

CAPTARIS INC  
Form 10-Q  
November 14, 2003  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

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**FORM 10-Q**

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(Mark One)

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

For the quarterly period ended September 30, 2003

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

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**CAPTARIS, INC.**

(Name of Registrant as Specified in Its Charter)

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**Washington**  
(State of Incorporation)

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

**10885 N.E. 4th Street, Suite 400**

**Bellevue, WA**  
(Address of Principal Executive Offices)

**98004**  
(Zip Code)

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

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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 an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes  No

The number of outstanding shares of the registrant's common stock as of November 10, 2003 was 32,154,531.

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**CAPTARIS, INC.**

**FORM 10-Q**

**For the Quarter Ended September 30, 2003**

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

(in thousands, except per share data)

(unaudited)

	September 30,	December 31,
	2003	2002
	<u>          </u>	<u>          </u>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 29,747	\$ 21,971
Short-term investments, available for sale	21,588	30,519
Accounts receivable, net	12,471	17,811
Inventories finished goods	1,464	2,928
Deferred income taxes	1,734	4,308
Prepaid expenses and other	2,147	1,544
	<u>          </u>	<u>          </u>
Total current assets	69,151	79,081
Long-term investments, available for sale	35,874	20,599
Equipment and leasehold improvements, net	4,882	7,595
Restricted cash	1,000	1,000
Deferred income taxes	1,723	1,546
Goodwill	14,825	8,976
Intangible and other assets, net	7,008	2,480
	<u>          </u>	<u>          </u>
Total assets	\$ 134,463	\$ 121,277
	<u>          </u>	<u>          </u>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 5,761	\$ 7,204
Accrued compensation and benefits	2,990	4,186
Deferred revenue	8,668	8,185
Other accrued liabilities	3,553	3,401
Income taxes payable	1,679	
Current portion of note payable	50	
	<u>          </u>	<u>          </u>
Total current liabilities	22,701	22,976
Note payable, net of current portion	424	

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Commitments and contingencies		
Redeemable common stock to be issued	3,000	
Shareholders' equity:		
Preferred stock, par value \$0.01 per share, 2,000 shares authorized; none outstanding		
Common stock, par value \$0.01 per share, 120,000 shares authorized; 30,932 and 30,218 outstanding, respectively	309	302
Additional paid-in capital	64,205	60,539
Retained earnings	43,404	37,148
Accumulated other comprehensive income	420	312
	<u>          </u>	<u>          </u>
Total shareholders' equity	108,338	98,301
	<u>          </u>	<u>          </u>
Total liabilities and shareholders' equity	\$ 134,463	\$ 121,277
	<u>          </u>	<u>          </u>

See the accompanying notes to unaudited condensed consolidated financial statements.

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

	<b>Quarter Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2003</b>	<b>2002</b>	<b>2003</b>	<b>2002</b>
Net revenue	\$ 18,079	\$ 17,065	\$ 51,917	\$ 49,632
Cost of revenue	6,920	6,618	19,154	18,710
Gross profit	11,159	10,447	32,763	30,922
Operating expenses:				
Research and development	2,384	2,643	7,182	7,266
Selling, general and administrative	9,330	9,172	27,727	29,055
Impairment of intangible assets				5,529
Amortization of intangibles	57	76	170	849
Restructuring charges	423		423	2,033
Stock compensation expense (benefit)	454	(498)	1,267	(1,016)
Gain on sale of the CallXpress product line	(2,088)		(2,088)	
Other				875
Total operating expenses	10,560	11,393	34,681	44,591
Operating income (loss)	599	(946)	(1,918)	(13,669)
Other income (expense):				
Interest	338	609	1,143	1,917
Other, net	(59)	(115)	(105)	(552)
Other income	279	494	1,038	1,365
Income (loss) from continuing operations before income tax expense (benefit)	878	(452)	(880)	(12,304)
Income tax expense (benefit)	334	(204)	(351)	(5,069)
Income (loss) from continuing operations before discontinued operations and cumulative effect of change in accounting principle	544	(248)	(529)	(7,235)
Discontinued operations:				
Income (loss) from operations of MediaLinq, net of income taxes	(37)	611	886	1,742
Gain on sale of MediaLinq, net of income taxes	5,899		5,899	
Income from discontinued operations	5,862	611	6,785	1,742
Income (loss) before cumulative effect of change in accounting principle	6,406	363	6,256	(5,493)

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Cumulative effect of change in accounting principle				(2,695)
Net income (loss)	\$ 6,406	\$ 363	\$ 6,256	\$ (8,188)
Basic income (loss) per common share from continuing operations before discontinued operations and cumulative effect of change in accounting principle	\$ 0.02	\$ (0.01)	\$ (0.02)	\$ (0.23)
Basic income per common share from discontinued operations	0.19	0.02	0.22	0.05
Basic loss per common share from cumulative effect of change in accounting principle				(0.08)
Basic net income (loss) per common share	\$ 0.21	\$ 0.01	\$ 0.20	\$ (0.26)
Weighted average basic common shares outstanding	30,597	31,914	30,383	31,876
Diluted income (loss) per common share from continuing operations before discontinued operations and cumulative effect of change in accounting principle	\$ 0.02	\$ (0.01)	\$ (0.02)	\$ (0.23)
Diluted income per common share from discontinued operations	0.18	0.02	0.22	0.05
Diluted loss per common share from cumulative effect of change in accounting principle				(0.08)
Diluted net income (loss) per common share	\$ 0.20	\$ 0.01	\$ 0.20	\$ (0.26)
Weighted average diluted common shares outstanding	31,425	32,047	30,823	31,876

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>Nine Months Ended</b>	
	<b>September 30,</b>	
	<b>2003</b>	<b>2002</b>
Cash flows from operating activities:		
Net income (loss)	\$ 6,256	\$ (8,188)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	3,118	3,921
Loss on disposition of equipment	118	396
Gain on sale of CallXpress product line	(2,088)	
Gain on sale of MediaLinq, net of income taxes	(5,899)	
Stock compensation expense (benefit)	1,846	(1,254)
Impairment of intangibles		5,529
Cumulative effect of change in accounting principle		2,695
Restructuring charges	177	
Changes in current assets and liabilities net of effects from purchase of businesses and sale of MediaLinq and CallXpress:		
Accounts receivable, net	2,125	(1,503)
Inventories	952	(128)
Deferred income taxes	(1,462)	(2,232)
Prepaid expenses and other assets	(760)	359
Accounts payable	(1,656)	122
Accrued compensation and benefits	(1,007)	(2,365)
Deferred revenue	752	505
Other accrued liabilities	572	(473)
Income taxes payable	1,856	
Net cash provided (used) by operating activities	4,900	(2,616)
Cash flows from investing activities:		
Purchase of equipment and leasehold improvements	(2,568)	(2,411)
Purchase of investments	(53,961)	(26,419)
Purchase of businesses, net of cash acquired	(7,252)	(456)
Proceeds from sale of CallXpress product line	2,500	
Proceeds from sale of MediaLinq	14,852	
Proceeds from sale and maturities of investments	47,617	33,954
Net cash provided (used) by investing activities	1,188	4,668
Cash flows from financing activities:		
Proceeds from exercise of common stock options	1,787	513
Settlement of note payable		(1,456)

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Lease deposit		(1,000)
Repurchase of common stock	(177)	(87)
	<u>          </u>	<u>          </u>
Net cash provided (used) by financing activities	1,610	(2,030)
	<u>          </u>	<u>          </u>
Net increase (decrease) in cash	7,698	22
Effect of exchange rate changes on cash	78	(13)
Cash and cash equivalents at beginning of period	21,971	19,654
	<u>          </u>	<u>          </u>
Cash and cash equivalents at end of period	\$ 29,747	\$ 19,663
	<u>          </u>	<u>          </u>

See the accompanying notes to unaudited condensed consolidated financial statements.

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**CAPTARIS, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**1. Interim Financial Statements**

In the opinion of management, the accompanying unaudited condensed consolidated balance sheets and related interim consolidated statements of operations and cash flows have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and notes required by accounting principles generally accepted in the United States of America for complete financial statements. All adjustments considered necessary for fair presentation have been included. Interim results are not necessarily indicative of results for a full year. These unaudited condensed consolidated financial statements should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and the Company's critical accounting policies, financial statements and notes thereto included in Captaris, Inc.'s (the Company's) Annual Report on Form 10-K for the fiscal year ended December 31, 2002. The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual amounts may differ from those estimates.

As described in Note 3, on September 15, 2003, the Company sold its MediaLinq division. As such, in accordance with generally accepted accounting principles, prior period results of operations have been reclassified to reflect MediaLinq's operating results and the gain on sale, net of income taxes, as Discontinued Operations.

**Stock 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 per share. 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 all employee options modified during the year. Variable accounting will continue until all options subject to variable accounting treatment are exercised, cancelled or expired. Variable accounting treatment will result in charges or credits, recorded to stock compensation expense (benefit), dependent on unpredictable fluctuations in quoted prices for the Company's common stock. At September 30, 2003 and 2002, the Company had 707,553 and 1,400,811 options, respectively, to purchase common shares subject to variable accounting. The Company recorded a charge of \$736,000 and a benefit of \$639,000 during the third quarter of 2003 and 2002, respectively, for variable stock compensation. For the nine months ended September 30, 2003 and 2002, the Company recorded a charge of \$1.8 million and a benefit of \$1.3 million, respectively, for variable stock compensation.

Allocation of this stock compensation expense (benefit) to the operating categories is as follows:

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	Quarter ended September 30,		Nine months ended September 30,	
	2003	2002	2003	2002
	(in thousands)			
Cost of revenue	\$ (2)	\$ (5)	\$ 2	\$ (8)
Research and development	137	(123)	296	(235)
Selling, general and administrative	319	(370)	969	(773)
Total operating expense (benefit)	\$ 454	\$ (498)	\$ 1,267	\$ (1,016)
Discontinued operations	282	(141)	579	(238)
Total stock compensation expense (benefit)	\$ 736	\$ (639)	\$ 1,846	\$ (1,254)

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The Company accounts for stock options under Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, under which no compensation expense has been recognized, as there is no difference between the exercise price and fair market value of stock options at the date of grant. Had compensation expense for stock option grants been determined using the fair value method consistent with SFAS No. 123, *Accounting for Stock-Based Compensation*, the Company's net income (loss) and net income (loss) per share would have been as shown in the following pro forma amounts for the quarters and nine months ended September 30, 2003 and September 30, 2002:

		Quarter ended September 30,		Nine months ended September 30,	
		2003	2002	2003	2002
(in thousands, except per share data)					
Net Income (Loss):	As reported	\$ 6,406	\$ 363	\$ 6,256	\$ (8,188)
	Fair value of stock compensation, net of tax	(297)	(370)	(853)	(1,220)
	Variable accounting expense (benefit), net of tax	450	(358)	1,112	(741)
	Pro forma	\$ 6,559	\$ (365)	\$ 6,515	\$ (10,149)
Basic EPS:	As reported	0.21	0.01	0.20	(0.26)
	Fair value of stock compensation, net of tax	(0.01)	(0.01)	(0.03)	(0.04)
	Variable accounting expense (benefit), net of tax	0.01	(0.01)	0.04	(0.02)
	Pro forma	\$ 0.21	\$ (0.01)	\$ 0.21	\$ (0.32)
Diluted EPS:	As reported	0.20	0.01	0.20	(0.26)
	Fair value of stock compensation, net of tax	(0.02)	(0.01)	(0.03)	(0.04)
	Variable accounting expense (benefit), net of tax	0.01	(0.01)	0.04	(0.02)
	Pro forma	\$ 0.21	\$ (0.01)	\$ 0.21	\$ (0.32)

In calculating the pro forma compensation expense, the fair value of each stock option grant is estimated on the date of grant using the Black-Scholes option pricing model and the following weighted average assumptions:

	Quarter ended September 30,		Nine months ended September 30,	
	2003	2002	2003	2002
Dividend yield	0.0%	0.0%	0.0%	0.0%
Volatility	58.3%	61.4%	61.8%	61.4%
Risk-free interest rate	2.23%	4.48%	2.42%	4.48%
Expected life (in years)	3	5	4	5

**2. Acquisition of Teemplate**

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On September 30, 2003, Captaris and its indirect wholly-owned subsidiary, Nova Scotia Company, a Nova Scotia, Canada unlimited liability company, acquired Teemplate, Inc. ( Teemplate ), an Alberta, Canada corporation. Teemplate s product is the first business process automation product built on the Microsoft .NET framework for Web services. This acquisition enhances the Captaris business strategy to become a market leader in business information delivery solutions for enterprise customers worldwide, and provides resources and market power to further penetrate the business process automation market. Teemplate s technology extends the Captaris business information delivery solutions with streamlined enterprise application integration, rapid solution deployment, sophisticated business rules processing and integrated process monitoring and metrics. The Company believes that combining the technologies of both companies will allow customers to achieve new levels of collaboration, accountability and business agility while reducing overall operational costs. Since the transaction occurred on September 30, 2003, the transaction is included in the quarter-end balance sheet and did not impact the results of operations for the quarter ended September 30, 2003.

Under the terms of the agreement, Captaris acquired all of the stock of Teemplate for \$8.15 million in cash, issued 574,727 shares of Captaris common stock valued at approximately \$3.0 million that were issued on October 3, 2003, and assumed liabilities of approximately \$823,000, all resulting in an aggregate purchase price of \$12.3 million, including transaction costs of approximately \$282,000. The value of the common stock issued was determined using the closing price of Captaris stock on the NASDAQ National Market on September 30, 2003, the date the acquisition was announced and consummated. The purchase price is subject to a post closing adjustment, as defined, to be determined on December 31, 2003, and collection of certain receivables by September 30, 2004. The common stock will be held in a third-party escrow account for one year as security for certain post closing obligations of the Teemplate shareholders, including indemnification provisions whereby the Teemplate shareholders agreed to indemnify the Company against claims resulting from various representations and warranties made by the former Teemplate shareholders. On the first anniversary of the closing, each Teemplate shareholder will have the option to require Captaris to purchase all of the shareholder s portion of the Captaris common stock issued in the transaction at a price per share of \$5.22 if (a) the average of the last sale prices of the common stock for the 20 trading days prior to September 30, 2004 is less than \$5.22 per share; and (b) the last sale price of the common stock on September 30, 2004 is less than \$5.22 per share. As a result of this buyback clause, the Company has recorded the issuance of this common stock as Redeemable Common Stock on the balance sheet. In addition, the Company agreed to indemnify the Teemplate shareholders against claims resulting from various representations and warranties made by the Company. At September 30, 2003, the former Teemplate shareholders have made no indemnification claims.

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As part of an incentive program to the management team of Teemplate, if the business plan for the combination achieves certain performance targets, the management team may earn up to \$5.5 million over the three year period following the closing. The Company's obligation to pay this incentive compensation is also based on continued employment. Any incentive compensation earned under this program will be recorded as compensation expense in the period earned.

In accordance with Statement of Financial Accounting Standard ( SFAS ) No. 141, all identifiable assets and liabilities were assigned a portion of the cost of the acquisition based on their respective fair values. The Company engaged an independent valuation firm to provide an estimated fair value for all identifiable intangibles including workflow server technology, tradename, customer relationships and reseller agreements, using a discounted cash flow model. The determination of fair value is a critical and complex consideration that involves significant assumptions and estimates. These assumptions and estimates were based on the Company's best judgments and resulted in the allocation of purchase price for this acquisition as detailed below. The excess of the purchase price over the fair value of the assets acquired was allocated to goodwill.

	September 30, 2003
	(in thousands)
<b>Teemplate Purchase Price Allocation:</b>	
Workflow server technology	\$ 4,004
Tradename	90
Customer relationships	469
Reseller agreements	311
<b>Total identified amortizable intangibles</b>	<b>4,874</b>
Goodwill	5,805
Equipment	107
Current assets	1,510
<b>Total purchase price</b>	<b>\$ 12,296</b>

The purchase price allocation set forth above is subject to additional adjustments related to the ultimate determination of the fair value of certain liabilities. All such adjustments identified during the allocation period, expected to expire on September 30, 2004, would change the carrying amount of the goodwill generated as a result of the acquisition. Based on information available to management after September 30, 2003, the Company estimates the post-closing purchase price adjustment to be an increase in purchase price of approximately \$400,000. This post-closing purchase price adjustment when finalized will be recorded as additional goodwill. When finalized, the actual amount of the adjustment may differ from this estimate.

All identified intangible assets will be amortized on a straight-line basis over their estimated useful lives, ranging from fifteen months to seven years. The weighted-average useful life of these assets is approximately 6.9 years. The Company expects to recognize amortization expense for these intangible assets of approximately \$189,000 for the quarter ending December 31, 2003, \$755,000 for the year ending December 31, 2004 and \$683,000 during each of the years ending December 31, 2005 through September 30, 2010. All of the \$5.8 million allocated to Goodwill was assigned to the Teemplate reporting unit and is expected to be deductible for tax purposes.

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The following summarizes the unaudited pro forma results of operations, on a combined basis, as if the Company's acquisition of Teemplate occurred as of the beginning of each of the periods presented. The pro forma information gives effect to certain adjustments, including amortization of identified intangibles. This unaudited pro forma information is presented for illustrative purposes only and is not necessarily indicative of the results of future operations or results that would have been achieved if the Company had made these acquisitions at the beginning of the specified periods.

	Quarter Ended		Nine Months Ended	
	September 30,		September 30,	
	2003	2002	2003	2002
	(Unaudited)		(Unaudited)	
Net revenue	\$ 18,493	\$ 17,218	\$ 53,158	\$ 49,923
Income (loss) from continuing operations before discontinued operations and cumulative effect of change in accounting principle	\$ (213)	\$ (740)	\$ (2,801)	\$ (8,879)
Income from discontinued operations	5,862	611	6,785	1,742
Income (loss) before cumulative effect of change in accounting principle	5,649	(129)	3,984	(7,137)
Cumulative effect of change in accounting principle				(2,695)
Net income (loss)	\$ 5,649	\$ (129)	\$ 3,984	\$ (9,832)
Basic income (loss) per common share from continuing operations before discontinued operations and cumulative effect of change in accounting principle	\$ (0.01)	\$ (0.02)	\$ (0.09)	\$ (0.28)
Basic income per common share from discontinued operations	0.19	0.02	0.22	0.05
Basic loss per common share from cumulative effect of change in accounting principle				(0.08)
Basic net income (loss) per common share	\$ 0.18	\$ 0.00	\$ 0.13	\$ (0.31)
Weighted average basic common shares outstanding	30,597	31,914	30,383	31,876
Diluted income (loss) per common share from continuing operations before discontinued operations and cumulative effect of change in accounting principle	\$ (0.01)	\$ (0.02)	\$ (0.09)	\$ (0.28)
Diluted income per common share from discontinued operations	0.19	0.02	0.22	0.05
Diluted loss per common share from cumulative effect of change in accounting principle				(0.08)
Diluted net income (loss) per common share	\$ 0.18	\$ 0.00	\$ 0.13	\$ (0.31)
Weighted average diluted common shares outstanding	31,425	32,047	30,823	31,876

**3. Discontinued Operations**

On September 15, 2003, Captaris and its wholly-owned subsidiary, MediaTel Corporation (Delaware) ( MediaTel ), entered into an asset purchase agreement, effective as of August 31, 2003, to sell the assets of MediaLinq, an outsourced division of Captaris operated by MediaTel, to PTEK Holdings, Inc. and its wholly-owned subsidiary, Xpedite Systems, Inc. ( Xpedite ). MediaLinq provides outsourced e-document delivery services.

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Under the terms of the agreement, Xpedite paid Captaris \$14.9 million in cash and assumed certain liabilities. The purchase price is subject to a post-closing net working capital adjustment which will be determined before December 31, 2003. In addition, the Company agreed to indemnify Xpedite against claims resulting from various representations and warranties made by the Company. At September 30, 2003, Xpedite has made no indemnification claims. Concurrent with the sale transaction, the Company and Xpedite also entered into license and reseller agreements under which the Company will license its fax-to-mail technology to Xpedite in return for minimum compensation of \$2.0 million over a three year period, and the parties will cooperate in providing mutual resale opportunities for each other's products and services. The Company recognized a gain on the sale of MediaLinq, net of income taxes, of approximately \$5.9 million in the quarter ended September 30, 2003.

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For segment reporting purposes, MediaLinq's operations were previously reported in the E-document services segment. MediaLinq's current and prior period results of operations have been reclassified as Discontinued Operations. Components of MediaLinq's operations reflected in the Company's condensed consolidated statements of operations as discontinued operations are as follows:

	Quarter ended		Nine months ended	
	September 30,		September 30,	
	2003	2002	2003	2002
	(in thousands)			
Revenue	\$ 3,993	\$ 6,022	\$ 15,812	\$ 17,746
Income (loss) from operations, before tax	\$ (61)	\$ 1,010	\$ 1,465	\$ 2,882

Components of MediaLinq's balance sheet reflected in the Company's condensed consolidated balance sheets are as follows:

	September 30,	December 31,
	2003	2002
	(in thousands)	
Current assets	\$	\$ 8,158
Equipment and leasehold improvements, net		2,287
Current liabilities		2,451

**4. Sale of CallXpress Product Line**

On September 29, 2003, Captaris announced the sale of its CallXpress product line, which primarily includes the Captaris voice and unified messaging assets, to Sound Advantage, LLC ( "Sound Advantage"), a California limited liability company.

Under the terms of the agreement, Sound Advantage acquired the CallXpress product line for \$2.5 million in cash and will pay up to an additional \$1.0 million per year over a three year period beginning January 1, 2004 pursuant to an earn out arrangement, which is based on achievement of specified revenue targets for the CallXpress business. In addition, Captaris was issued a 10 percent equity interest in Applied Voice and Speech Technologies, Inc. ( "AVST"), a newly formed company established by Sound Advantage to acquire and operate the combined CallXpress and Sound Advantage businesses. RightFax will continue to be a part of AVST's Unified Messaging offering, based on an ongoing OEM agreement. Also, the Company agreed to indemnify AVST against claims resulting from various representations and warranties made by the Company. At September 30, 2003 no indemnification claims have been made by AVST. The Company recognized a gain on the sale of CallXpress of approximately \$2.1 million in the quarter ended September 30, 2003.

Components of the CallXpress product line reflected in the Company's condensed consolidated statements of operations are detailed below. Certain components of cost of revenue, operating expenses and operating income directly attributable to the CallXpress product line could not be separated from other product lines. Only direct revenue and cost of revenue directly attributable to the CallXpress product line are detailed

below:

	Quarter ended September 30,		Nine months ended September 30,	
	2003	2002	2003	2002
	(in thousands)			
Revenue	\$ 2,158	\$ 3,786	\$ 6,957	\$ 10,422
Cost of revenues	\$ 675	\$ 813	\$ 1,920	\$ 2,342

**Table of Contents****5. Segment Reporting**

Historically, the Company classified its business into two major segments: Software Products and E-document Services. In September 2003, the Company sold its E-document services operating segment (see Note 3). As a result of the sale, the Company now operates in only one operating segment.

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

	Quarter ended September 30,		Nine months ended September 30,	
	2003	2002	2003	2002
	(in thousands)			
United States	\$ 13,620	\$ 13,016	\$ 38,961	\$ 37,699
United Kingdom	519	806	2,174	2,713
Canada	792	550	2,177	1,283
Other	3,148	2,693	8,605	7,937
<b>Total net revenue</b>	<b>\$ 18,079</b>	<b>\$ 17,065</b>	<b>\$ 51,917</b>	<b>\$ 49,632</b>

**6. OEM Agreement**

In January 2002, the Company entered into an original equipment manufacturing (OEM) agreement with Cisco Systems, Inc., under which the Company has granted Cisco an exclusive third-party license to certain enabling technology. The agreement generally provided for quarterly payments to be made by Cisco to the Company through mid-2005. However, the timing and amount of these payments were subject to a number of conditions, some of which were beyond the control of the Company, including Cisco's ability to successfully implement the technology. The Company received a payment of \$833,000 in 2001 and received payments of \$2.5 million in 2002. The Company recognized \$3.3 million in revenue from this agreement in 2002, of which \$98,000, \$588,000 and \$588,000 were recognized in the first, second and third quarters of 2002, respectively. The Company did not receive a payment, or recognize revenue from Cisco in the first nine months of 2003. On October 30, 2003, the Company reached an agreement with Cisco to accelerate the conclusion of this OEM agreement. See Note 17, Subsequent Event.

**7. Note Payable**

In connection with the acquisition of Teemplate, see Note 2, the Company assumed a non-interest bearing note payable to the National Research Council of Canada (NRC) with an original principal balance of approximately \$366,000. Beginning on October 1, 2003 and at the beginning of every quarter thereafter up to and including April 1, 2006, the Company must pay NRC 2.2% of Teemplate's net revenue for the quarter preceding repayment. If by April 1, 2006, the total amount repaid and owed to NRC is less than \$366,000, the Company must continue to make repayments to NRC until the earlier of the full repayment of \$366,000 or ten years after the start of the repayment period. If at any time, the total amount paid to NRC equals or exceeds \$550,000, the note will be deemed paid in full. Based on an estimate of Teemplate's future revenue, the Company expects to repay the full \$550,000 on or before April 1, 2006. The Company estimated the fair value of this note payable to be

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\$474,000 at September 30, 2003 using a discount rate equal to Teamplate's estimated borrowing rate of 7.0%. The balance of the note payable at September 30, 2003 was as follows:

	<b>September 30, 2003</b>
	<b>(in thousands)</b>
Note payable	\$ 474
Less current portion of note payable	(50)
<b>Note payable, net of current portion</b>	<b>\$ 424</b>

**Table of Contents****8. Commitments and Contingencies**

The Company leases its facilities and certain equipment under non-cancelable operating leases which expire between December 2003 and February 2008. The Company is also obligated to pay a post-closing purchase price adjustment related to the acquisition of Teemplate. See Note 2. At September 30, 2003, the approximate future lease payments for the remainder of the lease terms and estimated post-closing purchase price commitment are as follows:

**Commitments**

(in thousands)	2003	2004	2005	2006	2007	Thereafter	Total
Operating lease obligations	\$ 435	\$ 1,397	\$ 1,289	\$ 1,237	\$ 1,012	\$ 153	\$ 5,523
Estimated post-closing purchase price adjustment for Teemplate acquisition (See Note 2)	400						
<b>Total commitments</b>	<b>\$ 835</b>	<b>\$ 1,397</b>	<b>\$ 1,289</b>	<b>\$ 1,237</b>	<b>\$ 1,012</b>	<b>\$ 153</b>	<b>\$ 5,923</b>

We have periodically received letters and other communications from third parties asserting patent rights and requesting royalty payments, and will probably receive additional claims in the future. For example, over the past six years, we have been involved in intermittent communications with Avaya, which was spun off from Lucent Technologies in 2001. Over this period of time, Lucent/Avaya asserted that we were infringing on their patents or technology, eventually identifying 10 patents as including claims that allegedly cover our current or former products and/or services. Several communications and meetings between us and Lucent/Avaya have occurred, and discussions are ongoing. We have also been in communication with BellSouth since December of 2001, at which time BellSouth asserted we were infringing on two of its patents. Analysis of both patents in light of our current and former products/services is still underway. The last communication with representatives of BellSouth was on June 19, 2003.

**9. Cumulative Effect of Change in Accounting Principle**

Effective January 1, 2002, the Company adopted SFAS No. 142, *Goodwill and Other Intangibles Assets*, which eliminated the amortization of goodwill and indefinite-lived intangible assets, proscribed the amortization of intangible assets with finite lives, and proscribed impairment testing and recognition for goodwill and intangible assets. In January 2002, the Company evaluated its intangible assets, including core technology, customer lists, and other intangibles and determined that these assets have finite lives. As a result of the Company's evaluation, the Company recorded a \$2.7 million non-cash charge in the first quarter of 2002 as a cumulative effect of change in accounting principle as a result of the impairment of goodwill. SFAS No. 142 prescribes an impairment testing of goodwill to be performed at least annually. The Company completed this annual evaluation during the first quarter of 2003 noting no additional impairment.

**10. Intangible and Other Assets, Net**

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On January 1, 2002, the Company adopted SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. SFAS No. 144 develops one accounting model for long-lived assets and requires these assets to be measured at the lower of book value or fair value. In January 2002, the Company engaged an independent valuation firm to provide an estimated fair value of each of its intangible, long-lived assets using a discounted cash flow model. The determination of fair value is a critical and complex consideration when assessing impairment under SFAS No. 144 that involves significant assumptions and estimates. These assumptions and estimates were based on the Company's best judgments. As a result, the Company determined that certain intangible assets acquired from Infinite Technologies in January 2001 were impaired. Accordingly, the Company recorded an impairment charge of \$5.5 million for the mobile delivery reporting unit in January 2002. This impairment charge consisted of a write-down of core technology of approximately \$2.4 million, a write-down of customer base and marketing channel of approximately \$2.2 million and a write-down of tradename of approximately \$849,000.

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On September 30, 2003, the Company acquired approximately \$4.9 million of intangible assets in connection with the acquisition of Teemplate, Inc. See Note 2. A summary of the Company's intangible and other assets, net at September 30, 2003 and December 31, 2002 is as follows:

Intangible and Other Assets, Net (in thousands)	September 30, 2003			December 31, 2002		
	Gross			Gross		
	Carrying Amount	Accumulated Amortization	Book Value	Carrying Amount	Accumulated Amortization	Book Value
Technology	\$ 4,314	\$ (70)	\$ 4,244	\$ 310	\$ (28)	\$ 282
Tradenames/domain name	1,020	(247)	773	930	(127)	803
Customer relationships and marketing channels	469		469			
Reseller agreements	311		311			
Other	3,020	(1,809)	1,211	3,020	(1,625)	1,395
<b>Total</b>	<b>\$ 9,134</b>	<b>\$ (2,126)</b>	<b>\$ 7,008</b>	<b>\$ 4,260</b>	<b>\$ (1,780)</b>	<b>\$ 2,480</b>

Intangible assets are being amortized using the straight-line method over their estimated useful life ranging from 15 months to twelve years. Amortization expense recorded in cost of revenue was \$58,000 and \$75,000 for the quarters ended September 30, 2003 and 2002, respectively, and \$175,000 and \$202,000 for the nine months ended September 30, 2003 and 2002, respectively. Amortization expense recorded in operating expenses was \$57,000 and \$76,000 for the quarters ended September 30, 2003 and 2002, respectively, and \$170,000 and \$849,000 for the nine months ended September 30, 2003 and 2002, respectively. Based on the current amount of intangible assets subject to amortization, the estimated amortization expense for the remainder of 2003 and each of the succeeding five years is as follows: \$304,000 for the remainder of 2003, \$1.2 million for 2004 and \$1.1 million in each of the years 2005 through 2007 and \$773,000 for 2008.

In April 2002, the Company entered into a nonexclusive license agreement with AudioFAX IP LLC, settling a patent infringement suit filed by AudioFAX on November 30, 2001. The Company paid a one-time fee to license the technology until the patents expire in 2008 and 2011. In the first quarter of 2002, the Company recorded an other charge of \$875,000, reflecting management's assessment of the fair value of the portion of the license fee that relates to prior years. The remaining balance of the license fee was capitalized and is being amortized over the remaining life of the licensor's patents. Amortization expense related to this license was \$22,000 and \$22,000 for the quarters ended September 30, 2003 and 2002, respectively. Amortization expense for this license was \$67,000 and \$44,000 for the nine months ended September 30, 2003 and 2002, respectively.

**11. Restructuring Charges**

In September 2003, partly in conjunction with the sale of its CallXpress product line, the Company recorded a restructure charge of approximately \$423,000 for severance and related benefits for terminated employees associated with CallXpress. In addition to the reduction of employees from the sale of the CallXpress product line, the Company recorded a charge of approximately \$624,000 in Selling, General and Administrative Expenses in September 30, 2003 for severance expense. Approximately \$177,000 of severance expense recorded in Accrued Compensation and Benefits remained unpaid as of September 30, 2003. The Company anticipates that these expenses will be paid during the fourth quarter of 2003.

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In January 2002, the Company announced a reduction of its workforce, affecting approximately 90 employees, or 18% of the total Company workforce. This reduction in force, primarily affecting the software products segment, resulted in the recognition of a restructuring charge of \$2.0 million primarily related to severance. All costs associated with this reduction in force were paid as of December 31, 2002.

### **12. Net Income (Loss) Per Share**

Basic net income (loss) per common share was computed by dividing net income (loss) by the weighted average number of shares of common stock outstanding during the year. Diluted net income (loss) per common share was computed by: (1) dividing net income (loss) by the sum of the weighted average number of shares of common stock outstanding during the year; (2) adding the net additional shares that would have been issued had all dilutive options been exercised less shares that would be repurchased with the proceeds from such exercise; (3) adding the additional shares to be issued in connection with the Teemplate acquisition. See Note 2. Dilutive options are those that have an exercise price that is less than the average stock price during the period.

There were 394,128 shares of common stock equivalent shares excluded from the calculation of diluted shares outstanding for the nine months ended September 30, 2002 as they were antidilutive.

**Table of Contents****13. Changes in Shareholders' Equity**

	Shares	Common Stock	Additional Paid in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total
(in thousands)						
Balance at December 31, 2002	30,218	\$ 302	\$ 60,539	\$ 37,148	\$ 312	\$ 98,301
Net income				6,256		6,256
Exercise of stock options	782	8	1,779			1,787
Repurchase of common stock	(68)	(1)	(176)			(177)
Stock issued to acquire Teemplate, Inc.			40			40
Stock compensation expense			1,846			1,846
Stock option income tax benefits			177			177
Unrealized loss on investments, net of tax					(137)	(137)
Foreign currency translation adjustment					245	245
Balance at September 30, 2003	30,932	\$ 309	\$ 64,205	\$ 43,404	\$ 420	\$ 108,338

**14. Supplemental Cash Flow Information**

Disclosure of supplemental cash flow information is summarized below:

	Nine Months Ended September 30, 2003	Nine Months Ended September 30, 2002
<b>Supplemental cash flow information:</b>		
Cash paid (refund received) for taxes	\$ (345)	\$ (1,447)
Issuance of redeemable common stock in purchase of Teemplate, Inc.	\$ 3,040	\$

**15. Legal Proceedings**

One of the services provided by MediaTel Corporation ( MediaTel ), a wholly owned subsidiary of Captaris, was the transmission of facsimile advertisements to travel industry participants on behalf of travel service providers. MediaTel held a license to use a database supplied by Northstar Travel Media that lists recipients for these facsimile advertisements. All of the assets of MediaTel were sold to a subsidiary of PTEK

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Holdings, Inc. ( PTEK ) on September 16, 2003. On or about July 29, 2003, Travel 100 Group, Inc. ( Travel 100&#148