

CAPTARIS INC
Form 10-Q
August 09, 2004
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2004

or

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

For the transition period from _____ to _____.

Commission File Number 0-25186

CAPTARIS, INC.

(Name of Registrant as Specified in Its Charter)

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Washington
(State of Incorporation)

91-1190085
(I.R.S. Employer Identification Number)

10885 N.E. 4th Street, Suite 400

Bellevue, WA
(Address of Principal Executive Offices)

98004
(Zip Code)

Registrant's telephone number, including area code: (425) 455-6000

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 x No "

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

The number of outstanding shares of the registrant's common stock as of August 2, 2004 was 31,548,235.

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CAPTARIS, INC.

FORM 10-Q

For the Quarter Ended June 30, 2004

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Table of Contents**PART I.****FINANCIAL INFORMATION****Item 1. FINANCIAL STATEMENTS (UNAUDITED)****CAPTARIS, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

(in thousands, except per share data)

(unaudited)

	June 30,	December 31,
	2004	2003
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 3,315	\$ 41,896
Short-term investments, available for sale	55,354	28,081
Accounts receivable, net	12,857	13,638
Inventories	905	1,973
Prepaid expenses and other	2,595	2,516
Deferred income tax assets	2,686	1,770
	<u>77,712</u>	<u>89,874</u>
Total current assets	77,712	89,874
Long-term investments, available for sale	30,161	25,684
Restricted cash	1,000	1,000
Equipment and leasehold improvements, net	5,480	4,605
Intangible and other assets, net	6,096	6,705
Goodwill	15,440	15,541
Deferred income tax assets	1,603	1,346
	<u>\$ 137,492</u>	<u>\$ 144,755</u>
Total assets	\$ 137,492	\$ 144,755
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 3,489	\$ 4,875
Accrued compensation and benefits	2,876	4,403
Other accrued liabilities	1,137	1,393
Income taxes payable	1,647	2,999
Deferred revenue	12,918	10,257
	<u>22,067</u>	<u>23,927</u>
Total current liabilities	22,067	23,927
Commitments and contingencies (Note 6)		

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Redeemable common stock	3,000	3,000
Shareholders' equity:		
Preferred stock, par value \$0.01 per share, 2,000 shares authorized; none issued and outstanding		
Common stock, par value \$0.01 per share, 120,000 shares authorized; 31,542 and 32,358 outstanding, respectively	310	318
Additional paid-in capital	62,662	67,453
Retained earnings	49,605	49,681
Accumulated other comprehensive income (loss)	(152)	376
	<u> </u>	<u> </u>
Total shareholders' equity	112,425	117,828
	<u> </u>	<u> </u>
Total liabilities and shareholders' equity	\$ 137,492	\$ 144,755
	<u> </u>	<u> </u>

See the accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents**CAPTARIS, INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(in thousands, except per share data)****(unaudited)**

	Quarter Ended		Six Months Ended	
	June 30,		June 30,	
	2004	2003	2004	2003
Net revenue	\$ 18,191	\$ 18,139	\$ 36,366	\$ 33,839
Cost of revenue	6,104	6,440	12,272	12,235
Gross profit	12,087	11,699	24,094	21,604
Operating expenses:				
Research and development	2,260	2,441	4,391	4,798
Selling, general and administrative	10,046	8,577	20,117	18,403
Amortization of intangibles	103	57	206	113
Stock compensation expense	215	508	219	992
Total operating expenses	12,624	11,583	24,933	24,306
Operating income (loss)	(537)	116	(839)	(2,702)
Other income (expense):				
Interest	332	358	671	810
Other, net	(216)	(8)	(285)	(51)
Other income, net	116	350	386	759
Income (loss) from continuing operations before income tax (benefit)	(421)	466	(453)	(1,943)
Income tax (benefit) expense	(161)	134	(173)	(755)
Income (loss) from continuing operations	(260)	332	(280)	(1,188)
Discontinued operations:				
Income from operations of MediaLinq, net of income taxes		376		918
Gain on sale of MediaLinq, net of income taxes	204		204	
Income from discontinued operations, net of taxes	204	376	204	918
Net income (loss)	\$ (56)	\$ 708	\$ (76)	\$ (270)
Income (loss) per common share:				
Basic and diluted income (loss) per common share from continuing operations	\$ (0.01)	0.01	(0.01)	(0.04)
Basic and diluted income per common share from discontinued operations	0.01	0.01	0.01	0.03
Basic and diluted net income (loss) per common share	\$ (0.00)	\$ 0.02	\$ (0.00)	\$ (0.01)

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Weighted average basic common shares	31,860	30,311	32,076	30,274
Weighted average diluted common shares	31,860	30,816	32,076	30,274

See the accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents**CAPTARIS, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(in thousands)****(unaudited)**

	Six Months Ended	
	June 30,	
	2004	2003
Cash flows from operating activities:		
Net loss	\$ (76)	\$ (270)
Adjustments to reconcile net loss to net cash used by operating activities:		
Depreciation and amortization	1,900	2,192
Gain on sale of MediaLinq	(204)	
Stock compensation expense	219	1,297
Stock issued for consulting services		6
Bad debt provision	31	
Changes in assets and liabilities:		
Accounts receivable	729	2,629
Inventories	1,049	907
Prepaid expenses and other	(96)	(306)
Deferred income tax assets	(772)	110
Accounts payable	(1,315)	(1,786)
Accrued compensation and benefits	(1,503)	(365)
Other accrued liabilities	(245)	(1,266)
Income taxes payable	(1,352)	
Deferred revenue	2,680	838
Net cash flow provided by operating activities	1,045	3,986
Cash flows from investing activities:		
Purchase of equipment and leasehold improvements	(2,181)	(1,856)
Purchase of investments	(60,328)	(47,165)
Purchase of businesses, net of cash acquired	(170)	
Proceeds from sale of MediaLinq	204	
Proceeds from sale and maturities of investments	28,277	37,010
Net cash flow used by investing activities	(34,198)	(12,011)
Cash flows from financing activities:		
Proceeds from exercise of common stock options	911	602
Repurchase of common stock	(6,329)	(177)
Net cash flow (used) provided by financing activities	(5,418)	425
Net decrease in cash flow	(38,571)	(7,600)
Effect of exchange rate changes on cash	(10)	79
Cash and cash equivalents at beginning of period	41,896	21,971

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Cash and cash equivalents at end of period	<u>\$ 3,315</u>	<u>\$ 14,450</u>
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See the accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****Six Months Ended June 30, 2004****1. Interim Financial Statements**

In the opinion of management, the accompanying unaudited condensed consolidated balance sheets and related interim condensed consolidated statements of operations and cash flows have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and notes required by accounting principles generally accepted in the United States of America for complete financial statements. All adjustments considered necessary for fair presentation have been included. Interim results are not necessarily indicative of results for a full year. These unaudited condensed consolidated financial statements should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2003. The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual amounts may differ from those estimates. The Company's results of operations may fluctuate as a result of seasonal factors. Historically, the Company's business experiences seasonality with a sequential decline in revenue during the first quarter compared to the fourth quarter of the prior year, and fourth quarter revenue tends to be the largest quarter for revenue during the year.

On September 1, 2003, we completed the sale of our MediaLinq division. As such, MediaLinq's results of operations for the three and six months ended June 30, 2003 have been reclassified as discontinued operations.

Certain prior-period balances have been reclassified to conform to the current period presentation.

During the second quarter of 2001, the Company offered a limited non-compulsory exchange of employee stock options on a less than one-for-one basis. The exchange (which closed on July 10, 2001) resulted in the voluntary cancellation of employee stock options to purchase 3,135,720 shares of our common stock with varying exercise prices greater than \$10.00 per share in exchange for 1,286,790 employee stock options with an exercise price of \$2.11. The option exchange offer resulted in variable accounting treatment for a total of 1,993,250 options, representing the 1,286,790 new options granted in the exchange, as well as all employee options modified during the year. Variable accounting will continue until all options subject to variable accounting treatment are exercised, cancelled or expire. Variable accounting treatment results in charges or credits, recorded to stock compensation, dependent on fluctuations in quoted prices for the Company's common stock, and the number of stock options subject to variable accounting that are outstanding for the period, neither of which can be predicted. At June 30, 2004 and 2003, the Company had 197,762 and 1,194,057 options outstanding subject to variable accounting.

Allocation of stock compensation charges to the operating expense categories is as follows:

Quarter Ended		Six Months Ended	
June 30,		June 30,	
2004	2003	2004	2003

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	_____	_____	_____	_____
	(in thousands)			
Cost of revenue	\$ 18	\$ 55	\$ 19	\$ 101
Research and development	62	115	60	227
Selling, general and administrative	135	338	140	664
	_____	_____	_____	_____
Total cost of revenue and operating expense	215	508	219	992
Discontinued operations		165		305
	_____	_____	_____	_____
Total stock compensation expense	\$ 215	\$ 673	\$ 219	\$ 1,297
	_____	_____	_____	_____

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The Company accounts for stock options under Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, under which no compensation cost has been recognized other than for stock options subject to variable accounting treatment, as there is no difference between the exercise price and fair market value at the date of grant. Had compensation cost for stock option grants been determined using the fair value method consistent with SFAS No. 123, *Accounting for Stock-Based Compensation*, the Company's net income (loss) and net income (loss) per share would have been as shown in the following pro forma amounts:

	Quarter Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
	As		As	
	Restated		Restated	
Net income (loss), as reported	\$ (56)	\$ 708	\$ (76)	\$ (270)
Add: Stock compensation expense, as reported, net of income taxes	133	415	136	799
Deduct: Total stock compensation expense determined under fair value based method for all awards, net of income taxes	684	541	(1,270)	963
Net income (loss), pro forma	\$ (607)	\$ 582	\$ (1,210)	\$ (434)
Net income (loss) per share:				
Basic and diluted as reported	\$ (0.00)	\$ 0.02	\$ (0.00)	\$ (0.01)
Basic and diluted pro forma	\$ (0.02)	\$ 0.02	\$ (0.04)	\$ (0.01)

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions:

	Quarter Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Dividend yield	0.0%	0.0%	0.0%	0.0%
Volatility	49%	69%	49%	69%
Risk-free interest rate	3.24%	2.81%	3.22%	2.81%
Expected life (in years)	3	5	3	5

After filing our amended quarterly report on Form 10-Q/A for the quarter ended June 30, 2003 which was filed on March 12, 2004, we discovered a computational error in the calculation of pro forma net income (loss) and pro forma net income (loss) per share for the quarter and six months ended June 30, 2003, which caused the amounts of pro forma net income (loss) and pro forma net income (loss) per share to be understated. In addition, we also identified an error in calculating the denominator in pro forma net income (loss) per share. Accordingly, we have restated this disclosure to reflect the proper amounts of pro forma net income (loss) and pro forma net income (loss) per share for the quarter and six months ended June 30, 2003.

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The table below indicates the amounts of pro forma net income (loss) and pro forma net income (loss) per share as previously reported and as restated:

	Quarter Ended		Six Months Ended	
	June 30, 2003		June 30, 2003	
	As	As	As	As
	Previously Reported	Restated	Previously Reported	Restated
	(in thousands, except per share data)			
Net income (loss), as reported	\$ 708	\$ 708	\$ (270)	\$ (270)
Add: Stock compensation expense, as reported, net of income taxes	415	415	799	799
Deduct: Total stock compensation expense determined under fair value based method for all awards, net of income taxes	237	541	526	963
Pro forma net income (loss)	\$ 886	\$ 582	\$ 3	\$ (434)
Net income (loss) per share:				
Basic and diluted - as reported	\$ 0.02	\$ 0.02	\$ (0.01)	\$ (0.01)
Basic and diluted - pro forma	\$ 0.03	\$ 0.02	\$ 0.00	\$ (0.01)

Table of Contents**2. Segment Reporting**

Historically, the Company classified its business into two major segments: Software Products and E-document Services. In September 2003, the Company sold its E-document services operating segment, MediaLinq. As a result of the sale, the Company now operates in only one operating segment.

The Company's revenue by country, as determined by shipping destination, was as follows:

	Quarter Ended		Six Months Ended	
	June 30,		June 30,	
	2004	2003	2004	2003
	(in thousands)			
United States	\$ 13,891	\$ 13,926	\$ 27,629	\$ 25,314
United Kingdom	423	735	683	1,655
Canada	659	629	1,428	1,382
Other	3,218	2,849	6,626	5,488
Total net revenue	\$ 18,191	\$ 18,139	\$ 36,366	\$ 33,839

3. Net Income (Loss) Per Share

Basic net income (loss) per common share was computed by dividing net income (loss) by the weighted average number of shares of common stock outstanding during the period. Diluted net income (loss) per common share was computed by dividing net income (loss) by the sum of (1) the weighted average number of shares of common stock outstanding during the period and (2) net additional shares that would have been issued had all dilutive options been exercised less shares that would be repurchased with the proceeds from such exercise. Dilutive options are those that have an exercise price less than the average stock price during the period.

The following table sets forth the computation of basic and diluted income (loss) per common share:

	Quarter Ended		Six Months Ended	
	June 30,		June 30,	
	2004	2003	2004	2003
	(in thousands, except per share data)			
Numerator:				
Income (loss) from continuing operations	\$ (260)	\$ 332	\$ (280)	\$ (1,188)
Discontinued operations:				

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Income from operations of MediaLinq, net of income taxes		376		918
Gain on sale of Medialinq, net of income taxes	204		204	
	<u>204</u>	<u>376</u>	<u>204</u>	<u>918</u>
Income from discontinued operations	204	376	204	918
	<u>204</u>	<u>376</u>	<u>204</u>	<u>918</u>
Net income (loss)	\$ (56)	\$ 708	\$ (76)	\$ (270)
	<u>\$ (56)</u>	<u>\$ 708</u>	<u>\$ (76)</u>	<u>\$ (270)</u>
Denominator:				
Weighted average shares outstanding basic	31,860	30,311	32,076	30,274
Dilutive effect of common shares from stock options		505		
	<u>31,860</u>	<u>30,816</u>	<u>32,076</u>	<u>30,274</u>
Weighted average shares outstanding diluted	31,860	30,816	32,076	30,274
	<u>31,860</u>	<u>30,816</u>	<u>32,076</u>	<u>30,274</u>
Basic and diluted net income (loss) per share:				
Income (loss) from continuing operations	\$ (0.01)	\$ 0.01	\$ (0.01)	\$ (0.04)
Income from discontinued operations	0.01	0.01	0.01	0.03
	<u>\$ (0.01)</u>	<u>\$ 0.01</u>	<u>\$ (0.01)</u>	<u>\$ (0.04)</u>
Net income (loss)	\$ (0.00)	\$ 0.02	\$ (0.00)	\$ (0.01)
	<u>\$ (0.00)</u>	<u>\$ 0.02</u>	<u>\$ (0.00)</u>	<u>\$ (0.01)</u>

Potentially issuable common shares under outstanding stock options of 2,251,163 and 3,445,368 were excluded from the calculation of diluted shares outstanding for the quarters ended June 30, 2004 and 2003, respectively, as they were antidilutive. In addition, potentially issuable common shares under outstanding stock options of 2,249,910 and 4,136,107 were excluded from the calculation of diluted shares outstanding for the six months ended June 30, 2004 and 2003, respectively, as they were antidilutive.

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	Common Shares ¹	Common Stock	Additional Paid-in Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Total Shareholders Equity	Total Other Comprehensive Loss
(in thousands, except share data)							
Balance at January 1, 2004 ¹	32,357,675	\$ 318	\$ 67,453	\$ 376	\$ 49,681	\$ 117,828	\$
Exercise of stock options	266,296	3	908			911	
Repurchase of common stock	(1,081,568)	(11)	(6,318)			(6,329)	
Stock compensation expense			219			219	
Stock option income tax benefit			400			400	
Unrealized loss on investments, net of income tax benefit of \$217				(302)		(302)	(302)
Foreign currency translation adjustment				(226)		(226)	(226)
Net loss					(76)	(76)	(76)
Balance at June 30, 2004 ¹	31,542,403	\$ 310	\$ 62,662	\$ (152)	\$ 49,605	\$ 112,425	\$ (604)

¹ Includes 574,727 shares of redeemable common stock issued on October 3, 2003.

Total other comprehensive loss was \$447,000 for the quarter ended June 30, 2004 compared to total other comprehensive income of \$881,000 for the quarter ended June 30, 2003. Total other comprehensive loss was \$604,000 and \$179,000 for the six months ended June 30, 2004 and 2003, respectively.

5. Repurchase Program

Pursuant to a stock repurchase program approved by the Company's Board of Directors in July 2003, in which the Board authorized the Company to repurchase up to \$15.0 million of our common stock, we repurchased \$2.5 million of our common stock in the first quarter of 2004. As of March 31, 2004, approximately \$9.6 million remained available to repurchase shares under this program. On May 4, 2004, the Company's Board of Directors allocated an additional \$5.4 million in funds for the Company's stock repurchase program. The Company repurchased an additional \$3.8 million of our common stock in the second quarter of 2004. At June 30, 2004, \$11.1 million of funds were available under the program. The Company may repurchase shares in the future subject to open trading windows, overall market conditions, stock prices and its cash position and requirements going forward. The repurchase program will continue until the earlier of (a) such time when the maximum dollar amount authorized is repurchased or (b) the Board discontinues the repurchase program.

6. Commitments and Contingencies

The Company periodically receives letters and other communications from third parties asserting patent rights and requesting royalty payments and will probably receive additional claims in the future. We follow the provisions of Statement of Financial Accounting Standards (SFAS) No. 5, *Accounting for Contingencies*, to record litigation or claim-related expenses. For example, over the past six years, the Company has been involved in intermittent communications with Avaya, which was spun off from Lucent Technologies in 2001. Over this period of time, Lucent/Avaya asserted that the Company was infringing on their patents or technology, eventually identifying 10 patents as including claims that allegedly cover the Company's current or former products and/or services. Several communications and meetings between the Company and

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Lucent/Avaya have occurred. The Company has also received communication in the past from BellSouth, beginning in December of 2001, at which time BellSouth asserted that the Company was infringing on two of its patents. Analysis of both patents in light of the Company's current and former products/services is still underway. The last communication with representatives of BellSouth was on June 19, 2003. The ultimate outcome of these matters cannot presently be determined. As such, we have not recorded an accrual for these exposures. Accordingly, the ultimate resolution of these matters could have a material adverse effect on the Company's financial position, cash flow and results of operations.

On September 15, 2003, Captaris and its wholly-owned subsidiary, MediaTel Corporation (Delaware) (MediaTel), entered into an asset purchase agreement, effective as of September 1, 2003, to sell the assets of MediaLinq, an outsourced division of Captaris operated by MediaTel, to PTEK Holdings, Inc. and its wholly-owned subsidiary, Xpedite Systems, Inc. (Xpedite). MediaLinq provides outsourced e-document delivery services. The Company is contingently obligated to indemnify Xpedite against claims resulting from various representations and warranties made by the Company. At June 30, 2004,

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no indemnification claims are outstanding and a previous claim by Xpedite has been resolved with no impact to the Company's financial position, cash flow or results of operations.

On September 29, 2003, Captaris announced the sale of its CallXpress product line, which primarily includes the Captaris voice and unified messaging assets, to Sound Advantage, LLC ("Sound Advantage"), a California limited liability company. Under the terms of the agreement, Sound Advantage acquired the CallXpress product line for \$2.5 million in cash and will pay up to an additional \$1.0 million per year over a three year period beginning January 1, 2004 pursuant to an earn out arrangement, which is based on achievement of specified revenue targets for the CallXpress business. In addition, Captaris was issued a 10 percent equity interest in Applied Voice and Speech Technologies, Inc. ("AVST"), a newly formed company established by Sound Advantage to acquire and operate the combined CallXpress and Sound Advantage businesses. RightFax will continue to be a part of AVST's Unified Messaging offering, based on an ongoing OEM agreement. Also, the Company agreed to indemnify AVST against claims resulting from various representations and warranties made by the Company. At June 30, 2004 no indemnification claims have been made by AVST.

7. Final Purchase Price Adjustment for the Sale of MediaLinq

Pursuant to the sale of our MediaLinq assets in September 2003, during the second quarter of 2004, we received additional proceeds from the sale of MediaLinq of \$232,000, net of income taxes, related to a working capital adjustment defined in the purchase agreement. In addition, during the second quarter of 2004 we incurred \$28,000 of legal fees, net of income taxes, related to outstanding MediaLinq legal liabilities we retained. We expect to incur additional legal fees during the remainder of 2004 in conjunction with these retained liabilities. See Note 9.

8. Final Purchase Price Adjustment for the Purchase of Teemplate

On September 30, 2003, Captaris acquired Teemplate, Inc. ("Teemplate"). In accordance with the agreement to acquire Teemplate, the original purchase price was subject to additional adjustments related to working capital at September 30, 2003, the payment of a certain liability and the ultimate collection of certain accounts receivable. As of June 30, 2004, each of these adjustments have been resolved and therefore, pursuant to that agreement, the Company paid additional proceeds of \$69,000 to the original investors of Teemplate and recorded it as additional goodwill in June 2004.

9. Legal Proceedings

One of the services provided by MediaTel Corporation ("MediaTel"), a wholly owned subsidiary of Captaris, was the transmission of facsimiles to travel industry participants on behalf of travel service providers. MediaTel held a license to use a database supplied by Northstar Travel Media that lists recipients for these facsimiles. All of the assets of MediaTel were sold to a subsidiary of PTEK Holdings, Inc. ("PTEK") on September 1, 2003. On or about July 29, 2003, Travel 100 Group, Inc. ("Travel 100") filed two lawsuits in Circuit Court in Cook County, Illinois, one against Mediterranean Shipping Company ("Mediterranean") and another against The Melrose Hotel Company ("Melrose"). The complaints are substantially identical in form and allege violations of the Telephone Consumer Protection Act in connection with the receipt of facsimile advertisements that were transmitted by MediaTel. Each complaint seeks injunctive relief and unspecified damages and certification as a class action on behalf of Travel 100 and others similarly situated that received the facsimile advertisements.

MediaTel contracted with a third party to provide facsimile advertising services for Mediterranean. The third party, in turn, contracted with Mediterranean. Melrose contracted directly with MediaTel for transmission of the facsimiles. In its answer filed on September 23, 2003, Mediterranean named Captaris as a third-party defendant and asserted that to the extent that Mediterranean is liable, Captaris should be liable under theories of indemnification or contribution for any damages suffered by Mediterranean. Similarly, in its answer filed on October 14, 2003,

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Melrose named Captaris, as well as PTEK, as third-party defendants based on allegations of breach of contract and claims for contribution. In response to Mediterranean's third-party complaint, Captaris filed its answer on November 3, 2003, denying the allegations filed by Mediterranean and further answering by way of affirmative defenses that to the extent Captaris is found liable for any damages allegedly suffered by plaintiffs or any third-party plaintiffs in this action, Captaris is entitled to indemnification and/or contribution from other non-parties to this action. Captaris filed a similar answer to Melrose's complaint on November 20, 2003. The outcome of these matters, including the plaintiff's success in achieving class certification, is uncertain. We have not recorded an accrual related to this exposure.

The ultimate outcome of these matters, discussed above, cannot presently be determined. Accordingly, the ultimate resolution of these matters could have a material adverse effect on the Company's financial position, cash flow and results of operations.

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10. New Accounting Pronouncements

In November 2003, the Emerging Issues Task Force (EITF), reached a consensus on Issue 03-1, *The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments*. EITF 03-1 establishes additional disclosure requirements for each category of SFAS No. 115 investments in a loss position. Effective for years ending after December 15, 2003, companies must disclose the aggregate amount of unrealized losses and the aggregate related fair value of their investments with unrealized losses. Those investments are required to be segregated by those in a loss position for less than twelve months and those in a loss position for greater than twelve months. Additionally, certain qualitative disclosures should be made to clarify a circumstance whereby an investment's fair value that is below cost is not considered other-than-temporary. Effective for the third quarter ending September 30, 2004, unrealized losses on investments that are deemed other-than-temporary must be recognized in earnings equal to the difference between the investment cost and its fair value at the balance sheet date of the reporting period for which the assessment is made. The Company is currently reviewing the impact of adopting this EITF, which may have a material impact on our financial position, results of operations and cash flows.

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Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This discussion and analysis should be read in conjunction with our unaudited condensed consolidated financial statements and accompanying notes included in this document and the 2003 audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K, which was filed with the Securities and Exchange Commission on March 19, 2004.

The following discussion of our financial condition and results of operations contains forward-looking statements that involve risks and uncertainties, such as statements of our plans, objectives, expectations and intentions. Words such as believes, expects, anticipates, intends, plans and similar expressions are intended to identify forward-looking statements. Captaris' actual results could differ materially from those anticipated in these forward-looking statements for many reasons, including the factors described below and under the caption "Factors that May Affect Our Business, Future Operating Results, Financial Condition and Market Price of Our Stock". These factors may cause our actual results to differ materially from any forward-looking statements. We undertake no obligation to publicly release any revisions to these forward-looking statements, which apply only as of the date of this Form 10-Q, that may be made to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events, except as required by securities laws.

Overview

We are a provider of business information delivery solutions that integrate, process and automate the flow of messages, data and documents primarily for medium and large-sized enterprises, which we consider to be enterprises with more than 100 employees. We produce a suite of products and services, in partnership with leading enterprise technology companies, delivered through a global distribution network in more than 40 countries. These products address the fax server, network fax, production fax, e-document delivery, enterprise fax, business process automation/workflow and mobile business markets and are primarily distributed through independent distributors and value added resellers. Our products run on off-the-shelf server hardware, Windows NT, Windows 2000, Microsoft.NET and interface with a wide variety of telephony and computer equipment.

We sell our products primarily through an indirect channel of resellers and distributors, as well as through direct sales, Original Equipment Manufacturers (OEMs) and private label agreements. Our data oriented enhanced fax products include RightFax and RightFax Enterprise, the Company's Local Area Network (LAN) based fax server lines for Windows based operating systems and the RightFax Production System, a high-volume production-oriented server that enables fax and other forms of electronic transmission for electronic commerce applications. We acquired our business automation product line, Teamplate, on September 30, 2003. Teamplate is a Microsoft.NET compliant workflow product that automates many intra-departmental, inter-departmental and inter-company processes with thorough rules logic and an intuitive interface. The suite of Teamplate products includes Teamplate.NET full license, Teamplate Enterprise, Teamplate Solutions and Teamplate Wizards for popular Microsoft Office, SharePoint, Exchange and Content Management System (CMS) software. The mobility-oriented products acquired from Infinite Technologies (Infinite) in 2001 allow customers to use our document delivery and business process automation products to receive and access information from a wide variety of web-enabled devices.

During the second quarter of 2004, we continued to make progress in our six strategic areas of focus: enhancing our reseller channel, global accounts, strategic partnerships, solutions, vertical and regulatory initiatives and executing on our recent acquisition. Net revenue for the second quarter of 2004 remained relatively flat as compared to the second quarter of 2003. Prior year results included \$2.5 million of revenue from our CallXpress product line, which we divested in September 2003. Revenue from our RightFax product line increased 12.4% in the second quarter of 2004 compared to the second quarter of 2003. Revenue from the Teamplate product line, which we acquired on September 30, 2003 was \$652,000 for the second quarter of 2004.

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Even with our strategic investment in Teemplate, which is currently dilutive, we have begun to see operating leverage in our business model and expect to build on this leverage as the year progresses. Our gross margin for the second quarter of 2004 improved to 66.4% compared to 64.5% for the second quarter of 2003 due to improved efficiency and scale in the RightFax product line and the disposition of the CallXpress product line. Operating expenses, excluding stock compensation expense increased 12% in the second quarter of 2004 compared to the second quarter of 2003 due primarily to increased spending for Sarbanes-Oxley compliance, investing in additional staff in our accounting organization and sales and marketing expenses related to the Teemplate product line.

Consolidated cash and investments at June 30, 2004 were \$88.8 million, a decrease of \$2.9 million from March 31, 2004. Cash flow provided by operations during the second quarter of 2004 was \$2.6 million and we used \$3.8 million of cash to repurchase common stock during the second quarter of 2004. Our deferred revenue liability increased \$1.0 million from March

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31, 2004. Our new maintenance and service initiatives are key drivers of this increase in deferred revenue. We expect that continued success will enhance our cash flow this year and improve the predictability of our future revenues.

Critical Accounting Policies

We believe you must take into account certain of our accounting policies to fully understand our results of operations. The impact and any associated risks related to these policies on our business operations is discussed throughout Management's Discussion and Analysis of Financial Condition and Results of Operations where such policies affect our reported and expected financial results. Note that our preparation of financial statements in conformity with accounting principles generally accepted in the United States requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of our financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results may differ from those estimates.

The Securities and Exchange Commission has defined a company's most critical accounting policies as the policies that are the most important to the portrayal of the company's financial condition and results of operations and which require the company to make its most difficult and subjective judgments, often as a result of the need to make estimates of matters that are inherently uncertain. On an ongoing basis, we evaluate our estimates used, including those related to the valuation of goodwill and other intangible assets, useful lives of intangible assets and equipment and leasehold improvements, inventory valuation allowances, revenue recognition and the estimated allowances for sales returns and doubtful accounts. We base our estimates on historical experience, current conditions and on various other assumptions that we believe to be reasonable under the circumstances. Our estimates form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources, as well as identifying and assessing our accounting treatment with respect to commitments and contingencies. Actual results may differ significantly from these estimates under different assumptions, judgments or conditions. We believe the following critical accounting policies involve the more significant judgments and estimates used in the preparation of our consolidated financial statements. We also follow other key accounting policies, which involve the use of estimates, judgments and assumptions that are significant to understanding our results. For a detailed discussion on the application of these and other accounting policies, see Note 1 in Notes to Consolidated Financial Statements in Item 8 of our Annual Report on Form 10-K for the year ended December 31, 2003.

Our most critical accounting policies relate to the following areas:

Revenue recognition;

Allowances for sales returns and doubtful accounts;

Valuation of inventory at lower of cost or market value;

Valuation of acquired businesses, assets and liabilities;

Valuation of long-lived and intangible assets and goodwill;

Useful lives of intangible assets, equipment and leasehold improvements; and

Contingencies

Revenue recognition. Our revenue recognition policies follow the guidelines of the American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) No. 97-2, *Software Revenue Recognition*, as amended. Before revenue can be recognized, these guidelines require that (1) persuasive evidence of an arrangement exists; (2) delivery has occurred; (3) the selling price is fixed or determinable; and (4) collection is reasonably assured.

We sell products through resellers, OEMs and other channel partners, as well as directly to end users. We recognize product revenue upon shipment, net of estimated returns, provided that collection is determined to be probable and no significant obligations remain. All software licenses are bundled with 30 days of telephone support. Revenue associated with this telephone support is not significant. Therefore we do not defer any revenue related to this telephone support and we accrue the cost of providing this telephone support at the time the revenue is recognized. Whenever a software license, hardware, installation and post-contract customer support or PCS elements are combined into a package with a single bundled price, a portion of the sales price is allocated to each element of the bundled elements based on their respective fair values as determined when the individual elements are sold separately. Revenue from the license of software is recognized when the software has been shipped and the customer is obligated to pay for the software. Revenue for PCS is recognized on a straight-line basis over the service contract term, generally one to five years. PCS includes rights to unspecified upgrades and updates, when and if available and bug fixes. Installation revenue is recognized when the product has been installed at the customer's site and accepted by the customer. Recognition of revenue from software sold with installation services is recognized either when the software is shipped or when the installation services are completed, depending on our agreement with the customer and whether the installation services are integral to the functionality of the software. Consulting services are customarily billed at fixed rates, plus out-of-pocket expenses and revenues are recognized when the consulting has been completed. However, if it is determined that a consulting engagement

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will be unprofitable, we recognize the loss at the time of such determination. Training revenue is recognized when the training is completed. In general, customers are granted a 30-day right of return for product sales. We accrue estimated product returns. When rights of return are present and we cannot estimate returns, we recognize revenue when customer acceptance occurs. Costs related to insignificant customer support obligations, which include telephone support, are accrued at the time the related revenue is recognized.

Allowance for sales return. We must make estimates of potential future product returns related to current period revenue. We analyze historical returns, current economic trends, changes in customer demand and acceptance of our products when evaluating the adequacy of the sales returns in any accounting period. It is possible that these estimates will change in the future or that the actual amounts could vary from our estimates and result in reductions to recognized revenue.

Allowance for doubtful accounts. We must estimate the collectibility of our accounts receivable. We analyze historical bad debts, the aging of customer accounts, customer concentrations, customer credit-worthiness, current economic trends and changes in our customer payment patterns when evaluating the adequacy of the allowance for doubtful accounts. Material differences may result in the amount and timing of our bad debt expenses for any period compared to other periods, if we were to make different judgments or utilized different estimates.

Valuation of inventory at lower of cost or market value. Due to rapid changes in technology, it is possible that older products in inventory may become obsolete or that we may sell these products below cost. When we determine that the carrying value of inventories is not recoverable, we write down inventories to market value. If actual market conditions are less favorable than we project, inventory write-downs may be required and this may have a material adverse effect on our financial results.

Valuation of acquired businesses, assets and liabilities. Our business acquisitions typically result in recording goodwill and other intangible assets, which may affect the amount of future period amortization expense and potential impairment charges that we will incur. The determination of the fair value of such intangible assets and goodwill is a critical and complex consideration that involves significant assumptions and estimates. These assumptions and estimates are based on our best judgments and could materially affect our financial condition and results of operations.

Impairment of goodwill. We assess impairment at least annually for goodwill, or when indicators of impairment exist. We conducted our annual assessment during the first quarter of 2004 and determined our goodwill at March 31, 2004 was not impaired. Our judgments regarding the existence of impairment indicators include our assessment of the impacts of legal factors, market and economic conditions; the results of our operational performance and strategic plans; competition and market share; and any potential for the sale or disposal of a significant portion of our principal operations. If we conclude that indicators of impairment exist, we then assess the fair value of goodwill. The valuation process provides an estimate of a fair value of goodwill using a discounted cash flow model and includes many assumptions and estimates. Once the valuation is determined, we will write down goodwill to its determined fair value, if necessary. Any write-down could have a material adverse effect on our financial condition and results of operations.

Impairment of equipment and leasehold improvements, long-lived assets and other intangible assets. We periodically review long-lived assets, other intangibles and product lines that we are more likely than not to sell or otherwise dispose of before the end of the asset's previously estimated useful life for impairment. We assess the impairment of these assets whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Our judgments regarding the existence of impairment indicators are based on legal factors, market conditions and operational performance of our long-lived assets and other intangibles. Future events could cause us to conclude that impairment indicators exist and that certain assets are impaired resulting in a material write-down of assets to the then-determined fair value. When we determine that indicators of impairment exist, we then assess the fair value of these assets. The valuation process provides an estimate of a fair value of these assets using a discounted cash flow model and includes many assumptions and estimates. Once the valuation is determined, we will write down these assets to their determined fair value. Any write-down could have a material adverse effect on our financial condition and

results of operations.

Useful lives of equipment, leasehold improvements and intangible assets. Equipment and leasehold improvements, identifiable intangible assets and certain other long-lived assets are amortized over their useful lives. Useful lives for equipment and leasehold improvements are based on our estimates of the period that the equipment or leasehold improvement will be used. Useful lives for intangible assets are based on our estimates of the period that the intangible assets will generate revenue. Changes in useful lives could have a material effect on our financial condition and results of operations.

Contingencies. We are periodically involved in litigation or claims, including patent infringement claims, in the normal course of our business. We follow the provisions of Statement of Financial Accounting Standards (SFAS) No. 5, *Accounting for Contingencies*, to record litigation or claim-related expenses. We evaluate, among other factors, the degree of probability of

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an unfavorable outcome and the ability to make a reasonable estimate of the amount of loss. We accrue for settlements when the outcome is probable and the amount or range of the settlement can be reasonably estimated. In addition to our judgments and use of estimates, there are inherent uncertainties surrounding litigation and claims that could result in actual settlement amounts that differ materially from estimates. We expense our legal costs associated with these matters at the time incurred. See "Liquidity and Capital Resources" section regarding contingencies.

Results of Operations**Net Revenue**

We derive net revenue primarily from licensing software as well as follow-on sales of add-on software modules and the sale of maintenance and support agreements and professional services. We continue to distribute fax boards with a significant number of our software product sales for which we receive a margin significantly less than the margin on our software products.

	Quarter Ended June 30,			Six Months Ended June 30,		
	% Change from			% Change from		
	2004	2003	2003	2004	2003	2003
	(in thousands)			(in thousands)		
RightFax product line	\$ 17,539	12.4%	\$ 15,601	\$ 34,976	20.4%	\$ 29,039
Teemplate product line	652	100.0%		1,390	100.0%	
CallXpress product line		(100.0)%	2,538		(100.0)%	4,800
Net revenue	\$ 18,191	0.3%	\$ 18,139	\$ 36,366	7.5%	\$ 33,839

The increase in net revenue in the three and six months ended June 30, 2004 compared to the three and six months ended June 30, 2003 is attributable to increased revenue from the RightFax product line and revenue from the Teemplate product line that we acquired on September 30, 2003. The CallXpress product line, which contributed approximately \$2.5 million in revenue in the second quarter of 2003 and \$4.8 million in the first six months of 2003 was divested on September 29, 2003. The increase in RightFax revenue was due to an increase in volume of software licenses sold as well as an increase in revenue from maintenance and support contracts and professional services. In February 2004, we began bundling first year maintenance with our software licenses, significantly increasing revenue derived from maintenance agreements compared to prior periods. Revenue for maintenance agreements is recognized on a straight-line basis over the maintenance contract term, generally one to five years. International revenue represented approximately 23.6% of total revenue for the second quarter of 2004 and 24.0% for the first six months of 2004. In addition, international revenue was 23.2% of total revenue for the second quarter of 2003 and 25.2% for the first six months of 2003. We anticipate that revenue for 2004 from the RightFax product line will continue to grow in the mid-teens percent over 2003 revenue from the RightFax product line. During 2004, we expect that Teemplate product line revenue will grow more rapidly than the RightFax product line revenue. Historically, our business experiences seasonality with a sequential decline in revenue during the first quarter compared to the fourth quarter of the prior year, and our fourth quarter revenue tends to be the largest quarter for revenue during the year. We anticipate this pattern to continue in 2004.

Gross Profit

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Gross profit is calculated as the selling price of our services and products, net of estimated returns, less cost of revenue. Cost of revenue includes manufacturing and distribution costs for products and programs sold, royalties for licensed products, amortization of acquired technology, product warranty costs, operation costs related to product support and costs associated with the delivery of professional services.

	Quarter Ended June 30,			Six Months Ended June 30,		
	Change from			Change from		
	2004	2003	2003	2004	2003	2003
	(in thousands)			(in thousands)		
Gross profit	\$ 12,087	\$ 388	\$ 11,699	\$ 24,094	\$ 2,490	\$ 21,604
Percentage of revenue	66.4%		64.5%	66.3%		63.8%

The increase in gross profit for the three and six months ended June 30, 2004 compared to the three and six months ended June 30, 2003 is primarily attributable to increased sales volume from the RightFax product line, revenue from the Teemplate product line and divesting the lower margin CallXpress product line in September 2003. Gross profit increased as a percentage of revenue due to the switch in mix from the lower margin CallXpress product line to the RightFax product line. The increase in

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gross profit was offset by amortization of technology intangibles included in cost of revenue related to the Teemplate product line acquired in September 2003. We anticipate that gross profit, as a percentage of revenue, will be approximately 67% for 2004.

Research and Development

Research and development expenses consist primarily of salaries and benefits and related expenses for developers, product managers, quality assurance personnel and payments to outside contractors for programming services.

	Quarter Ended June 30,			Six Months Ended June 30,		
	Change from			Change from		
	2004	2003	2003	2004	2003	2003
	(in thousands)			(in thousands)		
Research and development	\$ 2,260	\$ (181)	\$ 2,441	\$ 4,391	\$ (407)	\$ 4,798
Percentage of revenue	12.4%		13.5%	12.1%		14.2%

The decrease in research and development expenses in the three and six months ended June 30, 2004 compared to the three and six months ended June 30, 2003 is due to a decrease in staffing costs as a result of having fewer employees in 2004 compared to 2003. We divested the CallXpress product line in September 2003 and development expenses for this product line were eliminated at that time. On September 30, 2003, we acquired the Teemplate product line and added several development positions for this product line. We expect research and development expenses to increase slightly during the remainder of 2004 compared to the same period in 2003 as we invest further in the combined RightFax and Teemplate product line. We anticipate subsequent releases of RightFax and Teemplate later in 2004. The Teemplate product is relatively young and we anticipate more frequent and substantive product releases than with our more mature RightFax product. However, as a percentage of revenue, we expect research and development expenses to be consistent with the year ended December 31, 2003.

Selling, General and Administrative

Selling, general and administrative expenses consist primarily of salaries and benefits and related expenses for sales, marketing, business development, customer service, finance, administrative and information technology personnel, as well as advertising and marketing expenses. In addition, selling, general and administrative expenses include legal, accounting and other professional fees.

	Quarter Ended June 30,			Six Months Ended June 30,		
	Change from			Change from		
	2004	2003	2003	2004	2003	2003
	(in thousands)			(in thousands)		
Selling, general and administrative	\$ 10,046	\$ 1,469	\$ 8,577	\$ 20,117	\$ 1,714	\$ 18,403
Percentage of revenue	55.2%		47.3%	55.3%		54.4%

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The increase in selling, general and administrative expenses in the second quarter of 2004 compared to the second quarter of 2003 is primarily attributable to increased selling and marketing expenses related to our Teemplate product line, and temporary labor and professional fees associated with our Sarbanes-Oxley Act compliance project. In addition, the increase in selling, general and administration expenses in the first six months of 2004 compared to the first six months of 2003 was also due to a significant increase in audit and legal fees related to the 2003 audit and restatements of quarterly reports on Form 10-Q for 2003, as well as increased selling commissions due to the increase in revenue in the first quarter of 2004 compared to 2003. We expect selling, general and administrative expenses to increase modestly in absolute dollars from expenses incurred in the first six months of 2004 particularly since costs of the Sarbanes-Oxley project will increase in the third quarter. In addition, we expect revenue to increase in the second half of 2004 and therefore, certain expenses such as sales commissions will increase relative to the increase in revenue. Due to expected increases in revenue, we expect selling general and administrative expenses to decrease as a percentage of revenue for the remainder of 2004 compared to the first six months of 2004. For the year ending December 31, we expect to incur significant costs to comply with the Sarbanes-Oxley Act of 2002, pursuant to which we will be required to furnish an internal controls report of management's assessment of the effectiveness of our internal control over financial reporting as part of our Annual Report on Form 10-K. During the first six months of 2004, we incurred approximately \$307,000 of such costs. We expect to incur additional costs in the range of approximately \$400,000 to \$750,000 during the remainder of 2004 related to our compliance with the Sarbanes-Oxley Act for third party consultants and outside audit attestation costs in addition to significant internal costs. Due to the complexity of the Sarbanes-Oxley project, ultimate costs of the project are difficult to predict and could differ materially from this estimate.

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Amortization of Intangibles

Amortization of intangible assets is a result of core technology and other intangible assets acquired with Teemplate and Infinite Technologies, in addition to amortization expense associated with two nonexclusive license agreements with Syntellect. Amortization expense for the license agreements and core technology is recorded in cost of revenue and was \$201,000 and \$58,000 for the quarters ended June 30, 2004 and 2003, respectively and \$402,000 and \$117,000 for the six months ended, June 30, 2004 and 2003, respectively. Amortization expense recorded in operating expenses was \$103,000 and \$57,000 for the quarters ended June 30, 2004 and 2003, respectively. For the six months ended June 30, 2004 and 2003, amortization expense recorded in operating expenses was \$206,000 and \$113,000, respectively. Based on the current amount of intangible assets subject to amortization, we estimate amortization expense for the remainder of 2004 of \$606,000.

Stock Compensation

During the second quarter of 2001, we offered a limited non-compulsory exchange of employee stock options on a less than one-for-one basis. The exchange (which closed on July 10, 2001) resulted in the voluntary cancellation of employee stock options to purchase 3,135,720 shares of our common stock with varying exercise prices greater than \$10.00 per share in exchange for 1,286,790 employee stock options with an exercise price of \$2.11. The option exchange offer resulted in variable accounting treatment for a total of 1,993,250 options, representing the 1,286,790 new options granted in the exchange, as well as all employee options modified during the year. Variable accounting will continue until all options subject to variable accounting treatment are exercised, cancelled or expire. Variable accounting treatment will result in charges or credits, recorded to stock compensation, dependent on fluctuations in quoted prices for our common stock and the number of stock options subject to variable accounting that are outstanding for the period, neither of which can be predicted. At June 30, 2004 and 2003, we had 197,762 and 1,194,057 options outstanding subject to variable accounting. We recorded charges of \$215,000 and \$673,000 for the second quarter of 2004 and 2003, respectively, as well as \$219,000 and \$1.3 million for the six months ended June 30, 2004 and 2003 respectively. The stock compensation charge for the second quarter of 2003 included \$508,000 recorded in operating expenses and \$165,000 recorded in discontinued operations. In addition, the stock compensation charge for the six months ended June 30, 2003 included \$992,000 recorded in operating expenses and \$305,000 recorded in discontinued operations.

We expect to record stock compensation charges or benefits in future quarters for the options outstanding subject to variable accounting. The amount of these charges or benefits will depend on our stock price and the number of stock options subject to variable accounting that are outstanding during each quarter, neither of which can be predicted. These charges or benefits could have a material impact on our reported financial results in a particular quarter or for the year.

Other Income, Net

Other income, net consists primarily of investment income and foreign currency transaction gains and losses as well as bank charges and credit card fees. Interest income for the three and six months ended June 30, 2004 decreased 7% and 17%, respectively from interest income for comparable periods of 2003 due to lower interest rates. This was primarily due to investments that matured in the later part of 2003 and early 2004, which were reinvested at significantly lower interest rates than rates realized in 2003. Assuming interest rates remain at recent levels, we expect interest income to further decline, as rates on maturing investments are greater than rates currently available.

Income Tax Benefit

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Our effective tax rate is based on a combination of our estimated combined statutory federal and state income tax rates. We expect our effective tax rate for 2004 to be 38%.

Discontinued Operations

On September 1, 2003, we completed the sale of our MediaLinq division. As such, MediaLinq's results of operations for the three and six months ended June 30, 2003 have been reclassified as discontinued operations. In May 2004, pursuant to the terms of the agreement to sale MediaLinq, we received additional proceeds of \$232,000, net of income taxes. In addition, during the second quarter of 2004 we incurred \$28,000 of legal fees, net of income taxes, related to outstanding MediaLinq liabilities we retained. We expect to incur additional legal fees during the remainder of 2004 in conjunction with these retained liabilities. See Note 9, in Notes to Condensed Consolidated Financial Statements in Part 1, Item 1 of this Quarterly Report on Form 10Q.

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Liquidity and Capital Resources

Our principal sources of liquidity are our cash, cash equivalents, short-term investments available for sale and long-term investments available for sale. Our portfolio consists primarily of money market funds and U.S. government agency securities. At June 30, 2004, cash and cash equivalents and investment balances totaled \$88.8 million, down \$6.9 million from December 31, 2003. The cash and investments decrease was due primarily to cash used to repurchase our common stock of \$6.3 million and cash to purchase equipment of \$2.2 million, offset by cash provided by operations of \$1.0 million, proceeds of \$911,000 from the exercise of stock options and proceeds from the sale of MediaLinq of \$204,000, net of income taxes.

Cash flow provided by operations during the first six months of 2004 was \$1.0 million compared to \$4.0 million provided during the first six months of 2003. The decrease in cash provided by operations in 2004 compared to 2003 was primarily due to the payment of bonuses and commissions during the first quarter of 2004, which were accrued at December 31, 2003. Payments during the first quarter of 2003 for bonuses and commissions accrued at December 31, 2002 were significantly less than amounts paid in 2004 due to the significant improvement in operating results for the year ended December 31, 2003 compared to the year ended December 31, 2002. In addition, there was a significant increase in cash used to pay estimated income taxes on 2003 net income during the first quarter of 2004. We did not pay income taxes in the first quarter of 2003.

In addition to cash and investment balances, we have a \$4.0 million unsecured revolving line of credit, \$2.0 million for unsecured borrowings and \$2.0 million reserved for letters of credit. As of June 30, 2004, the Company has utilized \$1.0 million of its letter of credit capacity in conjunction with its corporate headquarters lease. The Company has placed \$1.0 million in a restricted certificate of deposit with the bank that supports the letter of credit. The Company did not borrow under its line of credit during the six months ended June 30, 2004. The line expired in August 2004, which we did not renew in its entirety. The Company only renewed \$1.0 million of the line used to secure the corporate headquarters lease. The line contains certain financial covenants and restrictions as to various matters, including restrictions on our ability to pay cash dividends without the bank's prior approval. We are currently in compliance with such financial covenants and restrictions. Borrowings under the line of credit bear interest at the bank's prime rate or, at our option, the one-, two-, three- or six-month LIBOR rate plus 1.5%.

We periodically receive letters and other communications from third parties asserting patent rights and requesting royalty payments and will probably receive additional claims in the future. For example, over the past six years, we have been involved in intermittent communications with Avaya, which was spun off from Lucent Technologies in 2001. Over this period of time, Lucent/Avaya asserted that we were infringing on their patents or technology, eventually identifying 10 patents as including claims that allegedly cover our current or former products and/or services. Several communications and meetings between our Company and Lucent/Avaya have occurred. We have also been in communication with BellSouth since December of 2001, at which time BellSouth asserted that we were infringing on two of its patents. Analysis of both patents in light of our current and former products/services is still underway. The last communication with representatives of BellSouth was on June 19, 2003. The ultimate outcome of these matters cannot presently be determined. Accordingly, the ultimate resolution of these matters could have a material adverse effect on our financial position, cash flow and results of operations.

Pursuant to a stock repurchase program approved by our Board of Directors in July 2003, in which the Board authorized us to repurchase up to \$15.0 million of our common stock, we repurchased \$2.5 million of our common stock in the first quarter of 2004. As of March 31, 2004, approximately \$9.6 million remained available to repurchase shares under this program. On May 4, 2004, our Board of Directors allocated an additional \$5.4 million in funds for our Company's stock repurchase program. We repurchased an additional \$3.8 million of our common stock in the second quarter of 2004. At June 30, 2004, \$11.1 million of funds were available under the program. We may repurchase shares in the future subject to open trading windows, overall market conditions, stock prices and our cash position and requirements going forward. The repurchase program will continue until the earlier of (a) such time when the maximum dollar amount authorized is repurchased or (b) the Board discontinues the repurchase program.

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We believe existing cash and short-term investments together with funds generated from operations will be sufficient to meet our anticipated working capital needs, capital expenditure needs and future business acquisitions for the next 12 months and the foreseeable future.

New Accounting Pronouncements

In November 2003, the Emerging Issues Task Force (EITF), reached a consensus on Issue 03-1, *The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments*. EITF 03-1 establishes additional disclosure requirements for each category of SFAS No. 115 investments in a loss position. Effective for years ending after December 15, 2003, companies must disclose the aggregate amount of unrealized losses and the aggregate related fair value of their investments with

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unrealized losses. Those investments are required to be segregated by those in a loss position for less than twelve months and those in a loss position for greater than twelve months. Additionally, certain qualitative disclosures should be made to clarify a circumstance whereby an investment's fair value that is below cost is not considered other-than-temporary. Effective for the third quarter ending September 30, 2004, unrealized losses on investments that are deemed other-than-temporary must be recognized in earnings equal to the difference between the investment cost and its fair value at the balance sheet date of the reporting period for which the assessment is made. The Company is currently reviewing the impact of adopting this EITF, which may have a material impact on our financial position, results of operations and cash flows.

**FACTORS THAT MAY AFFECT OUR BUSINESS, FUTURE OPERATING RESULTS,
FINANCIAL CONDITION AND MARKET PRICE OF OUR STOCK**

The following factors may materially adversely affect our business, financial condition or results of operations. In that event, the trading price of our common stock could decline and shareholders may lose part or all of their investment. Therefore, shareholders should carefully consider the risks described below before making an investment decision.

Our stock price has been highly volatile.

The market price of our common stock has been and may continue to be highly volatile. The future price of our common stock may fluctuate in response to factors, involving our competitors or us, such as:

new product announcements or changes in product pricing policies;

quarterly fluctuations in our operating results;

announcements of technical innovations;

announcements relating to strategic relationships or acquisitions;

changes in earnings estimates by securities analysts; and

general conditions in the economy and/or levels of information technology spending.

In addition, the market prices of securities issued by many companies, particularly in high-technology industries, are volatile for reasons unrelated to the operating performance of the specific companies. This industry volatility, along with broad market fluctuations, may adversely affect the market price of our common stock.

Our quarterly sales patterns fluctuate, causing our quarterly operating results to vary. These operating results may fall below expectations of securities analysts and investors.

We expect our operating results to fluctuate significantly from quarter to quarter in the future. Because of these fluctuations, our operating results for a particular quarter may fall below the expectations of securities analysts and investors. If this occurs, the trading price of our common stock may decline. Such fluctuations could cause period-to-period comparisons to be less than meaningful. Numerous factors contribute to the unpredictability of our operating results, including:

the timing of customers' orders;

changes in our mix of products and distribution channels;

the announcement or introduction of new products by us or our competitors;

pricing pressures;

costs related to acquisition of technologies or businesses;

costs of maintaining, integrating or expanding our operations;

costs of hiring qualified personnel;

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technological changes in our market, including changes in standards for protocols, platforms and operating systems applicable to software, hardware and networking environments; and

general economic conditions.

Most of our software product revenue comes from current-quarter orders and sales, of which a substantial portion has, at times, occurred in the last month of the quarter. We do not maintain a large backlog of orders and most of our distributors maintain little or no inventory. Order fulfillment cycles are typically short and often as short as one to two days. Accordingly, the timing of customer orders can cause significant variations in quarterly results of operations. Because we sell our products to end-customers through various third parties, such as value-added resellers and independent distributors, we are unable to project with certainty the actual orders, sales and revenue these third parties will generate in a given quarter. The combination of these factors impairs and delays our ability to know when revenue and earnings will be higher or lower than expected. We base product development and other operating expenses on our expected revenue. Because our expenses are relatively fixed in the short term, we may be unable to adjust our spending in time to compensate for any unexpected shortfall in quarterly revenue.

Our results of operations may also fluctuate as a result of seasonal factors and this may cause our operating results to fall below the expectations of securities analysts and investors for a particular quarter. Specifically, due to typical year-end dealer sales patterns and end-user buying patterns, revenue in our first quarter, without taking into account the effect of acquisitions, have historically declined from the fourth quarter of the previous year.

We depend on third parties for certain key components of our products.

Our fax products operate on standard computer hardware, most of which is readily available. However, only two domestic suppliers can provide fax processing circuit boards to meet our specifications. Historically, we have relied almost exclusively on Brooktrout, Inc. for fax boards. We rely on this supplier primarily because of volume price discounts and the cost and effort required to develop software for alternate fax boards. Significant changes in technology, issues regarding quality performance, delays, interruptions or reductions in our supply of fax boards, or unfavorable changes to price and delivery terms could adversely affect our business.

We rely heavily on independent distributors and value-added resellers.

A substantial majority of our revenue depends on a network of computer-oriented value-added resellers and independent distributors. There is intense competition for the attention of these resellers from our competitors and from providers of other products distributed through these channels. Many of these resellers do not have the financial resources to withstand a downturn in their businesses. We may not be able to maintain or expand our network of resellers in the future. Moreover, our resellers may not maintain or expand their present level of efforts to sell our products. If we lose a major dealer or reseller, or if our dealers and resellers lose interest in selling our products, our business, results of operations and financial condition may be adversely affected.

Failure to establish and maintain strategic relationships could limit our ability to maintain or increase revenue.

Creating and maintaining strategic relationships is important to our success, because these relationships enable us to market and distribute our products to a larger customer base than we could otherwise reach through our direct marketing efforts. We may not be successful in creating new

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strategic relationships on acceptable terms, if at all. Moreover, although we view our strategic relationships as an important factor in the successful commercialization of our products, our current strategic partners may not view their relationships with us as significant for their own businesses and any one of them could reassess their commitment to us in the future. Further, our strategic relationships are generally non-exclusive, which means our strategic partners may develop relationships with some of our competitors. Failure of one or more of our strategic partners to successfully develop and sustain a market for our products, or the termination of one or more of our strategic relationships, could adversely affect our ability to maintain or increase revenue.

Additionally, our strategic partners from time to time require us to customize our products and/or develop further enhancements or capabilities. If we are unable to meet these requests in a timely manner, our relationships with our partners and operating results could be negatively impacted.

Our market is highly competitive.

The business solutions market is highly competitive and is rapidly changing. We may not have the financial resources, marketing, distribution and service capability and depth of key personnel or technological knowledge to continue to compete successfully in each of our markets.

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We believe the main competitive factors affecting our business are breadth and quality of software alternatives, product integration, ability to respond to technological change, relationships with distributors, strategic partners, value-added resellers and systems integrators, price, size of the installed base, level of customer support and professional services.

In the market for LAN-based fax systems, our principal competitors are Esker, Inc. S.A., Biscom, Inc., TOPCALL International AG, Omtool, Ltd., Fenestrae and GFI Software, Ltd. Our fax server products also compete broadly with vendors offering a range of alternative fax solutions, including operating systems containing fax and document transmission features, low-end fax modem products, desktop fax software, single-platform fax software products, outsource fax players and customized proprietary software solutions. In the market for production fax systems, our principal competitors are Biscom, Inc., Esker, Inc. S.A. and TOPCALL International AG. The direct competitors of our business process automation products include K2.net (SourceCode Technology Holdings, Ltd.), Metastorm, Ultimus, Inc. and Skelta Software, Pvt. Ltd.

We may not be able to compete successfully against current and future competitors and the competitive pressures we face could harm our business and prospects. We expect the competition in our markets to increase over time. There can be no assurance that our current or future competitors will not develop products comparable or superior in terms of price and performance features to those developed by us or be able to adopt more quickly than we can to new or emerging technologies and changes in market opportunities. Increased competition may result in changes in market share or pressure for price reductions and related reductions in gross margins, any of which could materially affect our ability to achieve our financial and business goals. There can be no assurance in the future that we will be able to successfully compete against current and future competitors.

Technology and customer demands change rapidly in our industry.

In our industry, technology and customer demands change rapidly and our competitors frequently introduce new products and features. To succeed, we must identify, develop and market new products, features and services that achieve broad market acceptance by satisfying those changing customer needs and keeping pace with those technological developments. To do this, we must spend substantial funds on product development. We regularly devote significant resources to technologies that we anticipate will be widely adopted. To be successful, we must, among other things, develop and market products and services that achieve broad market acceptance. We may not be able to develop new products or product enhancements on a timely basis. Even if we do, the market may not accept the new products or product enhancements that we develop and accordingly, the results of our operations may be adversely affected.

We face risks from expansion of our international operations.

Maintaining or growing our revenue depends, in part, on continued expansion of our international product sales. We have focused significant management attention and financial resources to our international operations. Significant portions of our revenue are subject to the risks associated with international operations, which include:

difficulty adapting products to local languages and technologies;

inability to respond to changes in regulatory requirements;

inability to meet special standards requirements;

exposure to exchange rate fluctuations;

tariffs and other trade barriers;

difficulties in staffing and managing international operations;

potentially adverse tax consequences; and

uncertainties arising from local economic or market conditions, local business practices and cultural considerations.

In addition, the laws of some foreign countries are uncertain or do not protect intellectual property rights to the same extent as the U.S. Moreover, we could be sued for patent infringement or other intellectual property violations in a foreign country where it could be very costly to defend such a lawsuit.

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Currently, substantially all of our revenue is denominated in U.S. dollars. We price our international sales to the United Kingdom in U.K. pounds sterling, to Canada in Canadian dollars, to Australia in Australian dollars and to participating European Community countries in Euros. Increases in the value of the dollar against any local currencies could cause our products to become relatively more expensive to customers in a particular country or region, leading to reduced revenue or profitability in that country or region. As we continue to expand our international operations, we expect our non-U.S.-dollar-denominated sales and our exposure to gains and losses on international currency transactions to increase. We do not currently engage in transactions to hedge against the risk of currency fluctuations, but we may do so in the future.

Our investment in the business process automation market, which is an unproven market, may not be successful.

In September 2003, with the acquisition of Teamplate, we announced that we are expanding our business strategy to focus on the business process automation market. Our business strategy is to become a leading provider of business information delivery solutions. In the future, in order to implement our strategy, we must continue to design, develop and introduce competitive new products. Execution of this strategy may involve a substantial increase in costs and, as a result, our expenses could increase disproportionately to revenue in the future. We cannot guarantee that demand for business information delivery solutions will grow in the future, that new technologies will not cause the market to evolve in a manner different from what we expect or that we will be able to obtain a leadership position in this market opportunity or that our investment in this unproven market will be successful.

Our investment in the mobile business solutions market, whose technology offerings and customers buying behaviors have undergone significant changes, may not be successful.

In March 2001, we announced that we were expanding our business strategy to focus on the mobile business solutions market, which we believed to be a potential higher-growth opportunity. This market has been slower to develop than we anticipated. To date, a significant share of market revenue has been in mobile services rather than in deployed software licenses for mobile solutions. As a result, we have reduced our development resources applied to this technology and there can be no assurance that we will realize a return on our past or future costs incurred in this unproven, stand-alone mobile business solutions market.

In the future, if the market for mobile business solutions develops, competing in this market would likely require an increase in our development and marketing efforts disproportionate to potential revenue streams. Accordingly, the results of our operations may be negatively impacted. Moreover, future focus on this strategy could disrupt our other operations and distract management, which could have a material adverse effect on our operating results.

The integration of recent and any future acquisitions may be difficult and disruptive.

We frequently evaluate potential acquisitions of products, technologies and businesses. The acquisition of Teamplate in September 2003, as well as any future acquisitions we may undertake, may direct management's attention away from the day-to-day operations of our business and may pose numerous other risks. For instance, we may not be able to successfully integrate technologies, products, personnel or operations of companies that we may acquire or to retain customers of the acquired business. In addition, we may need to make significant cash payments and dilutive issuances of our equity securities, incur debt, assume unknown liabilities, write-off purchased in-process research and development, amortize expenses related to other intangible assets and incur restructuring charges as well as costs of integrating personnel and operations. Any of these events could have a material adverse effect on our financial condition or results of operations.

Our average sales prices may decline for some of our products.

If the average sales prices of our more significant products decline, our overall gross margins will likely decline. To offset and forestall potential declines in average sales prices, we must continue to develop product enhancements and new products with advanced features that are likely to generate higher-margin incremental revenue. If we are unable to do so in a timely manner, or if our products do not achieve significant customer acceptance, our business, results of operations and financial condition may suffer.

Subsequent activities related to the sale of our CallXpress product line and MediaLinq division and activities associated with liabilities retained by us in these dispositions, may continue to be disruptive to our ongoing operations.

In September 2003, we sold our CallXpress product line and MediaLinq division. Such dispositions were intended to allow us to focus our resources on products and services we have determined to be critical to our long-term success. The impact of

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these dispositions, the associated change in our business focus and the retained liabilities related to certain legal proceedings (some of which are disclosed under Legal Proceedings in our Annual Report on Form 10-K for the year ended December 31, 2003) and indemnifications provided by us to the buyers for certain representations and warranties, may continue to be disruptive to our ongoing business, may negatively impact our operations in the near term and may be distracting to management or our workforce in general. Moreover, although the dispositions are intended to improve our long-term results of operations, there can be no assurance that we will realize the benefits we expect from these dispositions.

Security breach of confidential data may expose us to additional costs and to litigation, which could harm our business.

Our business information delivery solutions may involve the transmission of business-critical, proprietary or confidential information. If the security measures that we implement are breached or if there is an inappropriate disclosure of confidential information, we could be exposed to litigation and possible liability. Even if we were not held liable, a security breach or inappropriate disclosure of confidential information could harm our reputation and even the perception of a security risk could inhibit market acceptance of our products and services. In addition, we may be required to invest additional resources to protect us against damages caused by these actual or perceived disruptions of security breaches in the future.

Further, our applications may be vulnerable to unauthorized and illegal access, sabotage, computer viruses and other disruptive problems, including natural disasters. Eliminating computer viruses and addressing other security problems may cause either loss or compromise of data or interruptions, delay or cessation of service to users accessing our business information delivery applications, which could harm our business, expose us to risks of loss or litigation and possible liability. We may be required to expend significant capital or other resources to protect against the threat of security breaches or to alleviate problems caused by breaches.

We may be unable to adequately protect our proprietary rights.

To succeed, we must adequately protect our proprietary technology. We rely on a combination of patents, copyrights, trademarks and trade secret laws, nondisclosure and other agreements and technical measures to protect our proprietary technology, but those measures may be insufficient. Our competitors may challenge or circumvent the claims in our patents. Our current patents, or any future patents, may never provide us with any competitive advantages. Other measures that we take to protect our proprietary technology may not prevent or deter misappropriation of our technology or the development of technologies with similar characteristics. Moreover, our use of open systems architecture in the design of our products may make it easier for competitors to misappropriate or replicate our designs and developments.

Other companies may claim that we infringe their intellectual property or proprietary rights, which could cause us to incur significant expenses or be prevented from selling our products.

Our success depends on our ability to operate without infringing the patents and proprietary rights of third parties. Product development is inherently uncertain in a rapidly evolving technological environment in which there may be numerous patent applications pending, many of which are confidential when filed, with regard to similar technologies. Historically, competitors in our industry have filed numerous allegations of patent infringement, resulting in considerable litigation.

We have periodically received letters and other communications from third parties asserting patent rights and requesting royalty payments and will probably receive additional claims in the future. For example, over the past six years, we have been involved in intermittent

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communications with Avaya, which was spun off from Lucent Technologies in 2001. Over this period of time, Lucent/Avaya asserted that we were infringing on their patents or technology, eventually identifying 10 patents as including claims that allegedly cover our current or former products and/or services. Several communications and meetings between us and Lucent/Avaya have occurred. We have also received communication in the past from BellSouth, beginning in December of 2001, at which time BellSouth asserted we were infringing on two of its patents. Analysis of both patents in light of our current and former products/services is still underway. The last communication with representatives of BellSouth was on June 19, 2003. The ultimate outcome of these matters cannot presently be determined. Accordingly, the ultimate resolution of these matters could have a material adverse effect on our financial position, cash flow and results of operations.

Any litigation, regardless of our success, would probably be costly and require significant time and attention of our key management and technical personnel. Litigation could also force us to:

stop or delay selling or using products that use the challenged intellectual property;

pay damages for infringement;

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obtain licenses, which may be unavailable on acceptable terms; or

redesign products or services that use the infringing technology.

We may not be able to hire and retain highly skilled employees, which could affect our ability to compete effectively.

To succeed, we must attract and retain key personnel in engineering, research and development, marketing, sales, finance and administration. We also depend, to a significant degree, on the efforts of our senior management team. If we fail to recruit such personnel or lose the services of existing key personnel in any functional area, our current operations and new product development efforts could be adversely affected. Competition for skilled personnel is intense. Past reductions in force and any additional reductions in force we undertake may adversely impact employee morale and impair our ability to attract and retain highly qualified personnel. We do not maintain material key person life insurance.

Failure to improve our internal controls and procedures in a timely manner could harm our business and hamper management's ability to report on the effectiveness of our internal controls.

In connection with the completion of its audit for each of the three years ended December 31, 2003, our independent accountants, Deloitte & Touche LLP ("D&T"), have formally advised our management and the Audit Committee of our Board of Directors of a reportable condition related to certain deficiencies that exist in the design or operation of the Company's internal accounting controls surrounding timely reconciliation of accounts and supervision and monitoring of staff who have significant roles in internal control. These deficiencies contributed to a computational error in the calculation of compensation expense for options subject to variable accounting, resulting in the restatement of the Company's 2003 quarterly financial results.

We have endeavored during 2003 and the first six months of 2004 to make improvements to our policies, procedures, systems and staff who have significant roles in internal control to address the internal control deficiencies identified by D&T, including the hiring of a new Chief Financial Officer and a new Corporate Controller, as well as other financial staff. We intend to continue to improve and enhance the design of control processes, procedures and to upgrade staff to strengthen internal controls. If we are unable to improve our internal controls, our ability to report our financial results on a timely and accurate basis could be adversely affected which could have a substantial adverse effect on our ability to operate our business.

In addition, pursuant to Section 404 of Sarbanes-Oxley, we will be required to furnish an internal controls report of management's assessment of the effectiveness of our internal controls as part of our Annual Report on Form 10-K for the fiscal year ended December 31, 2004. Our auditors will be required to attest to and report on, management's assessment. To issue our report, our management must document both the design for our internal controls and the testing processes that support management's evaluation and conclusion. Our management has begun the necessary processes and procedures for issuing its report on our internal controls. There can be no assurance, however, that we will be able to complete the work necessary for our management to issue its management report in a timely manner.

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Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company is exposed to market risk, changes in interest rates and foreign currency exchange rates, each of which could adversely affect the value of our investments. We do not currently use derivative financial instruments to hedge this risk.

Interest rate risk:

We maintain an investment portfolio consisting primarily of investment grade interest bearing securities. These securities are classified as available for sale securities. The interest bearing securities in our portfolio are subject to interest rate risk and will fall in value if market interest rates increase. An increase of 10% in the average interest rate would not have a material effect on our results of operations, financial position or cash flows.

Investment risk:

If market interest rates were to increase immediately and uniformly by 100 basis points from levels at June 30, 2004, the decline in the fair value of the portfolio would be approximately \$643,000. Because we have the ability to hold our fixed income investments until maturity, we do not expect our operating results, financial position or cash flows to be affected to any significant degree by a sudden change in market interest rates on our securities portfolio. Cash available for reinvestment, however, may be invested in lower interest rate securities.

Foreign currency risk:

Currently, substantially all of our revenue is denominated in U.S. dollars. We price our international sales to the United Kingdom in U.K. pounds sterling, to Canada in Canadian dollars, to Australia in Australian dollars and to participating European Community countries in Euros. Increases in the value of the dollar against any local currencies could cause our products to become relatively more expensive to customers in a particular country or region, leading to reduced revenue or profitability in that country or region. As we continue to expand our international operations, we expect our non-U.S.-dollar-denominated revenue and our exposure to gains and losses on international currency transactions to increase. We do not currently engage in transactions to hedge against the risk of currency fluctuations, but we may do so in the future.

In addition, we are exposed to foreign currency translation fluctuations associated with our assets and liabilities denominated in Australian dollars, Canadian dollars, Euros and United Kingdom pounds sterling. The objective in managing these foreign currency translation exposures is to minimize the risk through minimizing the level of activity and financial instruments denominated in those currencies. Our foreign currency financial instruments primarily consist of cash, trade receivables, trade payables, accrued expenses and intercompany loans.

For an entity with various financial instruments denominated in a foreign currency in a net asset position, an increase in the exchange rate would result in less net assets when converted to U.S. dollars. Conversely, for an entity with various financial instruments denominated in a foreign currency in a net liability position, a decrease in the exchange rate would result in more net liabilities when converted to U.S. dollars.

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Historically, we have not hedged our translation risks on these currencies. We have the ability to hold our foreign-currency denominated assets indefinitely and do not expect that a sudden or significant change in foreign exchange rates would have a material impact on future operations or cash flows.

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Item 4. CONTROLS AND PROCEDURES

In connection with the completion of its audit and the issuance of an unqualified report on the Company's financial statements for each of the three years in the period ended December 31, 2003, Deloitte & Touche, LLP ("D&T") formally advised management of the Company and the Audit Committee of its Board of Directors of certain deficiencies that exist in the design or operation of the Company's internal accounting controls which constitute a reportable condition in the Company's internal controls pursuant to standards established by the American Institute of Certified Public Accountants. Such deficiencies included the design of controls and processes surrounding timely reconciliation of accounts and supervision and monitoring of staff who have significant roles in internal control. These deficiencies contributed to a computational error in the calculation of compensation expense for options subject to variable accounting and other items, resulting in the restatement of the Company's 2003 quarterly financial results.

Under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer (the "CEO") and Chief Financial Officer (the "CFO"), the Company has evaluated the internal control deficiencies and the effectiveness of the Company's disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(3)) as of the end of the period covered by this report (the "Evaluation"). During the course of the Evaluation, the CEO and CFO took note of and considered as part of the Company's disclosure controls and procedures, the additional procedures performed and controls instituted by the Company to supplement its internal controls in order to mitigate the effect of the deficiencies and to prevent misstatements or omissions in its consolidated financial statements. Based on the Evaluation, the CEO and CFO concluded, that the Company's disclosure controls and procedures, including the additional procedures, were effective as of the end of the quarter to ensure that information required to be disclosed by the Company in this report is recorded, processed, summarized and reported within the appropriate time periods.

The Company has made and will continue to make, improvements to its policies, procedures, systems and staff who have significant roles in internal control to address the internal control deficiencies identified by D&T. Key improvements include hiring a new Chief Financial Officer and Corporate Controller in the third and fourth quarters of 2003, respectively and other financial staff in the fourth quarter of 2003 and the first six months of 2004. The Company will continue to improve and enhance the design of control processes, procedures and upgrade staff to strengthen internal controls. In addition, the Company implemented its enterprise reporting system in its Australian and Netherlands subsidiaries during the first six months of 2004. As of April 30, 2004, the entire Company began operating under one worldwide accounting system. The steps being taken to correct the weaknesses and deficiencies identified by D&T constitute changes that materially affected the Company's internal control over financial reporting during the most recent fiscal quarter.

Table of Contents**Part II. OTHER INFORMATION****Item 2. CHANGES IN SECURITIES, USE OF PROCEEDS AND ISSUER PURCHASES OF EQUITY SECURITIES**

(e) Pursuant to a stock repurchase program approved by the Company's Board of Directors in July 2003, in which the Board authorized the Company to repurchase up to \$15.0 million of our common stock, we repurchased \$3.8 million of our common stock in the second quarter of 2004. On May 4, 2004, the Company's Board of Directors allocated an additional \$5.4 million in funds for the Company's stock repurchase program, replenishing the funds available under the plan to the full \$15.0 million originally authorized. At June 30, 2004, \$11.1 million of funds were available under the program. We may repurchase shares in the future subject to open trading windows, overall market conditions, stock prices and our cash position and requirements going forward. The repurchase program will continue until the earlier of (a) such time when the maximum dollar amount authorized is repurchased or (b) the Board discontinues the repurchase program.

The following table summarizes information regarding shares repurchased during the quarter ended June 30, 2004, all of which were repurchased in open market transactions pursuant to the Board-approved stock repurchase program described above:

Period	Total # of Shares Purchased	Average Price Paid per Share	Total # of Shares Purchased as Part of the Program	Maximum Approximate
				Dollar Value that May Yet Be Purchased Under the Program as of the End of the Period
April 1 through 30, 2004				\$ 12,100,253
May 1 through 31, 2004 ¹	495,834	5.69	495,834	12,176,638 ¹
June 1 through 30, 2004	162,034	6.36	162,034	11,146,156
Three months ended June 30, 2004	657,868	5.86	657,868	\$ 11,146,156

¹ On May 4, 2004, \$5.4 million of additional funds were made available to the program.

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

The Annual Meeting of Shareholders of Captaris, Inc. was held on May 4, 2004. A total of 32,258,506 shares of the Company's common stock were represented in person or by proxy at the meeting, which comprised of 97.42% of the total number of shares of the Company's common stock outstanding on March 5, 2004, the record date for the meeting.

At the meeting, Robert F. Gilb, John A. Kelley, Jr., Patrick J. Swanick, and Thomas M. Murnane were elected to serve as directors of the Company for terms described in the proxy statement relating to the meeting or until their earlier retirement, resignation or removal. The vote was as follows:

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<u>Name</u>	<u>For</u>	<u>Withheld</u>
Robert F. Gilb	29,477,693	780,813
John A. Kelley, Jr.	29,569,093	689,413
Patrick J. Swanick	29,562,943	695,563
Thomas M. Murnane	29,452,126	806,380

The proposal to ratify the appointment of Deloitte & Touche LLP as the Company's independent accountants for 2004 was approved. The vote was as follows:

	<u>Votes</u>
For	30,088,053
Against	148,829
Abstain	21,624

There were no broker non-votes for the matters described above since brokers who hold shares for the accounts of the clients have discretionary authority to vote such shares with respect to such matters.

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Item 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

- 31.1 Rule 13a-14(a) Certification (Chief Executive Officer)
- 31.2 Rule 13a-14(a) Certification (Chief Financial Officer)
- 32.1 Section 1350 Certification (Chief Executive Officer)
- 32.2 Section 1350 Certification (Chief Financial Officer)

(b) Reports on Form 8-K

None.

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SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized on the 9th day of August 2004.

CAPTARIS, INC.

By: /s/ PETER PAPANO
Peter Papano

Chief Financial Officer and Secretary