CAPTARIS INC
Form 10-Q
August 14, 2001

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d)
of the Securities Exchange Act of 1934
for the quarterly period ended June 30, 2001

Commission File Number 0-25186

CAPTARIS, INC.
(Name of Registrant as Specified in Its Charter)

Washington	91-1190085
(State of incorporation)	(I.R.S. Employer Identification Number)

11410 NE 122nd Way
Kirkland, WA 98034
(Address of principal executive offices)

Registrant's telephone number, including area code: (425) 820-6000

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes X No

The number of outstanding shares of the Registrant's Common Stock as of August 7, 2001 was 32,104,767.

CAPTARIS, INC.

FORM 10-Q
For the Quarter Ended June 30, 2001

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Part I. FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

CAPTARIS, INC.

CONSOLIDATED BALANCE SHEETS

(Unaudited)

	June 30, 2001	December 31, 2000
ASSETS	(in thousands)	
Current assets:		
Cash and cash equivalents	$ 21,129	$ 36,744
Short-term investments	55,276	51,679
Accounts receivable, net	12,209	16,010
Inventories	5,653	6,249
Deferred and prepaid income taxes	5,948	3,007
Prepaid expenses and other	2,399	1,871
Total current assets	102,614	115,560
Equipment and leasehold improvements, net	7,646	6,220
Goodwill, intangibles and other, net	21,119	5,256
Deferred income taxes	3,208	3,208
	$134,587	$130,244
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 3,410	4,914
Accrued compensation and benefits	5,693	3,584
Other accrued liabilities	9,386	8,745

Current portion of note payable	469	-
Total current liabilities	18,958	17,243
Note payable, net of current portion	882	-
Total liabilities	19,840	17,243
Commitments and contingencies		
Shareholders' equity:		
Preferred stock, par value $.01 per share, 2,000,000 authorized; none outstanding	-	-
Common stock, par value $.01 per share, 120,000,000 authorized; 32,104,141 and 30,666,319 shares outstanding, respectively, and additional paid-in capital	65,585	56,493
Retained earnings	49,162	56,508
Total shareholders' equity	114,747	113,001
	$134,587	$130,244

See accompanying notes to consolidated financial statements.

CAPTARIS, INC.

CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

	Quarter ended June 30,		Six months end June 30,	
	2001	2000	2001	2
	(in thousands, except per share data)			
Net sales	$23,550	$25,240	$ 43,977	$5
Cost of sales	9,026	8,548	16,375	1
Gross profit	14,524	16,692	27,602	3
Operating expenses:				
Research and development	4,113	2,494	7,503	
Sales, general and administrative	14,976	11,724	30,187	2
Non-recurring charges	-	-	2,942	
Total operating expenses	19,089	14,218	40,632	2
Operating (loss) income	(4,565)	2,474	(13,030)	
Other income, net	952	930	1,817	

(Loss) Income before income taxes	(3,613)	3,404	(11,213)	
Income tax (benefit) provision	(1,266)	1,192	(3,924)	
Net (loss) income	$(2,347)	$ 2,212	$ (7,289)	$
Basic net (loss) income per common share	$(0.07)	$0.07	$(0.23)	
Weighted average common shares outstanding	32,104	31,008	32,168	3
Diluted net (loss) income per common share	$(0.07)	$0.07	$(0.23)	
Weighted average common and common equivalent shares outstanding	32,104	31,884	32,168	3

See accompanying notes to consolidated financial statements.

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CAPTARIS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Six months ended June 30,	
	2001	2000
	(in thousands)	
Cash flows from operating activities:		
Net (loss) income	$ (7,289)	$ 5,763
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	3,421	2,575
Deferred and prepaid income taxes	(2,941)	(1,624)
Gain on sale of marketable securities	-	(1,784)
Purchased in-process research and development, expensed	1,900	
Stock option income tax benefit	-	5,128
Changes in current assets and liabilities:		
Accounts receivable	3,998	6,247
Inventories	607	(100)
Prepaid expenses and other assets	(428)	12
Accounts payable	(2,070)	(2)
Accrued compensation and benefits	2,106	(23)
Other accrued liabilities	300	(179)
Federal income taxes payable	-	(1,031)
Net cash (used) provided by operating activities	(396)	14,982
Cash flows from investing activities:		
Purchase of equipment and leasehold improvements	(2,340)	(1,416)
Purchase of short-term investments, net	(3,597)	(5,570)
Proceeds from sale of marketable securities	-	2,101

Cash paid in acquisition, net	(8,800)	-
Purchase of intangibles and other long-term assets	(41)	(296)
Net cash used by investing activities	(14,778)	(5,181)
Cash flows from financing activities:		
Repurchase of common stock	(446)	(9,699)
Proceeds from exercise of stock options	5	5,019
Net cash provided by financing activities	(441)	(4,680)
Net (decrease) increase in cash and cash equivalents	(15,615)	5,121
Cash and cash equivalents at beginning of period	36,744	23,923
Cash and cash equivalents at end of period	$ 21,129	$29,044
Supplementary disclosures of cash flows:		
Cash paid (refunded) for income taxes	$ (742)	$ 205
Supplementary disclosures of noncash portion of acquisitions:		
Stock issued in Infinite acquisition	$ 9,538	-

See accompanying notes to consolidated financial statements.

CAPTARIS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Interim Financial Statements

The accompanying consolidated financial statements of Captaris, Inc. and subsidiaries (the Company) are unaudited. In the opinion of the Company's management, the financial statements include all adjustments, consisting only of normal recurring adjustments, necessary to state fairly the financial information set forth therein. Results of operations for the three-month period ended June 30, 2001 are not necessarily indicative of future financial results.

Certain notes and other information have been condensed or omitted from the interim financial statements presented in this quarterly report on Form 10-Q. Accordingly, these financial statements should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2000.

2. Businesses Acquired

On January 3, 2001 the Company acquired all of the outstanding stock of Infinite Technologies, a privately held global supplier of wireless applications and wireless infrastructure solutions for a total consideration of $24,083,000. At closing, the Company paid approximately $9.1 million in cash and issued 1,631,600 shares of the Company's common stock valued at $8,058,000. The Company will pay approximately $2,900,000 in a combination of cash and the Company's common stock under a deferred payment arrangement over the next three years, which was recorded at the time of closing as a note payable of $1,351,000, net of imputed interest, and stock to be issued totaling $1,480,000. In addition the Company will pay up to an additional $3,900,000 in a combination of cash and the Company's common stock under an earn-out arrangement over the

next three years which will be expensed as compensation by the Company. The Company has accounted for the business combination as a purchase. In connection with the acquisition, the Company recorded a one-time charge in the first quarter of 2001 related to purchased in-process research and development in the amount of $ 1.9 million. The total consideration of $24,083,000 was allocated as follows:

	(in thousands)
Goodwill	$ 8,383
Purchased in-process research & development, expensed	1,900
Other intangibles	9,900
Total purchase price	20,183
Earn-out	3,900
Total consideration	$24,083

All goodwill and identified intangibles associated with the acquisition are being amortized over lives ranging from two to seven years.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

3. Segment Reporting

The Company has adopted Statement of Accounting Standard No. 131 "Disclosures about Segments of an Enterprise and Related Information"(SFAS No. 131). This standard is based on a management approach, which requires segmentation based upon the Company's internal organization and disclosure of revenue and operating income based upon internal accounting methods. The segment information provided reflects the two distinct business models of the Company's organizational structure: software products and e-document delivery services. Interest and other debt expense, provision for income taxes, interest income and gains and losses on the disposition of marketable securities are centrally managed at the corporate level and, accordingly, such items are not presented by segment since they are excluded from the measure of segment profitability reviewed by the Company's management. Reconciling items include corporate expense items and non-recurring charges, which are not allocated to operating segments. The Company's assets are managed on a company-wide basis versus by segment and accordingly, asset information is not reported.

	Software Products	E-document Services	Reconciling Amounts	Total
		(in thousands)		
Quarter ended June 30, 2001				
Net Sales................................	$17,693	$ 5,857	$ -	$ 23,55
Operating Income (loss)..................	(328)	298	(4,535)	(4,56
Quarter ended June 30, 2000				
Net Sales................................	$18,828	$ 6,412	$ -	$ 25,24

Operating Income.........................	2,336	2,010	(1,872)	2,47
Six months ended June 30, 2001				
Net Sales................................	$32,452	$11,525	$ -	$ 43,97
Operating Income (loss)..................	(1,937)	779	(11,872)	(13,03
Six months ended June 30, 2000				
Net Sales................................	$36,057	$14,058	$ -	$ 50,11
Operating Income.........................	5,348	3,172	(3,055)	5,46

The Company's sales by country were as follows:

	Quarter ended June 30,		Six months ended June 30,	
	2001	2000	2001	2000
	(in thousands)			
United States.............	$18,711	$20,239	$34,563	$40,684
Canada....................	729	763	1,433	1,506
United Kingdom............	1,288	1,588	2,754	2,951
Other.....................	2,822	2,650	5,227	4,974
	$23,550	$25,240	$43,977	$50,115

CAPTARIS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

4. Earnings Per Share

	Quarter ended June 30,		
	2001		2000
	(in thousands, except per share data)		
	Basic	Diluted	Basic
Net income	$(2,347)	$(2,347)	$ 2,212
Computation of common and common equivalent shares outstanding:			
Common Stock	32,104	32,104	31,008
Options	-	-	-
Common and common equivalent shares used in computing per share amounts	32,104	32,104	31,008

Net income per share	$ (0.07)	$ (0.07)	$ 0.07

	Six months ended June 30,		
	2001		2000
	(in thousands, except per share data)		
	Basic	Diluted	Basic
Net income	$(7,289)	$(7,289)	$ 5,763
Computation of common and common equivalent shares outstanding:			
Common Stock	32,168	32,168	31,131
Options	-	-	-
Common and common equivalent shares used in computing per share amounts	32,168	32,168	31,131
Net income per share	$ (0.23)	$ (0.23)	$ 0.19

At June 30, 2001, equivalent shares of 38,261 and 312,035 were excluded from the calculation of diluted shares outstanding for the quarter and six-month periods, respectively, as they were antidilutive.

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CAPTARIS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

5. Non-recurring Charges

On March 15, 2001, the Company announced the consolidation of its two primary product groups, Computer Telephony Software Group and Document Exchange Software Group, resulting in a 14% reduction of its workforce and a one-time charge of approximately $1 million, which consisted of mainly severance and other employee benefits and consulting services.

6. Changes in Shareholders' Equity

Beginning balance at December 31, 2000	$113,001
Net loss	(7,289)
Repurchase of common stock	(446)
Unrealized foreign currency loss	(62)
Exercise of stock options	5
Stock issued for Infinite acquisition	9,538
Ending balance at June 30, 2001	$114,747

7. Legal Proceedings

In March 2000 several class-action lawsuits were filed in the United States District Court for the Western District of Washington alleging that during the period January 20, 2000 through March 17, 2000, the Company and several officers and directors made or participated in misrepresentations about the Company's ability to achieve revenue expectations for the first quarter of 2000. The court has approved appointment of three plaintiffs to act as Lead Plaintiffs and has consolidated all lawsuits into a single action. No class has been certified. On January 25, 2001, the Court granted Captaris' motion to dismiss the consolidated complaints on the grounds that "none of the four events relied upon by plaintiffs, whether considered separately or in combination, gives rise to a strong inference that any of the defendant directors or officers acted with knowledge or deliberate recklessness." The Court dismissed the claims against four Captaris officers and directors with prejudice. Based on additional representations made by plaintiffs' counsel at oral argument, the Court granted plaintiffs' request that they be allowed to file an amended complaint to attempt to correct the legal deficiencies the Court identified in the consolidated complaint as to Captaris and two officers. Plaintiffs filed their Second Consolidated Amended Complaint on February 25, 2001. Captaris and the two remaining individual defendants have filed a motion to dismiss the Second Consolidated Amended Complaint with prejudice. On July 2, the Court granted Captaris' motion and ruled in its favor, dismissing all claims against the plaintiffs with prejudice. The plaintiffs filed a notice of appeal on July 31, 2001. The Company continues to believe that the allegations of the lawsuits are without merit and intends to continue to vigorously defend the lawsuit.

8. New Accounting Pronouncements

In June 2001 the Financial Accounting Standards Board approved Statement of Financial Accounting Standard No. 141, "Business Combinations," and SFAS No. 142, "Goodwill and Other Intangible Assets." SFAS No. 141 prospectively prohibits the pooling of interest method of accounting for business combinations initiated after June 30, 2001. SFAS No. 142 requires companies to cease amortizing goodwill that existed at June 30, 2001. The amortization of existing goodwill will cease on December 31, 2001. Any goodwill resulting from acquisitions completed after June 30, 2001 will not be amortized. SFAS No. 142 also establishes a new method of testing goodwill for impairment on an annual basis or on an interim basis if an event occurs or circumstances change that would reduce the fair value of a reporting unit below is carrying value. The adoption of SFAS No. 142 will result in the Company's discontinuation of amortization of its goodwill; however, the Company will be required to test its goodwill for impairment under the new standard beginning in the first quarter of 2002, which could have an adverse effect on the Company's future results of operations if an impairment occurs. At June 30, 2001, the Company had net goodwill of approximately $19.3 million and recorded related amortization expense of $1,112,000 and $2,224,000 for the quarter and six-month periods, respectively. This amortization expense will continue through the end of 2001, at which point amortization will cease. At implementation, the Company expects to have unamortized goodwill of approximately $17.1 million which will be treated in accordance with SFAS No. 142.

9. Stock Based Compensation

During the second quarter of 2001, the Company offered a limited non-

compulsory exchange of employee stock options on a less than one-for-one basis. The exchange (which closed on July 10, 2001) resulted in the voluntary cancellation of employee stock options to purchase 3,125,620 shares of our common stock with varying exercise prices greater than $10.00 per share in exchange for 1,298,284 employee stock options with an exercise price of $2.11. The option exchange offer resulted in variable accounting treatment for a total of 1,951,307 options, representing the 1,298,284 new options granted in the exchange as well as any stock options granted to participating employees within the six months before or after the exchange that have an exercise price less than the tendered stock options to the extent the employee's new grant was for fewer shares than the shares subject to the tendered options. Variable accounting will continue until all options subject to variable accounting treatment are exercised, cancelled or expired. At July 31, 2001, stock options to purchase 1,951,307 shares of our common stock were subject to variable accounting treatment. Variable accounting treatment will result in charges or credits, recorded to "Stock-based compensation", dependent on unpredictable fluctuations in quoted prices for the Company's common stock.

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 consolidated financial statements and accompanying notes included in this document and the 2000 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 29, 2001.

The following discussion of our financial condition and results of operations contains forward-looking statements that involve risks and uncertainties, such as statements of our plans, objectives, expectations and intentions. Words such as "believes," "expects," "anticipates," "intends," "plans" and similar expressions are intended to identify forward-looking statements. Captaris' actual results could differ materially from those anticipated in these forward-looking statements for many reasons, including the factors described below and under the caption "Additional Factors that May Affect Our Business, Future Operating Results and Financial Condition" set forth at the end of this Item 2. You should not place undue reliance on these forward-looking statements, which apply only as of the date of this Form 10-Q.

The Company is a leading provider of business to business communication solutions for small, medium and enterprise-sized organizations. The Company provides flexible, cost-effective products that address the unified messaging, voice messaging, fax server, production fax and outsourced document delivery markets, and distributes these products primarily through independent distributors, value-added resellers and OEM's. The Company's products run on off-the-shelf hardware, support Windows NT and Windows 2000, and interface with a wide variety of telephony and computer equipment. The Company also offers add-on modules and software upgrades that provide increased capacity and functionality.

The Company's product lines include both telephony-oriented and computer-oriented products, and outsourced electronic document (e-document) delivery services. The Company's telephony-oriented product lines serve the messaging markets and focus on voice and call processing, unified messaging, and personal and workgroup call management. The Company's computer-oriented product lines target the fax server and production fax markets and focus on high-performance fax processing and unified messaging, as well as Internet, corporate intranet and phone-based information access. E-document delivery services target the outsourced mass fax and email markets for time-critical business-to-business

(B2B) communications. These services include high-volume, instantaneous IP fax and email broadcast and merge offerings, fax reply and fax-on-demand applications as well as industry-specific services and custom workflow solutions for unique customer requirements.

The Company sells its products primarily through an indirect channel of resellers and distributors, as well as through direct sales, OEM and private label agreements. The Company's telephony-oriented products include: CallXpress, and CallXpress Enterprise, a multi-application, high capacity unified messaging platform and PhoneXpress, a full-featured advanced messaging system for small to medium-sized enterprises. The Company's data oriented enhanced fax products include RightFAX and RightFAX Enterprise, the Company's LAN-based fax server lines for Windows NT / Windows 2000, and the RightFAX Production System, a high-volume production-oriented server that enables fax and other forms of electronic transmission for electronic commerce applications. The Company's e-document delivery services, branded under the name MediaLinq, offer high-volume, simultaneous delivery of fax and email documents via the web, from desktop software or a fax machine.

On January 3, 2001 the Company acquired Infinite Technologies, a privately held global supplier of wireless applications and wireless infrastructure solutions. As described in Note 2 to

the Consolidated Financial Statements, total consideration paid under terms of the merger agreement approximated $24 million.

On March 15, 2001, the Company announced a new business strategy based on the Mobile Business Solutions market and subsequently announced the commercial availability of its initial Mobile Delivery product in April, 2001. In conjunction with the March 15, 2001 announcement the Company announced the consolidation of its two primary product groups, Computer Telephony Software Group and Document Exchange Software Group, resulting in a 14% reduction of its workforce and a one-time charge of approximately $1 million during the first quarter.

Results of Operations

Net sales. Net sales decreased 6.7% to $23,550,000 in the quarter ended June 30, 2001, from $25,240,000 in the comparable 2000 quarter. Software product sales decreased 6.0% while E-document services decreased 8.7% over the preceding year. International sales for the quarter decreased 3.2% compared to the second quarter of 2000, and represented 20.5% of total net sales.

For the six months ended June 30, 2001, net sales decreased 12.2% to $43,977,000 from $50,115,000 in the comparable prior year period. Software product sales decreased 10.0% while E-document services decreased 18.0% over the same period in 2000. International sales for the six-month period ending June 30, 2001 were $9,414,000, approximately equal to the same period in the previous year and represented 21.4% of total net sales. Decreases in net sales in the products group are believed to be reflective of the continued softness in the telecommunication equipment marketplace and in information technology spending in general. Decreases in services net sales over prior year periods are believed to be the result of continued pricing pressures in the broadcast fax and email industry.

Gross profit. Gross profit as a percentage of net sales decreased to 61.7% in the quarter ended June 30, 2001, as compared to 66.1% in the comparable prior-year quarter. Gross profit for the six months ended June 30, 2001 was 62.8% compared to 65.8% in the same period in the previous year. These

percentage decreases for the three and six months periods were driven by the effect of fixed cost of sales on lower sales volumes and changes in product mix.

Research and development. As a percentage of sales, research and development expenses for the current quarter increased to 17.5% compared with 9.9% of net sales in the comparable prior-year quarter. Research and development expenses increased to $4,113,000 in the quarter ended June 30, 2001 from $2,494,000 in the comparable prior-year period.

For the six months ended June 30, 2001 research and development expenses were $7,503,000 constituting 17.1% of net sales as compared to $4,957,000 or 9.9% in the prior year period. This increase for both the quarter and six month period reflects the addition of staff from the acquisition of Infinite Technologies and increases associated with new product development. The Company currently expects to continue to invest in research and development at greater than historical levels as it expands its mobile business solutions and other product offerings.

Sales, general and administrative. Sales, general and administrative expenses increased to $14,976,000 in the quarter ended June 30, 2001 from $11,724,000 in the comparable prior-year quarter, due primarily to the addition of the operations of Infinite Technologies, and the corporate re-branding program begun during the first quarter. Sales, general and administrative costs for the current quarter represented 63.6% of net sales, an increase from 46.5% in the comparable prior-year quarter.

For the six months ended June 30, 2001, sales, general and administrative expenses increased to $30,187,000 or 68.6% of net sales compared to 45.0% or $22,551,000 in the same period in 2000. The Company expects that such expenditures will continue at approximately these levels as a percentage of sales as the Company pursues its investment in its mobile business solutions and the infrastructure necessary to support these efforts.

Non-recurring charges. In the first quarter of 2001 non-recurring charges of $1,042,000 were incurred related primarily to the consolidation of the operations of the Tucson and Kirkland product groups and consisted of mainly severance and other employee benefits and consulting services. Additionally, $1,900,000 of acquired in-process research and development related to the acquisition of Infinite Technologies was expensed during the first quarter.

Operating (loss) income. Operating loss for the quarter ended June 30, 2001 was $4,565,000 compared to operating income of $2,474,000 in the comparable prior-year quarter.

Operating loss for the six months ended June 30, 2001 was $13,030,000 compared to operating income of $5,465,000 during the same period in the previous year.

Other income, net. Net other income was $952,000 in the quarter ended June 30, 2001, as compared to $930,000 in the comparable prior-year quarter, due to increased interest income on investments.

Other income was $1,817,000 during the six-month period ended June 30, 2001 reflecting primarily interest income on investments. In the six month period ended June 30, 2000, other income was $3,486,000 and included a one-time $1,784,000 realized gain on the sale of a marketable security held for investment.

Income tax. The effective tax benefit rate for the quarter ended June 30,

2001 was 35.0% compared with an effective tax rate of 35.0% for the prior year period. Income tax benefit for the quarter ended June 30, 2001 was $1,266,000 compared with income tax expense of $1,192,000 in the comparable prior-year quarter.

For the six months ended June 30, 2001 the Company recorded an income tax benefit of $3,924,000 compared to income tax expense of $3,188,000 during the same period of 2000.

Net (loss) income. The Company recognized a net loss of $2,347,000 or $0.07 per diluted common share for the quarter ended June 30, 2001, as compared to net income of $2,212,000 or $0.07 per diluted common share for the comparable prior-year quarter.

For the six-month period ending June 30, 2001, the Company recognized a net loss of $7,289,000 or $0.23 per diluted common share compared to net income of $5,763,000 or $0.17 per diluted common share in the comparable prior-year period.

Liquidity and Capital Resources

Cash used by operating activities in the six months ended June 30, 2001 was $396,000 due primarily to the loss from operations and the consolidation of product groups, offset by improvement in working capital items. The accounts receivable collection period was approximately 50 days at June 30, 2001 compared to 45 days in the comparable prior year period. Accounts receivable decreased from $16.0 million at December 31, 2000 to $12.2 million at June 30, 2001.

As further described in Note 2 of the Consolidated Financial Statements, on January 3, 2001 the Company acquired Infinite Technologies, a privately held global supplier of wireless applications and wireless infrastructure solutions. The Company has accounted for the business combination as a purchase. Under the terms of the merger agreement, the Company will pay up to an additional $3.9 million in a combination of cash and the Company's common stock under an earn-out arrangement over the next three years which will be expensed as compensation by the Company.

During the second quarter of 2001, the Company repurchased approximately 228,000 shares of its common stock, utilizing approximately $446,000. The Company may continue to repurchase shares subject to overall market conditions, its stock price, and the Company's cash position and requirements going forward.

The Company maintains a $4.0 million unsecured revolving line of credit, none of which is outstanding. The Company's line of credit expires in August 2003, and contains certain financial covenants and restrictions as to various matters. The Company is currently in compliance with all such covenants and restrictions. Borrowings under the line of credit bear interest at the bank's prime rate or its interbank offering rate plus 1.50%, at the Company's option.

The Company expects that its current cash, cash flow from operations, and available bank line of credit will provide sufficient working capital for operations for the foreseeable future.

Stock Based Compensation

During the second quarter of 2001, the Company offered a limited non-compulsory exchange of employee stock options on a less than one-for-one basis. The exchange (which closed on July 10, 2001) resulted in the voluntary cancellation of employee stock options to purchase 3,125,620 shares of our

common stock with varying exercise prices greater than $10.00 per share in exchange for 1,298,284 employee stock options with an exercise price of $2.11. The option exchange offer resulted in variable accounting treatment for a total of 1,951,307 options, representing the 1,298,284 new options granted in the exchange as well as any stock options granted to participating employees within the six months before or after the exchange that have an exercise price less than the tendered stock options to the extent the employee's new grant was for fewer shares than the shares subject to the tendered options. Variable accounting will continue until all options subject to variable accounting treatment are exercised, cancelled or expired. At July 31, 2001, stock options to purchase 1,951,307 shares of our common stock were subject to variable accounting treatment. Variable accounting treatment will result in charges or credits, recorded to "Stock-based compensation", dependent on unpredictable fluctuations in quoted prices for the Company's common stock.

Additional Factors that May Affect our Business, Future Operating Results and Financial Condition

You should carefully consider the risks described below, together with all of the other information included in this quarterly report on Form 10-Q. The risks and uncertainties described below are not the only ones facing our company. If any of the following risks actually occurs, our business, financial condition or operating results could be harmed.

Our recently expanded business strategy to focus on the mobile business solutions market, which is a new and unproven market, may not be successful.

In March 2001, we announced that we are expanding our business strategy to focus on the mobile business solutions market, which we believe is a higher-growth opportunity. On April 2, 2001 we announced initial availability of our Mobile Delivery product. In order to implement this strategy, we will be required to design, develop and introduce competitive new wireless products, improve our marketing of such products and build credibility among customers that we are capable of delivering advanced mobile business solutions. Implementation of this strategy will involve substantial increased costs and, as a result, our expenses will increase disproportionately to revenue in the near term. Moreover, implementation on this strategy may disrupt our existing operations and distract management, which could have a material adverse effect on our operating results.

There can be no assurance that we will realize a return on our investment in the mobile business solutions market. If we are not successful in implementing our strategy, our revenue could decline. Even if we are successful, our revenue may still decrease if the market opportunity for mobile wireless solutions does not develop in the ways we anticipate. This market opportunity is in its early stages and we can not guarantee that the demand for mobile business solutions will develop as fast as we anticipate, that new technologies will not cause the market to evolve in a manner different from what we expect or that we will be able to obtain a leadership position as this market opportunity develops.

Our operating results fluctuate from quarter to quarter, which could cause our operating results to fall below expectations of securities analysts and investors.

We expect our operating results to fluctuate significantly from quarter to quarter in the future. Because of these fluctuations, our operating results for a particular quarter may fall below the expectations of securities analysts and investors. If this occurs, the trading price of our stock may decline. Such

fluctuations could cause period-to-period comparisons to be less than meaningful. Numerous factors contribute to the unpredictability of our operating results, including

- the timing of customer orders;
- changes in our mix of products and distribution channels;
- the announcement or introduction of new products by us or our competitors;
- the effect of variable accounting relating to stock based compensation that could result from fluctuations in our stock price;
- the effect of the adoption of SFAS #142 regarding the potential impairment in value of goodwill and other intangible assets;
- pricing pressures; and
- general economic conditions.

Most of our software product revenue comes from current quarter orders and sales, of which a substantial portion, and sometimes a majority, occurs in the last month of each quarter. However, because we sell our products to end-customers through various third parties such as telephone system manufacturers, value-added resellers, telephone interconnect dealers, and others, we are unable to project with certainty the actual orders, sales, and revenues these third parties will generate in a given quarter. We do not maintain a large backlog of orders, and most of our distributors maintain little or no inventory. Order fulfillment cycles are typically short, and often as short as one to two days. The combination of these factors impairs and delays our ability to know when revenues and earnings will be higher or lower than expected.

Our sales may also vary by season. Specifically, due to typical year-end dealer sales patterns and end-user buying patterns, net sales in our first quarter, without taking into account the effect of acquisitions, have in the past declined from the fourth quarter of the previous year. Other factors that may contribute to the unpredictability of our operating results include changes in our mix of products and distribution channels, the announcement or introduction of new products by us or our competitors, pricing pressures, and general economic conditions.

While our revenues may fluctuate from quarter to quarter for the reasons described above, most of our expenses are relatively fixed in the short term. We base product development and other operating expenses on our expected revenues. As a result, any shortfall in revenues relative to our expectations could cause significant changes in our operating results from quarter to quarter. In

particular, we may be unable to adjust our spending in time to compensate for any unexpected shortfall in quarterly revenues.

We rely heavily on telephone system manufacturers, independent equipment dealers and value-added resellers.

A substantial majority of our net sales depends on a network of independent telephone equipment dealers and computer-oriented value-added resellers. There is intense competition for the attention of these independent dealers and resellers from our competitors and from providers of other products distributed through these channels. Many of these dealers and resellers do not have the

financial resources to withstand a downturn in their businesses. We may not be able to maintain or expand our network of dealers and resellers in the future. Moreover, our dealers and resellers may not maintain or expand their present level of efforts to sell our products. If we lose a major dealer or reseller, or if our dealers and resellers lose interest in selling our products, our business, results of operations and financial condition may suffer.

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

Creation and maintenance of strategic relationships is important to our success because these relationships enable us to market and distribute our products to a larger customer base than we could otherwise reach through our director marketing efforts. We currently have strategic relationships with Ericsson, NEC Corporation, Fujitsu Limited, Lotus Development Corporation, Xerox Corporation and others. However, we may not be successful in creating new strategic relationships on acceptable terms, if at all. This is especially true in our Mobile Delivery market where the need to create new strategic relationships will be necessary for our success. Moreover, although we view our strategic relationships as an important factor in the successful commercialization of our products and services, our current strategic partners may not view their relationships with us as significant for their own businesses and any one them could reassess their commitment to us in the future. Further, our relationships are generally non-exclusive, which means our strategic partners may develop relationships with some of our competitors. Failure of one or more of our strategic partners to successfully develop and sustain a market for our services, or the termination of one or more of our strategic relationships could adversely affect our ability to increase sales.

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

We frequently evaluate potential acquisitions of products, technologies and businesses. Since January 1997, we have made five strategic acquisitions including the January 2001 acquisition of Infinite Technologies. Our recent and any future acquisitions may direct management's attention away from the day-to-day operations of our business and may pose numerous other risks. For instance, we may not be able to successfully integrate any technologies, products, personnel or operations of companies that we may acquire.

In making acquisitions, we may need to make dilutive issuances of our equity securities, incur debt, write off purchased, in-process research and development and amortize expenses related to goodwill and other intangible assets.

Technology and customer needs change rapidly in our industry.

In our industry, technology and customer demands change rapidly, and our competitors and we frequently introduce new products and features. To succeed, we must identify, develop and market new products, features and services that achieve broad market acceptance by satisfying those changing customer needs and keeping pace with those technological developments. To do this, we must spend substantial funds on product development. We regularly devote significant resources to

technologies that we anticipate will be widely adopted. In addition, in the future, we intend to pursue new revenue streams by leveraging our expertise in voice and data communication to integrate these capabilities in unified messaging and mobile wireless delivery, among other possible areas. The market for unified messaging software and mobile wireless delivery is relatively new

and as yet unproven. To be successful, we must, among other things, develop and market products and services that achieve broad market acceptance. We may not be able to develop new products or product enhancements on a timely basis. Even if we do, the market may not accept the new products or product enhancements that we develop.

Our market is highly competitive.

The computer-telephony market is highly competitive. Moreover, we believe the competitive pressures we face are likely to intensify, particularly as our competitors make new offerings based on the Windows operating system. We may not have the financial resources, marketing, distribution and service capability, and depth of key personnel or technological knowledge to continue to compete successfully in each of our markets.

We believe the main competitive factors affecting our business are breadth and quality of application software, product integration, ability to respond to technological change, quality of a Company's sales force, price, size of the installed base, level of customer support and professional services.

In the telephony-oriented market for messaging systems, our principal competitors are independent suppliers such as Avaya Inc., Mitel Networks, Active Voice Inc., Cisco Systems, Inc. and Callware Technologies, Inc.

In addition to independent suppliers of computer-telephony solutions, we also compete with private branch exchange and key telephone systems manufacturers. Those manufacturers offer integrated voice messaging systems, unified messaging systems and automatic call distribution systems of their own design or under various OEM agreements. Competitors in this category include Lucent Technologies, Inc., Nortel Networks Corporation, Siemens Business Communication Systems, Inc., Mitel Networks and NEC America, Inc.

In the market for LAN-based facsimile systems, our principal competitors are Omtool, Ltd., Optus Software, Inc., Esker, S.A. and Computer Associates International, Inc. Our fax server products also compete with vendors offering a range of alternative facsimile solutions, including operating systems containing facsimile and document transmission features, low-end fax modem products, desktop fax software, single-platform facsimile software products and customized proprietary software solutions. In the market for production facsimile systems, our principal competitors are Biscom, Inc., Esker, S.A. and Topcall International AG. In the market for document distribution products, our principal competitors include the Xpedite division of PTEK Holdings, Inc. and other telecommunications providers such as Cable & Wireless, Inc. The competitors of our newly acquired Infinite Technologies include Openwave Systems, Inc., Aether Systems, Inc. and 724 Solutions, Inc.

Further acceptance of open systems architectures and the development of industry standards in the call processing market may eliminate some of the technical barriers to entry, allowing additional competitors to enter the market. Many of our existing competitors have larger customer and installed bases and substantially greater technical, financial and marketing resources than we do. In addition, some of our competitors have a marketing advantage because they can sell their call processing equipment or facsimile solutions as part of their broader product offerings. Recently we believe our business has been, and may continue to be, adversely affected by the introduction of next generation IP PBX switches as potential customers delay purchasing decisions as they evaluate these new product offerings. We expect our competitors will continue to offer improved

product technologies and capabilities. The availability of these products could cause sales of our existing products to decline. For these reasons, we may be unable to compete successfully against our current and future competitors.

Our average sales prices have declined for some of our products.

The average sales prices in our basic voice messaging products have declined due to competitive pressures. In the future, prices may decline in some of our other product lines. If the average sales prices of our more significant product lines fall, our overall gross margins will likely fall. To offset and forestall declining average sales prices, we must continue to develop product enhancements and new products with advanced features that are likely to generate higher-margin incremental revenue. If we are unable to do so in a timely manner or if our products do not achieve significant customer acceptance, our business, results of operations and financial condition may suffer. Additionally, we have experienced, as have others in our broadcast fax and document delivery markets, pricing pressures for our services.

We may be unable to adequately protect our proprietary rights.

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

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

Our success depends on our ability to operate without infringing the patents and proprietary rights of third parties. Product development is inherently uncertain in a rapidly evolving technological environment in which there may be numerous patent applications pending, many of which are confidential when filed, with regard to similar technologies. Historically, competitors in the computer-telephony software industry have filed numerous allegations of patent infringement, resulting in considerable litigation. We have received claims of patent infringement from several parties and will probably receive additional claims in the future. While none of those claims has led to litigation, they may yet result in litigation. Any litigation, regardless of our success, would probably be costly and require significant time and attention of our key management and technical personnel. Litigation could also force us to

- stop or delay selling, or using, products that use the challenged intellectual property;
- pay damages for infringement;
- obtain licenses, which may be unavailable on acceptable terms; or
- redesign products or services that use the infringing technology.

We face risks from expansion of our international operations.

Our growth depends in part on continued expansion of our international sales.

International sales generated approximately 15%, 18% and 19% of our net sales in the years ended December 31, 1998, 1999 and 2000, respectively. We have spent significant management attention and financial resources on our international operations. A significant portion of our revenues are subject to the risks associated with international sales, which include

- difficulty adapting products to local languages and telephone system technology;
- inability to respond to changes in regulatory requirements;
- inability to meet special standards requirements;
- exposure to exchange rate fluctuations;
- tariffs and other trade barriers;
- difficulties in staffing and managing international operations;
- potentially adverse tax consequences; and
- uncertainties arising from local business practices and cultural considerations.

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

Currently, substantially all of our international sales are denominated in U.S. dollars. Increases in the value of the dollar against local currency could cause our products to become relatively more expensive to customers in a particular country, leading to reduced sales or profitability in that country. As we continue to expand our international operations, we expect our non-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 may not be able to hire and retain highly skilled employees, which could affect our ability to compete effectively.

To succeed, we must attract and retain key personnel in engineering, research and development, marketing, sales, finance and administration. In particular, as we implement our recently announced strategy of focusing on mobile business solutions, we will need to hire employees with experience developing and providing wireless products and services. We also depend to a significant degree on the efforts of our senior management team. If we fail to recruit such personnel or lose the services of existing key persons in any functional area, our current operations and new product development efforts could be adversely affected. Competition for skilled personnel is intense. When our stock price is lower than our employees' stock option price, it is particularly difficult to retain skilled personnel. We do not maintain material key person life insurance.

We may experience difficulties in managing our growth.

Growth in our business has placed, and will continue to place, significant demands on our management and operations. To succeed, our officers and key

employees must manage growth successfully. We must continue to implement and improve our operational, financial and management information systems. In addition, we must expand, train and manage our employee base. We may be unable to timely and successfully accomplish these tasks.

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

We use standard computer hardware for our products. Most of the components we use are readily available. However, only three domestic suppliers can provide voice processing circuit boards in

the quantities we need. In addition, only two domestic suppliers can provide our facsimile processing circuit boards in the quantity we require. Historically, we have relied almost exclusively on Dialogic Corporation (now a part of Intel Corporation) for our voice cards, and on Dialogic and Brooktrout, Inc. for our fax cards. We rely on those suppliers primarily because of volume price discounts and the cost and effort required to develop software for an alternate voice or fax card. Significant delays, interruptions or reductions in our supply of voice or fax cards, or unfavorable changes to price and delivery terms could adversely affect our business.

Our stock price may be highly volatile.

The market price of our common stock has been, and may continue to be, highly volatile. The future price of the common stock will fluctuate in response to factors such as

- new product announcements or changes in product pricing policies by us or our competitors;
- quarterly fluctuations in our operating results;
- announcements of technical innovations;
- announcements relating to strategic relationships or acquisitions;
- changes in earnings estimates by securities analysts; and
- general conditions in the computer-telephony market.

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

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company is exposed to market risk related to changes in interest rates and foreign currency exchange rates, each of which could adversely affect the value of the Company's investments. The Company does not currently use derivative financial instruments.

The Company maintains a short-term investment portfolio consisting of interest bearing securities with an average maturity of less than one year. These securities are classified as "available for sale" securities. The interest bearing securities are subject to interest rate risk and will fall in value if market interest rates increase. If market interest rates were to increase

immediately and uniformly by 10% from levels at June 30, 2001, the fair value of the portfolio would decline by an immaterial amount. Because the Company has the current ability to hold its fixed income investments until maturity, it does not expect its operating results or cash flows to be affected to any significant degree by a sudden change in market interest rates on its securities portfolio.

The Company has assets and liabilities denominated in certain foreign currencies related to the Company's international sales operations. The Company has not hedged its translation risk on these currencies as the Company has the current ability to hold its foreign-currency denominated assets indefinitely and does not expect that a sudden or significant change in foreign exchange rates would have a material impact on future net income or cash flows.

Part II. OTHER INFORMATION

Item 1. Legal Proceedings

In March 2000 several class-action lawsuits were filed in the United States District Court for the Western District of Washington alleging that during the period January 20, 2000 through March 17, 2000, the Company and several officers and directors made or participated in misrepresentations about the Company's ability to achieve revenue expectations for the first quarter of 2000. The court has approved appointment of three plaintiffs to act as Lead Plaintiffs and has consolidated all lawsuits into a single action. No class has been certified. On January 25, 2001, the Court granted Captaris' motion to dismiss the consolidated complaints on the grounds that "none of the four events relied upon by plaintiffs, whether considered separately or in combination, gives rise to a strong inference that any of the defendant directors or officers acted with knowledge or deliberate recklessness." The Court dismissed the claims against four Captaris officers and directors with prejudice. Based on additional representations made by plaintiffs' counsel at oral argument, the Court granted plaintiffs' request that they be allowed to file an amended complaint to attempt to correct the legal deficiencies the Court identified in the consolidated complaint as to Captaris and two officers. Plaintiffs filed their Second Consolidated Amended Complaint on February 25, 2001. Captaris and the two remaining individual defendants have filed a motion to dismiss the Second Consolidated Amended Complaint with prejudice. On July 2, the Court granted Captaris' motion and ruled in its favor, dismissing all claims against the plaintiffs with prejudice. The plaintiffs filed a notice of appeal on July 31, 2001. The Company continues to believe that the allegations of the lawsuits are without merit and intends to continue to vigorously defend the lawsuit.

Item 4. Submission of Matters to a Vote of Security Holders

The Annual Meeting of Shareholders of Captaris, Inc. was held on May 15, 2001. A total of 27,151,947 shares of the Company's common stock were represented in person or by proxy at the meeting, which comprised 83.89% of the total number of shares of the Company's common stock outstanding on March 29, 2001, the record date for the meeting.

At the meeting Robert F. Gilb and John A. Kelley, Jr. were re-elected to serve as directors of the Company for a term of three years until the Company's Annual Meeting of Shareholders in 2004. The vote was as follows:

	For	Withheld
Robert F. Gilb	26,958,646	193,301

John A. Kelley, Jr	26,945,689	206,258

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits
None

(b) Reports on Form 8-K
The Company did not file any reports on Form 8-K during the quarter ended June 30, 2001.

SIGNATURES

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.

Captaris, Inc.
(Registrant)

Date: August 14, 2001

By: /s/ Jeffrey B. deCillia

Jeffrey B. deCillia
Executive Vice President,
Chief Financial Officer

Signing on behalf of registrant and as principal financial officer