumed certain liabilities of MyDocOnline, a subsidiary of Aventis Pharmaceuticals, Inc., the North American pharmaceuticals business of Aventis SA and a leading provider of secure Web-based communications, disease management, and laboratory information solutions, pursuant to an asset purchase agreement. The consideration for the net assets acquired consisted of 583,411 shares of the Company s common stock.

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The components of the aggregate cost of the acquisition are as follows:

Fair market value of 583,411 shares of the Company s common stock	$9,037,000
Transaction costs	282,000
Total acquisition cost	$9,319,000

The fair market value of the Company s common stock for financial accounting purposes was calculated using the five day average of the closing prices on the date that the terms were agreed to and announced and the two trading days before and after such date.

The Company is in the process of obtaining third-party valuations of certain intangible assets; thus, the allocation of the purchase price is subject to refinement. The cost of the acquisition of MyDocOnline has been allocated, on a preliminary basis, to in-process research and development and to the identified assets and liabilities acquired with the remainder recorded as goodwill, based on estimates of fair values as follows:

Working capital items:	
Receivables and prepaid expenses	$ 354,000
Deferred revenue	(140,000)
Net working capital acquired	214,000
Property and equipment	1,293,000
Customer relationships	658,000
Developed technology	2,051,000
Goodwill	4,797,000
In-process research and development	306,000
	$9,319,000

The value of the acquired developed technology, customer relationships and in-process research and development was determined by discounting the estimated projected net cash flows to be generated from the related assets using a discount rate of 31%. In-process research and development was immediately expensed. Values assigned to developed technology and customer relationships are being amortized to cost of revenues and selling, general and administrative expenses, respectively, on a straight-line basis over three to five years from the acquisition date.

The results of operations of MyDocOnline are included in the Company s results of operations from the date of closing. Revenues from the acquired business of MyDocOnline for the three month period ended March 31, 2004 totaled $123,000.

Promissory Note Payable and Warrants Issued to Aventis

Concurrent with the MyDocOnline acquisition, Aventis, Inc. (Aventis) loaned the Company $3,000,000 due March 15, 2007, which loan bears interest at an annual rate of 4.5%. The loan is evidenced by a secured promissory note. Interest on the note is payable only in services provided by the Company to Aventis unless there is an event of default. The principal portion of the note is payable in either cash or shares of the Company s common stock, based on the then current value of such shares, at the option of the Company and may be prepaid by the Company at any time without penalty. Additionally, at Aventis discretion and after the $4,000,000 customer deposit from Aventis under the Master Services Agreement described below has been consumed, the principal portion of the note may be paid in the form of additional services provided to Aventis by the Company pursuant to the terms of such services agreement. Should Aventis choose to not have the note paid in the form of services, the Company is required to pay the note in cash or stock at maturity, however, at an amount equal to 90% of the face amount of the loan, or $2,700,000, which the Company considers its minimum liability.

Concurrent with the issuance of the note payable to Aventis, the Company issued warrants to purchase 145,853 shares of ZixCorp common stock. The exercise price and term of the warrants is $13.01 per share and three years, respectively. Based on relative fair values at time of issuance, the loan proceeds were allocated to the note payable of $1,525,000 and to the warrants of $1,475,000. The fair value of the warrants was calculated using the Black-Scholes pricing model. The fair value of the note was calculated based on an estimated interest rate that the Company could obtain independently. The resulting discount of $1,175,000 on the minimum liability of $2,700,000 represents unamortized debt discount which is being amortized to interest expense over the three year loan life to yield an effective interest rate of 11%. This rate approximates a cost of borrowing valuation estimated by an independent valuation company. The loan is secured by the Company s property and equipment and accounts receivable pursuant to a security agreement.

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Customer Deposit from Aventis

A Master Services Agreement was entered into with Aventis for $4,000,000 on the same date as the acquisition of MyDocOnline for the performance, by the Company, of various future services. The services are to be delivered in minimum amounts of $1,000,000, $1,000,000 and $2,000,000 prior to the first, second and third calendar year anniversary dates of the acquisition closing, respectively. The services will be defined on an ongoing basis over the life of the agreement and valued in accordance with similar pricing for similar services rendered to other customers. Aventis paid the $4,000,000 upon execution of the Master Services Agreement.

The Company s services, to be provided to Aventis, have not yet been fully defined; therefore, the liability has been recorded as a customer deposit. As the services are defined and priced in individual project agreements, the value of the defined element will be reclassified to deferred revenues and then recognized as revenue in accordance with applicable revenue recognition criteria. Aventis will forfeit any unused amounts annually if services are not requested by Aventis in accordance with the terms of the Master Services Agreement. The Company is required to return to Aventis any unused portion of the deposit only in the event of material breach of the contract by the Company, in the event the Company or a party employed or engaged by the Company is debarred pursuant to the Generic Drug Enforcement Act of 1992 or similar state, local or foreign law, in the event ZixCorp files for bankruptcy, or in the event of force majeure. The Company believes these circumstances are unlikely. The Company s obligations associated with the Master Services Agreement are secured by a first priority lien on the Company s property and equipment and accounts receivable.

Elron Software, Inc.

On September 2, 2003, the Company acquired substantially all of the operating assets and the business of Elron Software, a majority-owned subsidiary of Elron Electronic Industries Ltd. Elron Software develops, markets, licenses, supports and maintains computer software products that provide anti-spam, email content filtering and Web filtering solutions. The consideration for the acquisition totaled $7,471,000 and consisted of 1,709,402 shares of the Company s common stock with a fair market value of $6,333,000, a 5.75% convertible note for $1,000,000 and acquisition related transaction costs of $138,000. In November 2003, the note and related accrued interest were converted by the holder into 262,454 shares of the Company s common stock at a conversion price of $3.86 per share.

PocketScript, Inc.

On July 22, 2003, the Company acquired substantially all of the operating assets and the business of PocketScript, a privately-held development stage enterprise that provides electronic prescription solutions for the healthcare industry. The consideration for the acquisition totaled $1,457,000 and consisted of 362,903 shares of the Company s common stock with a fair market value of $1,386,000, a $50,000 cash payment and acquisition related transaction costs of $21,000. PocketScript s historical operating results are insignificant compared to the Company s historical operating results.

Pro Forma Information

The following unaudited pro forma information presents the Company s results of operations as if the acquisitions of MyDocOnline and Elron Software had occurred as of January 1, 2003. The pro forma information has been prepared by combining the results of operations of the Company, MyDocOnline and Elron Software, with adjustments to record the amortization of intangible assets resulting from the allocation of the cost of the acquisitions, to eliminate the historical expenses of MyDocOnline and Elron Software for amortization of intangible assets that were excluded from the assets acquired by the Company and to eliminate the historical interest expense on the intercompany debt of MyDocOnline and Elron Software, which was excluded from the liabilities acquired by

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the Company. Adjustments related to the MyDocOnline acquistion include the recording of interest expense on the promissory note payable to Aventis. In addition, adjustments related to the Elron Software acquisition include the elimination of historical expenses for stock compensation, the recording of interest expense and adjustments to recognized revenues resulting from the application of purchase accounting. The pro forma information does not purport to be indicative of what would have occurred had the acquisition occurred as of January 1, 2003, or the results of operations that may occur in the future.

	Three Months Ended March 31	
	2004	2003
Revenues	$ 2,897,000	$ 2,537,000
Net loss	$(12,248,000)	$(15,301,000)
Basic and diluted loss per common share	$ (0.40)	$ (0.69)

3. Conversion/Redemption of Convertible Preferred Stock

In September 2002, the Company received total proceeds of $8,000,000 in exchange for shares of two newly created series of convertible preferred stocks and related warrants to purchase 709,528 shares of the Company s common stock. Beginning in September 2002 and concluding in September 2003, all of the convertible preferred stocks were redeemed by the Company or converted by the investors into 2,166,977 shares of the Company s common stock. During the three-month period ending March 31, 2003, the Company recorded preferred stock dividends of $494,000. At March 31, 2004, of these warrants issued in September 2002, warrants to purchase 514,408 shares of the Company s common stock remained outstanding. These warrants have an exercise price of $4.42 per share and expire in 2006.

4. Revenues and Significant Customers

The Company develops, markets, licenses and supports computer software products and services. Certain of the Company s products and services, such as ZixMail, ZixVPM, ZixPort, ZixWorks, anti-spam signatures, various electronic prescription services and some of the recently acquired products from MyDocOnline are offered on a subscription basis. The Company s subscription services include delivering licensed software and providing customer support and secure electronic communications throughout the subscription period. The customer generally is provided an appliance with pre-installed software or contractually subscribes to data center resident service capability and capacity. Subscriptions to date have generally been annual non-refundable contracts. Some of the contracts have automatic renewal provisions. The subscription period begins on the date specified by the parties. Revenues from subscription services are recorded as the services are rendered. Subscription fees received from customers in advance are recorded as deferred revenue and recognized as revenues ratably over the subscription period. Some of the Company s services also incorporate a transaction fee per event occurrence or when predetermined usage levels have been reached. These fees are recognized as revenue when the transaction occurs.

The Company also sells anti-spam, email content filtering and Web filtering solutions to customers under perpetual license agreements. The Company recognizes revenue on these arrangements after all of the following occur: persuasive evidence that an arrangement exists, the software is delivered, collection is probable, fees are fixed and determinable, and vendor-specific objective evidence of fair value (VSOE) exists to allocate the total fees to the elements of the arrangement. These software licenses are sold as part of multiple element arrangements that include annual maintenance, and often times implementation or training services. Where VSOE has not been established for certain elements, revenue for all elements is deferred until those elements have been delivered or their fair values have been determined. However, if VSOE is determinable for all of the undelivered elements, and the undelivered elements are not essential to the delivered elements, the Company will defer recognition of the full fair value related to the undelivered elements and recognize as revenue the remaining portion of the arrangement value through application of the residual method. Evidence of VSOE for implementation and training services is based upon standard billing rates and the estimated level of effort for the individuals expected to perform the related services. Installation and training revenues are recognized as the services are rendered. The Company establishes VSOE for maintenance based upon current contract renewal rates. The Company recognizes maintenance revenue over the term of the maintenance agreement, generally one year.

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Cigna Corporation accounted for $289,000 or 10% and $90,000 or 14%, respectively, of the Company s total revenues for the three-month periods ending March 31, 2004 and 2003 stemming from the ratable service revenue recognition of contracted subscription services. Separately, service revenues for the three-month period ended March 31, 2003 also included $234,000 (37% of quarterly revenues) resulting from the pro-rata recognition of certain minimum payments associated with the Company s marketing agreement with Entrust, Inc. (Entrust). These minimum payments aggregating $3,750,000 were being recognized as revenue ratably over the four-year maximum service period ending in December 2005. Entrust paid the Company a $1,000,000 guaranteed minimum payment in January 2003. In July 2003, the Company and Entrust mutually agreed to terminate the marketing agreement, because the marketing agreement, as structured, no longer served their respective business interests. In connection with the termination of the marketing agreement, Entrust paid the Company $700,000 and the scheduled minimum guaranteed payments to have been made in 2004 and 2005, totaling $2,750,000, were cancelled.

5. Stock Options and Warrant Exercises

In the first quarter of 2004, the Company received $10,985,000 in cash from the exercise of warrants and options, which resulted in the issuance of 1,403,647 shares of the Company s common stock. Subsequent to March 31, 2004, the Company received an additional $9,338,000 in cash from the exercise of warrants and options, which resulted in the issuance of 868,486 shares of the Company s common stock.

6. Restatement

Subsequent to the filing of our Form 10-Q as of March 31, 2004 and filed on May, 10, 2004, the Company determined the need to change the initial accounting for the Company s acquisition of substantially all the assets of MyDocOnline on January 30, 2004. This restatement is primarily to record liabilities, incurred concurrently with the acquisition, for the values assigned to the note payable of $1,525,000 ($1,580,000 on March 31, 2004 after the accretion of the debt discount in the quarter) and the customer deposit of $4,000,000 received for future services to be rendered, and to record the resulting increases in purchased assets of $5,364,000 (namely goodwill, identified intangibles, and property and equipment), and in operating expenses of $252,000 (namely in process research and development and amortization expense). The note payable and deposit were previously reported with no values assigned in the initial price allocation. The table below shows each line item that was affected by this adjustment:

Changes to the Condensed Consolidated Statement of Operations

	Three Months ended March 31, 2004	
	As reported	**As restated**
Cost of revenues	$ (3,160,000)	$ (3,174,000)
Research and development expenses	$ (2,691,000)	$ (2,845,000)
Selling, general and administrative expenses	$ (7,777,000)	$ (7,806,000)
Interest expense	$	$ (55,000)
Loss before income taxes	$(10,657,000)	$(10,909,000)
Net loss	$(10,686,000)	$(10,938,000)
Basic and diluted loss per common share	$ (0.35)	$ (0.36)

Changes to the Condensed Consolidated Balance Sheet

	As of March 31, 2004	
	As reported	**As restated**
Other current assets	$ 1,513,000	$ 1,524,000
Total current assets	$26,100,000	$26,111,000
Property and equipment, net	$ 4,296,000	$ 4,638,000
Intangible assets , net	$ 5,666,000	$ 5,881,000
Goodwill	$ 4,323,000	$ 9,119,000
Total assets	$40,385,000	$45,749,000

	As of March 31, 2004	
	As reported	As restated
Accounts payable and accrued expenses	$ 4,630,000	$ 4,666,000
Customer deposits current	$	$ 1,000,000
Total current liabilities	$ 8,981,000	$ 10,017,000
Customer deposits non-current	$	$ 3,000,000
Promissory note non-current	$	$ 1,580,000
Accumulated deficit	$(212,126,000)	$(212,378,000)
Total stockholders equity	$ 30,274,000	$ 30,022,000
Total liabilities and stockholders equity	$ 40,385,000	$ 45,749,000

Changes to the Condensed Consolidated Statement of Cash Flows

	Three Months ended March 31, 2004	
	As reported	As restated
Net cash used by operating activities	$ (6,941,000)	$ (2,941,000)
Net cash provided by investing activities	$ 8,682,000	$ 1,682,000
Net cash provided by financing activities	$10,985,000	$13,985,000

ITEM 2.

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

As described in Note 6 to our condensed consolidated financial statements, we have restated certain interim financial information for the quarter ended March 31, 2004. The discussion below gives effect to this restatement.

Overview

The Company operates in a single industry segment, providing solutions that protect, manage and deliver sensitive electronic information. These solutions are grouped into two categories: Communications Protection and Care Delivery Solutions. By offering two comprehensive sets of products and services, the Company protects organizations from viruses and spam, provides the management tools needed for Web access control and policy-driven email encryption, and provides care delivery solutions for e-prescribing, e-lab results delivery, online doctor visits and e-consulting that enable physicians to leverage technology for better patient care.

In 1998 and prior years, the Company provided systems and solutions for the intelligent transportation, electronic security and other markets. The Company sold all of its operating units in 1998 and began evaluating new Internet-related business opportunities. The Company perceived a need for products and services to bring privacy, security and convenience to Internet communications and since January 1999, the Company has been developing and marketing products and services that bring privacy, security and convenience to Internet users. In the first quarter of 2001, the Company began charging for the use of ZixMail, its initial product in the secure e-messaging space, and began focusing its sales and marketing efforts toward the business market. In 2002 and 2003, the Company significantly expanded its portfolio of commercial products and services and rebuilt its sales and marketing work force under new executive leadership. The expanded communications protection portfolio of commercial products and services included ZixVPM (Virtual Private Messenger), an e-messaging gateway solution that provides company-wide privacy protection for inbound and outbound email communications, ZixAuditor, an assessment service used to analyze email traffic patterns and monitor compliance with corporate and regulatory policies, ZixPort, a secure Web-messaging portal, and ZixWorks, a suite of fully managed hosted services that enables users to send email securely and that protects organizations from viruses, spam, inappropriate content and electronic attack. Further, the Company has targeted the healthcare sector, where the legislated mandates of the Health Insurance Portability and Accountability Act, a 1996 law that requires Protected Health Information to be safeguarded over open networks, are driving demand. The privacy regulations for this law took effect in April 2003 and the security regulations are scheduled to go into effect in early 2005.

In July 2003, the Company acquired substantially all of the operating assets and the business of Ohio-based PocketScript, LLC (PocketScript), a privately-held development stage enterprise which provides electronic prescription solutions for the healthcare industry. This acquisition enables the Company to expand its services into care delivery, specifically, the e-prescription marketplace, which is expected to grow significantly as more physicians are leveraging technology in delivering care, coupled with the fact that the number of prescriptions written annually in the United States continues to increase. In September 2003, the Company acquired substantially all of the operating assets and the business of Elron Software, Inc. (Elron Software or Elron), a majority-owned subsidiary of Elron Electronic Industries Ltd. and a provider of anti-spam, email content filtering and Web filtering solutions. This acquisition enables the Company to add a feature set to its anti-spam, anti-virus, and content filtering services while expanding its offerings to include Web filtering. In January 2004, the Company acquired substantially all of the operating assets and the business of MyDocOnline, Inc. (MyDocOnline), a subsidiary of Aventis Pharmaceuticals, Inc., the North American pharmaceuticals business of Aventis SA. MyDocOnline offers a variety of Internet-based healthcare services and is a provider of secure Web-based communications, disease management, and laboratory information solutions. PocketScript, Elron Software and MyDocOnline have incurred operating losses in recent years.

The foundation of the Company s business model is centered around the financial leverage expected to be generated by its various subscription and transaction based revenues that are believed to be predominantly recurring in nature and an efficient cost structure for its secure data center operations, the core of which is expected to remain relatively stable. Subscription fees are generally expected to be collected annually at the beginning of the subscription period and are recognized as revenue on a prorated basis over the length of the subscription period.

Operating in emerging markets involves risks and uncertainties, and there are no assurances that the Company will be successful in its efforts. Successful growth of an early stage enterprise is costly and highly competitive. The Company s growth depends on the timely development and market acceptance of its products and services. In 2003 and the three month period ending March 31, 2004, the Company and its recent acquisitions have incurred significant operating losses and the use of cash resources has continued at a substantial level. The Company anticipates further operating losses in 2004.

Critical Accounting Policies and Estimates

The preparation of financial statements and related disclosures in accordance with accounting principles generally accepted in the United States requires the Company s management to make estimates and assumptions that affect the amounts reported in the Company s consolidated financial statements and accompanying notes. Actual results could differ from these estimates and assumptions. Critical accounting policies and estimates are defined as those that are both most important to the portrayal of the Company s financial condition and results and require management s most subjective judgments. The Company s most critical accounting policies and estimates are described below.

Long Lived and Other Intangible Assets

The Company s long-lived assets, comprised of identified intangibles and property and equipment aggregating $10,519,000 or 23% of total assets at March 31, 2004, are periodically reviewed for impairment, by comparing the carrying value of the asset with its estimated fair value. The potential impairment is measured based on a projected discounted cashflow method, using a discount rate that is considered to be commensurate with the risk inherent in the Company s current business model. Assumptions are made with respect to future net cash flows expected to be generated by the related asset. An impairment charge would be recorded for an amount by which the carrying value of the asset exceeded the discounted projected net cash flows.

Goodwill, totaling $9,119,000 or 20% of total assets at March 31, 2004, represents the cost in excess of fair value of net assets acquired in the September 2003 acquisition of Elron Software and the January 2004 acquisition of MyDocOnline. The Company will evaluate its goodwill for impairment annually as of October 1, beginning in 2004, or when there is reason to believe that the value has been diminished or impaired. Evaluations for possible impairment are based upon a comparison of the estimated fair value of the business unit to which the goodwill relates to the sum of the carrying value of the assets and liabilities of that unit. The fair values used in this evaluation are estimated based upon discounted future cash flow projections for the unit and market values of comparable businesses where available. An impairment is deemed to exist if the net book value of the unit exceeds its estimated fair value.

Future changes made to the current estimates or assumptions, including such factors as order volumes and price levels, life spans of purchased technology, continuity of acquired customers, alternative uses for property and equipment and levels of operating expenses, could result in an unanticipated impairment charge from the write-down of the Company s long-lived assets or goodwill.

Deferred Tax Assets

As required by Statement of Financial Accounting Standards No. 109, the Company recognizes deferred tax assets on its consolidated balance sheet if it is more likely than not that the subject net operating loss carry forwards and unused tax credits will be realized on future federal income tax returns. At March 31, 2004, the Company continued to provide a full valuation allowance against accumulated U.S. deferred tax assets of approximately $73 million, reflecting the Company s historical losses and the uncertainty of future taxable income. If the Company begins to generate U.S. taxable income in a future period or if the facts and circumstances on which its estimates and assumptions are based were to change, thereby impacting the likelihood of realizing the deferred tax assets, judgment would have to be applied in determining the amount of valuation allowance no longer required. Reversal of all or a part of this valuation allowance could have a significant positive impact on operating results in the period that it becomes more likely than not that certain of the Company s deferred tax assets will be realized.

Revenue Recognition

The Company develops, markets, licenses and supports computer software products and services. For revenue purposes, the Company s products can be placed into several key revenue categories where each category has similar revenue recognition traits; Communications Protection subscription based services, perpetual software license sales, the PocketScript e-prescribing product, various transaction fees and professional services. Under all categories, the Company recognizes revenue after all of the following occur: persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, a right of return does not exist, the price is fixed and determinable, and collectability is reasonably assured. In the event the arrangement has multiple elements with delivered and undelivered elements, the delivered elements are recognized only when vendor-specific objective evidence of fair value (VSOE) exists to allocate the fair value of the total fees to the undelivered elements of the arrangement.

Communication Protection subscription based services include products such as ZixMail, ZixVPM, ZixPort, ZixWorks, anti-spam signatures subscription, anti-virus subscriptions and certain products acquired from MyDocOnline. The Company s Communications Protection subscription services include delivering licensed software and providing customer support and secure electronic communications throughout the subscription period. The customer is often provided an appliance during the subscription period with pre-installed software or contractually subscribes to a data center resident service. In a subscription service, the customer does not own a perpetual right to a software license, but is instead granted the use of that license during the period of the subscription. Subscriptions to date have generally been annual non-refundable contracts. Some of the contracts have automatic renewal provisions. The subscription period begins on the date specified by the parties. Revenues from subscription services are recorded as service revenue as the services are rendered. Subscription fees received from customers in advance are recorded as deferred revenue and recognized as revenues ratably over the subscription period.

The Company sells anti-spam filtering, email content filtering, Web filtering solutions and certain products acquired from MyDocOnline to customers under perpetual licensing arrangements. These perpetual software licenses are normally sold as part of multiple element arrangements that include annual maintenance, and may include implementation or training services. Where VSOE has not been established for undelivered elements, revenue for all elements is deferred until those elements have been delivered or their fair values have been determined. However, if VSOE is determinable for all of the undelivered elements, and the undelivered elements are not essential to the delivered elements, the Company will defer recognition of the fair value related to the undelivered elements and recognize as revenue the remaining portion of the arrangement through application of the residual method. Evidence of VSOE for implementation and training services associated with the anti-spam, email content filtering and Web filtering arrangements is based upon standard billing rates and the estimated level of effort for the individuals expected to perform the related services. Installation and training revenues are recognized as the services are rendered. The Company establishes VSOE for maintenance based upon contract renewal rates. The Company recognizes maintenance revenue over the term of the maintenance agreement, generally one year.

The Company recognizes revenue on the PocketScript e-prescribing service as a multiple element arrangement with separate units of accounting. VSOE is determined for the undelivered elements and the residual value is assigned to the device and is recognized upon installation of the device and service at an end-user location. Installation is determined by physical delivery of a functioning product. The fair values of the undelivered elements relate to ongoing services and are recognized ratably over the period of the service. The Company establishes VSOE for the service elements based upon contract renewal rates or fair market values if the element is commonly sold by others.

Some of the Company s services incorporate a transaction fee per event occurrence or when predetermined usage levels have been reached. These fees are recognized as revenue when the transaction occurs. The Company contracts with customers to provide certain professional services as stand alone offerings. The Company recognizes these as revenue as the services are rendered and utilizes the percentage completion method when appropriate.

Business Acquisitions

During 2003 and the three months ended March 31, 2004, the Company completed three acquisitions using the purchase method of accounting. The amounts assigned to the identifiable assets and liabilities acquired in connection with these acquisitions were based on estimated fair values as of the date of the acquisition, with the remainder recorded as goodwill. The fair values were determined by management, generally based upon information supplied by the management of the acquired entities and in two instances valuations prepared by independent appraisal experts. The fair values have been based primarily upon future cash flow projections for the acquired assets, discounted to present value using a risk-adjusted discount rate. In connection with these acquisitions, we have recorded a significant amount of intangible assets and goodwill.

Results of Operations

Revenues

Revenues increased from $639,000 for the three months ended March 31, 2003 to $2,843,000 for the corresponding period in 2004 due primarily to an increase of approximately $1,271,000 of secure e-messaging subscription fees generated from new U.S. corporate customers primarily in the healthcare sector, $327,000 in email content and Web filtering software sales as well as $576,000 in related maintenance in relation to the Elron Software acquisition and $264,000 in care delivery related subscription fees resulting from the acquisitions of PocketScript and MyDocOnline minus $234,000 of services revenue related to the Entrust Marketing Agreement described below.

Service revenues for the three month period ending March 31, 2003 included $234,000 resulting from the pro-rata recognition of certain minimum payments associated with the Marketing Agreement with Entrust. These minimum payments aggregating $3,750,000 were being recognized as revenue ratably over the four year maximum service period ending in December 2005. Entrust paid the Company a $1,000,000 guaranteed minimum payment in January 2003. In July 2003, the Company and Entrust mutually agreed to terminate the marketing agreement, because the marketing agreement, as structured, no longer served their respective business interests. In connection with the termination of the marketing agreement, Entrust paid the Company $700,000 and the scheduled minimum guaranteed payments to have been made in 2004 and 2005, totaling $2,750,000, were cancelled.

The Company s end-user order backlog as of March 31, 2004, increased to approximately $19,400,000, and is comprised of the following elements: $4,000,000 customer deposit from Aventis for future services, $5,481,000 of deferred revenue that has been billed and paid, $2,613,000 billed but unpaid and approximately $7,306,000 of unbilled contracts. Approximately 55% to 65% of this $19,400,000 is expected, by the Company, to be recognized as revenue in the next twelve months. The timing of revenue is affected by the length of time required to deploy a service and the length of the service. The backlog is a mix of contracts of varying lengths of service.

A Master Services Agreement was entered into with Aventis for $4,000,000 on the same date as the acquisition for the performance, by the Company, of various future services. The services are to be delivered in minimum amounts of $1,000,000, $1,000,000 and $2,000,000 prior to the first, second and third calendar year anniversary dates of the acquisition closing, respectively. The services will be defined on an ongoing basis over the life of the agreement and valued in accordance with similar pricing for similar services rendered to other customers. Aventis paid the $4,000,000 upon execution of the Master Services Agreement.

The Company s services, to be provided to Aventis, have not yet been fully defined and are subject to certain refund provisions; therefore, the liability has been recorded as a customer deposit. As the services are defined and priced in individual project agreements, the value of the defined element will be reclassified to deferred revenues and then recognized as revenue in accordance with applicable revenue recognition criteria. Aventis will forfeit any unused amounts annually if services are not requested by Aventis in accordance with the terms of the Master Services Agreement. The Company is required to return to Aventis any unused portion of the deposit only in the event of material breach of the contract by the Company, in the event the Company or a party employed or engaged by the Company is debarred pursuant to the Generic Drug Enforcement Act of 1992 or similar state, local or foreign law, in the event ZixCorp files for bankruptcy, or in the event of force majeure. The Company believes that it is unlikely any of these events will occur. The Company s obligations associated with the Master Services Agreement are secured by a first priority lien on the Company s property and equipment and accounts receivable.

The Company also currently generates revenues from the sale of perpetual software licenses and various transaction fees associated with services. These revenue elements typically do not get placed into backlog as the order and the revenue occur simultaneously.

Management follows several general metrics to gauge business performance and the results of these metrics can have an affect on management s estimate of future revenue. These metrics include: order input, renewal rate (customer retention) of service contracts, mix of single or multi-year service contracts and deployment statistics for the Company s products and services. In particular, as the market for e-prescription solutions matures, the number of our e-prescribing devices deployed to physicians and the prescription volume written by such physicians will become increasingly important metrics.

Cost of revenues

Cost of revenues increased from $1,760,000 for the three months ended March 31, 2003 to $3,174,000 for the corresponding period in 2004. The net increase of $1,414,000 consists of a $1,191,000 increase in cash expenses and a $223,000 increase in non-cash expenses. The increase in cash expenses is primarily due to $634,000 of incremental operating costs, consisting of approximately $100,000 for personnel and $534,000 for non-personnel operating costs resulting from the recent acquisitions of PocketScript, Elron Software and MyDocOnline and $557,000 due primarily to personnel additions totaling $360,000 and non-personnel cost increases totaling $197,000 which were necessary to expand the Company s deployment and client services capabilities to support the order growth of the Company s secure messaging products and services. Non-personnel costs primarily include expenses for data center maintenance and support, outside consultants and travel. The increase in non-cash expenses is primarily due to $432,000 of incremental operating costs associated with the recent acquisitions of PocketScript, Elron Software and MyDocOnline, primarily consisting of $270,000 for the amortization of intangible assets and $167,000 for the depreciation and amortization of property and equipment, partially offset by a reduction in depreciation and amortization of property and equipment resulting from certain data center equipment becoming fully depreciated.

A significant portion of the Company s cost of revenues has not been and is not expected to be directly variable to the revenue generated, such as the cost of operating and maintaining the ZixSecure Center which is currently not fully utilized. Accordingly, costs associated with the data center are expected to grow at a much slower pace than revenue. Cost of revenues also includes the activities of field deployment, professional services and customer service and support. For the Communication Protection products and services, in the near term, the Company expects to grow the cost of revenues for these products and services at rates less than the associated revenue growth rates for the same products. For the Care Delivery products and services, in the near term, the Company expects to grow the cost of revenues for these products at rates greater than the associated revenue growth rates for the same products. Additionally, other than the non-cash amortization of the fair value of developed technology acquired with the purchase of Elron Software, cost of revenues related directly to software sales has not been significant.

Research and development expenses

Research and development expenses increased from $1,204,000 for the three months ended March 31, 2003 to $2,845,000 for the corresponding period in 2004. The net increase of $1,641,000 consists of a $1,218,000 increase in cash expenses and a $423,000 increase in non-cash expenses. The increase in cash expenses is due primarily to $1,190,000 of incremental operating costs, consisting of $817,000 for personnel and $373,000 for non-personnel operating costs, resulting from the recent acquisitions of PocketScript, Elron Software and MyDocOnline. Non-personnel operating costs primarily include expenses for outside consultants, occupancy and travel. The increase in non-cash expenses consists of $306,000 for amortization of allocated in-process research and development expense associated with the cost of the acquisition of MyDocOnline and $162,000 for common stock issued in lieu of cash compensation for employee bonuses and severance costs.

Selling, general and administrative expenses

Selling, general and administrative expenses increased from $4,523,000 for the three months ended March 31, 2003 to $7,806,000 for the corresponding period in 2004. The net increase of $3,283,000 consists of a $1,916,000 increase in cash expenses and a $1,367,000 increase in non-cash expenses. The increase in cash expenses is primarily due to increased personnel costs of approximately $1,732,000 consisting primarily of $1,202,000 resulting from the third quarter 2003 acquisitions of PocketScript and Elron Software and the January 2004 acquisition of MyDocOnline and $393,000 for severance costs associated with a former senior executive and a net increase of $184,000 in operating expenses other than personnel costs. Operating expenses, excluding personnel costs, for the recent acquisitions increased approximately $922,000 and consisted principally of travel, facility costs, advertising and promotion and third-party consulting totaling $269,000, $213,000, $161,000 and $137,000, respectively, and were partially offset by reductions in operating expenses other than personnel costs of $738,000 for secure messaging products and services, consisting principally of advertising and promotion, third party consulting and business insurance totaling $331,000, $172,000 and $214,000, respectively.

The increase in non-cash expenses primarily consists of $886,000 for employee severance costs resulting from the acceleration of the vesting of certain stock options held by the involved employees, usually in lieu of cash payments per their respective severance agreements; $471,000 due to employee sales commissions paid using Company common stock; $120,000 for amortization of intangible assets associated with the 2003 acquisition of Elron Software; and, partially offset by a $154,000 decrease in stock-based compensation related to stock option grants for employees and third party service providers.

Investment and other income

Investment income increased from $41,000 for the three months ended March 31, 2003 to $58,000 for the corresponding period in 2004 primarily due to the increase in invested cash and marketable securities.

Interest expense

The interest expense of $55,000 for the three-month period ended March 31, 2004 represents interest on the promissory note issued in connection with the acquisition of MyDocOnline in January 2004.

Realized and unrealized gain on investments

The realized gain on investment of $70,000 for the three-month period ended March 31, 2004 represents a cash payment received in February 2004 from Maptuit Corporation (Maptuit) in exchange for the Company s remaining one million shares of Maptuit s common stock as a final, partial recovery of a previous related party investment.

Income taxes

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The Company s income tax expense for the three months ended March 31, 2003 was $24,000 and $29,000 for the corresponding period in 2004. These provisions represent non-U.S. taxes payable resulting from the operations of the Company s Canadian subsidiary. The income taxes on the pre-tax loss is different from the U.S. statutory rate of 34%, primarily due to unbenefitted U.S. losses. The Company has fully reserved its net deferred tax assets due to the uncertainty of future taxable income. There may be limitations on the Company s ability to fully use its substantial net operating loss carryforwards against any future taxable income, including potential limitations due to ownership changes as defined in Section 382 of the Internal Revenue Code.

Liquidity and Capital Resources

Net cash used by operations was $3,992,000 for the three months ended March 31, 2003 compared to $2,941,000 for the corresponding period in 2004. The decrease in cash flows used for operating activities totaling $1,051,000 was primarily due to the $4,000,000 customer deposit from Aventis, a $1,065,000 increase in trade payables and accrued expenses and a $2,013,000 increase in the 2004 non-cash operating expenses in the areas of depreciation and amortization and stock-based compensation, partially offset by a 60% increase in the Company s net loss, totaling $4,107,000, an increase in non-acquired accounts receivable and prepaid expenses totaling $1,447,000, and a decrease in non-acquired deferred revenue totaling $476,000. Net cash used by operating activities in 2004 was funded primarily by existing cash resources and investing and financing activities described below.

Net cash flows provided by investing activities was $4,405,000 for the three months ended March 31, 2003 compared to $1,682,000 for the corresponding period in 2004. The decrease in investing cash flows were primarily attributable to a net decrease in marketable securities totaling $2,486,000 and increased purchases of property and equipment totaling $307,000, as the Company continues to upgrade certain computer hardware in its data center and acquire computer equipment to satisfy customer orders for the Company s products and services, primarily ZixVPM and ZixWorks. The decrease was also partially offset by $70,000 received as partial recovery of the Company s investment in Maptuit Corporation.

Net cash provided by financing activities was $334,000 for the three months ended March 31, 2003 compared to $13,985,000 for the corresponding period in 2004. The increase in financing cash flows was attributable to the exercise of stock options and warrants by employees and outside holders in the first quarter of 2004 to purchase 1,403,647 shares of the Company s common stock at an average price per share of $7.83 and cash received in connection with the promissory note to Aventis.

Concurrent with the MyDocOnline acquisition, at closing Aventis, Inc. (Aventis) loaned the Company $3,000,000 due March 15, 2007, which loan bears interest at an annual rate of 4.5%. The loan is evidenced by a secured promissory note. Interest on the note is payable only in services provided by the Company to Aventis unless there is an event of default. The principal portion of the note is payable in either cash or shares of the Company s common stock, based on the then current value of such shares, at the option of the Company and may be prepaid by the Company at any time without penalty. Additionally, at Aventis discretion and after the $4,000,000 customer deposit from Aventis under the Master Services Agreement described below has been consumed, the principal portion of the note may be paid in the form of additional services provided to Aventis by the Company pursuant to the terms of such services agreement. Should Aventis choose to not have the note paid in the form of services, the Company is required to pay the note in cash or stock at maturity, however, at an amount equal to 90% of the face amount of the loan, or $2,700,000, which the Company considers its minimum liability.

Concurrent with the issuance of the note payable to Aventis, the Company issued warrants to purchase 145,853 shares of ZixCorp commons stock. The exercise price and term of the warrants is $13.01 per share and three years, respectively. Based on relative fair values at time of issuance, the loan proceeds were allocated to the note payable of $1,525,000 and to the warrants of $1,475,000. The fair value of the warrants was calculated using the Black-Scholes pricing model. The fair value of the note was calculated based on an estimated interest rate that the Company could obtain independently. The resulting discount of $1,175,000 on the minimum liability of $2,700,000 represents unamortized debt discount which is being amortized to interest expense over the three year loan life to yield an effective interest rate of 11%. This rate approximates a cost of borrowing valuation estimated by an independent valuation company. The loan is secured by the Company s property and equipment and accounts receivable pursuant to a security agreement.

At March 31, 2004, the Company s principal source of liquidity was its net working capital position of $16,094,000, including cash and marketable securities of $24,083,000. The Company plans to continue to invest its

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excess cash primarily in short-term, high-grade commercial paper, U.S. government and agency securities or money market funds. Subsequent to quarter end, through April 30, 2004, as a result of the exercise of stock options and warrants, the Company s liquidity improved as it received proceeds of $9,338,000 in exchange for 868,486 shares of the Company s common stock. On April 30, 2004, there were currently exercisable warrants and stock options, with an exercise price per share of $10.00 or less, to acquire approximately 3,864,000 shares of the Company s common stock, at an average price of approximately $5.31 per share, which if exercised would result in a significant level of additional new funding for the Company. On April 30, 2004, the total of the Company s cash and marketable securities was approximately $31,200,000.

The Company s cash requirements consist principally of funding the Company s operating losses as it pursues a leadership position in the emerging markets in which it operates and capital expenditures, primarily for data center expansion and refurbishment and for computer equipment to support new customer orders. The Company anticipates further losses in 2004 and the use of cash resources for operating activities continues at a substantial level. To complement and expand our business and product offerings, the Company acquired the assets and the businesses of PocketScript, Elron Software and MyDocOnline in July 2003, September 2003 and January 2004, respectively, in exchange for certain equity securities of the Company. While no significant cash was required to make these acquisitions, each of these businesses has incurred operating losses in recent years. The Company has significantly reduced the substantial historical operating losses of Elron Software and expects to significantly and quickly reduce the substantial historical operating losses of MyDocOnline based upon a reduced number of employees and contractors, strategic expense cuts, expected increases in sales volumes and anticipated cost synergies with its existing businesses. See Note 2 to the consolidated financial statements included herein. The Company expects to incur operating losses in the near term from the operation of its PocketScript operations as it continues to invest in new personnel and other resources necessary to effectively deploy its e-prescription devices.

The amount of the Company s future cash requirements depends primarily on the market acceptance of its products and services and the timing and magnitude of cash flows generated from new customer orders. Cash flows will also be impacted by capital expenditure requirements, resources devoted to the additional development of our products and services and resources devoted to sales and marketing including discretionary advertising initiatives. The Company expects the market for its products and services to expand as the business community recognizes the importance of privacy and security for electronic communications and as electronic prescription initiatives mature in the marketplace. The Company may need to raise additional funds in the future to sustain its operations or initiate reductions in operating expenses, or both. The Company will continue to consider various capital funding alternatives to strengthen its financial position. These capital funding alternatives could involve one or more types of equity securities, including convertible debt, common or convertible preferred stock and warrants to acquire common or preferred stock. Such equity securities could be issued at or below the then-prevailing market price for shares of the Company s common stock. The Company currently has no existing credit facilities. There can be no assurances that the Company will be able to raise additional capital on satisfactory terms if and when needed.

Options and Warrants of ZixCorp Common Stock

In 2003 and into 2004, the Company raised significant cash from individuals who hold warrants and options in the Company s common stock as they exercised these warrants and options. The Company continues to have significant warrants and options outstanding that are currently vested. The extent of future cash inflow from additional warrant and option activity is not certain and is likely to be less than the Company experienced in the prior two quarters. The following table summarizes the warrants and options that are outstanding as of April 30, 2004. The vested shares are a subset of the outstanding shares. The value of the shares is the number of shares multiplied by the exercise price for each share.

	Summary of Outstanding Options and Warrants			
Exercise Price Range	**Outstanding Shares**	**Total Value of Outstanding Shares**	**Vested Shares (included in outstanding shares)**	**Total Value of Vested Shares**
$2.50 to $10 a share	5,772,388	$ 31,014,818	3,884,380	$20,708,292
$10 to $20 share	1,687,211	20,682,686	579,511	8,627,351
Greater than $20 a share	1,254,871	64,134,151	1,254,871	64,134,151
Total	8,714,470	$115,831,655	5,718,762	$93,469,794

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Off-Balance Sheet Arrangements, Contractual Obligations, and Contingent Liabilities and Commitments

The following table aggregates the Company s material contractual cash obligations as of March 31, 2004:

	Payments Due by Period					
Contractual Obligations	**Remainder of 2004**	**2005**	**2006**	**2007**	**2008**	**Thereafter**
Operating leases	$ 994,000	$1,111,000	$925,000	$ 903,000	$905,000	$1,333,000
Promissory note payable				2,700,000		
Purchase obligations	293,000	68,000	67,000			
Total contractual obligations	$1,287,000	$1,179,000	$992,000	$3,603,000	$905,000	$1,333,000

The Company also has severance agreements with certain employees that would require the Company to pay approximately $2,724,000 if all such employees separated from employment with the Company following a change of control, as defined in the severance agreements.

Risks and Uncertainties

We continue to use significant amounts of cash.

Since 1999, we have been developing and marketing products and services that bring privacy, security and convenience to Internet users, with a particular focus in the healthcare sector. Our businesses operate in emerging markets, and developing these businesses is costly and the market is highly competitive. Emerging market businesses involve risks and uncertainties, and there are no assurances that we will be successful in our efforts. We have experienced significant operating losses in recent years and utilization of cash resources continues at a substantial level. ZixCorp anticipates further losses in 2004.

Our recent acquisitions of three companies may require us to invest significant resources to make them successful.

In July 2003, we acquired substantially all of the assets of PocketScript, a provider of electronic prescription solutions for the healthcare industry; in September 2003, we acquired substantially all of the assets of Elron Software, a provider of anti-spam, email content filtering and Web filtering solutions; and in late January 2004, we acquired substantially all of the assets of MyDocOnline, a provider of secure Web-based communications and laboratory information solutions. PocketScript and MyDocOnline are start-up ventures in emerging markets. While Elron has been in business for a number of years, its revenues have declined in recent years. PocketScript, Elron, and MyDocOnline have incurred operating losses in recent years. The ability to increase the companies revenues in the near future is largely dependent upon, in Elron s case, whether our efforts to bring enhanced and new products to market are successful, and in the case of PocketScript and MyDocOnline, whether we are able to develop the market for their products and services. Our challenge is to make these new subsidiaries profitable. To do so may require us to invest significant resources, including significant amounts of cash, and there are no assurances that these subsidiaries will become profitable in the near term.

The market may not broadly accept our products and services, which would prevent us from operating profitably.

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We must be able to achieve broad market acceptance for our products and services in order to operate profitably. We have not yet been able to do this. To our knowledge, there are currently no secure e-messaging protection and transaction businesses similar to our Zix branded business that currently operate at the scale that we would require, at our current expenditure levels and pricing, to become profitable. As previously noted, PocketScript and MyDocOnline are start-up ventures in emerging markets. There is no assurance that our products and services will become generally accepted or that they will be compatible with any standards that become generally accepted, nor is there any assurance that enough paying users will ultimately be obtained to enable us to operate profitably.

Competition in our businesses is expected to increase, which could cause our business including the business of our recently acquired subsidiaries to fail.

Our Zix branded solutions are targeted to the secure e-messaging protection and transaction services market. Elron s product solutions have enabled us to enhance our Zix branded protection management services by adding a new feature set to our anti-virus, anti-spam and email content filtering services while expanding our offering to include URL filtering. Our PocketScript and MyDocOnline businesses are targeted toward the emerging markets for electronic prescriptions and online communication among the healthcare community. As the public s and governmental authorities awareness about the need for privacy and security of electronic communications has increased over the past few years, an increasing number of competitors have entered the market.

Although there are many large, well-funded participants in the information technology security industry, few currently participate in the secure e-messaging protection and transaction services market in which our Zix branded solutions compete. Most other product-only solutions in this market require extensive increases in overhead to implement and deploy them. In addition, our Zix branded solutions can be made operational in a very short period of time compared to the longer procurement and deployment cycles common with the solutions of many of our competitors. Our service and product offerings are focused on the secure communications market, including secure e-messaging and protection management. Companies that compete with our Zix branded secure e-messaging and protection business include content management and secure delivery companies, such as Authentica, Inc., Certified Mail, Sigaba Corporation and Tumbleweed Communications Corp., and other messaging/spam protection participants such as BrightMail Incorporated, CipherTrust, Inc., ClearSwift Limited, FrontBridge Technologies, Inc., MessageLabs, Postini, Inc., NetIQ Corp. and SurfControl Incorporated.

Our Zix branded products and Elron products also compete with several product companies that deliver anti-virus solutions that may also contain limited email messaging/spam protection capabilities, including Network Associates, Inc. (McAfee), Sophos, Inc., Symantec Corporation and Trend Micro, Inc. We also compete with companies that offer Web filtering products, such as Secure Computing Corporation, SurfControl Incorporated, Websense, Inc. and NetIQ Corp.

In addition, we face competition from vendors of Internet server appliances, operating systems, networking hardware, network management solutions and security software, many of which now, or may in the future, develop or bundle secure e-messaging, messaging/spam protection and/or Web filtering capabilities into their products.

We may face increased competition as these competitors partner with others or develop new product and service offerings to expand the functionality that they can offer to their customers. We believe that the secure e-messaging protection and transaction services market is immature, and, for the most part, unpenetrated, unlike many segments of the information technology security industry which are saturated. We have spent several years on infrastructure development and product development. Our competitors may, over time, develop new technologies that are perceived as being more secure, effective or cost efficient than our own. If we are not successful in exploiting the technology advantage we believe we currently hold, these competitors could successfully garner a significant share of the market, to the exclusion of our company. Furthermore, increased competition could result in pricing pressures, reduced margins or the failure of our business to achieve or maintain market acceptance, any of which could harm our business.

Our PocketScript electronic prescription management services allow health care payors to effectively deliver drug information to physicians at the point of care, enabling providers to work more effectively within established formularies. Our PocketScript services, targeted to the e-prescription marketplace, are expected to grow as more physicians are leveraging technology in delivering healthcare services, coupled with the fact that the number of prescriptions written annually in the United States continues to increase. Participants in the e-prescribing space include AllScripts Healthcare Solutions, Ramp Corporation, Dr. First, Inc. and iScribe (a division of AdvancePCS).

Our recently acquired MyDocOnline business offers a variety of Internet-based healthcare services. MyDocOnline Connect is a subscription-based Web service that allows patients and physicians to securely communicate online. Connect helps patients become more active, informed participants in their own health. Communication features offered by the service cover the spectrum of patient needs, and include: online doctor visits, administrative questions, appointment requests, billing questions, prescription requests, and referral requests. The service also offers a host of educational, interactive content features that deliver condition-specific health information to patients. Connect competitors include Medem, Inc., RelayHealth Corporation and MedFusion, Inc. with respect to the communication features, and WebMD Corporation with respect to the content resources. We believe that Connect offers superior services in the online doctor visit arena with the comprehensiveness of the templates; its ability to intelligently evaluate symptoms, interface with electronic medical records, control template availability at a granular level, and enable patients to include their health history; and its compatibility with the vast number of business/financial arrangements that exist in the healthcare industry. Nevertheless, we expect to face increasing competition in this arena and our competitors may develop products and services that are perceived to be better than ours.

Dr. Chart, also a Web-based communication tool, connects healthcare providers and laboratories by allowing doctors to initiate lab orders, check medical necessity compliance and view results rapidly and accurately using a secure Internet connection. Dr. Chart also automatically integrates patient information, customizes requisition formats for individual practices, automatically prints specimen labels, automatically checks Medicare compliance and provides an up-front Advanced Beneficiary Notification (ABN) at point of order and allows labs to enhance reporting with historical analyses, trending, and graphing. Dr. Chart seamlessly integrates into labs current systems and is fully customizable. Competitors include: 4Medica, Inc., Cerner Corporation and Misys plc. All of the competitors offer the same basic services that Dr. Chart offers, although we believe that Dr. Chart is superior to services offered by its competitors because of the flexibility of the product, expertise in interfacing to other systems, and duration and breadth of experience delivering Internet-based orders and solutions to labs nationwide. Nevertheless, we expect to face increasing competition in this arena and our competitors may develop products and services that are perceived to be better than ours.

Our inability to successfully and timely develop and introduce new e-messaging protection and transaction products and related services and to implement technological changes could harm our business.

The emerging nature of the secure e-messaging protection and transaction services business and its rapid evolution require us continually to develop and introduce new products and services and to improve the performance, features and reliability of our existing products and services, particularly in response to competitive offerings. Our Elron business, while having a significant customer base and meaningful revenues, has not been profitable in recent years under its prior ownership.

We also have under development new feature sets for our current Zix branded product line and service offerings and are considering new secure e-messaging products and services. By adding Elron s product line to our current service offerings, we will be able to accelerate the development time we would have otherwise needed to build additional feature sets into our Zix branded product and service offerings. The success of new or enhanced products and services depends on several factors primarily, market acceptance. We may not succeed in developing and marketing new or enhanced products and services that respond to competitive and technological developments and changing customer needs. This could harm our business.

If the market for secure e-messaging protection and transaction services does not continue to grow, demand for our products and services will be adversely affected.

The market for secure electronic communications is a developing market. Continued growth of the secure e-messaging protection and transaction services market will depend to a large extent on the market recognizing the need for secure electronic communications, such as email encryption and e-prescribing. Failure of this market to grow would harm our business.

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If health care providers fail to adopt the PocketScript and MyDocOnline Care Delivery Solutions, we will fail to achieve the critical mass of physicians and patients to build a successful business.

Our PocketScript electronic prescription management services and our MyDocOnline services are targeted to the emerging market for providing secure communications among health care providers to deliver information in an efficient, economical manner. These are emerging markets, and the success of our PocketScript and MyDocOnline services is dependent, in large measure, on physicians and other health care providers changing the manner in which they conduct their medical practices by beginning to use secure wireless and Internet communications channels to communicate with their patients, medical laboratories, payors, drug formularies, and others. Our challenge is to make these new businesses profitable. To do so may require us to invest significant resources, including significant amounts of cash, and there are no assurances that these businesses will become profitable in the near term.

Capacity limits on our technology and network hardware and software may be difficult to project, and we may not be able to expand and upgrade our systems to meet increased use, which would result in reduced revenues.

While we have ample through-put capacity to handle our customers requirements for the medium term, at some point we may be required to expand and upgrade our technology and network hardware and software. We may not be able to accurately project the rate of increase in usage on our network, particularly since we have significantly expanded our potential customer base by our recent acquisition of PocketScript and MyDocOnline, whose service offerings will be supported by our ZixSecure Center, once we transition the data center operations of PocketScript and MyDocOnline to this facility. In addition, we may not be able to expand and upgrade, in a timely manner, our systems and network hardware and software capabilities to accommodate increased traffic on our network. If we do not timely and appropriately expand and upgrade our systems and network hardware and software, we may lose customers and revenues.

Security interruptions to our data centers could disrupt our business, and any security breaches could expose us to liability and negatively impact customer demand for our products and services.

Our business depends on the uninterrupted operation of our data centers - currently, our ZixSecure Center located in Dallas, Texas; the Austin, Texas data centers used for fail-over and staging of new customers of our Zix branded services; the Dallas, Texas co-location facility that supports the operations of our recently acquired MyDocOnline business; and the data center that supports the PocketScript operations. We must protect these centers from loss, damage or interruption caused by fire, power loss, telecommunications failure or other events beyond our control. Any damage or failure that causes interruptions in our data centers operations could materially harm our business, financial condition and results of operations.

In addition, our ability to issue digitally-signed certified time-stamps and public encryption codes in connection with our Zix branded products and services and to support PocketScript s e-prescribing services and MyDocOnline s services depends on the efficient operation of the Internet connections between customers and our data centers. We depend on Internet service providers efficiently operating these connections. These providers have experienced periodic operational problems or outages in the past. Any of these problems or outages could adversely affect customer satisfaction.

Furthermore, it is critical that our facilities and infrastructure remain secure and the market perceives them to be secure. Despite our implementation of network security measures, our infrastructure may be vulnerable to physical break-ins, computer viruses, attacks by hackers and similar disruptions from unauthorized tampering with our computer systems. In addition, we are vulnerable to coordinated attempts to overload our systems with data, resulting in denial or reduction of service to some or all of our users for a period of time. We do not carry insurance to compensate us for losses that may occur as a result of any of these events; therefore, it is possible that we may have to use additional resources to address these problems.

Secure messages sent through our ZixPort and ZixMessage Center messaging portals, in connection with the operation of our secure e-messaging protection and transaction services, will reside, for a user-specified period of time, in our secure data center network; individual prescription histories transmitted through our PocketScript system will reside in our secure data center network; and the personal health care information transmitted through

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our MyDocOnline system will reside in our secure data center network. Any physical or electronic break-ins or other security breaches or compromises of this information could expose us to significant liability, and customers could be reluctant to use our Internet-related products and services.

We may have to defend our rights in intellectual property that we use in our products and services, which could be disruptive and expensive to our business.

We may have to defend our intellectual property rights or defend against claims that we are infringing the rights of others. Intellectual property litigation and controversies are disruptive and expensive. Infringement claims could require us to develop non-infringing products or enter into royalty or licensing arrangements. Royalty or licensing arrangements, if required, may not be obtainable on terms acceptable to us. Our business could be significantly harmed if we are not able to develop or license the necessary technology. Furthermore, it is possible that others may independently develop substantially equivalent intellectual property, thus enabling them to effectively compete against us.

Defects or errors could affect the performance of our products and services.

We subject our Zix branded products and services to quality assurance testing prior to product release. There is no assurance that the quality and assurance testing previously conducted by the businesses we recently acquired on their current products and services conform to our standards for quality assurance testing. Regardless of the level of quality assurance testing, any of our products and services could contain undetected defects or errors. This could result in loss of or delay in revenues, failure to achieve market acceptance, diversion of development resources, injury to our reputation, litigation claims, increased insurance costs or increased service and warranty costs. Any of these could prevent us from implementing our business model and achieving the revenues we need to operate profitably.

Public key cryptography technology is subject to risks.

Our Zix branded products and services, the PocketScript e-prescription service and the MyDocOnline businesses employ, and future products and services may employ, public key cryptography technology. With public key cryptography technology, a public key and a private key are used to encrypt and decrypt messages. The security afforded by this technology depends, in large measure, on the integrity of the private key, which is dependent, in part, on the application of certain mathematical principles. The integrity of the private key is predicated on the assumption that it is difficult to mathematically derive the private key from the related public key. Should methods be developed that make it easier to derive the private key, the security of encryption products using public key cryptography technology would be reduced or eliminated and such products could become unmarketable. This could require us to make significant changes to our products, which could damage our reputation and otherwise hurt our business. Moreover, there have been public reports of the successful decryption of certain encrypted messages. This, or related, publicity could adversely affect public perception of the security afforded by public key cryptography technology, which could harm our business.

We depend on key personnel.

We depend on the performance of our senior management team including our chairman and chief executive officer, John A. Ryan; our president and chief operating officer, Richard Spurr and their direct reports and other key employees, particularly highly skilled technical personnel. Our success depends on our ability to attract, retain and motivate these individuals. There are no binding agreements with any of our employees which prevent them from leaving our company at any time. There is competition for these personnel. In addition, we do not maintain key person life insurance on any of our personnel. The loss of the services of any of our key employees or our failure to attract, retain and motivate key employees could harm our business.

We could be affected by government regulation.

Exports of software products using encryption technology, such as our Zix branded products and services, are generally restricted by the U.S. government. Although we have obtained U.S. government approval to export our products to almost all countries in the world, the list of countries to which our products cannot be exported could be

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revised in the future. Furthermore, some foreign countries impose restrictions on the use of encryption products, such as our products. Failure to obtain the required governmental approvals would preclude the sale or use of our products in international markets.

Furthermore, boards of pharmacy in the various states in which our PocketScript and MyDocOnline businesses operate regulate the process by which physicians write prescriptions. While regulations in the states in which these businesses currently generally operate permit the electronic writing of prescriptions, such regulations could be revised in the future. Moreover, regulations in states in which these businesses do not currently operate may not be as favorable and may impede our ability to develop business in these states. Furthermore, future state or federal regulation could mandate standards for the electronic writing of prescriptions or for the secure electronic transmittal of personal health information through the Internet that our technology and systems do not comply with, which would require us to modify our technology and systems.

Our stock price may be volatile.

The market price of our common stock has fluctuated significantly in the past and is likely to fluctuate in the future. Our stock price may decrease as a result of the dilutive effect caused by the additional number of shares that may become available in the market due to the issuances of our common stock in connection with the capital funding and acquisition transactions we completed over the last year. As of April 15, 2004, there was a short position in our common stock of 8,255,555 shares.

Our directors and executive officers own a substantial percentage of our securities. Their ownership could allow them to exercise significant control over corporate decisions and to implement corporate acts that are not in the best interests of our shareholders as a group.

Our directors and executive officers beneficially own shares of our securities that represent approximately 16.3% of the combined voting power eligible to vote on matters brought before our shareholders, including securities and associated warrants beneficially owned by Antonio R. Sanchez, Jr., a former director and father of a current director (Antonio R. Sanchez III), and current beneficial owner of approximately 8.4% of our outstanding common stock, and John A. Ryan, our chairman and chief executive officer. Therefore, our directors and executive officers, if they acted together, could exert substantial influence over matters requiring approval by our shareholders. These matters would include the election of directors. This concentration of ownership and voting power may discourage or prevent someone from acquiring our business.

A private investor owns a large percentage of our outstanding stock and could significantly influence the outcome of actions.

George W. Haywood, a private investor, beneficially owns approximately 16.0% of our outstanding common stock. Therefore, Mr. Haywood could exert substantial influence over all matters requiring approval by our shareholders, including the election of directors. Mr. Haywood s interests may not be aligned with the interests of our other shareholders. This concentration of ownership and voting power may discourage or prevent someone from acquiring our business.

Further issuances of equity securities may be dilutive to current shareholders.

At some point in the future we may determine to seek additional capital funding or to acquire additional businesses. These events could involve the issuance of one or more types of equity securities, including convertible debt, common or convertible preferred stock and warrants to acquire common or preferred stock. Such equity securities could be issued at or below the then-prevailing market price for our common stock. In addition, we incentivize employees and attract new employees by issuing shares of our common stock and options to purchase shares of our common stock. Therefore, the interest of our existing shareholders could be diluted by future share issuances and stock option grants to employees and any equity securities issued in capital funding financings or business acquisitions.

We may have liability for indemnification claims arising from the sale of our previous businesses in 1998 and 1997.

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We disposed of our previous operating businesses in 1998 and 1997. In selling those businesses, we agreed to provide customary indemnification to the purchasers of those businesses for breaches of representations and warranties, covenants and other specified matters. Although we believe that we have adequately provided for future costs associated with these indemnification obligations, indemnifiable claims could exceed our estimates.

We may encounter other unanticipated risks and uncertainties in the markets we serve or in developing new products and services, and we cannot assure you that we will be successful in responding to any unanticipated risks or uncertainties.

There are no assurances that we will be successful or that we will not encounter other, and even unanticipated, risks. We discuss other operating, financial or legal risks or uncertainties in our periodic filings with the SEC. We are, of course, also subject to general economic risks.

NOTE ON FORWARD-LOOKING STATEMENTS AND RISK FACTORS

This document contains forward-looking statements within the meaning of Section 27A of the Act and Section 21E of the Exchange Act. All statements other than statements of historical fact are forward-looking statements for purposes of federal and state securities laws, including: any projections of future business, market share, earnings, revenues or other financial items; any statements of the plans, strategies and objectives of management for future operations; any statements concerning proposed new products, services or developments; any statements regarding future economic conditions or performance; any statements of belief; and any statements of assumptions underlying any of the foregoing. Forward-looking statements may include the words may, will, predict, plan, should, goal estimate, intend, continue, believe, expect, anticipate and other similar words. Such forward-looking statemen be contained in the Risks and Uncertainties section above, among other places.

Although we believe that the expectations reflected in any of our forward-looking statements are reasonable, actual results could differ materially from those projected or assumed in any of our forward-looking statements. Our future financial condition and results of operations, as well as any forward-looking statements, are subject to change and to inherent risks and uncertainties, such as those disclosed in this document. We do not intend, and undertake no obligation, to update any forward-looking statement.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

For the three-month period ended March 31, 2004, the Company did not experience any material changes in market risk exposures with respect to its cash investments and marketable securities that affect the quantitative and qualitative disclosures presented in the Company s 2003 Annual Report to Shareholders on Form 10-K.

ITEM 4. CONTROLS AND PROCEDURES

An evaluation was carried out under the supervision and with the participation of the Company s management, including its Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company s disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) as of March 31, 2004. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the design and operation of these disclosure controls and procedures were effective. There have been no significant changes in the Company s internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation.

PART II   OTHER INFORMATION

ITEM 2. CHANGES IN SECURITIES

On January 30, 2004, the Company acquired substantially all of the assets and business of MyDocOnline, Inc., a subsidiary of Aventis Pharmaceuticals, the North American pharmaceuticals business of Aventis (NYSE:AVE). The consideration for the acquisition consisted of 583,411 shares of ZixCorp s common stock, and

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three year warrants to purchase 145,853 shares of ZixCorp s common stock at an exercise price of $13.01 per share. The shares and warrants were issued in a private placement effected in reliance on the exemption from registration afforded by Section 4(2) of the Securities Act of 1933. The Company has filed a registration statement with the SEC relating to the resale of the common stock shares issued at the closing of the acquisition and the shares issuable upon the exercise of the warrants. The Company anticipates that the registration statement will become effective by the end of May 2004.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

a. Exhibits

The following is a list of exhibits filed as part of this Quarterly Report on Form 10-Q/A:

Description of Exhibits	
10.1+	Zix Corporation 2004 Stock Option Plan, dated May 6, 2004.
10.2+	Zix Corporation 2004 Directors Stock Option Plan, dated May 6, 2004.
31.1*	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as amended.
31.2*	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as amended.
32.1**	Certification of John A. Ryan, Chief Executive Officer, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2**	Certification of Bradley C. Almond, Chief Financial Officer, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

\+ Previously filed.

* Filed herewith.

** Furnished herewith.

b. Reports on Form 8-K

The Company filed the following reports on Form 8-K during the three months ended March 31, 2004:

1. The Company filed a report on Form 8-K on February 4, 2004, reporting its financial results for the quarter ended December 31, 2003.

2.

The Company filed a report on Form 8-K on February 11, 2004, relating to the asset acquisition of MyDocOnline, Inc.

The Company also filed a report on Form 8-K on April 7, 2004, relating to new executive appointments (amended via Form 8-K/A dated May 6, 2004) and a report on Form 8-K/A dated April 14, 2004, reporting the historical financial statements of MyDocOnline, Inc. and certain pro forma financial information, a report on Form 8-K on May 5, 2004 reporting the Company s financial results for the quarter ended March 31, 2004.

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SIGNATURE

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

ZIX CORPORATION

(Registrant)

Date: August 9, 2004

By: /s/ Bradley C. Almond
Bradley C. Almond
Vice President, Chief Financial Officer, and Treasurer
(Principal Financial Officer and Duly Authorized Officer)

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