

CAPTARIS INC
Form 10-Q
November 04, 2005
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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 September 30, 2005

or

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

For the transition period from _____ to _____.

Commission File Number 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 No

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

The number of outstanding shares of the registrant's common stock as of November 2, 2005 was 28,425,807.

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CAPTARIS, INC.

FORM 10-Q

For the Quarter Ended September 30, 2005

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

(in thousands, except per share data)

(unaudited)

| | September 30, 2005 | December 31, 2004 |
|---|-----------------------|----------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 5,154 | \$ 7,563 |
| Short-term investments, available-for-sale | 14,172 | 25,725 |
| Accounts receivable, less allowances of \$1,519 and \$1,387 | 16,413 | 18,205 |
| Inventories | 731 | 992 |
| Prepaid expenses and other | 2,039 | 1,687 |
| Deferred tax assets and income tax receivable | 4,033 | 3,161 |
| Total current assets | 42,542 | 57,333 |
| Long-term investments, available-for-sale | 31,223 | 24,051 |
| Restricted cash | 1,000 | 1,000 |
| Other assets | 291 | 94 |
| Equipment and leasehold improvements, net | 7,193 | 7,168 |
| Intangible assets, net | 10,636 | 13,442 |
| Goodwill | 32,668 | 32,236 |
| Deferred tax assets, net | 4,676 | 3,022 |
| Total assets | \$ 130,229 | \$ 138,346 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 4,670 | \$ 6,875 |
| Accrued compensation and benefits | 4,270 | 4,462 |
| Other accrued liabilities | 2,225 | 1,565 |
| Income taxes payable | 368 | 375 |
| Deferred revenue | 16,882 | 15,699 |
| Total current liabilities | 28,415 | 28,976 |
| Accrued liabilities noncurrent | 366 | 386 |
| Deferred revenue noncurrent | 3,327 | 2,743 |

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| | | |
|--|------------|------------|
| Total liabilities | 32,108 | 32,105 |
| Commitments and contingencies (Note 5) | | |
| 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; 28,425 and 29,452 outstanding, respectively | 284 | 295 |
| Additional paid-in capital | 51,115 | 55,410 |
| Retained earnings | 45,765 | 49,788 |
| Accumulated other comprehensive income | 957 | 748 |
| Total shareholders' equity | 98,121 | 106,241 |
| Total liabilities and shareholders' equity | \$ 130,229 | \$ 138,346 |

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 | | Nine Months Ended | |
|--|---------------|-----------|-------------------|-----------|
| | September 30, | | September 30, | |
| | 2005 | 2004 | 2005 | 2004 |
| Net revenue | \$ 21,755 | \$ 18,031 | \$ 61,717 | \$ 54,397 |
| Cost of revenue | 6,613 | 6,544 | 19,670 | 18,816 |
| Gross profit | 15,142 | 11,487 | 42,047 | 35,581 |
| Operating expenses: | | | | |
| Research and development | 3,496 | 2,846 | 10,300 | 7,237 |
| Selling, general and administrative | 13,487 | 9,781 | 39,444 | 29,898 |
| Amortization of intangible assets | 454 | 102 | 1,362 | 308 |
| Stock compensation benefit | (59) | (413) | (239) | (194) |
| Gain on sale of discontinued product line CallXpress (Note 6) | | | (1,000) | |
| Total operating expenses | 17,378 | 12,316 | 49,867 | 37,249 |
| Operating loss | (2,236) | (829) | (7,820) | (1,668) |
| Other income (expense): | | | | |
| Interest | 281 | 340 | 835 | 1,011 |
| Other, net | (82) | (53) | (210) | (338) |
| Other income, net | 199 | 287 | 625 | 673 |
| Loss from continuing operations before income tax benefit | (2,037) | (542) | (7,195) | (995) |
| Income tax benefit | (1,343) | (205) | (3,137) | (378) |
| Loss from continuing operations | (694) | (337) | (4,058) | (617) |
| Discontinued operations: | | | | |
| Gain on sale of MediaTel assets, net of income tax expense | | 403 | | 607 |
| Income from operations of MediaTel, net of income tax expense | 5 | | 35 | |
| Income from discontinued operations, net of income tax expense | 5 | 403 | 35 | 607 |
| Net income (loss) | \$ (689) | \$ 66 | \$ (4,023) | \$ (10) |
| Net loss per common share: | | | | |
| Basic and diluted loss per common share from continuing operations | \$ (0.02) | \$ (0.01) | \$ (0.14) | \$ (0.02) |
| Basic and diluted income per common share from discontinued operations | 0.00 | 0.01 | 0.00 | 0.02 |
| Basic and diluted net loss per common share | \$ (0.02) | \$ (0.00) | \$ (0.14) | \$ (0.00) |

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| | | | | |
|--|--------|--------|--------|--------|
| Weighted average basic and diluted common shares | 29,056 | 31,248 | 29,077 | 31,798 |
|--|--------|--------|--------|--------|

See the accompanying notes to unaudited condensed consolidated financial statements.

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

| | Nine Months Ended | |
|---|--------------------------|-------------|
| | September 30, | |
| | 2005 | 2004 |
| Cash flows from operating activities: | | |
| Net loss | \$ (4,023) | \$ (10) |
| Adjustments to reconcile net loss to net cash provided by operating activities: | | |
| Depreciation | 2,607 | 1,937 |
| Amortization | 2,806 | 912 |
| Stock compensation benefit | (239) | (194) |
| Gain on sale of MediaTel assets, net of income taxes | | (607) |
| Provision for doubtful accounts | 438 | 116 |
| Gain on disposition of equipment | (19) | |
| Changes in assets and liabilities: | | |
| Accounts receivable | 1,238 | 2,312 |
| Inventories | 245 | 1,203 |
| Prepaid expenses and other assets | (551) | (530) |
| Deferred income tax assets, net | (2,693) | (353) |
| Accounts payable | (2,211) | (760) |
| Accrued compensation and benefits | (194) | (1,566) |
| Other accrued liabilities | 673 | 30 |
| Income taxes payable | (23) | (1,753) |
| Deferred revenue | 1,772 | 2,842 |
| Net cash flow provided by (used in) operating activities | (174) | 3,579 |
| Cash flows from investing activities: | | |
| Purchase of equipment and leasehold improvements | (2,646) | (2,565) |
| Purchase of investments | (44,002) | (67,236) |
| Purchase of businesses, net of cash acquired | 2 | (170) |
| Proceeds from disposals of fixed assets | 25 | |
| Proceeds from sale of MediaTel assets | | 177 |
| Proceeds from sales and maturities of investments | 48,446 | 62,259 |
| Net cash flow provided by (used in) investing activities | 1,825 | (7,535) |
| Cash flows from financing activities: | | |
| Proceeds from exercise of common stock options | 362 | 958 |
| Repurchase of common stock | (4,442) | (9,324) |
| Net cash used in financing activities | (4,080) | (8,366) |
| Net decrease in cash flow | (2,429) | (12,322) |

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| | | |
|--|-------------------|-------------------|
| Effect of exchange rate changes on cash | 20 | 32 |
| Cash and cash equivalents at beginning of period | 7,563 | 41,896 |
| | <u> </u> | <u> </u> |
| Cash and cash equivalents at end of period | \$ 5,154 | \$ 29,606 |
| | <u> </u> | <u> </u> |
| Supplemental disclosures: | | |
| Cash paid during the period for income taxes | \$ 335 | \$ 3,104 |

See the accompanying notes to unaudited condensed consolidated financial statements.

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CAPTARIS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Description of the Business and Summary of Significant Accounting Policies

The Business

Captaris, Inc. provides business information delivery solutions which enable our customers to capture, process, deliver, manage and archive data and documents. Our products and solutions address the fax server and e-document market, workflow and business process automation markets, as well as archiving and records management markets. We distribute our products globally primarily through independent distributors and value-added resellers. We also provide strategic and architectural technology consulting, integration of third party technologies and other services.

Basis of Presentation and Preparation

The accompanying unaudited condensed consolidated financial statements as of September 30, 2005, and December 31, 2004, and for the quarter and nine months ended September 30, 2005 and 2004, have been prepared by Captaris, Inc. pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC") and, in the opinion of management, reflect all adjustments and accruals, which are of a normal recurring nature, necessary for a fair presentation of the financial condition, results of operations and cash flows for the interim periods. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted for interim financial information in accordance with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. 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 year ended December 31, 2004.

The consolidated financial statements include the accounts of Captaris, Inc. and our wholly owned subsidiaries. All intercompany balances and transactions have been eliminated in consolidation.

The preparation of our consolidated financial statements, in conformity with accounting principles generally accepted in the United States of America, requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities and commitments at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. When the carrying values of assets and liabilities and commitments and contingencies are not readily apparent from other sources, we use estimates. Typically, estimates are used in accounting for the valuation of goodwill and other intangible assets, useful lives of intangible assets, equipment and leasehold improvements, inventory valuation allowances, revenue recognition, the estimated allowances for sales returns and doubtful accounts and income tax accruals. Actual results may differ significantly from these estimates. To the extent that there are material differences between these estimates and actual results, our presentation of our financial condition or results of operations may be affected. Our results of operations may fluctuate as a result of seasonal factors. Historically, our business experiences seasonality with a decline in revenue

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during the first quarter as compared to the prior year's fourth quarter, building gradually during the second and third quarters, and ending with the fourth quarter as our largest quarter for revenue.

Certain prior-period balances have been reclassified to conform to the current period presentation. These reclassifications had no impact on revenues, gross margin, net loss, assets or liabilities in either period presented.

On September 1, 2003, we sold the assets of MediaTel Corporation (MediaTel), our wholly owned subsidiary which operated the MediaLinq business. As such, in accordance with generally accepted accounting principles, results of operations have been classified, net of income taxes, as discontinued operations.

Summary of Significant Accounting Policies

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. We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred, the selling price is fixed or determinable and collection is reasonably assured.

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CAPTARIS, INC.

We sell products through resellers, original equipment manufacturers (OEM s) and other channel partners, as well as directly to end-users. Except for OEM sales described below, 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. We consider revenue associated with this telephone support to be insignificant, and therefore, we recognize this revenue when the software is shipped and record an estimate for the related cost of the telephone support. Revenue from term software licenses is recognized over the term of the license, generally twelve months. Whenever a software license, hardware, installation and post-contract customer support or PCS elements are sold together, we allocate the total arrangement fee among each element based on its respective fair value, which is the price charged when that element is sold separately. The amount of revenue assigned to each element is impacted by our judgment as to whether an arrangement includes multiple elements and, if so, whether vendor-specific objective evidence (VSOE) of fair value exists for those elements. Changes to the elements in an arrangement and our ability to establish VSOE for those elements could affect the timing of revenue recognition for these items. Revenue for PCS is recognized on a straight-line basis over the service contract term, ranging from 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. Revenue from perpetual software licenses is recognized when the software has been shipped, provided that collection for such revenue is deemed probable. For software sold to resellers in which we have granted exchange rights, we defer the revenue until the reseller sells the software through to end-users.

We have entered into agreements with certain OEMs from which we receive royalty payments periodically. Under the terms of the OEM license agreements, each OEM will qualify our software on their hardware and software configurations. Once the software has been qualified, the OEM will begin to ship products and report net sales to us. Most OEMs pay a license fee based on the number of copies of licensed software included in the products sold to their customers. These OEMs pay fees on a per-unit basis and we record associated revenue when we receive notification of the OEMs sales of the licensed software to an end-user. The terms of the license agreements generally require the OEMs to notify us of sales of our products within 30 to 45 days after the end of the month or quarter in which the sales occur. As a result, we recognize the revenue in the month or quarter following the sales of the product to these OEMs customers.

In general, customers are granted a 30-day right of return for product sales. We reduce revenue recognized for estimated product returns at the time the related revenue is recorded. When customer acceptance provisions are present and we cannot reasonably estimate returns, we recognize revenue upon the earlier of customer acceptance or expiration of the acceptance period.

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 will be unprofitable, we recognize the loss at the time of such determination. Training revenue is recognized when the training is completed.

Warranty Expense

A warranty reserve is established based on our historical experience and an estimate of the amounts necessary to settle future and existing claims on products sold as of the balance sheet date. While we believe that our warranty reserve is adequate and that the judgment applied is appropriate, such amounts estimated to be due and payable could differ materially from what will actually transpire in the future. Historically, warranty expenses have not been material.

Stock-Based 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 treatment results in charges or credits recorded to stock based compensation, depending on fluctuations in quoted prices for our common stock and the number of stock options subject to variable accounting, neither of which can be predicted. At September 30, 2005 and 2004, the number of options to purchase common stock subject to variable accounting, were 164,761 and 183,594, respectively. We recognized a benefit of \$59,000 in the third quarter of 2005 and a benefit of \$413,000 in the third quarter 2004 for variable stock compensation. We recorded a benefit of \$239,000 for variable stock compensation for the nine months ended September 30, 2005 and a benefit of \$194,000 for the nine months ended September 30, 2004.

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We expect to continue to record stock compensation charges or benefits in the fourth quarter of 2005 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.

When we adopt SFAS No. 123(R) *Share Based Payments* in the first quarter of 2006, stock compensation charges or benefits will be calculated in accordance with the new standard and charges or benefits related to options subject to variable accounting will cease. We are currently evaluating option valuation methodologies and assumptions in light of this new statement, and until we complete our evaluation and make a final determination of our approach and key assumptions, an estimate of the impact of this statement is not available. We expect the adoption of SFAS No. 123(R) will have a material adverse effect on our results of operations.

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

| | Quarter Ended | | Nine Months Ended | |
|-------------------------------------|----------------|----------|-------------------|----------|
| | September 30, | | September 30, | |
| | 2005 | 2004 | 2005 | 2004 |
| | (in thousands) | | | |
| Cost of revenue | \$ (5) | \$ (37) | \$ (12) | \$ (18) |
| Research and development | (20) | (118) | (72) | (58) |
| Selling, general and administrative | (34) | (258) | (155) | (118) |
| Total stock compensation benefit | \$ (59) | \$ (413) | \$ (239) | \$ (194) |

We account for stock options under Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, under which no compensation cost is recognized if 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*, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation - Transition and Disclosure*, our net loss and net loss per share would have been as shown in the following pro forma amounts:

| | Quarter Ended | | Nine Months Ended | |
|--------------------------------|---------------------------------------|-------|-------------------|---------|
| | September 30, | | September 30, | |
| | 2005 | 2004 | 2005 | 2004 |
| | (in thousands, except per share data) | | | |
| Net Income (loss), as reported | \$ (689) | \$ 66 | \$ (4,023) | \$ (10) |

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| | | | | |
|---|------------|------------|------------|------------|
| Add: Stock compensation benefit, as reported, net of income taxes | (35) | (256) | (150) | (120) |
| Deduct: Total stock compensation expense determined under fair value based method for all awards, net of income taxes | 1,515 | 996 | 2,313 | 2,265 |
| Net loss, pro forma | \$ (2,239) | \$ (1,186) | \$ (6,486) | \$ (2,395) |
| Net loss per common share: | | | | |
| Basic and diluted as reported | \$ (0.02) | \$ (0.00) | \$ (0.14) | \$ (0.00) |
| Basic and diluted pro forma | \$ (0.08) | \$ (0.04) | \$ (0.22) | \$ (0.08) |

On September 1, 2005, our Compensation Committee and Board of Directors approved the acceleration of vesting of certain unvested stock options granted to our employees and officers under our stock option plans that have an exercise price greater than \$3.73 per share, the closing price of our common stock on September 1, 2005. Options held by non-employee directors were not included in the acceleration. Options to purchase approximately 2.3 million shares of our common stock became immediately exercisable. The Board also imposed a holding period that will require all executive officers and certain other members of senior management to refrain from selling shares acquired upon the exercise of these options, other than shares needed to cover the exercise price and to satisfy withholding taxes and shares transferred by will or by the applicable laws of descent and distribution, until the date on which the exercise would have been permitted under the option's original vesting terms.

The accelerated vesting will eliminate future compensation expenses that we would otherwise recognize in our financial statements with respect to these options upon implementation of SFAS No. 123R. In accordance with APB No. 25 and FASB Interpretation No. 44, no compensation expense was recorded within the financial statements as a result of this modification because the options had an intrinsic value of \$0.00 on the date of the modification due to the exercise price being in excess of the current market price of the stock. However, in accordance with SFAS No. 123, we included the unamortized compensation expense of approximately \$1.4 million (net of income tax) related to the accelerated options in our pro forma net loss and net loss per

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common share for the three and nine months ended September 30, 2005. Had the options not been accelerated, the unamortized fair value-based compensation expense for the options would have been recorded in future periods through 2009, under vesting schedules in place prior to the acceleration, which generally would have resulted in fair value-based compensation expenses net of income tax of \$294,000 for the remainder of 2005, \$564,000 in 2006, \$333,000 in 2007, \$139,000 in 2008 and \$35,000 in 2009, all without regard to the effect of forfeitures.

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 | | Nine Months Ended | |
|--------------------------|---------------|-------|-------------------|-------|
| | September 30, | | September 30, | |
| | 2005 | 2004 | 2005 | 2004 |
| Dividend yield | 0.0% | 0.0% | 0.0% | 0.0% |
| Volatility | 49.3% | 45.7% | 49.9% | 49.1% |
| Risk-free interest rate | 3.98% | 2.81% | 3.64% | 3.21% |
| Expected life (in years) | 4.0 | 3.0 | 3.0 | 3.0 |

Net Loss Per Common Share

Basic net loss per common share was computed by dividing net loss by the weighted average number of shares of common stock outstanding during the period. Diluted net loss per common share was computed by dividing net 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 exercises. 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 loss per common share:

| | Quarter Ended | | Nine months ended | |
|--|---------------|----------|-------------------|----------|
| | September 30, | | September 30, | |
| | 2005 | 2004 | 2005 | 2004 |
| (in thousands, except per share data) | | | | |
| Numerator: | | | | |
| Loss from continuing operations | \$ (694) | \$ (337) | \$ (4,058) | \$ (617) |
| Discontinued operations: | | | | |
| Gain on sale of MediaTel assets, net of income tax expense | | 403 | | 607 |

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| | | | | |
|--|-----------|-----------|------------|-----------|
| Income from operations of MediaTel, net of income tax expense | 5 | | 35 | |
| Net loss | \$ (689) | \$ 66 | \$ (4,023) | \$ (10) |
| Denominator: | | | | |
| Weighted average shares outstanding basic | 29,056 | 31,248 | 29,077 | 31,798 |
| Dilutive effect of common shares from stock options | | | | |
| Weighted average shares outstanding diluted | 29,056 | 31,248 | 29,077 | 31,798 |
| Basic and diluted net loss per common share: | | | | |
| Basic and diluted loss per common share from continuing operations | \$ (0.02) | \$ (0.01) | \$ (0.14) | \$ (0.02) |
| Basic and diluted income per common share from discontinued operations | 0.00 | 0.01 | 0.00 | 0.02 |
| Basic and diluted net loss per common share | \$ (0.02) | \$ (0.00) | \$ (0.14) | \$ (0.00) |

For the quarters ended September 30, 2005 and 2004, we excluded 182,913 and 412,770, respectively, of common stock equivalent stock options and 226,706 and 511,819 for the nine months ended September 30, 2005 and 2004, respectively, from the calculation of diluted loss per common share because such securities were antidilutive in those periods due to net losses from continuing operations. Employee stock options to purchase 4,445,060 shares and 3,096,371 shares in the quarters ended September 30, 2005 and 2004, respectively, and 3,734,156 and 2,148,380 in the nine months ended September 30, 2005 and 2004, respectively, were outstanding, but were not included in the computation of diluted loss per common share because the exercise price of the stock options was greater than the average share price of the common shares and therefore, the effect would have been antidilutive.

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For segment reporting purposes, we operate in one segment.

Revenue by geographic region, as determined by shipping destination, was as follows:

| | Quarter Ended | | Nine Months Ended | |
|--------------------------|------------------|------------------|-------------------|------------------|
| | September 30, | | September 30, | |
| | 2005 | 2004 | 2005 | 2004 |
| | (in thousands) | | | |
| United States of America | \$ 16,452 | \$ 14,110 | \$ 45,993 | \$ 41,739 |
| Canada | 973 | 687 | 2,345 | 2,115 |
| United Kingdom | 471 | 161 | 1,425 | 845 |
| Other | 3,859 | 3,073 | 11,954 | 9,698 |
| Total net revenue | \$ 21,755 | \$ 18,031 | \$ 61,717 | \$ 54,397 |

Revenue from other consists primarily of sales to Asia Pacific, the Middle East, Africa, other European Countries and to countries in the Latin America region.

3. Changes in Shareholders' Equity

(in thousands, except share data)

| | Common Shares | Common Stock | Additional Paid-in Capital | Accumulated Other Comprehensive Income | Retained Earnings | Total Shareholders' Equity | Total Comprehensive Loss |
|------------------------------|---------------|--------------|----------------------------|--|-------------------|----------------------------|--------------------------|
| Balance at December 31, 2004 | 29,451,973 | \$ 295 | \$ 55,410 | \$ 748 | \$ 49,788 | \$ 106,241 | |
| Exercise of stock options | 131,532 | 1 | 361 | | | 362 | |
| Repurchase of common stock | (1,158,574) | (12) | (4,431) | | | (4,443) | |
| Stock compensation benefit | | | (239) | | | (239) | |

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| | | | | | | | |
|---|------------|--------|-----------|--------|-----------|-----------|------------|
| Stock option income tax expense | | | | 14 | | 14 | |
| Unrealized loss on investments, net of income tax benefit of \$37 | | | | 66 | | 66 | \$ 66 |
| Foreign currency translation adjustment | | | | 143 | | 143 | 143 |
| Net loss | | | | | (4,023) | (4,023) | (4,023) |
| Balance at September 30, 2005 | 28,424,931 | \$ 284 | \$ 51,115 | \$ 957 | \$ 45,765 | \$ 98,121 | \$ (3,814) |

Total comprehensive loss for the quarter ended September 30, 2005 was \$253,000 compared to \$594,000 for the quarter ended September 30, 2004. Total comprehensive loss for the nine months ended September 30, 2005 was \$3.8 million compared to \$10,000 for the nine months ended September 30, 2004.

4. Repurchase Program

In January 2005, our Board of Directors approved an \$11.0 million increase to our previously announced stock repurchase program, bringing the total available for repurchase under the program to \$15.0 million. During the quarter and nine months ended September 30, 2005, we repurchased 377,500 and 1,158,574 shares of our common stock, respectively, for approximately \$1.4 million and \$4.4 million, respectively. At September 30, 2005, \$10.6 million remains available to repurchase shares. 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 has been utilized or (b) our Board of Directors elects to discontinue the repurchase program.

Table of Contents**CAPTARIS, INC.****5. Commitments and Contingencies****Leases**

We lease our office space and certain equipment under non-cancelable operating leases which expire on various dates between November 2005 and June 2010. We sublease a portion of our office space to third parties. Certain of our lease agreements provide for scheduled rent increases over the lease term. Minimum rental expenses are recognized on a straight-line basis over the term of the lease. Future minimum lease payments under non-cancelable operating leases and future rental income under non-cancelable subleases having initial or remaining lease terms in excess of one year at September 30, 2005 were as follows (in thousands):

| Periods | Future Lease Payments | Future Rental Income | Net |
|-------------------------------|--------------------------|-------------------------|----------|
| October 2005 - September 2006 | \$ 2,309 | \$ (66) | \$ 2,243 |
| October 2006 - September 2007 | 1,866 | | 1,866 |
| October 2007 - September 2008 | 706 | | 706 |
| October 2008 - September 2009 | 229 | | 229 |
| Thereafter | 123 | | 123 |
| | \$ 5,233 | \$ (66) | \$ 5,167 |

Intellectual Property

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

Contingencies

We follow the provisions of SFAS No. 5 to record potential income tax claims. Significant judgment is required in evaluating our tax positions and in determining our provision for income taxes. We establish accruals for tax-related uncertainties based on estimates of whether, and to the extent which, additional taxes and interest will be due. These accruals are established when we believe that certain positions are likely to be challenged and may not be sustained on review by tax authorities. We do believe that our tax return positions are fully supportable. We adjust these accruals in light of changing facts and circumstances, such as the closing of a tax audit or the expiration of a statute of limitations. The

provision for income taxes includes the impact of potential tax claims and changes to accruals that we consider appropriate, as well as the related interest expense. In addition to our judgments and use of estimates, there are inherent uncertainties surrounding income taxes that could result in actual amounts that differ materially from our estimates. Any adjustments in our tax provision related to these contingencies could have a material effect on our financial condition, results of operations and cash flow. During the third quarter of 2005 we recorded an income tax benefit of approximately \$523,000. See Note 8.

6. Sale of CallXpress Product Line

On September 29, 2003, we sold our CallXpress product line to Applied Voice and Speech Technologies, Inc. (AVST). Concurrent with the transaction, we entered into an earn-out agreement with AVST which entitled us to receive additional payments of up to \$1.0 million per year for each of the three years following the sale, depending on AVST 's success in achieving certain revenue targets. On March 2, 2005, we received a report from AVST and payment of \$1.0 million, confirming achievement of the revenue target for 2004. This payment was recognized as an additional gain on the sale of the CallXpress product line and was classified on our income statement within operating loss in the first quarter of 2005.

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CAPTARIS, INC.

7. Legal Proceedings

One of the services provided by MediaTel Corporation, a wholly owned subsidiary of Captaris, until its business was sold, 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 NFO PLOG and then Northstar Travel Media that listed recipients for these facsimiles. All of the assets of MediaTel were sold to a subsidiary of PTEK Holdings, Inc. (PTEK) on September 1, 2003.

As reported in our Annual Report on Form 10-K for the year ended December 31, 2004 and our Quarterly Report on Form 10-Q for the quarter ended March 31, 2005 (the First Quarter Form 10-Q), on or about July 29, 2003, Travel 100 Group, Inc. (Travel 100) filed three lawsuits in Circuit Court in Cook County, Illinois, one against Mediterranean Shipping Company (Mediterranean), the second against The Melrose Hotel Company (Melrose) and the third against Oceania Cruises (Oceania). On or about April 13, 2004, a fourth lawsuit was filed by another travel agent, Travel Travel Kirkwood, Inc. (Kirkwood), against Oceania Cruises. That case was subsequently removed to the U.S. District Court, Eastern District of Missouri. As reported in the First Quarter 2005 Form 10-Q, the Oceania case was dismissed without prejudice in March 2005. As reported in our Second Quarter 2005 Form 10-Q, in June 2005, the parties entered into a cash settlement of the Kirkwood case, our portion of which was not material, and that case was dismissed with prejudice as to all parties on June 28, 2005.

The complaints in the remaining cases 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 of the Travel 100 complaints seeks injunctive relief and unspecified damages and certification as a class action on behalf of Travel 100 and others similarly situated throughout the United States that received the facsimile advertisements. Under the Telephone Consumer Protection Act, a court can impose liability of \$500 per fax on a party that sends a fax without the consent of the recipient. A court can increase the liability to \$1,500 per fax if the sending of the fax is willful.

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, contribution or breach of contract for any damages suffered by Mediterranean. Similarly, in its answer filed on October 14, 2003, Melrose named Captaris, as well as PTEK, as third-party defendants based on allegations of breach of contract, indemnification and contribution.

In response to Mediterranean's third-party complaint, we filed our answer on November 3, 2003, denying the allegations filed by Mediterranean and further answering by way of affirmative defenses that to the extent we are found liable for any damages allegedly suffered by plaintiffs or any third-party plaintiffs in this action, we are entitled to indemnification and/or contribution from other non-parties to this action. We filed similar answers to the Melrose complaint on November 20, 2003. Both Captaris and MediaTel have denied any liability in the cases because, among other facts and defenses, MediaTel understood that the database and lists of travel agent recipients to whom faxes were sent had authorized that information could be sent to them by fax. Based on Captaris' analysis to date, we estimate that there were approximately 500,000 faxes sent relating to the Mediterranean case and approximately 200,000 faxes sent relating to the Melrose case.

Discovery is ongoing in the remaining Travel 100 cases and the parties are in the process of working out a schedule for a class certification briefing. We expect the plaintiffs in the Mediterranean case to push for a hearing on class certification in the first quarter of 2006.

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We have tendered these claims to our general liability insurance carrier and the carrier has agreed to pay defense costs. In addition, the carrier has paid the settlement amount in the Kirkwood matter. However, the carrier has reserved its rights to contest their duty to indemnify Captaris with respect to the Melrose and Mediterranean matters. Even if coverage is determined to apply to these two matters, since the potential liability of these claims is substantially in excess of our coverage limits, there can be no assurance that our coverage will be sufficient to satisfy any damages we are required to pay.

We intend to vigorously defend each of these cases, but litigation is subject to numerous uncertainties and we are unable to predict the ultimate outcome of any of these matters. Moreover, the amount of any potential liability in connection with these cases will depend, to a large extent, on whether a class is certified, and if one is certified, on what the scope of that class will be, neither of which can be predicted at this time. We have not recorded a liability related to these cases. However, there is no guarantee that we will not determine in the future that an accrual is required or that we will not be required to pay damages in respect of these cases in the future, either of which could materially and adversely affect our results of operations, cash flows and financial condition for the quarter or year in which any accrual is recorded or any damages are paid.

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8. Income Taxes

We are subject to income taxes in both the United States and numerous foreign jurisdictions. Significant judgment is required in evaluating our tax positions and determining our provision for income taxes. During the ordinary course of business, there are many transactions and calculations for which the ultimate tax determination is uncertain. We establish accruals for tax-related uncertainties based on estimates of whether, and to the extent which, additional taxes and interest will be due. These accruals are established when, despite our belief that our tax return positions are fully supportable, we believe that certain positions are likely to be challenged and may not be sustained on review by tax authorities. We adjust these accruals in light of changing facts and circumstances, such as the closing of a tax audit or the expiration of statutes of limitations. The provision for income taxes includes the impact of potential tax claims and changes to accruals that we consider appropriate, as well as the related penalties and interest.

Our effective tax rates differ from the statutory rate primarily due to state income taxes, foreign income tax, tax exempt interest income and accruals for certain tax exposures discussed above. In the third quarter of 2005 and 2004, we recorded an income tax benefit of \$1.3 million and \$205,000, respectively, on income from continuing operations. In addition, we recorded an income tax benefit of \$3.1 million and \$378,000, respectively, on income from continuing operations for the nine months ended September 30, 2005 and 2004, respectively. The income tax benefit recorded for the three and nine months ended September 30, 2005 included the reversal of a tax liability of approximately \$523,000 which management determined was no longer probable based on updated information surrounding the related tax return. Excluding the impact of this tax benefit, we anticipate the effective tax rate for 2005 to be approximately 37.0%.

At September 30, 2005, we have available unused net operating losses that may be applied against future taxable income of approximately \$6.8 million. These net operating losses consist of international losses of \$851,000 that do not expire, Federal losses of \$5.5 million that expire from 2019 up to 2025, and State losses of \$422,000 that expire from 2006 up to 2022. We believe that there is sufficient positive evidence to support our conclusion not to record a valuation allowance against these net operating losses. Management believes that we will utilize the loss carryforwards in the future because: (1) we have had a history of pre-tax income, (2) in 2003, we sold a product that generated losses, and (3) the IRC Section 382 limitation for the acquired net operating loss of Information Management Research, Inc. (\$4.5 million) covers nine years which is well within the statute of limitations for these losses.

9. New Accounting Pronouncements

In March 2005, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations (FIN No. 47). FIN No. 47 clarifies that an entity must record a liability for a conditional asset retirement obligation if the fair value of the obligation can be reasonably estimated. The provision is effective for us at the end of fiscal year ending December 15, 2005. We do not expect the adoption of this standard to have a material effect on our financial position, results of operations or cash flows.

On April 14, 2005, the SEC announced the adoption of a new rule that amends the effective dates for SFAS No. 123 (revised 2004) (SFAS No. 123(R)), Share-Based Payment . Under SFAS No. 123R, public registrants would have been required to implement the standard as of the beginning of the first interim or annual period that begins after June 15, 2005. The SEC 's new rule allows companies to implement SFAS No. 123R at the beginning of their next fiscal year, instead of the next reporting period, that begins after June 15, 2005. For calendar year-end companies this means that SFAS No. 123R compliance will be required no later than the first quarter of 2006. The SEC 's new rule does not change the accounting required by SFAS No. 123R; it changes only the dates for compliance with the standard. We are currently evaluating

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option valuation methodologies and assumptions in light of this new statement. As such, at this time we have not estimated the effect of this statement on our results of operations. However, we expect the adoption of SFAS No. 123(R) to have a material adverse effect on our results of operations.

In May 2005, the FASB issued FASB Statement No. 154, Accounting Changes and Error Corrections (SFAS No. 154), which requires retrospective application to prior periods financial statements of voluntary changes in accounting principles unless it is impracticable to do so. SFAS No. 154 replaces APB Opinion No. 20, Accounting Changes and FASB Statement No. 3, Reporting Accounting Changes in Interim Financial Statements . SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. We do not anticipate the adoption of SFAS No. 154 will have a material impact on our consolidated financial statements.

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10. Subsequent Events

On November 3, 2005, we announced corporate changes intended to improve the efficiency and cost structure of our business. These changes include a reduction of our workforce by 12 mid to high level employees or 3.0% of our total workforce, the abandonment of a portion of our Portland, Oregon office lease and the write-off of amounts previously deferred for an application systems software project. The reduction in staff includes certain founders of Teemplate, which we acquired in September 2003, and triggers the acceleration of our remaining minimum incentive plan obligation to the management team of Teemplate that we entered into in connection with the acquisition of Teemplate. We will record a charge of approximately \$2.3 million in the fourth quarter of 2005 as a result of these changes, which includes: \$620,000 for severance and related costs, \$1.0 million for the Teemplate incentive plan obligation, \$193,000 for lease abandonment and \$440,000 for the write-off of the software project. Of the total charge, \$2.0 million are cash expenditures in the fourth quarter of 2005.

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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 2004 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 31, 2005.

This Quarterly Report on Form 10-Q and the documents incorporated herein by reference contain forward-looking statements. These statements relate to future events or our future financial performance. In some cases, you can identify forward-looking statements by terminology such as may, will, should, expect, plan, intend, anticipate, believe, estimate, predict, potential, continue, could, future, seek, target or the negative of these terms or other terminology. These statements are only predictions. Actual events or results may differ materially. In evaluating these statements, you should specifically consider various factors, including the risks outlined in the Factors That May Affect Our Business, Future Operating Results, Financial Condition and Market Price of Our Stock section included elsewhere in this report. These factors may cause our actual results to differ materially from any forward-looking statements. Except as required by law, we undertake no obligation to publicly release any revisions to these forward-looking statements that may be made to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

Overview

Captaris Business Information Delivery (BID) solutions capture, process, deliver, manage and archive data and documents enabling customers to reduce costs and increase the performance of critical business information investments. Through our global distribution network, we deliver software products and services that help organizations manage and leverage the value of corporate information. In partnership with leading enterprise technology companies, we have installed more than 90,000 systems in 95 countries in companies of all sizes, including the entire current Fortune 100. We consider our current business activities to be business information delivery solutions and, as such, we operate under one business unit segment. Our products and solutions address the fax server and e-document market, workflow and business process automation markets, as well as archiving and records management markets. We distribute our products primarily through independent distributors and value-added resellers. Our products run on off-the-shelf server hardware and on Microsoft certified software platforms including Microsoft® Windows NT, Windows 2000, Windows 2003 and Windows XP. We utilize the Microsoft.NET development tools widely in our suite of products and interface with a wide variety of hardware equipment and enterprise software products. Captaris was incorporated in the State of Washington in 1982. Our principal executive offices are located in Bellevue, Washington.

During the first nine months of 2005, we continued to concentrate on our six strategic areas of focus: strengthening our reseller channels; enhancing our strategic partnerships; creating vertical market solutions; extending our product offerings; growing enterprise accounts; and expanding our solutions capabilities. Net revenue for the quarter ended September 30, 2005 increased by \$3.7 million or 20.7% compared to the quarter ended September 30, 2004. Net revenue for the first nine months of 2005 increased \$7.3 million or 13.5% compared to the first nine months of 2004.

The increase in revenue for the quarter and nine months ended September 30, 2005 was primarily attributable to revenue from our new BID product lines, Document Management (formerly Alchemy) and Workflow. We acquired the Document Management product line in October 2004 and the Workflow product line in September 2003. Revenue from our new BID product lines increased approximately \$2.9 million and \$7.7 million in the third quarter and first nine months of 2005, respectively, compared to the same periods of 2004. The increase in BID revenue is due primarily to the inclusion of sales from our Document Management product line in the 2005 periods.

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Revenue from our RightFax product line increased by \$790,000 or 4.5% in the third quarter of 2005 compared to the third quarter of 2004. This increase was not enough to fully recover from the decline in the first quarter of 2005 from the first quarter of 2004 and a flat second quarter 2005 compared to second quarter 2004, resulting in a decrease of \$406,000 or 0.8% for the nine months ended September 30, 2005. RightFax product revenue, which includes revenue from software licenses and hardware sales, was \$11.7 million for the third quarter, down 3.5% from the same quarter of last year. For the nine months ended September 30, 2005, RightFax product revenue was \$33.4 million down 8.5% from the same period last year. RightFax maintenance, support and services revenue was \$6.5 million for the third quarter of 2005, up \$1.2 million or 22.8% from the same quarter last year. For the nine months ended September 30, 2005, RightFax maintenance, support and services revenue was \$18.6 million, up 16.9% from the same period last year.

We believe that revenue from the RightFax product line was negatively impacted in the first half of 2005 in part from changes we introduced into the sales channel in the first quarter of 2005. We acquired the Document Management product line from Information Management Research, Inc. (IMR) in the fourth quarter of 2004 and postponed integrating revenue

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operations until after the first of the year, which is typically our slowest sales quarter. In the first half of 2005, many of our traditional RightFax resellers increased their emphasis on the new BID product lines as we integrated the Document Management product line. Other changes included new technology in our RightFax product, reassignment in field support and emphasis on multi-product solution selling. We believe these changes temporarily negatively impacted revenue from the RightFax product line, as the resellers have been focused on training and integrating the new products into their product lines. We anticipated training and similar transitional activities with our partners, however, we believe these activities took longer and had a greater impact on RightFax product revenue than we expected. We believe that the RightFax product line revenue will continue to see improvements during the fourth quarter and expect it to stay reasonably consistent with the prior year sales of the RightFax product line.

Gross margin increased to 69.6% in the third quarter of 2005 from 63.7% in the third quarter of 2004, and increased to 68.1% in the nine months ended September 30, 2005 up from 65.4% in the nine months ended September 30, 2004. The improved gross margins in the quarter and nine months ended September 30, 2005 are a result of increased sales of our new BID product lines which contribute higher gross margins compared to the RightFax product line which contributes lower gross margins due to its lower margin hardware components.

Aggregate research and development, selling, general and administrative expenses, net of gain on the sale of the CallXpress product line and stock compensation benefit, increased by \$5.1 million or 41.1% in the third quarter of 2005 compared to the third quarter of 2004, and increased by \$12.7 million or 33.9% in the first nine months of 2005 compared to the first nine months of 2004. The increase in these expenses is primarily due to increased sales, marketing, development and amortization expenses related to the Document Management product line as well as increased commission expense, increased costs associated with compliance with the Sarbanes-Oxley Act of 2002 and increased staffing costs in our accounting, legal and information technology functions.

Consolidated cash, cash equivalents and investments at September 30, 2005 were \$50.5 million, a decrease of approximately \$6.8 million from December 31, 2004. During the first nine months of 2005, we used approximately \$4.4 million to repurchase our common stock, \$2.6 million to purchase capital assets and \$174,000 in operating activities, which was partially offset by cash provided from the exercise of stock options from our employee stock option plans of \$362,000.

Critical Accounting Judgments and Estimates

The preparation of our consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, 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. We base our estimates on historical experience, current conditions and various other assumptions 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. To the extent that there are material differences between these estimates and actual results, our presentation of our financial condition or results of operations may be affected.

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, the estimated allowances for sales returns and doubtful accounts and income tax accruals. We believe that the following accounting policies are critical to understanding

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our historical and future performance, as these policies may involve a higher degree of judgment and complexity than others. For a detailed discussion on the application of these and other accounting policies, see Note 1 in Notes to Condensed Consolidated Financial Statements in Item 1 of this Quarterly Report on Form 10-Q.

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;

Classification of investments and assessment of related unrealized losses;

Valuation of acquired businesses, assets and liabilities;

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Impairment of goodwill and intangible assets;

Impairment of equipment, leasehold improvements and long-lived assets;

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. We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred, the selling price is fixed or determinable and collection is reasonably assured.

We sell products through resellers, original equipment manufacturers (OEM s) and other channel partners, as well as directly to end-users. Except for OEM sales described below, 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. We consider revenue associated with this telephone support to be insignificant, and therefore, we recognize this revenue when the software is shipped and record an estimate for the related cost of the telephone support. Revenue from term software licenses is recognized over the term of the license, generally twelve months. Whenever a software license, hardware, installation and post-contract customer support or PCS elements are sold together, we allocate the total arrangement fee among each element based on its respective fair value, which is the price charged when that element is sold separately. The amount of revenue assigned to each element is impacted by our judgment as to whether an arrangement includes multiple elements and, if so, whether vendor-specific objective evidence (VSOE) of fair value exists for those elements. Changes to the elements in an arrangement and our ability to establish VSOE for those elements could affect the timing of revenue recognition for these items. Revenue for PCS is recognized on a straight-line basis over the service contract term, ranging from 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. Revenue from perpetual software licenses is recognized when the software has been shipped, provided that collection for such revenue is deemed probable. For software sold to resellers in which we have granted exchange rights, we defer the revenue until the reseller sells the software through to end-users.

We have entered into agreements with certain OEMs from which we receive royalty payments periodically. Under the terms of the OEM license agreements, each OEM will qualify our software on their hardware and software configurations. Once the software has been qualified, the OEM will begin to ship products and report net sales to us. Most OEMs pay a license fee based on the number of copies of licensed software included in the products sold to their customers. These OEMs pay fees on a per-unit basis and we record associated revenue when we receive notification of the OEMs sales of the licensed software to an end-user. The terms of the license agreements generally require the OEMs to notify us of sales of our products within 30 to 45 days after the end of the month or quarter in which the sales occur. As a result, we recognize the revenue in the month or quarter following the sales of the product to these OEMs customers.

In general, customers are granted a 30-day right of return for product sales. We reduce revenue recognized for estimated product returns at the time the related revenue is recorded. When customer acceptance provisions are present and we cannot reasonably estimate returns, we recognize revenue upon the earlier of customer acceptance or expiration of the acceptance period.

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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 will be unprofitable, we recognize the loss at the time of such determination. Training revenue is recognized when the training is completed.

Allowance for sales return. We estimate potential future product returns related to current period revenue based on our historical returns, current economic trends, changes in customer demand and acceptance of our products. We periodically review the adequacy of our sales returns allowance and underlying assumptions. If the assumptions we use to calculate the estimated sales returns do not properly reflect future returns, a change in accruals for sales returns would be made in the period in which such a determination was made.

Allowance for doubtful accounts. We make ongoing assumptions as to the collectibility of our accounts receivable in our calculation of the allowance for doubtful accounts. In determining the amount of the allowance, we make estimates based on our

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historical bad debts, the aging of customer accounts, customer concentrations, customer credit-worthiness, current economic trends and changes in our customer payment patterns. Our reserves historically have been adequate to cover our actual credit losses. However, if actual credit losses were to fluctuate significantly from the reserves we have established, our general and administrative expenses could be adversely affected.

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, which may have a material adverse effect on our financial results.

Classification of investments and assessment of related unrealized losses. We classify our short-term and long-term investments as available-for-sale. Our portfolio consists primarily of money market funds, adjustable rate mortgage-backed securities, municipal and U.S. government agency-backed securities and are recorded at fair market value. We determine the fair value of our investments based on quoted market prices. Investments with expected maturities of one year or less are classified as short-term. We recognize realized gains and losses upon sale of investments using the specific identification method. We believe that the expected lives of our mortgage-backed securities investments are much shorter than the stated maturities due to mortgage refinances and sales of homes. Accordingly, we have estimated the portion of the mortgages likely to be prepaid within one year based on historical prepayment data, current interest rates and other economic factors, and classified a portion of these investments as short-term. Unrealized gains and losses, net of any income tax effect, are recorded as a component of other comprehensive income. Interest income is recorded using an effective interest rate, with the associated premium or discount amortized to interest income over the term of the investment.

We recognize an impairment charge for unrealized losses when an investment's decline in fair value is below the cost basis and is judged to be other than temporary. In making this judgment, we evaluate, among other factors, the duration and extent to which the fair value of an investment is less than its cost, the financial condition and near-term business outlook for the investee and our intent and ability to hold the investment for a period of time sufficient to allow for any anticipated recovery in market value.

Valuation of acquired businesses, assets and liabilities. Our business acquisitions typically result in goodwill and other intangible assets, and the recorded values of those assets may become impaired in the future. As of September 30, 2005 our goodwill and intangible assets, net of accumulated amortization, were \$43.3 million. 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. Goodwill is tested for impairment on an annual basis in the first quarter of the year, and on an interim basis in certain circumstances. We conducted our annual assessment during the first quarter of 2005 and determined our goodwill at March 31, 2005, was not impaired. No conditions or events have occurred during the third quarter which would require us to update the assessment. 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, 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 to determine if there is any impairment of these assets. We assess the impairment of these assets, or the need to accelerate amortization, 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 the assets should be reviewed to determine their fair value. 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, if necessary. 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

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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 cash. Changes in estimated 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 Standard (SFAS) No. 5, *Accounting for Contingencies*, to record litigation or claim-related expenses. We evaluate, among other factors, the degree of probability of 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 when incurred.

In addition, we follow the provisions of SFAS No. 5 to record potential income tax claims. Significant judgment is required in evaluating our tax positions and in determining our provision for income taxes. During the ordinary course of business, there are many transactions and calculations for which the ultimate tax determination is uncertain. We establish accruals for tax-related uncertainties based on estimates of whether, and to the extent which, additional taxes and interest will be due. These accruals are established when, despite our belief that our tax return positions are fully supportable, we believe that certain positions are likely to be challenged and may not be sustained on review by tax authorities. We adjust these accruals in light of changing facts and circumstances, such as the closing of a tax audit or the expiration of a statute of limitations. The provision for income taxes includes the impact of potential tax claims and changes to accruals that we consider appropriate, as well as the related interest expense. In addition to our judgments and use of estimates, there are inherent uncertainties surrounding income taxes that could result in actual amounts that differ materially from our estimates. Any adjustments in our tax provision related to these contingencies could have a material effect on our financial condition, results of operations and cash flow.

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 sales of maintenance, which includes software upgrades and support agreements. We distribute fax boards with a significant number of our RightFax product sales for which we receive a margin significantly less than the margin on our software products. Our new BID product lines consist of our Workflow and Document Management products and related services.

| Quarter Ended September 30, | | | Nine Months Ended September 30, | | |
|-----------------------------|------|------|---------------------------------|------|------|
| % Change from | | | % Change from | | |
| 2005 | 2004 | 2004 | 2005 | 2004 | 2004 |
| (in thousands) | | | (in thousands) | | |

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| | | | | | | |
|-----------------------|-----------|--------|-----------|-----------|--------|-----------|
| RightFax product line | \$ 18,186 | 4.5% | \$ 17,396 | \$ 51,966 | (0.8)% | \$ 52,372 |
| New BID product lines | 3,569 | 462.0% | 635 | 9,751 | 381.5% | 2,025 |
| | <hr/> | | <hr/> | <hr/> | | <hr/> |
| Net revenue | \$ 21,755 | 20.7% | \$ 18,031 | \$ 61,717 | 13.5% | \$ 54,397 |
| | <hr/> | | <hr/> | <hr/> | | <hr/> |

Net revenue for the quarter ended September 30, 2005 increased by \$3.7 million or 20.7% compared to the quarter ended September 30, 2004. Net revenue for the first nine months of 2005 increased \$7.3 million or 13.5% compared to the first nine months of 2004.

The increase in revenue for the quarter and nine months ended September 30, 2005 was primarily attributable to revenue from our new BID product lines, the Document Management and Workflow product lines. We acquired the Document Management product line in October 2004 and the Workflow product line in September 2003. Revenue from our new BID product lines increased approximately \$2.9 million and \$7.7 million in the third quarter and first nine months of 2005, respectively, compared to the same periods of 2004. This increase is due primarily to the inclusion of sales from our Document Management product line in the 2005 periods.

Revenue from our RightFax product line increased slightly in the third quarter of 2005 compared to the third quarter of 2004 with an increase of \$790,000 or 4.5%. This increase was not enough to fully recover from the decline in the first quarter of 2005 from the first quarter of 2004 and a flat second quarter compared to second quarter 2004, resulting in a decrease of \$406,000 or 0.8% for the nine months ended September 30, 2005. RightFax product revenue, which includes revenue from software licenses and hardware sales, was \$11.7 million for the third quarter, down 3.5% from the same quarter of last year. For the nine months ended September 30, 2005, RightFax product revenue was \$33.4 million down 8.5% from the same period last year. RightFax maintenance, support and services revenue was \$6.5 million for the third quarter of 2005, up \$1.2 million or 22.8% from the same quarter last year. For the nine

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months ended September 30, 2005, RightFax maintenance, support and services revenue was \$18.6 million, up 16.9% from the same period last year.

We believe that revenue from the RightFax product line was negatively impacted in the first half of 2005 in part from changes we introduced into the sales channel in the first quarter of 2005. We acquired the Document Management product line from IMR in the fourth quarter of 2004 and postponed integrating revenue operations until after the first of the year, which is typically our slowest sales quarter. In the first half of 2005, many of our traditional RightFax resellers increased their emphasis on the new BID product lines as we integrated the Document Management product line. Other changes included new technology in our RightFax product, reassignment in field support and emphasis on multi-product solution selling. We believe these changes temporarily negatively impacted revenue from the RightFax product line, as the resellers have been focused on training and integrating the new products into their product lines. We anticipated training and similar transitional activities with our partners, however, we believe these activities took longer and had a greater impact on RightFax product revenue than we expected. We believe that the RightFax product line revenue will continue to see improvements during the fourth quarter and expect it to stay reasonably consistent with the prior year sales of the RightFax product line.

International net revenue represented approximately 24.4% and 25.5% of total net revenue for the third quarter and nine months ended September 30, 2005, compared to 21.7% and 23.3% for the same periods in 2004. International revenue from the RightFax product line represented approximately 20.4% and 21.5% of total net revenue for the third quarter and nine months ended September 30, 2005, compared to 21.0% and 21.8% for the third quarter and nine months ended September 30, 2004. The overall increase in revenue from our international regions was due to our continued investment and expansion into international markets and to a higher distribution of sales outside North America from our Document Management product line. We expect the portion of our revenue derived from international markets to continue to increase in 2005 because a significant portion of our new BID product line sales are made internationally.

We anticipate that consolidated net revenue will grow by approximately 10% to 15% in 2005 compared to 2004 due to an increase in the volume of products and services sold as well as recognition of a full twelve months in 2005 of revenue from the Document Management product line, which we acquired in late October 2004. Historically, our business experiences seasonality with a decline in revenue during the first quarter compared to the prior year's fourth quarter, building gradually during the second and third quarters, and ending with the fourth quarter as our largest quarter for revenue. We anticipate this pattern to continue in 2005. After a 7.8% decline in the first quarter of 2005 from first quarter 2004, and a flat second quarter 2005 compared to second quarter 2004, revenue for the RightFax product line has increased 4.5% in the third quarter 2005 over third quarter 2004. We believe that this growth trend is consistent with our seasonality and is reasonably representative of the anticipated increase in the quarter and year ending December 31, 2005.

Gross Profit

Gross profit is calculated as the selling price of our 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 September 30,

Nine months ended September 30,

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| | % | | | | % | |
|-----------------------|----------------|-------|-----------|-----------|----------------|-----------|
| | Change from | | | | Change from | |
| | 2005 | 2004 | 2004 | 2005 | 2004 | 2004 |
| | (in thousands) | | | | (in thousands) | |
| Gross profit | \$ 15,142 | 31.8% | \$ 11,487 | \$ 42,047 | 18.2% | \$ 35,581 |
| Percentage of revenue | 69.6% | | 63.7% | 68.1% | | 65.4% |

The increase in gross profit for the quarter and nine months ended September 30, 2005 compared to the quarter and nine months ended September 30, 2004 is primarily attributable to increased sales of our new BID product lines which contribute higher gross margins compared to the RightFax product line which contributes lower gross margins due to its lower margin hardware components. We anticipate gross profit as a percentage of revenue for the quarter and year ending December 2005 will continue to be improved over quarter and year ended December 2004 due to increased revenue, as a percent of our total revenue, from our new BID product lines. The increase in BID revenue is due primarily to the inclusion of sales from our Document Management product line in the 2005 periods.

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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 September 30, | | | Nine months ended September 30, | | |
|--------------------------|-----------------------------|-------|----------|---------------------------------|-------|----------|
| | % Change from | | | % Change from | | |
| | 2005 | 2004 | 2004 | 2005 | 2004 | 2004 |
| | (in thousands) | | | (in thousands) | | |
| Research and development | \$ 3,496 | 22.8% | \$ 2,846 | \$10,300 | 42.3% | \$ 7,237 |
| Percentage of revenue | 16.1% | | 15.8% | 16.7% | | 13.3% |

For the quarter and nine months ended September 30, 2005, research and development expenses increased compared to the quarter and nine months ended September 30, 2004, primarily due to additional staff related to the Document Management product line, which we acquired in our acquisition of IMR in late October 2004. We expect research and development expenses to remain relatively flat in the fourth quarter 2005 compared to the third quarter of 2005. The Workflow product line is relatively young and we anticipate more frequent and substantive product releases than with our more mature RightFax and Document Management product lines.

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 September 30, | | | Nine months ended September 30, | | |
|-------------------------------------|-----------------------------|-------|----------|---------------------------------|-------|-----------|
| | % Change from | | | % Change from | | |
| | 2005 | 2004 | 2004 | 2005 | 2004 | 2004 |
| | (in thousands) | | | (in thousands) | | |
| Selling, general and administrative | \$ 13,487 | 37.9% | \$ 9,781 | \$ 39,444 | 31.9% | \$ 29,898 |
| Percentage of revenue | 62.0% | | 54.2% | 63.9% | | 55.0% |

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The increase in selling, general and administrative expenses in the third quarter and nine months ended September 30, 2005 compared to the same periods of 2004 was primarily attributable to the following: 1) an increase in Sales and Marketing employee and operating costs of approximately \$2.7 million and \$6.0 million for the third quarter and first nine months of 2005, respectively, over the same periods in 2004 primarily attributable to the addition of staff to support the new Document Management product line, acquired in late October 2004, channel expansion and other program costs; 2) an increase of approximately \$668,000 and \$1.7 million in the third quarter and first nine months of 2005, respectively, over the same periods in 2004 related to additional internal finance, information systems and legal staff and related costs; 3) an increase in Finance and Administrative costs of approximately \$199,000 and \$924,000 in the third quarter and first nine months of 2005, respectively, for costs incurred for financial statement audits, Sarbanes-Oxley Act of 2002 audits, legal expenses and consulting services and 4) costs incurred for third-party consultants related to an upgrade to our financial systems of \$576,000 in the nine months ended September 30, 2005.

Included in our Finance and Administrative expenses are external costs, third-party consultants and outside audit services associated with the Sarbanes-Oxley Act of 2002. These costs were approximately \$230,000 and \$885,000 for the third quarter and first nine months of 2005, respectively, compared to \$259,000 and \$556,000 in the third quarter and first nine months of 2004, respectively.

We expect selling, general and administrative expenses in 2005 to increase in the next quarter over 2004 resulting from an expected increase in sales due to seasonality and the inclusion of selling, general and administrative expenses related to the Document Management product line, and as we continue to focus our efforts on our sales and marketing strategies. We expect to continue to incur elevated expenses similar to the past nine months and 2004 associated with our compliance with the Sarbanes-Oxley Act of 2002.

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Amortization of Intangible Assets

Amortization expense for license agreements and core technology is recorded in cost of revenue and was \$481,000 and \$201,000 for the quarters ended September 30, 2005 and 2004, respectively, and \$1.4 million and \$604,000 for the nine months ended, September 30, 2005 and 2004, respectively. Amortization expense of other purchased intangible assets recorded in operating expenses was \$454,000 and \$102,000 for the quarters ended September 30, 2005 and 2004, respectively. For the nine months ended September 30, 2005 and 2004, amortization expense recorded in operating expenses was \$1.4 million and \$308,000, respectively. The increase in amortization expense in the quarter and nine months ended 2005 compared to the prior year periods are due to the intangibles we acquired with the acquisition of IMR and the Document Management product line in October 2004. We expect amortization expense for the remaining quarter of 2005 to be similar to amortization expense in the first three quarters of 2005.

Sale of CallXpress Product Line

On September 29, 2003, we sold our CallXpress product line to Applied Voice and Speech Technologies, Inc. (AVST). Concurrent with the transaction, we entered into an earn-out agreement with AVST which entitled us to receive additional payments of up to \$1.0 million per year for each of the three years following the sale, depending on AVST 's success in achieving certain revenue targets. On March 2, 2005, we received a report from AVST and payment of \$1.0 million, confirming achievement of the revenue target for 2004. This payment was recognized as an additional gain on the sale of the CallXpress product line and was classified on our income statement within operating loss in the first quarter of 2005.

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 treatment results in charges or credits recorded to stock based compensation, depending on fluctuations in quoted prices for our common stock and the number of stock options subject to variable accounting, neither of which can be predicted. At September 30, 2005 and 2004, the number of options to purchase common stock subject to variable accounting, were 164,761 and 183,594, respectively. We recognized a benefit of \$59,000 in the third quarter of 2005 and a benefit of \$413,000 in the third quarter 2004 for variable stock compensation. We recorded a benefit of \$239,000 for variable stock compensation for the nine months ended September 30, 2005 and a benefit of \$194,000 for the nine months ended September 30, 2004.

On September 1, 2005, our Compensation Committee and Board of Directors approved the acceleration of vesting of certain unvested stock options granted to our employees and officers under our stock option plans that have an exercise price greater than \$3.73 per share, the closing price of our common stock on September 1, 2005. Options held by non-employee directors were not included in the acceleration. Options to purchase approximately 2.3 million shares of our common stock became immediately exercisable. In accordance with APB No. 25 and FASB Interpretation No. 44, no compensation expense was recorded within the financial statements as a result of this modification as the options had an intrinsic value of \$0.00 on the date of the modification due to the exercise price being in excess of the current market price of the stock.

We expect to continue to record stock compensation charges or benefits in the fourth quarter of 2005 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. When we adopt SFAS No. 123(R) in the first quarter of 2006, stock compensation charges or benefits will be calculated in accordance with the new standard and charges or benefits related to options subject to variable accounting will cease. We are currently evaluating option valuation methodologies and assumptions in light of this new statement and as such, estimates of the effect of this statement cannot be reasonably determined at this time; however, we expect the adoption of SFAS No. 123(R) to have a material adverse effect on our results of operations. See New Accounting Pronouncements below.

Other Income, Net

Other income, net, consists primarily of investment income and foreign currency transaction gains and losses. For the quarter and nine months ended September 30, 2005, net other income was \$199,000 and \$625,000, respectively, compared to \$287,000 and \$673,000 for the quarter and nine months ended September 30, 2004, respectively. The decrease in net other

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income was due primarily to a decrease in interest income due to a decrease in our invested cash balances. Our invested cash balances have decreased significantly primarily due to our use of \$26.4 million of cash to acquire IMR in October 2004 and \$20.9 million of cash to repurchase and redeem our common stock in 2004 and 2005. Assuming interest rates remain at recent levels, we expect interest income to decline further during 2005 due to the reduction in our investment balances.

Income Tax Benefit

We are subject to income taxes in both the United States and numerous foreign jurisdictions. Significant judgment is required in evaluating our tax positions and determining our provision for income taxes. During the ordinary course of business, there are many transactions and calculations for which the ultimate tax determination is uncertain. We establish accruals for tax-related uncertainties based on estimates of whether, and to the extent which, additional taxes and interest will be due. These accruals are established when, despite our belief that our tax return positions are fully supportable, we believe that certain positions are likely to be challenged and may not be sustained on review by tax authorities. We adjust these accruals in light of changing facts and circumstances, such as the closing of a tax audit or the expiration of statutes of limitations. The provision for income taxes includes the impact of potential tax claims and changes to accruals that we consider appropriate, as well as the related penalties and interest.

Our effective tax rates differ from the statutory rate primarily due to state income taxes, foreign income tax, tax exempt interest income and accruals for certain tax exposures discussed above. In the third quarter of 2005 and 2004, we recorded an income tax benefit of \$1.3 million and \$205,000, respectively, on income from continuing operations. In addition, we recorded an income tax benefit of \$3.1 million and \$378,000, respectively, on income from continuing operations for the nine months ended September 30, 2005 and 2004, respectively. The income tax benefit for the three and nine months ended September 30, 2005 included the reversal of a tax liability of approximately \$523,000 which management determined was no longer probable based on updated information surrounding the related tax return. Excluding the impact of this tax benefit, we anticipate the effective tax rate for 2005 to be approximately 37.0%.

At September 30, 2005, we have available unused net operating losses that may be applied against future taxable income of approximately \$6.8 million. These net operating losses consist of international losses of \$851,000 that do not expire, Federal losses of \$5.5 million that expire from 2019 up to 2025, and State losses of \$422,000 that expire from 2006 up to 2022. We believe that there is sufficient positive evidence to support our conclusion not to record a valuation allowance against these net operating losses. Management believes that we will utilize the loss carryforwards in the future because: (1) we have had a history of pre-tax income, (2) in 2003, we sold a product that generated losses, and (3) the IRC Section 382 limitation for the acquired net operating loss of IMR (\$4.5 million) covers nine years which is well within the statute of limitations for these losses.

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, adjustable rate mortgage-backed securities, municipal and U.S. government agency-backed securities. Consolidated cash, cash equivalents and investments at September 30, 2005 were \$50.5 million, a decrease of approximately \$6.8 million from December 31, 2004. During the first nine months of 2005, we used approximately \$4.4 million to repurchase our common stock, \$2.6 million to purchase capital assets and \$174,000 in operating activities. The decrease in cash was partially offset by \$362,000 of proceeds received from the exercise of stock options through our employee stock option plans.

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Cash used in operations during the first nine months of 2005 was \$174,000 compared to cash provided by operations of \$3.6 million during the first nine months of 2004. Cash used by operating activities in the first nine months of 2005 was primarily attributable to our loss from operations and a decrease in accounts payable, partially offset by a decrease in accounts receivable and an increase in deferred revenue. Cash provided by operating activities in the first nine months of 2004 was primarily due to an increase in deferred revenue and decreases in accounts receivable and inventories partially offset by decreases in income taxes payable and accrued compensation and benefits.

Cash provided by investing activities was \$1.8 million for the first nine months of 2005, due to \$4.4 million of proceeds and maturities of investments, net of investment purchases, partially offset by \$2.6 million of capital asset purchases, compared to cash used of \$7.5 million for the first nine months of 2004. Cash used in investing for the nine months ended September 30, 2004 consisted primarily of \$5.0 million in purchases of marketable securities, net of proceeds from sales and maturities of investments, and \$2.5 million capital asset purchases.

Cash used in financing activities during the first nine months of 2005 was \$4.1 million compared to cash used in financing activities of \$8.4 million in the first nine months of 2004. In the first nine months of 2005, we repurchased \$4.4 million of our common stock under our repurchase program compared to \$9.3 million in the first nine months of 2004. The use of cash was

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partially offset by cash provided from the exercise of stock options from our employee stock option plans of \$362,000 and \$958,000 in the nine months ended September 30, 2005 and 2004, respectively.

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

In addition to cash, cash equivalents and investment balances, we have a \$1.0 million irrevocable standby letter of credit. We have collateralized the letter of credit with a \$1.0 million restricted certificate of deposit, which secures our corporate headquarters lease, which is included in restricted cash at September 30, 2005 and December 31, 2004.

Subsequent Event

On November 3, 2005, we announced corporate changes intended to improve the efficiency and cost structure of our business. These changes include a reduction of our workforce by 12 mid to high level employees or 3.0% of our total workforce, the abandonment of a portion of our Portland, Oregon office lease and the write-off of amounts previously deferred for an application systems software project. The reduction in staff includes certain founders of Teemplate, which we acquired in September 2003, and triggers the acceleration of our remaining minimum incentive plan obligation to the management team of Teemplate that we entered into in connection with the acquisition of Teemplate. We will record a charge of approximately \$2.3 million in the fourth quarter of 2005 as a result of these changes, which includes: \$620,000 for severance and related costs, \$1.0 million for the Teemplate incentive plan obligation, \$193,000 for lease abandonment and \$440,000 for the write-off of the software project. Of the total charge, \$2.0 million are cash expenditures in the fourth quarter of 2005.

Contractual Obligations and Commercial Commitments

The following table summarizes our contractual obligations and estimated commercial commitments as of September 30, 2005 and the effect such obligations are expected to have on liquidity in future periods:

| | Payments Due by Period | | | | |
|--|------------------------|---------------------|--------------|--------------|----------------------|
| | (in thousands) | | | | |
| | Total | Less than 1 year | 1-3 years | 3-5 years | More than 5 Years |
| Contractual Obligations | | | | | |
| Operating leases, net of sublease income | \$ 5,167 | \$ 2,243 | \$ 2,572 | \$ 352 | \$ |
| Purchase obligations: | | | | | |
| Teemplate incentive program ¹ | 1,250 | 1,250 | | | |

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| | | | | | |
|---|-----------------|-----------------|-----------------|---------------|-----------|
| Long-term purchase commitments ² | 3,197 | 1,812 | 1,000 | 385 | |
| Total contractual obligations and estimated commercial commitments | \$ 9,614 | \$ 5,305 | \$ 3,572 | \$ 737 | \$ |

Notes:

1. As part of the effort to retain the management team of Teemplate, Inc. which we acquired in September 2003, we offered an incentive plan that allows the Teemplate management team to earn a minimum of \$2.8 million up to a maximum of \$8.3 million over the thirteen quarter period following the closing, subject to their continued employment and our success in achieving certain performance targets. This payment was accelerated in November 2005. See Subsequent Event disclosure above.
2. Long-term commitments represent a commitment made to purchase software maintenance and support and telecommunication services.

New Accounting Pronouncements

In March 2005, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations* (FIN No. 47). FIN No. 47 clarifies that an entity must record a liability for a conditional asset retirement obligation if the fair value of the obligation can be reasonably estimated. The provision is effective for us at the end of fiscal year ending December 15, 2005. We do not expect the adoption of this standard to have a material effect on our financial position, results of operations or cash flows.

On April 14, 2005, the Securities and Exchange Commission (SEC) announced the adoption of a new rule that amends the effective dates for Statement of Financial Accounting Standards No. 123 (revised 2004) (SFAS No. 123(R)), *Share-Based Payment*. Under SFAS No. 123R, public registrants would have been required to implement the standard as of the beginning of the first interim or annual period that begins after June 15, 2005. The SEC's new rule allows companies to implement SFAS No.

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123R at the beginning of their next fiscal year, instead of the next reporting period, that begins after June 15, 2005. For calendar year-end companies this means that SFAS No. 123R compliance will be required no later than the first quarter of 2006. The SEC's new rule does not change the accounting required by SFAS No. 123R; it changes only the dates for compliance with the standard. We are currently evaluating option valuation methodologies and assumptions in light of this new statement. As such, at this time we have not estimated the effect of this statement on our results of operations. However, we expect the adoption of SFAS No. 123(R) to have a material adverse effect on our results of operations.

In May 2005, the FASB issued FASB Statement No. 154, Accounting Changes and Error Corrections (SFAS No. 154), which requires retrospective application to prior periods' financial statements of voluntary changes in accounting principles unless it is impracticable to do so. SFAS No. 154 replaces APB Opinion No. 20, Accounting Changes and FASB Statement No. 3, Reporting Accounting Changes in Interim Financial Statements. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. We do not anticipate the adoption of SFAS No. 154 will have a material impact on our consolidated financial statements.

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;

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costs related to acquisition of technologies or businesses;

costs of maintaining, integrating or expanding our operations;

costs of hiring qualified personnel;

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

general economic conditions; and

unpredictable exchange rate fluctuations.

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 predict with certainty the actual orders, sales and revenue these third parties will generate in a given quarter. The combination of these factors could impair and delay 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, value-added resellers and IT service partners.

A substantial majority of our revenue depends on a network of computer-oriented value-added resellers, independent distributors and IT service partners. 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 OEM and strategic relationships could limit our ability to maintain or increase revenue.

Creating and maintaining OEM and 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 OEM or strategic relationships on acceptable terms, if at all. Moreover, although we view our OEM and 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 OEM and strategic relationships are generally non-exclusive, which means our OEM and strategic partners may develop relationships with some of our competitors. Failure of one or more of our OEM and strategic partners to successfully develop and sustain a market for our products, or the termination of one or more of our OEM and strategic relationships, could adversely affect our ability to maintain or increase revenue.

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Additionally, our OEM and 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.

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, recently acquired by Dicom Group plc., 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. The direct competitors of our business process automation products include K2.net (SourceCode Technology Holdings, Ltd.), Metastorm, Ultimius, Inc. and Skelta Software, Pvt. Ltd. Our main competitors for archiving and records management solutions are Hyland Software, Inc., EMC Corporation and Stellent, Inc.

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 adapt more quickly than we can to new or emerging technologies and changes in market opportunities. Increased competition and competitive pressures may result in changes in market share, decreased sales volumes, price reductions and/or increased operating costs associated with marketing and sales incentives, resulting in related reductions in revenue, gross margins and operating income, any of which could materially adversely 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. It is costly to establish international facilities and operations to promote our brand internationally and to develop localized systems. We may not succeed in these efforts. Our net sales from international market segments may not offset the expense of establishing and maintaining the related operations and, therefore, these operations may not be profitable on a sustained basis. 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;

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exposure to exchange rate fluctuations;

restrictive governmental actions (such as trade protection measures, including export duties and quotas and custom duties and tariffs);

import or export licensing requirements;

limitations on the repatriation of funds;

longer receivables cycles;

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.

Currently, substantially all of our revenue is denominated in U.S. dollars; however, we also may price our international sales to the United Kingdom in British 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 U.S. dollar against these 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 information delivery solutions market may not be successful.

Our business strategy is to become a leading provider of business information delivery solutions. To further this strategy, we acquired Teemplate in September 2003, which provides solutions for the business process automation market and IMR in October 2004, which provides solutions in the document archiving and records management market. To implement our strategy, we must successfully integrate these acquisitions and 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 market will be successful.

The integration of recent and any future acquisitions may be difficult and disruptive, and we may incur significant costs in connection with the evaluation and negotiation of potential acquisitions.

We frequently evaluate potential acquisitions of products, technologies and businesses. The acquisition of Teemplate in September 2003, the acquisition of IMR in October 2004, 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. 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.

In connection with our evaluation of, and negotiation with, potential acquisition candidates, we may incur significant costs, including legal, accounting and financial advisory fees. These expenses are typically deferred and, upon completion of the transaction, are capitalized as part of the purchase price. However, if the transaction is not completed, we are required to record the deferred expenses as a charge to operating expenses in the quarter in which we conclude the transaction will not be completed. In some cases, particularly when a potential acquisition is abandoned in the late stages of the due diligence and

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negotiation process, this charge may be significant and could have a material adverse effect on our financial results in the quarter or year in which the charge is recorded.

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 the assets of MediaTel Corporation 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 MediaTel Corporation assets. 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 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 this report) 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.

Our business may be seriously harmed by third-party litigation against us relating to alleged violations of the Telephone Consumer Protection Act.

We are named as third-party defendants in two pending lawsuits alleging violations of the Telephone Consumer Protection Act in connection with the receipt by the plaintiffs of facsimile advertisements that were transmitted by MediaTel Corporation, our wholly owned subsidiary, before its business was sold in September 2003. The complaints seek injunctive relief and unspecified damages and certification as a class action on behalf of the plaintiff and others similarly situated throughout the United States that received the facsimile advertisements. Under the Telephone Consumer Protection Act, a court can impose liability of \$500 per fax on a party that sends a fax without consent of the recipient and can increase the liability to \$1,500 per fax if the sending of the fax is willful. Additional information regarding these matters is disclosed under Legal Proceedings in this Quarterly Report on Form 10-Q.

We are vigorously defending these cases, but litigation is subject to numerous uncertainties and we are unable to predict the ultimate outcome of any of these matters. Moreover, the amount of any potential liability in connection with these cases will depend, to a large extent, on whether a class is certified, and if one is certified, on what the scope of that class will be, neither of which can be predicted at this time. We have not recorded a liability related to these cases. However, there is no guarantee that we will not determine in the future that an accrual is required or that we will not be required to pay damages in respect of these cases in the future, either of which could materially and adversely affect our results of operations, cash flows and financial condition for the quarter or year in which any accrual is recorded or any damages are paid. We

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have tendered these claims to our general liability insurance carrier and the carrier has agreed to pay defense costs. However, the carrier has reserved its rights to contest their duty to indemnify Captaris with respect to these matters. Even if coverage is determined to apply, since the potential liability of these claims is substantially in excess of our coverage limits, there can be no assurance that our coverage will be sufficient to satisfy any damages we are required to pay. We expect the plaintiffs in one of the cases to push for a hearing on class certification in the first quarter of 2006.

Regardless of the outcome, these lawsuits may cause us to incur significant expenses and divert the attention of our management and key personnel from our business operations.

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

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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 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 results of operations, cash flows and financial condition.

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;

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.

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Failure to remediate material weaknesses in our internal control over financial reporting could adversely impact our ability to report accurate financial results in a timely manner, which could cause current and potential shareholders to lose confidence in our financial reporting, harming our business and the trading price of our stock.

As discussed in Item 9A of Amendment No. 1 to our Annual Report on Form 10-K for the year ended December 31, 2004, which was filed on May 2, 2005, we have concluded that we have material weaknesses in our internal control over financial reporting and, as a result, that our internal control over financial reporting was not effective as of December 31, 2004.

We are endeavoring to remediate the material weaknesses we have identified and continue to improve and enhance our internal control over financial reporting. If we are unable to improve our internal controls, our ability to report our financial results in a timely and accurate basis could be adversely affected which could have a substantial adverse effect on our ability to operate our business. Deficient internal controls could also cause investors to lose confidence in our reported financial information, which could have a negative effect on the trading price of our stock.

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Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our company is exposed to market risk, changes in interest rates and foreign currency exchange rates, each of which could adversely affect the value of the 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. Conversely, declines in interest rates could have a material impact on interest earnings of our investment portfolio. If market interest rates were to increase immediately and uniformly by 100 basis points from levels at September 30, 2005, the decline in the fair value of the portfolio would be approximately \$152,000. Because we have the ability to hold our fixed income investments until maturity, we do not expect our operating results, financial condition or cash flows to be affected to any significant degree by a sudden change in market interest rates on our securities portfolio.

Foreign currency risk

Currently, substantially all of our revenue is denominated in U.S. dollars. We price certain international sales to the United Kingdom in British 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 British 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, a strengthening U.S. dollar 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 weakening in the U.S. dollar would result in more net liabilities when converted to U.S. dollars.

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 results of operations or cash flow.

We performed a sensitivity analysis assuming a hypothetical 10.0% adverse movement in foreign exchange rates to the underlying foreign currency exposures described above. The sensitivity analysis indicated that a hypothetical 10.0% adverse movement in foreign currency exchange rates would result in a \$219,000 loss in fair values of foreign currency denominated assets and liabilities at September 30, 2005.

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Item 4. CONTROLS AND PROCEDURES

Under the supervision and with the participation of our management, including our Chief Executive Officer (the CEO) and Chief Financial Officer (the CFO), we have evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based on our evaluation, our CEO and CFO concluded that our disclosure controls and procedures were not effective as of September 30, 2005 to ensure that information required to be disclosed in this report is recorded, processed, summarized and reported within the appropriate time periods. The basis for this determination was that we identified material weaknesses in our internal control over financial reporting as of December 31, 2004, which we view as an integral part of our disclosure controls and procedures. These material weaknesses were first described in our management's report on internal control over financial reporting that is included in Amendment No. 1 to our Form 10-K for the year ended December 31, 2004, which was filed with the Securities and Exchange Commission on May 2, 2005 (Management's Internal Control Report). As of September 30, 2005, certain items of our remediation plan have yet to be fully implemented and others are pending testing as to their effectiveness. As a result we were unable to rely fully on our controls due to untested remediation or unremediated material weaknesses, and therefore additional review, evaluation and oversight were required on the part of management to ensure we adequately compensated for the weaknesses in our internal control over financial reporting.

Our management is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is defined in Rule 13a-15(f) promulgated under the Securities Exchange Act of 1934 and includes those policies and procedures that: (a) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (b) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (c) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Information Management Research, Inc. (IMR) was excluded from management's assessment as of December 31, 2004 because it was acquired by us in a purchase business combination on October 28, 2004 and it was not possible for management to conduct an assessment of IMR's internal control over financial reporting in the period between the consummation date and due date of management's assessment. The exclusion of IMR from our assessment was pursuant to the guidance from the Division of Corporation Finance and Office of the Chief Accountant of the Commission contained in the release captioned Frequently Asked Questions (revised October 6, 2004). At December 31, 2004, IMR represented 23.7% of total consolidated assets and represented 2.4% of total consolidated revenue for the year ended December 31, 2004. Since December 31, 2004 IMR's operations have been integrated into the internal controls and process of the Company and accordingly, the following discussions include the related controls and procedures of the acquired IMR operations.

Material weaknesses in our internal control over financial reporting were identified and reported in Management's Internal Control Report as part of our annual assessment as of December 31, 2004. In addition to our assessment, we included in that report our 2005 remediation plans in response to the identified material weaknesses. We have listed below the nature of the material weaknesses we identified, and the steps we are taking or have implemented to remediate these material weaknesses as of September 30, 2005.

Changes in Internal Control Over Financial Reporting

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We continue to take steps to remediate the material weaknesses identified at December 31, 2004, and to implement, test and remediate controls. However, we will not be able to demonstrate that these material weaknesses have been fully remediated or that controls are operating effectively, until we complete our remediation efforts and both we and our independent registered public accounting firm conduct fiscal year-end processes and assessments of the Company's internal control over financial reporting in connection with the December 31, 2005 annual measurement date. Our remediation efforts involve establishing new policies and procedures which take time to implement and ongoing efforts to monitor in order to ensure the remediated controls are operating as designed.

We may have difficulty achieving our anticipated timing for the remediation efforts. These difficulties may arise as a result of multiple factors, including any new deficiencies in control processes we may identify, unanticipated changes in personnel, or finding that our newly implemented remediation is not operating effectively through testing and assessment to be performed as of December 31, 2005.

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In summary, during the nine month period ended September 30, 2005, we implemented new controls and procedures to specifically address previously identified material weaknesses. Our efforts have been carried out both internally and through the use of outside consultants. Additionally, we have expanded and enhanced our internal capabilities through the hiring and/or seasoning of experienced and knowledgeable personnel within accounting, finance and information technology.

During the first and second quarters of 2005, we began to implement new controls and procedures designed to remediate deficiencies in controls identified and we developed testing plans to evaluate the operating effectiveness of these controls. During the second and third quarters of 2005 we continued implementing remediation plans and conducted internal testing for our internal control over financial reporting. During the third quarter of 2005, we made the following key changes:

1. We hired a Vice President of Information Technology. In addition, the Information Technology Department moved from the Operations area to the Finance and Administration area and now reports to the Chief Financial Officer.
2. We upgraded our deferred revenue and our financial system applications to the current version of the software.
3. We completed an entity level business risk assessment and presented the assessment to the Company's Board of Directors.
4. We completed an assessment of our finance and accounting personnel, our financial and operations information requirements and our information systems.
5. We engaged a third party to provide technical assistance in preparation for our implementation in January 2006 of FAS 123R.

As previously noted, our remediation efforts are subject to our final testing and assessment as of December 31, 2005 and while we believe that the design of our remediation efforts are effective, they may be deemed ineffective due to operational deficiencies or currently unknown design deficiencies discovered prior to our year end assessment.

Based on management's assessment at December 31, 2004 and as disclosed in Management's Internal Control Report, we have identified material weaknesses in our internal control over financial reporting. A material weakness is a significant deficiency (as defined in PCAOB Auditing Standard No. 2), or combination of significant deficiencies, that results in there being more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The following is a summary of the material weaknesses we identified and a summary of the remediation completed through September 30, 2005:

1. We determined that a material weakness exists in that our culture did not establish and promote an environment that results in effective internal control over financial reporting and the generation of reliable financial statements. This material weakness led to additional material weaknesses, as discussed below, that resulted in material adjustments and reclassifications to our consolidated financial statements as of and for the year ended December 31, 2004. This material weakness also resulted in an absence of a comprehensive and effective entity level risk assessment, insufficient information systems support for financial reporting, and a persistent inadequacy in the number of accounting personnel with appropriate technical expertise.

Remediation as of September 30, 2005 Management has continued to make changes within the organization in regards to entity wide controls and procedures. Specifically, a new program has been implemented during 2005 which emphasizes performance planning, communication plans, employee training, and expanded accountability for internal control across the organization to address previously identified deficiencies. Remediation of this area is partly dependant on proactive remediation efforts in place to address the other material weaknesses as described below. These efforts include our completed assessment of both Finance and IT personnel, completion of an entity level business risk assessment process and completion of certain financial automation projects that we believe provide more accurate and timely financial reporting. We have expanded and trained our accounting and financial reporting departments and believe we currently have an adequate number of personnel with sufficient technical knowledge for our business to produce timely and accurate financial reporting.

Changes have also been made to our organizational structure and personnel. During August 2005, we hired a Vice President of Information Technology. In addition, the Information Technology Department moved from the Operations area to the Finance and Administration area and reports to the Chief Financial Officer. We continue to implement changes to personnel and internal controls and procedures within our information technology control environment to ensure our financial reporting and operating systems are adequately supported. We will continue to implement changes and testing; however, initial tests performed in the third quarter indicated that further remediation and training will be required during the remainder of the year which will be considered as part of our final assessment and testing as of the December 31, 2005 measurement date.

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2. We determined that a material weakness exists in that we do not have an adequate entity level business risk assessment process to identify and consider the implications of relevant risks. In addition, there were not sufficient risk assessments conducted to evaluate the impact on internal control over financial reporting of business changes and non-routine financial transactions arising from acquisitions and divestitures and from a broadening and diversification of our business.

Remediation as of September 30, 2005 During September 2005 we completed an entity level business risk assessment and presented the assessment to the Company's Board of Directors. The financial reporting risks are one of the key areas of evaluation in the risk assessment. The on-going risk assessment review process includes a quarterly review to ensure the identification of new and changing risks in a timely manner. We believe this entity level risk assessment process is designed appropriately to address previously identified deficiencies, and will continue to be evaluated through December 31, 2005. We believe that our changes to personnel, including training to existing personnel, have also improved our ability to evaluate non-routine financial transactions and the impacts of operational changes in financial reporting.

3. We determined that a material weakness also exists in our information systems, in that the information systems do not appropriately address the requirements necessary for preparation of timely and accurate financial reports and do not sufficiently support the finance function, resulting in adjustments and reclassifications to our consolidated financial statements as of and for the year ended December 31, 2004. The underlying data reporting structure utilized in the financial reporting application does not adequately address our reporting requirements. The financial application and related information applications and systems are not sufficiently robust and comprehensive, resulting in a lack of automation in the financial close and related financial reporting processes.

Remediation as of September 30, 2005 As of September 30, 2005 we had upgraded our financial system to the current version of the software, implemented Equity Edge for record keeping and reporting of our stock based compensation and implemented a more automated deferred revenue system. An initial control assessment has been performed through the testing of our IT general computer controls. We will continue to make changes in our general computer controls and within our IT control environment for the remainder of the year to address previously identified deficiencies and enhance the internal controls and procedures sufficient to support the financial reporting and operating systems within the Company.

The remediation plan outlined in Management's Internal Control Report included implementation of a revision to our data architecture structure in our financial system application and related systems by the third quarter of 2005. Due to delays in portions of our financial automation projects, the revision to the data architecture structure was not implemented in the third quarter. We evaluated completing the revision to the data reporting structure in the fourth quarter of 2005. We concluded the internal control risks were too high for a project with significant changes to our financial system application so close to the end of the year. We decided to delay the revision to our data reporting structure until fiscal year 2006. Excluding the delay associated with the data reporting revision, we expect to complete all the actions outlined in our remediation plan by the end of 2005.

We do not believe that the delay in the revision to the data architecture structure in itself will result in a material weakness as of the end of the year, however the related controls and systems will be evaluated and subject to our final assessment in conjunction with our complete evaluation of internal control over financial reporting. It is possible that such delay, when combined with current unremediated or unknown deficiencies, may aggregate to a material weakness.

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4. Management has also determined that a lack of sufficient and specialized technical accounting personnel is a material weakness in our internal control over financial reporting. This weakness gave rise to the following material weaknesses, each of which resulted in material adjustments and reclassifications to our consolidated financial statements as of and for the year ended December 31, 2004:

Controls over software revenue recognition were not effective to determine the appropriate application of authoritative accounting literature related to a software contract with exchange rights.

Controls over non-routine and complex transactions were not effective to properly evaluate and account for transactions associated with an acquisition. Specifically, there were errors in recording the revenue and cost of revenue for the fair value of acquired deferred revenue related to the support contracts assumed in the IMR acquisition.

Controls over the calculation of the income tax provision, taxes payable and deferred income tax accounts were not effective. Specifically, supervisory controls did not identify errors in supporting account reconciliations and the application of the appropriate statutory tax requirements.

Controls over the financial close process were not effective. Specifically, sufficient review procedures were not performed resulting in material adjustments to the financial statements for the fourth quarter and for the year ended December 31, 2004.

Remediation as of September 30, 2005 A significant component of our remediation plan was to hire additional qualified accounting and financial reporting personnel and to train existing personnel. We believe our current accounting and financial reporting department includes an adequate number of qualified personnel to ensure accurate and timely financial reporting. Additionally, for some non-routine transactions and complex tax issues, management engages third party technical experts on an ongoing basis. Management also uses the periodic assessment of our finance and accounting personnel to identify and plan for necessary technical training for key accounting personnel. During 2005, we also assigned a dedicated revenue accountant that we believe has the technical expertise required to focus on the revenue recognition controls. We believe that as of September 30, 2005 appropriate internal controls and procedures surrounding the accounting close and financial reporting process have been implemented to correct previously identified deficiencies. We will continue to test the internal controls in place to ensure they are operating effectively for the remainder of the year and as part of our year end close and financial reporting process.

We plan on making refinements to our internal controls during the remainder of the year to continue addressing the previously identified material weaknesses as noted in Management's Internal Control Report. The remediation plan, both those components already implemented and described above and in previous 2005 filings, and those pending implementation, will be subject to testing and our final assessment as of December 31, 2005 to determine their effectiveness. As of September 30, 2005, we believe we have initiated significant remediation efforts to address our material weaknesses identified as of December 31, 2004, and continue to make significant changes in response to our controls and procedures surrounding Information Technology and our overall entity level business risk assessment. The ultimate success and effectiveness of our remediation efforts are subject to proper implementation of pending changes within our Information Technology control environment and within in our entity level business risk assessment. Additionally, our internal controls over financial reporting are subject to our final assessment and testing as well as testing by our independent registered public accounting firm as of December 31, 2005.

Except for the items noted above, there have been no other changes in our internal control over financial reporting during the quarter ended September 30, 2005 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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CAPTARIS, INC.

Part II. OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

One of the services provided by MediaTel Corporation, a wholly owned subsidiary of Captaris, until its business was sold, 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 NFO PLOG and then Northstar Travel Media that listed recipients for these facsimiles. All of the assets of MediaTel were sold to a subsidiary of PTEK Holdings, Inc. (PTEK) on September 1, 2003.

As reported in our Annual Report on Form 10-K for the year ended December 31, 2004 and our Quarterly Report on Form 10-Q for the quarter ended March 31, 2005 (the First Quarter Form 10-Q), on or about July 29, 2003, Travel 100 Group, Inc. (Travel 100) filed three lawsuits in Circuit Court in Cook County, Illinois, one against Mediterranean Shipping Company (Mediterranean), the second against The Melrose Hotel Company (Melrose) and the third against Oceania Cruises (Oceania). On or about April 13, 2004, a fourth lawsuit was filed by another travel agent, Travel Travel Kirkwood, Inc. (Kirkwood), against Oceania Cruises. That case was subsequently removed to the U.S. District Court, Eastern District of Missouri. As reported in the First Quarter 2005 Form 10-Q, the Oceania case was dismissed without prejudice in March 2005. As reported in our Second Quarter 2005 Form 10-Q, in June 2005, the parties entered into a cash settlement of the Kirkwood case, our portion of which was not material, and that case was dismissed with prejudice as to all parties on June 28, 2005.

The complaints in the remaining cases 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 of the Travel 100 complaints seeks injunctive relief and unspecified damages and certification as a class action on behalf of Travel 100 and others similarly situated throughout the United States that received the facsimile advertisements. Under the Telephone Consumer Protection Act, a court can impose liability of \$500 per fax on a party that sends a fax without the consent of the recipient. A court can increase the liability to \$1,500 per fax if the sending of the fax is willful.

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, contribution or breach of contract for any damages suffered by Mediterranean. Similarly, in its answer filed on October 14, 2003, Melrose named Captaris, as well as PTEK, as third-party defendants based on allegations of breach of contract, indemnification and contribution.

In response to Mediterranean s third-party complaint, we filed our answer on November 3, 2003, denying the allegations filed by Mediterranean and further answering by way of affirmative defenses that to the extent we are found liable for any damages allegedly suffered by plaintiffs or any third-party plaintiffs in this action, we are entitled to indemnification and/or contribution from other non-parties to this action. We filed similar answers to the Melrose complaint on November 20, 2003. Both Captaris and MediaTel have denied any liability in the cases because, among other facts and defenses, MediaTel understood that the database and lists of travel agent recipients to whom faxes were sent had authorized that information could be sent to them by fax. Based on Captaris analysis to date, we estimate that there were approximately 500,000 faxes sent relating to the Mediterranean case and approximately 200,000 faxes sent relating to the Melrose case.

Discovery is ongoing in the Melrose and Mediterranean cases and the parties are in the process of working out a schedule for a class certification briefing. We expect the plaintiffs in the Mediterranean case to push for a hearing on class certification in the first quarter of 2006.

We have tendered these claims to our general liability insurance carrier and the carrier has agreed to pay defense costs. In addition, the carrier has paid the settlement amount in the Kirkwood matter. However, the carrier has reserved its rights to contest their duty to indemnify Captaris with respect to the Melrose and Mediterranean matters. Even if coverage is determined to apply to these two matters, since the potential liability of these claims is substantially in excess of our coverage limits, there can be no assurance that our coverage will be sufficient to satisfy any damages we are required to pay.

We intend to vigorously defend each of these cases, but litigation is subject to numerous uncertainties and we are unable to predict the ultimate outcome of any of these matters. Moreover, the amount of any potential liability in connection with these cases will depend, to a large extent, on whether a class is certified, and if one is certified, on what the scope of that class will be, neither of which can be predicted at this time. We have not recorded a liability related to these cases. However, there is no guarantee that we will not determine in the future that an accrual is required or that we will not be required to pay damages in respect of these cases in the future, either of which could materially and adversely affect our results of operations, cash flows and financial condition for the quarter or year in which any accrual is recorded or any damages are paid.

Table of Contents**CAPTARIS, INC.****Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

(c) In January 2005, our Board of Directors approved an \$11.0 million increase to our share repurchase program, which was announced on January 19, 2005, bringing the total available for repurchase under the program to \$15.0 million. During the quarter ended September 30, 2005, we repurchased 377,500 shares of our common stock at approximately \$1.4 million. Approximately \$10.6 million remains available to repurchase shares as of September 30, 2005. 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 has been utilized or (b) our Board of Directors elects to discontinue the repurchase program.

The following table summarizes information regarding shares repurchased during the three months ended September 30, 2005.

| Period | Total Number of Shares Repurchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of the Publicly Announced Repurchase Program | Maximum Approximate Dollar Value of Shares that May Yet be Purchased Under the Program |
|--|---|---|--|---|
| July 1 through 31, 2005 | | | | \$ 12,006,183 |
| August 1 through 31, 2005 | 293,400 | \$ 3.84 | 293,400 | 10,878,166 |
| September 1 through 30, 2005 | 84,100 | 3.81 | 84,100 | 10,557,766 |
| Three months ended September 30, 2005 | 377,500 | \$ 3.84 | 377,500 | \$ 10,557,766 |

Item 6. EXHIBITS**Exhibits**

| | |
|-------|---|
| 10.1* | Form of Amendment of Option Agreement (incorporated by reference to Captaris, Inc. Current Report on Form 8-K dated as of September 1, 2005). |
| 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) |

* Management contract of compensatory plan or arrangement.

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CAPTARIS, INC.

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 4th day of November 2005.

CAPTARIS, INC.

By: /s/ PETER PAPANO
Peter Papano
Chief Financial Officer and Secretary