

CAPTARIS INC  
Form 10-Q  
August 06, 2007  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

\_\_\_\_\_  
**FORM 10-Q**  
\_\_\_\_\_

(Mark One)

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

For the quarterly period ended June 30, 2007

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)

\_\_\_\_\_

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

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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 a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

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 August 1, 2007 was 27,167,076

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**CAPTARIS, INC.**

**FORM 10-Q**

**For the Quarter Ended June 30, 2007**

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**CAPTARIS, INC.**

**Forward-Looking Statements**

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, or similar 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 that may cause our actual results to differ materially from any forward-looking statements. Factors that could affect Captaris' actual results include, without limitation:

Quarterly and seasonal fluctuations in operating results, which may negatively impact the trading price of our common stock.

Our inability to compete successfully against current and future competitors.

Our inability to meet technology and customer demands in a rapidly changing industry.

Our inability to integrate recent and future acquisitions.

Our inability to obtain fax processing circuit boards and related software, including Fax Over Internet Protocol ( FOIP ), a key component of our RightFax product, on acceptable terms, which may be affected by significant changes in technology, issues regarding quality performance, delays, interruptions or reductions in our supply, or unfavorable changes to price and delivery terms.

Our inability to maintain or expand our network of resellers, distributors and Information Technology ( IT ) service providers.

Our inability to establish and maintain Original Equipment Manufacturers ( OEM ) and strategic relationships.

Our inability to maintain and expand our international operations, which are subject to numerous risks, including, difficulty in adapting products to local languages and technologies, regulatory requirements, exchange rate fluctuations, restrictive governmental actions, import/export licensing requirements, limits on the repatriation of funds, longer receivables cycles, staffing/managing international operations, adverse tax consequences and changing local and international environments.

Our inability to affect and forestall potential declines in the average sales prices on our products which could cause our overall gross margins to decline.

Our inability to protect our proprietary rights or to operate without infringing the patents and proprietary rights of others.

Ongoing litigation matters and disputes, including litigation related to the Telephone Consumer Protection Act (as further described under Legal Proceedings in this report).

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Our inability to protect against security breaches and exposure of confidential data, which if breached could subject us to litigation, liability and decreased market acceptance of our products.

Our inability to attract and retain qualified employees.

More information about factors that potentially could affect Captaris' s financial results is included under Item 1A "Risk Factors" in our most recent Annual Report on Form 10-K and in other Quarterly Reports on Form 10-Q filed by us with the Securities and Exchange Commission ( "SEC" ). Readers are cautioned not to place undue reliance upon these forward-looking statements that speak only as to the date of this report. Except as required by law, Captaris undertakes no obligation to update any forward-looking or other statements in this report whether as a result of new information, future events or otherwise.

**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. FINANCIAL STATEMENTS****CAPTARIS, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS****(in thousands, except per share amounts)****(unaudited)**

	<b>June 30,</b>	<b>December 31,</b>
	<b>2007</b>	<b>2006</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 17,659	\$ 10,695
Short-term investments, available-for-sale	3,421	7,084
Accounts receivable, net	15,324	21,347
Inventories, net	613	961
Prepaid expenses and other current assets	4,000	2,971
Income tax receivable and current deferred tax assets, net	2,321	3,052
<b>Total current assets</b>	<b>43,338</b>	<b>46,110</b>
Long-term investments, available-for-sale	40,129	41,584
Restricted cash	1,000	1,000
Other long-term assets	312	303
Equipment and leasehold improvements, net	6,020	4,340
Intangible assets, net	5,325	6,570
Goodwill	32,916	32,199
Long-term deferred tax assets, net	5,278	3,842
<b>Total assets</b>	<b>\$ 134,318</b>	<b>\$ 135,948</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 4,731	\$ 5,308
Accrued compensation and benefits	3,583	4,522
Other accrued liabilities	1,915	1,920
Income taxes payable	294	192
Deferred revenue	21,029	20,328
<b>Total current liabilities</b>	<b>31,552</b>	<b>32,720</b>
Other long-term accrued liabilities	618	307
Long-term deferred revenue	6,130	5,544
<b>Total liabilities</b>	<b>38,300</b>	<b>38,121</b>
Commitments and contingencies		

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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; 27,248 and 27,556 issued and outstanding, respectively	272	275
Additional paid-in capital	44,585	46,614
Retained earnings	49,307	49,790
Accumulated other comprehensive income	1,854	1,148
Total shareholders' equity	96,018	97,827
Total liabilities and shareholders' equity	\$ 134,318	\$ 135,948

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 amounts)

(unaudited)

	Quarter Ended		Six Months Ended	
	June 30,	June 30,	June 30,	June 30,
	2007	2006	2007	2006
Net revenue	\$ 22,966	\$ 22,630	\$ 43,479	\$ 42,203
Cost of revenue	6,893	6,761	13,151	12,414
Gross profit	16,073	15,869	30,328	29,789
Operating expenses:				
Research and development	3,633	3,189	6,819	6,358
Selling and marketing	8,900	8,676	17,178	15,973
General and administrative	4,102	3,902	8,818	8,210
Amortization of intangible assets	142	354	283	708
Gain on sale of discontinued product line CallXpress			(1,000)	(1,000)
Total operating expenses	16,777	16,121	32,098	30,249
Operating loss	(704)	(252)	(1,770)	(460)
Other income (expense):				
Interest income	548	441	1,123	913
Other income (expense), net	82	(69)	226	(91)
Other income	630	372	1,349	822
Income (loss) from continuing operations before income tax expense	(74)	120	(421)	362
Income tax expense	90	87	6	296
Income (loss) from continuing operations	(164)	33	(427)	66
Discontinued operations:				
Gain (loss) on sale of MediaTel assets, net of income tax expense (benefit) of (\$1), (\$3), (\$2) and \$28, respectively respectively	(1)	(5)	(3)	43
Income (loss) from discontinued operations	(1)	(5)	(3)	43
Net income (loss)	\$ (165)	\$ 28	\$ (430)	\$ 109
<b>Basic net income (loss) per common share:</b>				
Income (loss) from continuing operations	\$ (0.01)	\$ 0.00	\$ (0.02)	\$ 0.00
Income (loss) from discontinued operations	(0.00)	0.00	(0.00)	0.00
Basic net income (loss)	\$ (0.01)	\$ 0.00	\$ (0.02)	\$ 0.00



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**Diluted net income (loss) per common share:**

Income (loss) from continuing operations	\$ (0.01)	\$ 0.00	\$ (0.02)	\$ 0.00
Income (loss) from discontinued operations	(0.00)	0.00	(0.00)	0.00

Diluted net income (loss) \$ (0.01) \$ 0.00 \$ (0.02) \$ 0.00

**Weighted average shares used in computation of:**

Basic net income (loss) per share	27,223	28,191	27,368	28,269
Diluted net income (loss) per share	27,223	28,526	27,368	28,546

See the accompanying notes to unaudited condensed consolidated financial statements.

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

	<b>June 30,</b>	<b>December 31,</b>
	<b>2007</b>	<b>2006</b>
Cash flows from operating activities:		
Net income (loss)	\$ (430)	\$ 109
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation	1,317	1,658
Amortization	1,244	1,670
Stock-based compensation expense	532	241
Provision for doubtful accounts	15	39
Loss on disposition of assets	58	54
Changes in assets and liabilities:		
Accounts receivable	5,995	3,727
Inventories, net	347	(207)
Prepaid expenses and other assets	(1,038)	(1,001)
Income tax receivable and deferred tax assets, net	(705)	27
Accounts payable	(909)	(178)
Accrued compensation and benefits	(937)	(414)
Other accrued liabilities	(57)	(545)
Income taxes payable	103	(8)
Deferred revenue	1,290	1,262
<b>Net cash provided by operating activities</b>	<b>6,825</b>	<b>6,434</b>
Cash flows from investing activities:		
Purchase of equipment and leasehold improvements	(2,433)	(426)
Purchase of investments	(16,569)	(34,240)
Proceeds from disposals of assets	55	7
Proceeds from sales and maturities of investments	21,683	30,005
<b>Net cash provided by (used in) investing activities</b>	<b>2,736</b>	<b>(4,654)</b>
Cash flows from financing activities:		
Proceeds from exercise of common stock options	2,037	1,007
Repurchase of common stock	(4,895)	(2,384)
Excess tax benefits from stock-based compensation	294	233
<b>Net cash used in financing activities</b>	<b>(2,564)</b>	<b>(1,144)</b>
<b>Net increase in cash</b>	<b>6,997</b>	<b>636</b>
Effect of exchange rate changes on cash	(33)	(44)
Cash and cash equivalents at beginning of period	10,695	6,420

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Cash and cash equivalents at end of period	\$ 17,659	\$ 7,012
<b>Supplemental disclosures:</b>		
Cash paid during the period for income taxes	\$ 199	\$ 86
<b>Software acquired with three year payment terms:</b>		
Fair value of software acquired	\$ 935	\$
Cash paid for the software	(301)	
Liabilities assumed	\$ 634	\$

See the accompanying notes to unaudited condensed consolidated financial statements.

**Table of Contents****CAPTARIS, INC.****CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY**

(in thousands, except share amounts)

(unaudited)

	Common Shares	Common Stock	Additional Paid-in Capital	Accumulated Other Comprehensive Income	Retained Earnings	Total Shareholders' Equity	Total Comprehensive Income(loss)
Balance at December 31, 2006	27,555,847	\$ 275	\$ 46,614	\$ 1,148	\$ 49,790	\$ 97,827	\$
Exercise of stock options	453,666	5	2,032			2,037	
Repurchase of common stock	(761,900)	(8)	(4,887)			(4,895)	
Stock-based compensation expense			532			532	
Tax benefit from stock-based compensation			294			294	
Unrealized loss on investments, net of income tax benefit of \$2				(3)		(3)	(3)
Cumulative effect of adoption of FASB Interpretation No. 48					(53)	(53)	
Foreign currency translation adjustment				709		709	709
Net loss					(430)	(430)	(430)
Balance at June 30, 2007	27,247,613	\$ 272	\$ 44,585	\$ 1,854	\$ 49,307	\$ 96,018	\$ 276

See the accompanying notes to unaudited condensed consolidated financial statements.

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**CAPTARIS, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(unaudited)**

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

***The Business***

We develop software products that automate business processes, manage documents electronically and provide efficient information delivery.

***Basis of Presentation and Preparation***

The accompanying unaudited condensed consolidated financial statements as of June 30, 2007, and December 31, 2006, and for the quarter and six months ended June 30, 2007 and 2006, have been prepared in accordance with accounting principles generally accepted in the United States of America and pursuant to the rules and regulations of the Securities and Exchange Commission ( SEC ). Certain information and footnote disclosures normally included in annual financial statements 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, 2006. In the opinion of management, these condensed consolidated financial statements reflect all adjustments, consisting of normal and recurring adjustments and accruals, necessary for a fair presentation of our financial condition, results of operations and cash flows for the periods indicated.

***Principles of Consolidation***

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.

***Use of Estimates***

The preparation of our condensed 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 appropriate accrual and disclosure 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.

***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 ) and other channel partners, as well as directly to end-users. Generally our resellers do not stock product, and 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. If a reseller does stock product, we defer this revenue until the reseller sells the product through to end-users. 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 concurrently record an estimate for the related cost of the telephone support. Revenue from perpetual software licenses is recognized when the software has been shipped, provided that collection for such revenue is deemed probable. 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

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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

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**CAPTARIS, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(unaudited)**

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.

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 not granted return rights at the time of sale. However, historically, we have accepted returns and therefore, we reduce revenue recognized for estimated product returns. If we do grant return rights and cannot reasonably estimate returns, we defer the revenue until the return rights lapse. 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. 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.

Professional services are customarily billed at fixed rates plus out-of-pocket expenses. Revenue is recognized when the service 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.

***Stock-Based Compensation***

Our equity option plans are broad-based, long-term retention programs that are intended to attract and retain talented employees and align shareholder and employee interest. We rely on our share-based compensation plans that provide broad discretion to our Board of Directors to create appropriate share-based incentives for members of our Board of Directors, executives and select employees.

We account for stock-based compensation under the provisions of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 123(R), *Share-Based Payment*, (SFAS No. 123R), which requires us to recognize expense related to the fair value of our stock-based compensation. We adopted SFAS No. 123R using the modified prospective transition method. Under this method, compensation cost recognized for the quarter and six months ended June 30, 2007 and 2006 includes: a) compensation cost for all stock-based compensation granted prior to, but not vested as of January 1, 2006, based on the grant-date fair value estimated in accordance with the original provisions of SFAS No. 123, and b) compensation cost for all stock-based compensation granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123R. We chose the straight-line method for recognizing compensation expense. For all unvested options outstanding as of January 1, 2006, the previously measured but unrecognized compensation expense, based on the fair value at the original grant date, will be recognized on an accelerated basis over the remaining vesting period. For stock-based compensation granted subsequent to January 1, 2006, compensation expense, based on the fair value on the date of grant, will be recognized on a straight-line basis over the vesting period.

***Impairment of goodwill***

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. Our 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

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write-down could have a material adverse effect on our financial condition and results of operations. We test goodwill 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 2007 and determined our goodwill at March 31, 2007 was not impaired.



**Table of Contents****CAPTARIS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(unaudited)*****Impairment of intangibles***

We periodically review our intangibles that are more likely than not to be sold or otherwise disposed 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 asset 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 intangibles. We determined that no impairment indicators occurred during the first half of 2007; therefore, we have not evaluated our intangible assets for impairment as of June 30, 2007. Future events could cause us to conclude that impairment indicators exist and that the assets should be reviewed to determine their fair value. We assess the assets for impairment based on the estimated future undiscounted cash flows expected to result from the use of the assets and their eventual disposition. If the carrying amount of an asset exceeds its estimated future undiscounted cash flows, an impairment loss is recorded for the excess of the asset's carrying amount over its fair value. Fair value is generally determined based on a valuation process that provides an estimate of a fair value of these assets using a discounted cash flow model, which 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.

***Net Income (Loss) Per Common Share***

Basic net income (loss) per common share was computed by dividing net income (loss) by the weighted average number of shares of common stock outstanding during the period, including vested deferred stock units. Diluted net income (loss) per common share was computed by dividing net income (loss) by the sum of (1) the basic weighted average number of shares of common stock outstanding during the period and (2) additional shares that would have been issued, including unvested deferred stock units, 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 income (loss) per common share:

(in thousands, except per share amounts)	Quarter Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
<b>Numerator:</b>				
Income (loss) from continuing operations	\$ (164)	\$ 33	\$ (427)	\$ 66
Income (loss) from discontinued operations	(1)	(5)	(3)	43
Net income (loss)	\$ (165)	\$ 28	\$ (430)	\$ 109
<b>Denominator:</b>				
Weighted average shares outstanding - basic	27,223	28,191	27,368	28,269
Dilutive effect of common shares from stock options		335		277
Weighted average shares outstanding - diluted	27,223	28,526	27,368	28,546
<b>Basic net income (loss) per common share:</b>				
Income (loss) from continuing operations	\$ (0.01)	\$ 0.00	\$ (0.02)	\$ 0.00
Income (loss) from discontinued operations	(0.00)	(0.00)	(0.00)	0.00

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Basic net income (loss)	\$ (0.01)	\$ 0.00	\$ (0.02)	\$ 0.00
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**Diluted net income (loss) per common share:**

Income (loss) from continuing operations	\$ (0.01)	\$ 0.00	\$ (0.02)	\$ 0.00
Income (loss) from discontinued operations	(0.00)	(0.00)	(0.00)	0.00

Diluted net income (loss)	\$ (0.01)	\$ 0.00	\$ (0.02)	\$ 0.00
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Due to the net loss from continuing operations in the quarter and six months ended June 30, 2007, we excluded 562,534 and 1,001,964 of common stock equivalents from the calculation of diluted loss per share because such securities were anti-dilutive in these periods. Employee stock options to purchase 3,423,991 and 4,187,511 common shares in the quarters ended June 30, 2007 and 2006, respectively, and 782,710 and 3,959,054 common shares in the six months ended June 30, 2007 and 2006, respectively, were outstanding, but were not included in the computation of diluted income (loss) per share because the exercise price of the stock options were greater than the average share price of the common shares; therefore, the effect would have been anti-dilutive.

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For segment reporting purposes, we operate in one segment. Our results of operations may fluctuate as a result of seasonal factors. In recent years, our product lines have experienced 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.

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

(in thousands)	Quarter Ended		Six Months Ended	
	June 30,		June 30,	
	2007	2006	2007	2006
North America	\$ 16,595	\$ 16,770	\$ 31,839	\$ 31,762
Europe	2,968	2,938	5,450	5,447
Asia Pacific	1,811	1,410	3,238	2,433
Rest of world	1,592	1,512	2,952	2,561
<b>Total net revenue</b>	<b>\$ 22,966</b>	<b>\$ 22,630</b>	<b>\$ 43,479</b>	<b>\$ 42,203</b>

Revenue from the rest of world consists primarily of sales to the Middle East, Africa, India and countries in the Latin America region. Revenue for the United States was \$15.8 million and \$15.9 million for the quarters ended June 30, 2007 and 2006, respectively and \$30.2 million and \$30.2 million for the six months ended June 30, 2007 and 2006, respectively.

**3. Stock-Based Compensation**

Included in stock-based compensation are expenses relating to both our stock options and our deferred stock units. The amount of stock-based compensation expense, net of forfeitures, recognized in the quarters ended June 30, 2007 and 2006 related to stock options and deferred stock units was \$339,000 and \$151,000, respectively, of which \$11,000 and \$65,000, respectively, related to options granted prior to January 1, 2006. The amount of stock-based compensation expenses, net of forfeitures, recognized in the six months ended June 30, 2007 and 2006 related to stock options and deferred stock units was \$532,000 and \$241,000, respectively, of which \$24,000 and \$152,000, respectively, related to options granted prior to January 1, 2006. Total unamortized compensation expense at June 30, 2007 was \$3.7 million, net of forfeitures, which will be recognized over a weighted average period of three years.

The following table summarizes the allocation of stock-based compensation to our expense categories for the periods indicated:

(in thousands)	Quarter Ended		Six Months Ended	
	June 30,		June 30,	
	2007	2006	2007	2006
Cost of revenue	\$ 6	\$ 3	\$ 10	\$ 3
Research and development	28	13	39	24
Selling and marketing	57	31	86	51
General and administrative	248	104	397	163

Total stock-based compensation expense	\$ 339	\$ 151	\$ 532	\$ 241
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The following weighted average assumptions were used in the Black-Scholes option pricing model to determine the fair value of stock options granted in the periods indicated:

	Quarter Ended		Six Months	
	June 30, 2007	2006	Ended June 30, 2007	2006
Dividend yield	0.0%	0.0%	0.0%	0.0%
Risk-free interest rate	4.92%	4.91%	4.64%	4.87%
Expected volatility	40.53%	53.9%	41.75%	53.9%
Expected term	5.27	5.3	5.27	5.3

We have not declared or paid any dividends and do not currently expect to do so in the future. The risk-free interest rate used in the Black-Scholes valuation model is based on the implied yield currently available in U.S. Treasury securities at maturity with an equivalent term. Expected volatility is based on the annualized daily historical volatility plus implied volatility of our stock price, including consideration of the implied volatility and market prices of traded options for comparable entities within our industry. The expected term of options represents the period that our stock-based awards are expected to be outstanding and was determined based on historical weighted average holding periods and projected holding periods for the remaining unexercised shares. Consideration was given to the contractual terms of our stock-based awards, vesting schedules and expectations of future employee behavior.

Our stock price volatility and option lives reflect our best estimates, both of which impact the fair value of the option calculated under the Black-Scholes methodology and, ultimately, the expense that will be recognized over the life of the option. SFAS No. 123R also requires that we recognize compensation expense for only the portion of options expected to vest; therefore, we applied an estimated forfeiture rate that we derived from historical employee termination behavior. If the actual number of forfeitures differs from our estimates, additional adjustments to compensation expense may be required in future periods.

**Stock Options**

Stock-based compensation expense related to stock options was \$258,000 and \$140,000 in the second quarters of 2007 and 2006, respectively and \$402,000 and \$230,000 in the six months ended June 30, 2007 and 2006, respectively. At June 30, 2007, total unamortized deferred compensation costs related to stock options was \$2.9 million, net of estimated forfeitures. Total unamortized deferred compensation cost will be adjusted for future changes in estimated forfeitures and is expected to be recognized over a weighted average period of three years.

A summary of the status of our stock option plans at June 30, 2007, and the changes during the six months then ended, is presented in the following table:

	Options Available for Grant	Number of Options Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)
Beginning of period at December 31, 2006	3,343,414	5,034,696	\$ 5.03	6.64
Granted <sup>(1)</sup>	(1,265,143)	972,695	5.62	
Exercised		(453,666)	4.49	
Cancelled	196,037		5.58	

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Forfeited		(157,696)	4.59	
Expired	(82,116)	(38,341)	9.64	
End of period	2,192,192	5,357,688	5.16	6.41
Vested and expected to vest at June 30, 2007		4,830,500	5.18	6.11
Exercisable at June 30, 2007		3,629,698	5.23	5.11

<sup>(1)</sup> The difference in shares granted under options available for grant and number of options outstanding is due to deferred stock unit grants. In accordance with the 2006 Plan, each deferred stock unit granted is to be counted as two shares against the number of shares available for issuance.

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During the second quarters of 2007 and 2006, we granted 264,020 and 954,811 options, respectively, with a weighted average Black-Scholes fair value of \$2.24 and \$2.40 per share, respectively. In the six months ended June 30, 2007 and 2006, we granted 972,695 and 1,027,311 options, respectively, with a weighted average Black-Scholes value of \$2.50 and \$2.38 per share, respectively.

The intrinsic value of options exercised during the second quarters of 2007 and 2006, were \$425,000 and \$132,000, respectively, and \$841,000 and \$333,000 for the six months ended June 30, 2007 and 2006, respectively. The aggregate intrinsic value of options outstanding, options vested and expected to vest and options exercisable as of June 30, 2007, were \$2.5 million, \$2.2 million and \$1.8 million, respectively. The intrinsic value is calculated as the difference between the market value of our common stock as of June 30, 2007 and the exercise price of the options. The market value on June 30, 2007 was \$5.11, the average of the high and low stock price as reported by Nasdaq Global Market.

***Deferred Stock Units***

Compensation expense related to deferred stock units was \$80,000 and \$11,000 for the three months ended June 30, 2007 and 2006, respectively, and \$130,000 and \$11,000 for the six months ended June 30, 2007 and 2006, respectively.

Information related to non-vested deferred stock units at June 30, 2007 is as follows:

	Shares	Weighted Average Fair Value	Weighted Average Remaining Contractual Term (in years)
Non-vested at beginning of period	46,624	\$ 4.43	0.44
Awarded	146,224	5.61	5.61
Exercised			
Canceled			
<b>Outstanding at end of period</b>	<b>192,848</b>	<b>5.32</b>	<b>3.64</b>
Ending expected to vest	192,848	5.32	3.64
<b>Ending exercisable</b>	<b>47,848</b>	<b>4.48</b>	

The aggregate intrinsic value of deferred stock units outstanding, vested or expected to vest and exercisable as of June 30, 2007 was \$985,000, \$741,000 and \$245,000, respectively.

Total unamortized deferred compensation expense related to deferred stock units at June 30, 2007 was \$766,000, net of estimated forfeitures, which will be recognized over a weighted average period of four years.

**4. Stock Repurchase Program**

We repurchase our stock under a Rule 10b5-1 repurchase plan and in the case of any discretionary purchases outside of the plan, subject to open trading windows, overall market conditions, our stock price and our cash position and other requirements, authorized by our Board of Directors. This plan facilitates the repurchase of our common shares in accordance with our previously announced stock repurchase program. A Rule 10b5-1 repurchase plan allows the purchase of our common shares at times when we ordinarily would not be in the market because of

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self-imposed trading blackout periods.

Pursuant to our repurchase plan, during the quarters ended June 30, 2007 and 2006, we repurchased 400,000 and 366,791 of our common shares for \$2.2 million and \$1.5 million, respectively, during the six months ended June 30, 2007 and 2006, we repurchased 761,900 and 553,746 of our common shares for \$4.9 million and \$2.4 million, respectively. Between July 1, 2007 and July 31, 2007 we repurchased an additional 210,000 shares under our repurchase plan for \$1.1 million.

On June 7, 2007, our Board of Directors approved a \$6.5 million increase to our stock repurchase program, bringing the amount available for repurchase to \$15.0 million. At June 30, 2007, approximately \$14.2 million was available under our repurchase plan. We may repurchase shares in the future subject to the rules of our 10b5-1 repurchase plan and in the case of any discretionary purchases outside of the plan, subject to open trading windows, overall market conditions, our stock price and our cash position and other requirements. The repurchase plan 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 plan.



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**CAPTARIS, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(unaudited)**

**5. Commitments and 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 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.

**6. Comprehensive Income**

Total comprehensive income for the quarter ended June 30, 2007 was \$497,000 compared to comprehensive income of \$609,000 for the quarter ended June 30, 2006. For the six months ended June 30, 2007, total comprehensive income was \$276,000 compared to income of \$713,000 for the six months ended June 30, 2006. The primary difference between net income (loss) as reported and comprehensive income (loss) are foreign currency translation adjustments and unrealized gains (losses), net of income taxes, on our investment portfolio.

**7. Sale of CallXpress Product Line**

In September of 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. In March 2007 and March 2006, we received cash payments of \$1.0 million, confirming achievement of the revenue targets for 2006 and 2005. These cash receipts were classified on our income statement as a credit to operating expenses in the first quarters of 2007 and 2006. The payment received in March 2007 is the final payment to be received under this agreement.

**8. Legal Proceedings**

As reported in our Annual Report on Form 10-K for the year ended December 31, 2006, Captaris has been involved in two ongoing lawsuits in Circuit Court in Cook County, Illinois. Both lawsuits were filed by Travel 100 Group, Inc. ( Travel 100 ), one against Mediterranean Shipping Company ( Mediterranean ) and the other against The Melrose Hotel Company ( Melrose ). The complaints allege violations of the Telephone Consumer Protection Act in connection with the receipt of facsimile advertisements that were transmitted by MediaTel Corporation, a wholly owned subsidiary of Captaris, on behalf of travel service providers, including Mediterranean and Melrose. All of the assets of MediaTel were sold to a subsidiary of PTEK Holdings, Inc. on September 1, 2003.

Each of the Travel 100 complaints sought 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. Both Mediterranean and Melrose named Captaris as a third-party defendant and asserted that, to the extent that they are liable, Captaris should be liable under theories of indemnification, contribution or breach of contract for any damages suffered by them. 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.

On July 28, 2006, the court in the Melrose case entered final approval of a settlement between the plaintiffs and Melrose. Under the settlement agreement, Melrose retained its right to pursue its claims for contribution against Captaris and MediaTel. Melrose subsequently settled these claims with Captaris and MediaTel without any material liability to Captaris or MediaTel and all claims against Captaris and MediaTel were dismissed with prejudice on January 24, 2007, bringing to a close the Melrose litigation.

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On September 29, 2006, the court in the Mediterranean case granted summary judgment in favor of Mediterranean and Captaris and dismissed the case. In granting summary judgment, the court ruled that Travel 100 had invited the facsimile advertisements and there was no violation of the Telephone Consumer Protection Act. Travel 100 filed a motion for reconsideration, which the court denied. Travel 100 then filed a notice of appeal on December 29, 2006. On July 20, 2007, Travel 100 filed their Appellate brief. At this time, no date has been set for oral argument on this matter. There can be no assurance that we will be successful in defending the appeal.

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**CAPTARIS, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(unaudited)**

Our insurance carrier paid the settlement amount in the Melrose matter. In the Mediterranean matter, our carrier has agreed to pay defense costs, but has reserved its rights to contest their duty to indemnify Captaris with respect to this matter. We intend to vigorously defend the appeal of the Mediterranean summary judgment ruling; however, litigation is subject to numerous uncertainties and we are unable to predict the ultimate outcome of the Mediterranean case. There is no guarantee that we will not be required to pay damages in respect of this case in the future, 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.

**9. 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 taxes, tax exempt interest income and accruals for certain tax exposures discussed above. We recorded an income tax provision of \$90,000 and \$87,000 in the quarters ended June 30, 2007 and 2006, respectively, on income (loss) from continuing operations. In addition, we recorded an income tax provision of \$6,000 and \$296,000, respectively, on income (loss) from continuing operations for the six months ended June 30, 2007 and 2006. For the six months ended June 30, 2007, we recorded additional income tax expense of approximately \$63,000 primarily related to a change in estimate of our blended effective state tax rate. For the six months ended June 30, 2006 we recorded additional income tax expense of approximately \$187,000 primarily related to additional federal income tax expense on state net operating loss carry forwards and a change in estimate of our blended effective state tax rate. We expect our effective tax rate for the remainder of 2007 to range from approximately 13 to 19%.

At June 30, 2007, we have available unused net operating losses that may be applied against future taxable income. These net operating losses consist of international losses of \$2.3 million that do not expire, federal losses of \$9.3 million that expire from 2019 to 2027, and state losses of \$14.5 million which expire from 2007 to 2027. We believe that there is sufficient positive evidence to support our conclusion not to record a valuation allowance against these net operating losses. We believe that we will utilize the loss carry forwards in the future because we have had a history of pre-tax income. In addition, it is projected that the Internal Revenue Code ( IRC ) Section 382 limitation for the acquired net operating losses will not prohibit the utilization of these losses in the future. At June 30, 2007, our Canadian subsidiary had unused tax attributes of \$1.8 million which primarily consist of investment tax credits. Due to the uncertainty of utilizing these tax attributes within the statute of limitations, we have recorded a full valuation allowance on them at June 30, 2007.

**10. Recent Pronouncements**

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which defines fair value, establishes guidelines for measuring fair value and expands disclosures regarding fair value measurements. SFAS No. 157 does not require any new fair value measurements but rather eliminates inconsistencies in guidance found in various prior accounting pronouncements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. Earlier adoption is permitted, provided the Company has not yet issued financial statements, including for interim periods, for that fiscal year. We are currently evaluating the impact of SFAS No. 157, but do not expect the adoption of SFAS No. 157 to have a material impact on our consolidated financial position, results of operations or cash flows.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115*. Under SFAS No. 159, the Company may elect to measure many financial instruments and certain other items at fair value on an instrument by instrument basis subject to certain restrictions. The Company may adopt SFAS No. 159 at the beginning of 2008.

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The impact of the adoption of SFAS No. 159 will be dependent on the extent to which the Company elects to measure eligible items at fair value. We are currently evaluating the impact of SFAS No. 159, but do not expect the adoption of SFAS No. 159 to have a material impact on our consolidated financial position, results of operations or cash flows.

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**CAPTARIS, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

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**11. Subsequent Events**

On July 10, 2007, the Company through its wholly-owned subsidiary, Merlot Acquisition Corporation, a California corporation ( Merger Sub ) consummated the acquisition of Castelle, a California corporation, pursuant to an agreement and plan of merger by and among Captaris, Castelle and Merger Sub, dated April 25, 2007. In accordance with the terms of the merger agreement, Merger Sub was merged with and into Castelle, with Castelle being the surviving corporation (the *Merger* ), and each issued and outstanding share of Castelle common stock was converted into the right to receive \$4.14 in cash, after the closing adjustments described in the merger agreement. In addition, each outstanding option to purchase shares of Castelle common stock was converted into the right to receive an amount of cash equal to the product of (a) the number of shares as to which such option was vested and exercisable, multiplied by (b) the excess, if any, of the per share merger consideration (\$4.14) over the per share exercise price of such option. The aggregate merger consideration paid by Captaris was approximately \$10.8 million, net of Castelle's cash balance at closing of approximately \$8.5 million.

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**CAPTARIS, INC.**

**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 2006 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 14, 2007.*

*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 at the beginning of this report under Forward-Looking Statements and in Item 1A of our most recent Annual Report on Form 10-K and Quarterly Reports on Form 10-Q filed with the Securities and Exchange Commission. 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 develops software products that automate business processes, manage documents electronically and provide efficient information delivery. With a comprehensive suite of software and services, Captaris specializes in automating paper and other document-centric processes that are found in many organizations. Our customers use our products to reduce costs, comply with regulations and increase the performance of critical business processes and system investments.

Our products and services address business needs in several related markets: the fax server and electronic document delivery market; the business process management market; and the enterprise content management market. We distribute our products primarily through independent distributors, value-added resellers, direct sales professionals and information technology ( IT ) service providers. Our products run on off-the-shelf hardware servers, networked personal computers and Microsoft software platforms including Microsoft® Windows NT, Windows 2000, Windows 2003 and Windows XP and we plan on compatibility with Windows Vista in the third quarter of 2007. We utilize .NET development tools in our suite of products and integrate 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.

We sell, promote and receive referrals for the use of our products primarily through an indirect channel of resellers and distributors, strategic partnerships, Original Equipment Manufacturers ( OEM ) and private label agreements, as well as through our enterprise sales team and national account managers that hold dedicated business relationships with assigned accounts on the Fortune 500 list. We believe the use of multiple distribution channels that access many of the same potential customers increases the likelihood that our products will be sold to a particular customer.

OEM partners market and sell our products and services in conjunction with their own core products and service portfolios, adding more value to their customers with an integrated go-to-market approach. In some cases, these OEM agreements provide minimum revenue commitments.

**Executive Summary**

On July 10, 2007 the Company announced the completion of its acquisition of Castelle (NASDAQ: CSTL). Under the terms of the definitive agreement announced on April 26, 2007, and following approval of the transaction by Castelle's shareholders on July 10, 2007, Captaris acquired all of Castelle's outstanding shares for a purchase price of \$4.14 per share. In addition, each outstanding in-the-money option to purchase shares of Castelle was converted into the right to receive the excess, if any, of the per share purchase price (\$4.14) over the per share exercise price of the option. The aggregate purchase price paid by Captaris was approximately \$10.8 million, net of Castelle's cash balance at closing of approximately \$8.5 million. Castelle's operations will be included in our financial results beginning in the third quarter of 2007.

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**CAPTARIS, INC.**

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

**(Continued)**

Net revenue is calculated as the selling price of our products less estimated returns. We derive net revenue primarily from licensing software as well as follow on sales of add-on software modules, incremental capacity and the sale of maintenance, support and service agreements, professional services and the resale of fax boards ( hardware ). Revenue for the quarter and six months ended June 30, 2007 was \$23.0 million and \$43.5 million, respectively and represented an increase over the same periods in 2006 of 1.5% and 3.0% respectively. The overall increase in revenue was driven by continued growth of maintenance, support and services revenue partially offset by a decline in hardware revenue.

Software revenue increased 1.6% and decreased 0.4% in the quarter and six months ended June 30, 2007, respectively, over the same periods of 2006. Maintenance, support and services revenue increased 9.3% and 11.0% in the quarter and six months ended June 30, 2007, respectively, over the same periods in 2006. Hardware revenue decreased 11.8% and 6.1% for the quarter and six months ended June 30, 2007, respectively, compared to the same periods in 2006.

Software revenue increased for the quarter ended June 30, 2007 as compared to the quarter ended June 30, 2006 due to increased international software sales. The year over year comparative decrease in software revenue was primarily due to a non-recurring \$750,000 strategic license arrangement recorded in the first quarter of 2006. This multi-year strategic license arrangement with Xpedite expired in September 2006. If the favorable financial impact of this transaction were excluded from the prior year results, instead of the year over year changes noted above, both software revenue and overall net revenue would have increased 4.7% and 4.9%, respectively.

The growth of maintenance, support and service revenue primarily reflects an increase in the sales volume of multi-year support and service agreements.

Hardware revenue decreased for the quarter and six months ended June 30, 2007 in comparison to the same periods in 2006 due to several large customer sales in 2006. We resell fax boards with a significant number of our software products and the volume and associated revenue will vary from period to period depending upon the mix of software sold and customer requirements.

A portion of our revenue is derived from strategic license arrangements and this revenue is difficult to predict and has inherent fluctuations based on the partner's business cycle which may or may not correlate with our business cycle. We anticipate revenue will grow in subsequent quarters in 2007, due to seasonality of our revenue which typically increases over the course of the year, and will grow compared to similar periods in 2006. Additionally, we expect revenue to increase as a result of the third quarter 2007 Castelle acquisition and subsequent consolidation of our joint operating results.

The slight gross profit margin decrease for the six months ended June 30, 2007, in comparison to the prior year, was primarily due to \$750,000 of non-recurring strategic license revenue recorded in 2006. This transaction had no associated cost of revenue and if the favorable financial impact of this transaction were excluded from the prior year results, gross profit increased 4.4% and the 2006 gross profit margin was 70.1%.

We expect our gross profit to be positively effected as a result of the third quarter 2007 Castelle acquisition and subsequent consolidation of our joint operating results. For the balance of 2007 we anticipate our quarterly gross profit margin will remain consistent with the first two quarters of 2007.

Operating expenses increased 4.1% and 6.1% in the quarter and six months ended June 30, 2007, respectively, over the same periods in 2006. These increases were due primarily to a planned expansion in both our domestic and international sales organizations, our International and North America Partner Summits, outsourcing of certain engineering efforts, relocation cost for a new employee and stock compensation cost. Additionally, the year over year increases included severance costs associated with the departure of our Chief Operating Officer and other organizational transitions. In the last two quarters of 2007, we anticipate operating expenses will remain consistent or slightly down as a percentage of revenue compared to 2006.

Loss from continuing operations was \$164,000 and \$427,000 for the quarter and six months ended June 30, 2007, respectively, compared to income from continuing operations of \$33,000 and \$66,000 for the quarter and six months ended June 30, 2006, respectively. The decrease from the prior year was due primarily to the increase in operating expenses detailed above.

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During the quarter and six months ended June 30, 2007, we granted 264,020 and 972,695 options, respectively with a weighted average Black Scholes value of \$2.24 and \$2.50 per share and 45,699 and 146,224 deferred stock units with a weighted



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**CAPTARIS, INC.**

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

**(Continued)**

average value of \$5.20 and \$5.61 per share, respectively. These grants will result in \$2.2 million of expense, net of forfeitures, and will amortize on a straight-line basis over the next one to five years. At June 30, 2007 total unamortized stock based compensation expense was \$3.7 million, net of forfeitures, and will amortize on a straight-line basis over the next one to five years.

Consolidated cash, cash equivalents and investments at June 30, 2007 totaled \$61.2 million, an increase of \$1.8 million from December 31, 2006. This increase was primarily due to net cash from operations (\$6.8 million), proceeds from the exercise of employee stock options (\$2.0 million) and related tax benefits (\$294,000). These increases in cash were partially offset by repurchases of our common stock (\$4.9 million) and capital investments (\$2.4 million). We anticipate our capital spending will remain consistent with the first six months of 2007 in the next two quarters due to planned investments in our IT infrastructure and improvements to our communications infrastructure.

**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 stock options, 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 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 Consolidated Financial Statements in Item 8 of our Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 14, 2007.

Our most critical accounting judgments and estimates 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;

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

Useful lives of equipment, leasehold improvements and intangible assets;

Contingencies;

Stock-based compensation plans; and

Accounting for income taxes.

**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, OEMs and other channel partners, as well as directly to end-users. Generally our resellers do not stock product, and 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;

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**Table of Contents****CAPTARIS, INC.****MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS****(Continued)**

therefore, we recognize this revenue when the software is shipped and concurrently 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 ( 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 product sold to resellers in which we have granted exchange rights, we defer the revenue until the reseller sells the product 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.

We reduce revenue recognized for estimated product returns at the time the related revenue is recorded. If we cannot reasonably estimate returns we defer the revenue until the return rights lapse. 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 revenue is recognized when the consulting services have 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. Historically, our accruals for sales returns have been adequate.

**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 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. At the time 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. Currently, our portfolio consists primarily of money market funds, municipal and U.S.

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government agency-backed securities and is 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. 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 June 30, 2007 our goodwill and intangible assets, net of accumulated amortization, were \$38.2 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.** 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. 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 2007 and determined our goodwill at March 31, 2007, was not impaired.

**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. We determined that no impairment indicators occurred during the second quarter of 2007; therefore, we have not evaluated our intangible assets for impairment as of June 30, 2007. Future events could cause us to conclude that impairment indicators exist and that the assets should be reviewed to determine their fair value. We assess the assets for impairment based on the estimated future undiscounted cash flows expected to result from the use of the assets and their eventual disposition. If the carrying amount of an asset exceeds its estimated future undiscounted cash flows, an impairment loss is recorded for the excess of the asset's carrying amount over its fair value. Fair value is generally determined based on a valuation process that provides an estimate of a fair value of these assets using a discounted cash flow model, which 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 recorded at cost less accumulated amortization and are amortized over their useful lives on a straight-line basis. Useful lives for equipment and leasehold improvements are based on our estimates of the period that the equipment or leasehold improvement will be used, which typically range from two to five years. 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.

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**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 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

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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.

**Stock-Based Compensation Plans.** Our equity option plans are broad-based, long-term retention programs that are intended to attract and retain talented employees and align shareholder and employee interest. We rely on our share-based compensation plans that provide broad discretion to our Board of Directors to create appropriate share-based incentives for members of our Board of Directors, executives and select employees.

We account for stock-based compensation under the provisions of Financial Accounting Standards Board ( FASB ) Statement of Financial Accounting Standards ( SFAS ) No. 123(R), *Share-Based Payment* ( SFAS No. 123R ), which requires us to recognize expense related to the fair value of our stock-based compensation. We adopted SFAS No. 123R using the modified prospective transition method. Under this transition method, compensation cost recognized for the quarter and six months ended June 30, 2007 and 2006 includes: a) compensation cost for all stock-based compensation granted prior to, but not vested as of January 1, 2006, based on the grant-date fair value estimated in accordance with the original provisions of SFAS No. 123, and b) compensation cost for all stock-based compensation granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123R. We chose the straight-line method for recognizing compensation expense. For all unvested options outstanding as of January 1, 2006, the previously measured but unrecognized compensation expense, based on the fair value at the original grant date, will be recognized on an accelerated basis over the remaining vesting period. For stock-based compensation granted subsequent to January 1, 2006, compensation expense, based on the fair value on the date of grant, will be recognized on a straight-line basis over the vesting period.

**Accounting for income taxes.** We follow the asset and liability method of accounting for income taxes as set forth by SFAS No. 109, *Accounting for Income Taxes*, and the provisions of FASB Interpretation No. 48. Accordingly, we are required to estimate our potential income tax claims in each of the jurisdictions in which we operate as part of the process of preparing our consolidated financial statements. 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 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, penalties 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 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. We will establish a valuation allowance to reduce deferred tax assets unless it is more likely than not that we will generate sufficient taxable income to allow for the realization of our deferred net tax assets. The provision for income taxes includes the impact of potential tax claims and changes to accruals and valuation allowances that we consider appropriate, as well as the related penalties and 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**

Net revenue is calculated as the selling price of our products less estimated returns. We derive net revenue from licensing software as well as follow on sales of add-on software modules, incremental capacity and the sale of maintenance, support and service agreements, professional services and the resale of fax boards ( hardware ).

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The following table provides revenue data for the periods indicated (in thousands, except % amounts):

	Quarter Ended June 30,			Six months Ended June 30,		
	2007	2006	Percent Change	2007	2006	Percent Change
Software revenue	\$ 8,363	\$ 8,230	1.6%	\$ 15,456	\$ 15,517	(0.4)%
Maintenance, support and services revenue	9,838	9,000	9.3%	19,217	17,308	11.0%
Hardware revenue	4,765	5,400	(11.8)%	8,806	9,378	(6.1)%
Net revenue	\$ 22,966	\$ 22,630	1.5%	\$ 43,479	\$ 42,203	3.0%

The overall revenue increase was driven by continued growth of maintenance, support and services partially offset by a decline in hardware revenue.

Software revenue increased in the quarter ended June 30, 2007 as compared to the quarter ended June 30, 2006 due to increased international software sales. The year over year comparative decrease in software revenue was primarily due to a non-recurring \$750,000 strategic license arrangement recorded in the first quarter of 2006. This multi-year strategic license arrangement with Xpedite expired in September 2006. If the favorable financial impact of this transaction were excluded from the prior year results, instead of the year over year changes noted above, both software revenue and overall net revenue would have increased 4.7% and 4.4%, respectively.

The growth of maintenance, support and services revenue primarily reflects an increase in the sales volume of multi-year support and service agreements.

Hardware revenue for the quarter and six months ended June 30, 2007 decreased in comparison to the same periods in 2006, due to several large sales to large customers in 2006. We resell fax boards with a significant number of our Rightfax software products and the volume and associated revenue will vary from period to period depending upon the mix of software sold and customer requirements.

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

(in thousands)	Quarter Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
North America	\$ 16,595	\$ 16,770	\$ 31,839	\$ 31,762
Europe	2,968	2,938	5,450	5,447
Asia Pacific	1,811	1,410	3,238	2,433
Rest of world	1,592	1,512	2,952	2,561
Total net revenue	\$ 22,966	\$ 22,630	\$ 43,479	\$ 42,203

International revenue, outside North America, as a percent of total revenue and as determined by shipping destination, was as follows:



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	Quarter Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Software revenue	13.8%	12.7%	12.9%	12.0%
Maintenance, support and services revenue	7.6%	6.2%	7.4%	6.6%
Hardware revenue	6.3%	7.0%	6.4%	6.1%
Net International revenue	27.7%	25.9%	26.7%	24.7%

Revenue from international customers generally does not experience and reflect the same seasonal variabilities as that from North America customers.

We anticipate our revenue will grow modestly in the next two quarters due to the seasonality of our revenue, as well as increase modestly over the same quarters of 2006. As a result of investing in our international sales organization, we expect our international revenue to grow and become a higher percentage of total company revenue. From time to time a portion of our

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revenue comes from strategic license arrangements. Because of the infrequent and irregular occurrence of a strategic license arrangement, the corresponding revenue is difficult to predict with respect to scope and timing. Additionally, we expect revenue to increase as a result of the third quarter 2007 Castelle acquisition and subsequent consolidation of our joint operating results.

**Gross Profit**

Gross profit is calculated as the difference between net revenue and the 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 technical support and costs associated with the delivery of professional services. Gross margin is calculated by dividing gross profit by total revenue.

The following table provides gross profit data for the periods indicated:

	Quarter Ended June 30,			Six Months Ended June 30,		
	2007	2006	Percent change	2007	2006	Percent change
(in thousands, except % amounts)						
Gross profit	\$ 16,073	\$ 15,869	1.3%	\$ 30,328	\$ 29,789	1.8%
Gross profit margin	70.0%	70.1%		69.8%	70.6%	

In comparison to the prior year, gross profit increased slightly for both the quarter and six months ended June 30, 2007, respectively, tracking positively to revenue increases for both of these periods. We expect our gross profit to be positively affected as a result of the third quarter 2007 Castelle acquisition and subsequent consolidation of our joint operating results.

In comparison to the prior year, gross profit margin decreased slightly for both the quarter and six months ended June 30, 2007, respectively. The slight gross profit margin decrease for the six months ended June 30, 2007, in comparison to the prior year, was primarily due to \$750,000 of non-recurring strategic license revenue recorded in 2006. This transaction had no associated cost of revenue and if the favorable financial impact of this transaction were excluded from the prior year results, gross profit increased 4.4% and the 2006 gross profit margin was 70.1%.

For the balance of 2007 we anticipate our quarterly gross profit margin will remain consistent with the first two quarters of 2007.

**Research and Development**

Research and development expenses consist of the salaries and related benefits for our product development personnel, prototype materials and expenses related to the development of new and improved products, facilities and depreciation expenses.

	Quarter Ended June 30,			Six Months Ended June 30,		
	2007	2006	Percent change	2007	2006	Percent change
(in thousands, except % amounts)						
Research and development	\$ 3,633	\$ 3,189	(13.9)%	\$ 6,819	\$ 6,358	(7.3)%
Percentage of revenue	15.8%	14.1%		15.7%	15.1%	

For the quarter ended June 30, 2007, research and development expenses increased \$444,000 compared to the quarter ended June 30, 2006, primarily due to increased staffing costs, including organizational transition costs (\$336,000), an increase in outsourced engineering efforts (\$159,000) and an increase in other expenses (\$32,000). This increase was partially offset by a decrease in depreciation costs (\$83,000) as

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certain assets became fully depreciated.

For the six months ended June 30, 2007, research and development expenses increased \$461,000 compared to the six months ended June 30, 2006, primarily due to increased staffing, including organizational transition cost (\$414,000), an increase in outsourced engineering services (\$152,000) and an increase in other expenses (\$47,000). This increase was partially offset by a decrease in depreciation costs (\$152,000) as certain assets became fully depreciated.

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We expect overall research and development expenses to increase in the remaining quarters of 2007 compared to the first two quarters of 2007 as we continue to maintain our investments in research and development and record additional research and development expenses as a result of the third quarter 2007 Castelle acquisition and subsequent consolidation of our joint operating results.

**Selling and Marketing**

Selling and marketing expenses consist primarily of salaries and benefits, sales commissions, travel expenses and related facilities costs for our sales, business development, marketing and order management personnel. Selling expenses also include professional fees associated with partner development, as well as costs of programs aimed at increasing revenue, such as advertising, trade shows, public relations and other market development programs.

	Quarter Ended June 30,			Six Months Ended June 30,		
	2007	2006	Percent change	2007	2006	Percent change
(in thousands, except % amounts)						
Selling and marketing	\$ 8,900	\$ 8,676	(2.5)%	\$ 17,178	\$ 15,973	(7.0)%
Percentage of revenue	38.7%	38.3%		39.5%	41.0%	

The increase of \$224,000 in selling and marketing expenses for the quarter ended June 30, 2007, compared to the quarter ended June 30, 2006, was due primarily to increases in staffing costs (\$496,000) due to hiring additional personnel in our sales organization, commissions on higher compensation plans (\$163,000) and other expenses (\$46,000). These increases were partially offset by a decrease for marketing programs (\$481,000).

The increase of \$1.2 million in selling and marketing expenses for the six months ended June 30, 2007, compared to the six months ended June 30, 2006, was due primarily to increases in staffing cost due to hiring additional personnel in our sales organization (\$1.0 million), commissions on higher compensation plans (\$469,000), travel and entertainment associated with an increased investment in our sales organization and partner conferences (\$231,000) and other expenses (\$11,000). These increases were partially offset by a decrease in marketing programs (\$442,000) and a reduction in depreciation as certain assets became fully depreciated (\$97,000).

We expect selling and marketing expenses in the third and fourth quarters of 2007 will be higher than the corresponding quarters of 2006 due to increased investment in our sales organization. We also expect to record additional selling and marketing expenses as a result of the third quarter 2007 Castelle acquisition and subsequent consolidation of our joint operating results. We expect selling and marketing expenses to increase in comparison to the first and second quarters of 2007 as a result of revenue seasonality as well as the expenses from investing in our sales organization and the inclusion of Castelle's operating results in our financial results. We expect selling and marketing expenses will remain relatively consistent or slightly down as a percentage of revenue.

**General and Administrative**

General and administrative expenses consist of the salaries, benefits and related costs of our executive, finance, information technology, human resource and legal personnel, third-party professional service fees, bad debt charges, facilities, and depreciation expenses.

	Quarter Ended June 30,			Six Months Ended June 30,		
	2007	2006	Percent change	2007	2006	Percent change
(in thousands, except % amounts)						

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General and administrative	\$ 4,102	\$ 3,902	(5.1)%	\$ 8,818	\$ 8,210	(7.4)%
Percentage of revenue	17.9%	17.2%		20.3%	19.5%	

The \$200,000 increase in general and administrative expenses in the quarter ended June 30, 2007 as compared to the same period last year was due primarily to increases in stock compensation (\$143,000), consulting costs related to our ERP system implementation (\$117,000) and other expenses (\$46,000). These increases were partially offset by a reduction in depreciation as certain assets became fully depreciated (\$106,000).

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The \$608,000 increase in general and administrative expenses in the six months ended June 30, 2007 as compared to the same period last year was due primarily to increases in salaries related to organizational changes including severance costs associated with the departure of our Chief Operating Officer (\$485,000), stock compensation (\$232,000) and consulting costs related to our ERP system implementation (\$95,000). These increases were partially offset by a reduction in depreciation as certain assets became fully depreciated (\$198,000) and a decrease in other expenses (\$6,000).

During the next two quarters we expect general and administrative costs to increase in comparison to the same quarters in the prior year as a result of the third quarter 2007 Castelle acquisition and subsequent consolidation of our joint operating results

**Amortization of Intangible Assets**

Amortization of intangible assets is a result of the acquisitions in prior years of IMR, Teamplate and Infinite Technologies, in addition to amortization expense associated with two nonexclusive license agreements with Syntellect and AudioFax. Amortization expense for acquired core technology and license agreements is recorded in cost of revenue and was \$481,000 and \$962,000 for the quarter and six months ended June 30, 2007, respectively, and \$482,000 and \$963,000 for the quarter and six months ended June 30, 2006, respectively. Amortization expense recorded in operating expenses related to the acquisitions was \$141,000 and \$283,000 for the quarter and six months ended June 30, 2007 and 2006, respectively, and \$354,000 and \$708,000 for the quarter and six months ended June 30, 2006, respectively. The decrease in amortization expense in the quarter and six months ended 2007 compared to 2006 are due to certain intangible assets becoming fully amortized. We expect amortization expense for 2007 to increase for the remainder of 2007, in comparison to 2006, due to the amortization of the Castelle intangibles acquired in July 2007.

**Sale of CallXpress Product Line**

In September of 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. In March 2007 and 2006, we received cash payments of \$1.0 million, confirming achievement of the revenue target for 2006 and 2005. These cash receipts were classified on our income statement in operating expenses in the first quarters of 2007 and 2006. The payment received in March 2007 is the final payment to be received under this agreement.

**Other Income, Net**

Other income, net, consists primarily of investment income and foreign currency transaction gains and losses. For the quarter and six months ended June 30, 2007, net other income was \$630,000 and \$1.3 million, respectively compared to \$372,000 and \$822,000 respectively for the same periods last year. The increase in other income for the quarter ended June 30, 2007 was due primarily to increased interest earned of \$548,000 on larger investment balances and a foreign currency gain of \$131,000. The increase in other income for the six months ended June 30, 2007 was due primarily to increased interest of \$1.1 million on larger investment balances and a foreign currency gain of \$253,000. Assuming interest rates and currency exchange rates remain constant, we expect other income, net to decrease slightly in the next two quarters due to a reduction in cash we used to purchase Castelle.

**Income Tax Expense (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 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, penalties 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 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

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taxes includes the impact of potential tax claims and changes to accruals that we consider appropriate, as well as the related penalties and interest.

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Our effective tax rates differ from the statutory rate primarily due to state income taxes, foreign income taxes, tax exempt interest income and accruals for certain tax exposures discussed above. We recorded an income tax provision of \$90,000 and \$87,000 in the quarters ended June 30, 2007 and 2006, respectively, on income (loss) from continuing operations. In addition, we recorded an income tax provision of \$6,000 and \$296,000, respectively, on income (loss) from continuing operations for the six months ended June 30, 2007 and 2006. For the six months ended June 30, 2007, we recorded additional income tax expense of approximately \$63,000 primarily related to a change in estimate of our blended effective state tax rate. For the six months ended June 30, 2006 we recorded additional income tax expense of approximately \$187,000 primarily related to additional federal income tax expense on state net operating loss carry forwards and a change in estimate of our blended effective state tax rate. We expect our effective tax rate for the remainder of 2007 to range from approximately 13 to 19%.

At June 30, 2007, we have available unused net operating losses that may be applied against future taxable income. These net operating losses consist of international losses of \$2.3 million that do not expire, federal losses of \$9.3 million that expire from 2019 to 2027, and state losses of \$14.5 million which expire from 2007 to 2027. We believe that there is sufficient positive evidence to support our conclusion not to record a valuation allowance against these net operating losses. We believe that we will utilize the loss carry forwards in the future because we have had a history of pre-tax income. In addition, it is projected that the Internal Revenue Code ( IRC ) Section 382 limitation for the acquired net operating losses will not prohibit the utilization of these losses in the future. At June 30, 2007, our Canadian subsidiary had unused tax attributes of \$1.8 million which primarily consist of investment tax credits. Because of the uncertainty of utilizing these tax attributes within the statute of limitations, we have recorded a full valuation allowance on them at June 30, 2007.

**Liquidity and Capital Resources**

Our principal sources of liquidity are our cash, cash equivalents, short-term investments available-for-sale and long-term investments available-for-sale. Our portfolio consists primarily of money market funds and municipal and U.S. government agency-backed securities. Cash, cash equivalents and investments at June 30, 2007 totaled \$61.2 million, up \$1.8 million from December 31, 2006. This increase was due primarily to net cash from operations (\$6.8 million) and proceeds from the exercise of employee stock options (\$2.0 million) and related tax benefits (\$294,000). These increases in cash were partially offset by repurchases of our common stock (\$4.9 million) and capital expenditures (\$2.4 million). We anticipate capital spending will remain consistent with the first six months of 2007 in the next two quarters due to planned investments in our IT infrastructure and improvements to our communications infrastructure.

Cash flow provided by operations during the first six months of 2007 was \$6.8 million compared to cash provided by operations of \$6.4 million during the first six months of 2006. Cash provided by operating activities in the first six months of 2007 was primarily attributable to cash collected from our accounts receivable.

Cash provided by investing activities during the first six months of 2007 was \$2.7 million, consisting primarily of maturities of investments net of purchases of marketable securities (\$5.1 million) partially offset by the purchase of equipment and software (\$2.4 million). Capital asset purchases in the first six months of 2007 were \$2.4 million compared to \$426,000 in the first six months of 2006. We anticipate capital spending will remain consistent with the first six months of 2007 for the next two quarters due to planned improvements in our communications infrastructure and investments in our IT infrastructure.

Cash used in financing activities during the first six months of 2007 was \$2.6 million compared to cash used in financing activities of \$1.1 million during the first six months of 2006. In the first six months of 2007, we repurchased 761,900 shares of our common stock for \$4.9 million under our stock repurchase program. Cash used in financing activities was partially offset by cash provided from the exercise of stock options through our employee stock option plans (\$2.0 million), as well as related excess tax benefits from stock-based compensation (\$294,000). We repurchased 553,746 shares of our common stock for \$2.4 million in the first six months of 2006. This was partially offset by cash provided from the exercise of stock options through our employee stock purchase plan (\$1.0 million) and related excess tax benefits from stock-based compensation (\$233,000).

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.



**Recent Pronouncements**

In September 2006, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards ( SFAS ) No. 157, *Fair Value Measurements*, which defines fair value, establishes guidelines for measuring fair value and expands disclosures regarding fair value measurements. SFAS No. 157 does not require any new fair value measurements but

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**CAPTARIS, INC.**

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

**(Continued)**

rather eliminates inconsistencies in guidance found in various prior accounting pronouncements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. Earlier adoption is permitted, provided the Company has not yet issued financial statements, including for interim periods, for that fiscal year. We are currently evaluating the impact of SFAS No. 157, but do not expect the adoption of SFAS No. 157 to have a material impact on our consolidated financial position, results of operations or cash flows.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* Including an amendment of FASB Statement No. 115. Under SFAS No. 159, the Company may elect to measure many financial instruments and certain other items at fair value on an instrument by instrument basis subject to certain restrictions. The Company may adopt SFAS No. 159 at the beginning of 2008. The impact of the adoption of SFAS No. 159 will be dependent on the extent to which the Company elects to measure eligible items at fair value. We are currently evaluating the impact of SFAS No. 159, but do not expect the adoption of SFAS No. 159 to have a material impact on our consolidated financial position, results of operations or cash flows.

**Subsequent Events**

On July 10, 2007, the Company through its wholly-owned subsidiary, Merlot Acquisition Corporation, a California corporation ( *Merger Sub* ) consummated its acquisition of Castelle, a California corporation, pursuant to an agreement and plan of merger by and among Captaris, Castelle and Merger Sub, dated April 25, 2007. In accordance with the terms of the merger agreement, Merger Sub was merged with and into Castelle, with Castelle being the surviving corporation (the *Merger* ), and each issued and outstanding share of Castelle common stock was converted into the right to receive \$4.14 in cash, after the closing adjustments described in the merger agreement. In addition, each outstanding option to purchase shares of Castelle common stock was converted into the right to receive an amount of cash equal to the product of (a) the number of shares as to which such option was vested and exercisable, multiplied by (b) the excess, if any, of the per share merger consideration (\$4.14) over the per share exercise price of such option. The aggregate merger consideration paid by Captaris was approximately \$10.8 million, net of Castelle's cash balance at closing of approximately \$8.5 million.

**10b5-1 Trading Plans**

In 2004, the Company's Board of Directors adopted securities trading policy guidelines that permit directors, executive officers and certain others to adopt pre-determined plans for trades of company stock in accordance with Rule 10b5-1 under the Securities Exchange Act of 1934. Rule 10b5-1 trading plans are designed to allow those who elect to adopt a plan to gradually diversify their investment portfolio, to minimize the market effect of stock sales by spreading them out over time and to avoid concerns about initiating stock transactions while aware of material, non-public information. Bob Lovely, a Company director, David P. Anastasi, the Company's President and Chief Executive Officer and Peter Papano, the Company's Chief Financial Officer have all adopted Rule 10b5-1 trading plans.

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**CAPTARIS, INC.**

**Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

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

***Interest rate risk***

We maintain an investment portfolio consisting primarily of investment grade interest bearing securities. These securities are classified as available-for-sale securities. The interest bearing securities in our portfolio are subject to interest rate risk and will fall in value if market interest rates increase. 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 June 30, 2007, the decline in the fair value of the portfolio would be approximately \$138,000. 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, our U.S. sales and some international sales are 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. 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.

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.

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 \$1.0 million loss in fair values of foreign currency denominated assets and liabilities at June 30, 2007.

**Item 4. CONTROLS AND PROCEDURES**

**Evaluation of Disclosure Controls and Procedures**

Under the supervision and with the participation of our management, including the chief executive officer and chief financial officer, Captaris has evaluated the effectiveness of its disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended) as of June 30, 2007, the end of the period covered by this report. Based upon that evaluation, the chief executive officer and chief financial officer concluded that these disclosure controls and procedures are effective.

There have been no changes in Captaris internal control over financial reporting during the quarter ended June 30, 2007 that have materially affected, or are reasonably likely to materially affect, Captaris internal control over financial reporting.



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**CAPTARIS, INC.**

**Part II. OTHER INFORMATION**

**Item 1. LEGAL PROCEEDINGS**

As reported in our Annual Report on Form 10-K for the year ended December 31, 2006, Captaris has been involved in two ongoing lawsuits in Circuit Court in Cook County, Illinois. Both lawsuits were filed by Travel 100 Group, Inc. ( Travel 100 ), one against Mediterranean Shipping Company ( Mediterranean ) and the other against The Melrose Hotel Company ( Melrose ). The complaints allege violations of the Telephone Consumer Protection Act in connection with the receipt of facsimile advertisements that were transmitted by MediaTel Corporation, a wholly owned subsidiary of Captaris, on behalf of travel service providers, including Mediterranean and Melrose. All of the assets of MediaTel were sold to a subsidiary of PTEK Holdings, Inc. on September 1, 2003.

Each of the Travel 100 complaints sought 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. Both Mediterranean and Melrose named Captaris as a third-party defendant and asserted that, to the extent that they are liable, Captaris should be liable under theories of indemnification, contribution or breach of contract for any damages suffered by them. 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.

On July 28, 2006, the court in the Melrose case entered final approval of a settlement between the plaintiffs and Melrose. Under the settlement agreement, Melrose retained its right to pursue its claims for contribution against Captaris and MediaTel. Melrose subsequently settled these claims with Captaris and MediaTel without any material liability to Captaris or MediaTel and all claims against Captaris and MediaTel were dismissed with prejudice on January 24, 2007, bringing to a close the Melrose litigation.

On September 29, 2006, the court in the Mediterranean case granted summary judgment in favor of Mediterranean and Captaris and dismissed the case. In granting summary judgment, the court ruled that Travel 100 had invited the facsimile advertisements and there was no violation of the Telephone Consumer Protection Act. Travel 100 filed a motion for reconsideration, which the court denied. Travel 100 then filed a notice of appeal on December 29, 2006. On July 20, 2007, Travel 100 filed their Appellate brief. At this time, no date has been set for oral argument on this matter. There can be no assurance that we will be successful in defending the appeal.

Our insurance carrier paid the settlement amount in the Melrose matter. In the Mediterranean matter, our carrier has agreed to pay defense costs, but has reserved its rights to contest their duty to indemnify Captaris with respect to this matter. We intend to vigorously defend the appeal of the Mediterranean summary judgment ruling; however, litigation is subject to numerous uncertainties and we are unable to predict the ultimate outcome of the Mediterranean case. There is no guarantee that we will not be required to pay damages in respect of this case in the future, 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.

**Item 1A. RISK FACTORS**

There have been no material changes from the risk factors set forth in Part I, Item 1A in our Annual Report on Form 10-K for the year ended December 31, 2006 filed with the Securities and Exchange Commission on March 14, 2007.

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

(c) Pursuant to a stock repurchase plan approved by our Board of Directors, during the quarters ended June 30, 2007 and 2006, we repurchased 400,000 and 336,791 of our common shares for \$2.2 million and \$1.5 million, respectively. Between July 1, 2007 and July 31, 2007 we acquired an additional 210,000 shares under our repurchase plan for \$1.1 million.

The following table summarizes information regarding shares repurchased during the quarter ended June 30, 2007.

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
April 1 through 30, 2007	180,000	\$ 6.05	180,000	\$ 8,878,485
May 1 through 31, 2007	50,000	\$ 5.97	50,000	\$ 8,580,087
June 1 through 30, 2007	170,000	\$ 5.05	170,000	\$ 14,190,993
Total	400,000	\$ 5.61	400,000	\$ 14,190,993

Our Board of Directors authorized us to enter into a Rule 10b5-1 plan to facilitate the repurchase of our common shares in accordance with our previously announced stock repurchase program. A Rule 10b5-1 repurchase plan allows the purchase of our common shares at times when we ordinarily would not be in the market because of self-imposed trading blackout periods.

We may repurchase shares in the future subject to the rules of our 10b5-1 repurchase plan and in the case of any discretionary purchases outside of the plan, subject to open trading windows, overall market conditions, our stock price and our cash position and other requirements. The repurchase plan 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 plan.

**Item 6. EXHIBITS****Exhibits**

- 2.1 Agreement and Plan of Merger, dated April 25, 2007, by and among Captaris, Inc., Merlot Acquisition Corporation and Castelle (incorporated herein by reference to Exhibit 2.1 to Captaris's Current Report on Form 8-K, filed with the Commission on April 30, 2007)
- 10.1\* Terms of Equity Grant Program for Non-Employee Directors under the Captaris, Inc. 2006 Equity Incentive Plan, as amended on June 7, 2007, filed herewith
- 10.2\* Captaris, Inc. 2007 Incentive Plan, filed herewith
- 10.3\* Director Cash Compensation Summary, as of July 1, 2007, filed herewith
- 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)

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\* Management contract or 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 6th day of August 2007.

CAPTARIS, INC.

By: */s/ Peter Papano*  
**Peter Papano**

**Chief Financial Officer, Treasurer**