CAPTARIS INC
Form 10-K
March 14, 2007
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

FOR ANNUAL AND TRANSITION REPORTS

PURSUANT TO SECTIONS 13 OR 15(d) OF THE

SECURITIES EXCHANGE ACT OF 1934.

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

For the fiscal year ended: December 31, 2006

OR

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

For the transition period from ______ to ______

Commission file number: 0-25186

CAPTARIS, INC.

(Exact name of registrant as specified in its charter)

Washington	**91-1190085**
(State or other jurisdiction of incorporation or organization)	**(IRS employer identification no.)**

10885 N.E. 4th Street, Suite 400

Bellevue, WA	**98004**
(Address of principal executive offices)	**(Zip code)**

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

Securities registered pursuant to Section 12(b) of the Act: None

Title of each class	Name of each exchange on which registered
Common Stock, $0.01 par value per share Preferred Stock Purchase Rights	**Nasdaq Global Market**

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes ¨ No x

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 twelve months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨

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

Aggregate market value of voting stock held by non-affiliates of the registrant as of June 30, 2006 (our most recently completed second quarter) was $129,823,871 (based upon the closing sale price of $4.65 per share on the Nasdaq Global Market on such date). For purposes of this disclosure, shares of common stock held by executive officers and directors of the registrant have been excluded because such persons may be deemed to be affiliates.

Number of shares of common stock outstanding as of March 1, 2007 was 27,465,537.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant s Proxy Statement for its 2007 Annual Meeting of Shareholders to be filed with the Commission pursuant to Regulation 14A not later than 120 days after December 31, 2006 is incorporated by reference in Part III hereof.

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PART I

This Annual Report on Form 10-K and the documents incorporated herein by reference contain forward-looking statements. These statements relate to future events or our future financial performance. In some cases, you can identify forward-looking statements by terminology such as may, will, should, expect, plan, intend, anticipate, believe, estimate, predict, potential, continue, could, future, seek, target or the negative of these terms or other terminology. These statements are only predictions. Actual events or results may differ materially. In evaluating these statements, you should specifically consider various factors, including the risks outlined under Item 1A Risk Factors. These factors may cause our actual results to differ materially from any forward-looking statement. Except as required by law, we undertake no obligation to publicly release any revisions to these forward-looking statements that may be made to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

Item 1. BUSINESS

Captaris develops software products that automate business processes, manage documents electronically and provide efficient information delivery. With a comprehensive suite of software and services, Captaris specializes in automating paper and other document-centric processes that are found in most organizations. Our customers use our products to reduce costs, comply with regulations and increase the performance of critical business processes and system investments.

Our products and services address business needs in several related markets: the fax server and electronic document delivery market; the business process management market; and the enterprise content management market. We distribute our products primarily through independent distributors, value-added resellers, direct sales professionals and information technology (IT) service providers. Our products are designed to run on off-the-shelf hardware servers, networked personal computers (PCs) and Microsoft software platforms including Microsoft® Windows NT, Windows 2000, Windows 2003, Windows XP and we plan on compatibility with Windows Vista. We utilize Microsoft.NET development tools in our suite of products and integrate with a wide variety of hardware equipment and enterprise software products. Captaris is a corporation formed in the State of Washington in 1982. Our principal executive offices are located in Bellevue, Washington.

In the third quarter of 2003, we divested CallXpress, our unified messaging business, and the assets of MediaTel Corporation, our wholly-owned subsidiary that operated the MediaLinq business, a hosted fax and e-mail business. Also in the third quarter of 2003, we acquired Teamplate, Inc. (Teamplate), a developer of business process automation software which is built on the .NET architecture platform and is now marketed as Captaris Workflow. Our decision to add a workflow offering was a natural extension of, and complement to, our RightFax product line, which provides fax and electronic document delivery solutions to enterprises, primarily because the delivery of a document is typically at the start of a work process in an organization. With Captaris Workflow, we offer our customers the technology to create and manage automated work processes and integrate documents and data with other enterprise applications.

In October of 2004, we acquired Information Management Research, Inc. (IMR) and its Alchemy document and records management product line. Imaging, archival and record management activities naturally follow after the processing and delivery of documents and data. The Alchemy product line is marketed as Captaris Alchemy.

Industry Background

Businesses optimize and automate internal processes to achieve several desirable outcomes: improve customer service; increase employee productivity; improve and accelerate revenue flows; decrease labor, system and program costs; and more efficiently disseminate, store and retrieve information. With increasing amounts of information in diverse delivery formats exchanged inside and between organizations, we believe there is a growing need for organizations to manage business information and resources throughout the information lifecycle in a more timely and cost-effective manner. The market for solutions to these business needs is part of the Enterprise Content Management (ECM) market categorized into the following market segments: Fax Servers, Integrated Document Output Management, Integrated Document Archiving and Retrieval Systems (IDARS), Records Management (RM), Business Process Management (BPM), Customer Relationship Management (CRM) and Enterprise Resource Planning (ERP). Captaris products serve and connect to each of these market segments.

Typical deployments of Captaris software solutions include:

The automation of paper-intensive processes such as mortgage origination, healthcare claims, government procurement and records management;

The automation of the capture and processing of documents received from outside sources;

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The automation and streamlining of information delivery from an enterprise application, such as SAP and Oracle, to many recipients; and

The creation and managing of document capture and archival processes to meet strict regulatory requirements.

We believe the growth in enterprise content management needs presents additional opportunities for Captaris products. For example, organizations are utilizing electronic document exchange systems and services to store, forward and broadcast their growing volume of document traffic in an efficient manner. We believe this rapid increase in multiple forms of content has further accentuated the need for enterprises to optimize and integrate their information management capabilities.

Customers also use Captaris software solutions to assist in their efforts to comply with applicable laws and regulations such as the Sarbanes-Oxley Act of 2002 and the Health Insurance Portability and Accountability Act of 1996. Our customers report that automating business processes and enhancing systems by deploying Captaris software solutions, either alone or in conjunction with other software solutions, facilitates compliance with these complex laws and regulations.

Strategy

We are a provider of software products and services that are focused on the automation of paper and other document-centric business processes and that leverage our RightFax brand. We offer our customers comprehensive software solutions that address every phase of the information lifecycle, from the capture of unstructured data, to processing, to delivery, to final archiving and retrieval. Our products can be deployed alone or integrated together in combinations to solve business problems.

While our solutions have historically been deployed in organizations of all sizes, our sales focus is targeted at the mid-size and enterprise departmental markets. Our intent is to expand our solutions into enterprise-wide deployments, while leveraging our customers existing IT systems.

Key components of our strategy include:

Focus on the mid-size to enterprise departmental market. We target mid-size to larger enterprises, including divisions and subsidiaries of Fortune 500 companies and Global 2000 companies. Our strategy is to invest in the development of new products and services that are highly scalable and reliable to meet the particular needs of these enterprises.

Expand our worldwide support and maintenance program. We are expanding our services portfolio, which includes technical support, training, maintenance and professional services. We strive to increase the percentage of our customers who contract for maintenance and technical support plans and to increase enterprise-level service agreement offerings. In early 2004, after instituting improvements in technical support and software upgrade programs, we began requiring the purchase of a first year maintenance program along with our software licenses. In addition, our Captaris Developer Support Program provides our customers and partners with application programming interface support across the Captaris product line.

Capitalize on our installed base. We plan to grow our existing customer relationships by extending our product offerings into other departments within our customer base, as well as offering add-on modules, software upgrades and new products, which are designed to provide increased capacity and/or functionality. We are continually training our sales force and selling partners to cross-sell our product lines into our existing customer base.

Grow our distribution ecosystem. We strive to sell to enterprises primarily through distributors and value-added resellers. We also distribute our products through independent software vendors, system integrators and an enterprise sales force. We seek to leverage the benefits of these multiple distribution opportunities to ensure adequate market coverage. Beginning in 2005, we broadened our distribution channels by expanding our enterprise sales efforts and collaborating with our regional, independent partners to raise awareness and distribution across enterprise accounts.

Leverage strategic technology partnerships worldwide. We have strategic partner relationships with large technology companies including Microsoft Corporation, Canon U.S.A., Inc., Cisco Systems, Inc., Xerox Corporation, Hewlett Packard Company and Oracle Corporation. Some of our strategic partners have entered into distribution agreements with Captaris that include private label original equipment manufacturer (OEM) agreements and reseller agreements. We plan to pursue an expansion of similar agreements in the future with our Business Development and Strategic Partner Marketing efforts.

Pursue global opportunities. We believe that the market for document-centric software solutions outside the United States will experience consistent growth in the next few years. To pursue these opportunities, we globalize and/or localize our products to either their full extent or their key application components for specific markets. We also actively recruit new international resellers, distributors and strategic partners to expand our market coverage and enhance technical expertise.

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Grow through acquisitions. Growth through acquisitions of complementary technologies, products and distribution channels offers the potential for significant competitive advantage. Our open platform is designed to facilitate the rapid integration of, and linkage to, other complementary technologies, especially as we have integrated Web services into our overall architecture. We believe we can accelerate introduction of new technologies to the market through acquisitions and respond rapidly to industry changes and opportunities.

Products and Services

Captaris software solutions are based on the Captaris product suite that addresses every phase of the information lifecycle, from the capture of unstructured data to processing, delivery and final archiving. Our products can be deployed alone or integrated together to solve challenging business problems and improve organizational efficiency.

Our products and services include the following categories:

- **fax server and document delivery** software and hardware products that target business needs for high-performance fax processing, electronic document delivery and business process automation;
- **business process automation** software products that target business needs for automating both functional and vertical business processes, helping organizations to maintain accountability, support compliance initiatives and increase productivity; and
- **document management, archiving and records management** software products that target business needs for storing and accessing content throughout the information lifecycle, and supporting compliance initiatives within organizations.

Electronic Document Delivery Products

Captaris RightFax

RightFax provides organizations with enterprise fax and advanced electronic document delivery solutions. The RightFax product suite includes a wide range of solutions ranging from desktop faxing over a network to capturing high volumes of business-critical data from back-office applications and electronically delivering this data to multiple recipients.

Our RightFax solutions are designed to work within our customers existing corporate IT infrastructure. As our customers business needs expand, upgrade packages are available to expand beyond day-to-day faxing to automating their key business processes and optimizing workflow. Customers use more advanced RightFax solutions to integrate with enterprise applications developed by companies such as Microsoft Corporation, International Business Machines Corporation (IBM), Oracle Corporation, Siebel Systems, Inc., SAP Corporation, Xerox Corporation, Hewlett Packard Company and FileNet Corporation.

RightFax products allow end-users to fax any document directly from applications running on their desktop or workstation. In addition, incoming faxes can be directly routed to end-user desktops and can be integrated into their e-mail inbox or delivered in many formats, including Web-enabled devices such as personal data assistants (PDAs) or mobile phones. The products are designed to ensure that faxes are secure, kept confidential and eliminate the need for individuals to walk to fax machines, wait in line, or search for faxes. The products are designed to integrate with other critical business applications, including operational and accounting applications that generate documents typically printed on forms which are then mailed. RightFax products automate this process by creating electronic images of the documents and delivering them automatically and instantaneously via fax, e-mail or over the Internet.

Organizations that receive substantial amounts of inbound faxes, such as mortgage or insurance companies, can receive these documents electronically and route them automatically to the intended recipient. The automation of manual processes improves accuracy and reliability and shortens cycle times and costs. By reducing the cycle time involved in exchanging invoices, statements and other electronic commerce documents with customers, vendors and partners, we believe deployments of RightFax products improve our customers cash flows.

The primary offerings in the RightFax product line are fax servers that differ by scalability, features, integration modules, fax volume capacity (channels) and vertical or application-specific solution packages. We resell third-party fax hardware that enables large volume fax processing. The RightFax product line includes the following products: *RightFax Small Business Server*, *RightFax Business Server, RightFax Enterprise Server, RightFax Enterprise Suite*, *RightFax Business Integration*, *RightFax Enterprise Integration, RightFax for Oracle* and *RightFax for SAP solutions*.

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In June 2006, we released RightFax 9.3 which offers the following key features and functionalities:

RightFax Shared Services Module Multiple RightFax application servers share a single RightFax database and services improving user administration, load-balancing, data redundancy and support for disaster recovery scenarios.

RightFax Database Enhancements RightFax 9.3 offers performance enhancements to inbound document processing designed to benefit companies seeing increased document traffic within their organization. This release uses Microsoft SQL Server to manage a new receive queue, which we believe adds more reliability, better performance and load-balancing for received faxes.

RightFax Web Access (RWA) Numerous updates improve usability for both users and administrators including simplified log-in and delegate support, online tutorials and documentation, streamlined error-handling, an Administrators Tab and client-side fax printing and saving.

Captaris Synchronization Module An XML-based tool synchronizes company data to RightFax 9.3 from Microsoft Active Directory or the Lightweight Directory Access Protocol (LDAP). The new Microsoft Active Directory integration does not require an update to the company s existing schema.

Server Side Application (SSA) Conversion Enhancements The new Captaris Isolated Conversion Engine improves the speed and efficiency by which documents are converted to faxes on the RightFax Server from native applications such as Microsoft Word, PowerPoint, Excel and HTML.

Windows and Database Certifications RightFax 9.3 is certified on Microsoft Windows 2000 Standard and Advanced Server; Windows Server 2003 Standard and Enterprise Edition. RightFax FaxUtil is certified as Designed for Windows XP. Database support includes SQL Server 2000 and 2005 Standard and Enterprise Edition, as well as SQL Server Express 2005. RightFax 9.3 is also certified with SQL Server 2000.

Installation Enhancements A new CD launches a wizard that conducts pre-installation checks and updates to the server or client computer. In addition, RightFax 9.3 also includes a separate client installation program that allows the client components to be installed and deployed separately from the server package.

Miscellaneous Feature Enhancements

SMTP gateway enhancement splits fax traffic between gateways.

FaxUtil supports mixed paper size printing. Letter and legal pages can be printed from a single fax.

The ability to set or deny routing of faxes that are not received completely.

Enhanced history records include more tracking information.

DocTransport simulation capability was added.

RightFax server uses SQL Server Express 2005 replacing the proprietary database previously bundled with every RightFax Server.

Enhancements for Dialogic Corporation Fax Boards RightFax 9.3 includes support for the Dialogic fax board features: call blocking, inbound routing and enhanced use of Computer System Identification Number (CSID). These features are available with Dialogic s Eicon Diva Server fax boards.

With RightFax 9.3 Feature Pack 1 launched in October 2006, we offer a fully software-supported Fax over IP offering in conjunction with the Cantata SR-140 product.

Business Process Automation Products

Captaris Workflow, previously known as Teamplate.NET

Captaris Workflow is a workflow platform built on the Microsoft.NET (.NET) Framework for Web Services and developed to take advantage of the .NET environment. Captaris Workflow for .NET is designed to improve operational processes for midsize and large businesses that have standardized on Microsoft technologies. We believe Captaris Workflow for .NET offers significant advantages over past workflow automation approaches with a design that we believe facilitates rapid, understandable, affordable and robust solutions that are highly scalable.

The Captaris Workflow platform offers certain key features and functionalities for creating workflows that: 1) are easy to develop, manage and use; 2) are flexible to deploy anywhere in the world and in diverse human or system workflow scenarios and 3) rapidly provide deep integration with a wide range of .NET products. The new features and enhancements of Captaris Workflow 6.0, which was launched in the second quarter of 2005, improve the usability of the software for business analysts and business users, rather than just for technical audiences such as software developers. The new features include workflow design support within Visual Studio 2005, support .NET Framework 2.0, support for SQL Server 2005, Service Oriented Architecture (SOA) for Microsoft Office SharePoint Server and Simulation Module 2.0. The module is designed to make it easy for a business analyst to simulate several weeks of what-if scenarios without impacting everyday business activities.

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Microsoft launched Windows Workflow foundation software (WinWF) as part of Windows in late 2006. Going forward, customers will be using the Microsoft stack more and more for basic workflow services coding and deployment. WinWF is a new foundation in .NET and as such, is a set of services that can be extended by the Visual Studio developer. In other words, WinWF is just like the services in the .NET framework that enable XML or Web services integration, yet these services do not offer out-of-the-box workflows specific enough for the end-user.

Our focus will be to embrace and extend the WinWF foundation using our Workflow product. Captaris Workflow provides the higher-level objects, interfaces and tools so that end-users, business analysts, and application developers can rapidly create and deploy applications to manage complex business processes, while supporting the users through the entire lifecycle of process-centric solutions.

Enterprise Content Management Products

Captaris Alchemy, previously known as Alchemy

The first version of the Captaris Alchemy software product was released in 1993. Captaris Alchemy addresses the imaging and archiving management needs of the mid-size enterprise market and is installed as a departmental application in many Global 2000 companies. In the second quarter of 2006, we released Captaris Alchemy 8.2. Captaris Alchemy 8.2 includes stronger document control and security, enhanced document history and auditing, a new software developer kit and expanded language support.

Captaris Alchemy provides organizations with document capture and indexing, document management, archiving, records management, and document viewing and retrieval. Captaris Alchemy specializes in the archiving of the fixed content that organizations must retain for business, compliance and/or legal purposes. Fixed content is enterprise content in its final form such as faxes, scanned documents, emails and portable document formats (PDFs) files.

We believe that most of the enterprise content in organizations today exists as fixed content in file formats such as paper, scanned images, faxes, e-mail, office documents, PDFs and computer reports. The Captaris Alchemy 8.2 product suite handles many content types and manages the content throughout the information lifecycle management stages, including capture, document management, archive, records management, retrieval and destruction.

Professional Services

The Captaris Solutions Team provides strategic and architectural technology consulting, custom deployment, integration of third-party technologies and other services. We extend these capabilities to our channel partners to enable them to offer the following services in their service portfolio:

Captaris Implementation Services assist customers in implementing Captaris products in the most effective and efficient way possible.

Captaris Consulting and Analysis provides customers early stage planning to identify ways that our technologies can help their enterprises best achieve their specific objectives.

Captaris Training Services offer on-site or remote training sessions with channel partners and customers. In addition, they create and update an online library of training materials that we make available to channel partners and customers.

Captaris Custom Development produces enhancements to tailor Captaris products to customers existing business processes and information flows.

The Captaris Developer Program enables developers to extend and integrate Captaris products by providing application programming support for the Captaris application program interfaces.

Distribution

We sell, promote and receive referrals for the use of our products primarily through an indirect channel of resellers and distributors, strategic partnerships, OEMs and private label agreements, as well as through our enterprise sales team and national account managers that hold dedicated business relationships with assigned accounts on the Fortune 500 list. We believe the use of multiple distribution channels that access many of the same potential customers increases the likelihood that our products will be sold to a particular customer. No single customer represented more than 10% of our net revenue in 2006, 2005 or 2004.

OEM partners market and sell our products and services in conjunction with their own core products and service portfolios, which we believe adds more value to their customers. In some cases, these OEM agreements provide minimum revenue commitments to us.

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Domestic Distribution (North America)

In North America, our sales force sells primarily through an indirect channel of value-added resellers, independent software vendors and professional service companies specializing in custom systems development. These selling partners are typically small to medium-sized, regionally-focused organizations. In addition, we maintain select enterprise end-user relationships through an enterprise sales force and a diverse mix of direct marketing activities. We have sales and support offices at our headquarters in Bellevue, Washington, as well as in Tucson, Arizona; Englewood, Colorado and Calgary, Alberta, Canada. Field sales representatives are located in various locations in North America.

Resellers typically attend Captaris-sponsored sales and technical training sessions on selling approach, technical system usage, installation, maintenance and customer support. We also offer advanced training on an ongoing basis. Sales transactions with resellers are subject to terms of reseller agreements relating to payment terms, protection of proprietary rights and non-exclusivity of sales territories. These agreements generally do not restrict the reseller s ability to carry competitive products.

International Distribution

Similar to our approach in North America, we sell in international markets through a variety of dealer, distributor and strategic relationships. The key difference for our international business is our two-tier distribution arrangements with a few large distributors that have business relationships with multiple resellers. We are actively recruiting new resellers and distributors in international markets. We have sales and support offices in the Netherlands, Hong Kong, Australia, United Kingdom, Germany and Dubai. We conduct business transactions in U.S. dollars, British pounds sterling, Canadian dollars, Australian dollars and Euros.

International revenue, excluding Canada, was 24.2%, 21.9%, and 21.1% of total net revenue for 2006, 2005, and 2004, respectively.

Product Support

We sell a variety of support packages for all of our products. In addition, we bundle all software licenses with mandatory first year maintenance. Our maintenance and support agreements provide customers with telephone, Web and on-location support and unspecified upgrades and updates, when and if available. Revenue for maintenance and support agreements is recognized on a straight-line basis over the service contract term, generally ranging from one to five years. We provide, worldwide, 24/7 support for all product lines via centralized support specialists located in our Tucson office.

We launched an online training program, The Captaris Learning Center, in October 2003 to meet a number of strategic goals, including the ability to allow our customers to improve their skill levels around Captaris products and solutions. Customers register for courses online, manage their curriculum, track their class history, receive training announcements on a regular basis, complete online surveys of classes taken and register and take Web-based training from one location. Some educational content is delivered as a subscription-based service and we recognize the revenue from these services on a straight-line basis over the term of the subscription.

Product Development

We have expertise in the development of systems that capture, index, route, process, render, store, retrieve and deliver messages, data and documents, including fax, e-mail and other corporate content. We also have expertise in integration with back-end office systems and databases. These systems handle message, data and document delivery spanning a wide range of input and output types. Additionally, we have expertise in the development of local-area network (LAN), wide-area network (WAN) and Internet software applications, integrations and services. We believe that our expertise in these areas enables us to efficiently bring to market innovative software products.

We maintain three primary product development centers: Tucson, Arizona; Englewood, Colorado and Calgary, Alberta, Canada. In addition to the three primary centers, we have development activities at our Bellevue location. In total, we employed 87 engineers, technicians, quality assurance specialists and other supporting personnel in our development centers as of December 31, 2006. The integration of technologies has allowed us to consolidate and leverage development efforts among these groups. We expect these cross-development efforts to continue in the future.

We internally develop or acquire our defining core technologies, and we license from third parties primarily broad-based, generic or non-strategic components of our products, such as database software, imaging and network connection software. Whenever practical, we will license and integrate such technology into our product offerings in order to decrease the cost of development and shorten the time to market for our products. We also believe that the acquisition of new technology and new product offerings is consistent with our strategic initiatives, and we will pursue such opportunities as they become available.

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For our product offerings to continue to achieve acceptance and remain competitive, we believe it is necessary to develop enhanced versions of our software applications. Our research and development expenditures were $12.2 million, $14.0 million and $10.3 million in 2006, 2005 and 2004, respectively. Research and development expenses as a percentage of revenue decreased during 2006 compared to 2005, but were relatively flat compared to 2004. Additional expenses in 2005 that we did not incur in 2006 included restructuring charges associated with our effort to reduce our operating structure and costs associated with the release of patches for our Alchemy and Workflow releases. In addition, we incurred twelve months of research and development expenses related to the Captaris Alchemy product line in 2005 compared to two months in 2004.

We develop versions of our products that have been prepared for localization in foreign markets. This globalization effort includes converting client interfaces and documentation into foreign languages and includes the expansion of internal character sets to accommodate a broader set of potential foreign languages. We expect to continue to expend research and development resources on these efforts.

Proprietary Rights

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. We own nine U.S. patents, including six patents acquired in 2000 in the areas of number qualification, unified messaging and fax technology and two patents acquired in 2002 in the areas of speech compression and operating system installation/servicing. The issued patents will expire between 2014 and 2019. We also own 15 pending patent applications in the U.S. and four internationally in a range of areas, including telephony, fax, unified messaging, workflow technology and mobility-related messaging. There can be no assurance that our efforts to protect our proprietary rights will be successful. In particular, there can be no assurance that our current or future patent applications will be granted or that our current or future issued patents will not be challenged, invalidated or circumvented, or that the rights granted under any such patents will provide competitive advantages to us.

We have periodically received letters and other communications from third parties asserting patent rights and requesting royalty payments. Some of these claims are unresolved and continue to be outstanding, even after several years of intermittent communication. Based upon our analysis, we do not believe it necessary, in most cases, to license any of the patent rights. In those cases in which we have determined a license of patent rights was necessary, we have entered into a license agreement.

We license certain portions of our technology from third parties under written agreements, some of which contain provisions for ongoing royalty payments. Our royalty expense was less than 1.0% of net revenue in 2006 and 2004, and 1.0% of net revenue in 2005.

Competition

The software markets that we are competing in, which include fax server software, electronic document delivery, workflow and BPM, IDARS and ECM software are quickly evolving, highly competitive and subject to rapid technological change. Moreover, we expect to face increasing competitive pressures from both current and future competitors in the markets we serve. In most cases, we face pure-play vendors that are focusing on one particular applications market. The principal competitive factors applicable to our products and services include:

- breadth and quality of software alternatives;
- the ability to integrate various products with customers existing business applications and networks;
- the ability to respond to technological change;
- the level of customer support and professional services;

- relationships with distributors, strategic partners, value-added resellers and systems integrators;
- an installed base of similar or related products;
- end user price; and
- channel partner margins.

Our suite of products that capture, process, deliver, manage and archive records, comprise versatile software solutions for the mid-market and enterprise departments provided through a single vendor, which we believe is a competitive advantage of our products. With respect to individual offerings in our product line, our competitive position with respect to the factors above varies depending on the market addressed.

For our **fax server and electronic document delivery** products, our principal competitors are Esker, Inc. S.A., Biscom, Inc., TOPCALL International AG, Omtool, Ltd., Fenestrae, GFI Software, Ltd. and SAGEM-Interstar. In the overall fax server market we

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believe we continue to hold the leading market share, based on revenue. Our fax server products also compete with vendors offering a range of alternative fax solutions, including standalone fax machines, operating systems containing fax and document transmission features, low-end fax modem products, desktop fax software, single-platform fax software products, application service providers and hosted solutions including J2 Global Communications and PTEK Holdings, Inc., bundled fax software and hardware providers, and customized proprietary software solutions.

For our **business process automation** products, we face many competitors. Competitors offering similar products to ours and using similar architecture designed for rapid deployment by knowledge workers are generally smaller companies. We believe the most visible direct competitors of our business process automation products also utilize the .NET product architecture and include K2.net (SourceCode Technology Holdings, Ltd.), Metastorm, and Ultimus, Inc. Overall, we believe our products are differentiated from our competitors products due to our deep integration with Microsoft technology and applications, as well as our ability to offer our own faxing, capture and document management products. Given the more recent acquisition of this product line, we believe we have a smaller revenue share within the BPM vendor market than in the fax server and electronic document delivery market.

Our **imaging and archiving** solutions compete primarily in the mid-market based on functionality and price. Our main competitors are Hyland Software, Inc. (OnBase product), EMC Corporation / Documentum (ApplicationXtender, EmailXtender products) and Compulink Business Systems, Inc. (Laserfiche product). While these vendors offer products with similar functionality, we strive to differentiate by the respective price/value received, and by the inherent benefits of offering two adjacent products in the Captaris product suite, RightFax and Workflow.

Order Fulfillment

Our order fulfillment operations consist primarily of compact disc duplication, documentation fulfillment and distribution of fax boards. The majority of our product sales are installed by third parties. In cases where the customer buys installation services from us, we typically contract with outside vendors to provide full systems integration and assembly.

Our fax server and document delivery products incorporate a number of commercially available application cards and fax cards that enable integration with certain fax servers. We currently purchase fax boards from Cantata, Inc. and Dialogic Corporation, formerly Eicon Networks Corporation. We depend upon these third-party manufacturers for fax boards. If these manufacturers terminate their relationships with us, are unable to fill orders on a timely basis, or experience quality performance issues, we may be unable to meet customer demands, which could delay or decrease our revenue or otherwise have an adverse impact on our operations.

Employees

As of December 31, 2006, we had 399 full-time employees, 152 in sales and marketing, 95 in technical support, 87 in engineering and product development and 65 in finance, information technology and administration. Our employees enter into agreements containing confidentiality restrictions. We have never had a work stoppage and no employees are represented by a labor organization. We consider our employee relations to be good.

Available Information

Our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to reports filed pursuant to Sections 13(a) and 15(d) of the Exchange Act are available free of charge on our Web site as soon as reasonably practicable after the reports have been filed with or furnished to the SEC at http://www.captaris.com under Corporate Investor Relations SEC Filings. In addition, the following corporate governance materials of Captaris are also available in the Corporate menu by selecting the Corporate Governance link on our Web site at http://www.captaris.com:

Audit Committee, Compensation Committee and Governance Committee Charters.

Code of Business Conduct applicable to all directors, officers and employees of Captaris (the Ethical Business Practices portion of the Captaris Ethics Guidebook).

Code of Ethics for our CEO and senior financial officers (included in the Captaris Ethics Guidebook).

If we waive any material provision of our Code of Business Conduct or Code of Ethics for our CEO and senior financial officers or substantively change the codes, we will disclose that fact on our Web site within four business days. A copy of any of the materials filed with or furnished to the SEC or copies of the corporate governance materials described above are also available free of charge and can be mailed to you upon request to Captaris, Inc., Investor Relations, 10885 NE 4th Street, Bellevue, WA 98004.

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CAPTARIS, INC.

Executive Officers

Our executive officers as of March 1, 2007 are as follows:

Name	Age	Position	Officer Since
David P. Anastasi	50	President, Chief Executive Officer and Director	2000
Matthias M. Scheuing	41	Chief Operating Officer	2002
Peter Papano	57	Chief Financial Officer and Treasurer	2003

Mr. Anastasi joined Captaris as President, Chief Executive Officer and a director in November 2000. From May to November of 2000, Mr. Anastasi served as President and Chief Executive Officer of Conversational Computing Corporation, a speech recognition technologies company. Prior to that, he was a founder and President and Chief Executive Officer of the Global Chipcard Alliance, a SmartCard consortium from 1999 to 2000. From 1994 to 1999, Mr. Anastasi served as Vice President and General Manager of the Public Access Solutions and SmartCard Division of U S WEST. Mr. Anastasi currently serves on the Board of Directors of the AeA (formerly known as the American Electronics Association). Mr. Anastasi holds a B.S. degree in marketing management from Bentley College and a Masters degree with an emphasis in international management from the University of San Francisco.

Mr. Scheuing joined Captaris in January 2002 as our Senior Vice President of Global Field Operations. In October 2002, Mr. Scheuing became Senior Vice President, General Manager of the Products Group. In October 2003, Mr. Scheuing was promoted to Chief Operating Officer. Prior to joining Captaris, Mr. Scheuing served as President and Chief Executive Officer of Conversational Computing Corporation, a speech recognition technologies company, from February 2001 to October 2001 and as Executive Vice President, Sales and Marketing of that company from July 2000 to February 2001. Prior to joining Conversational Computing Corporation, Mr. Scheuing served as Vice President, Marketing for U S WEST s Small Business Group from January 1999 to July 2000 and in other positions with U S WEST from 1994 to 1997. Mr. Scheuing holds a B.B.A. degree in finance and marketing and an M.B.A. degree in marketing and information systems from Texas Christian University. On February 14, 2007, we announced Mr. Scheuing will be leaving Captaris and that we expect Mr. Scheuing will remain in his current role through March 30, 2007.

Mr. Papano joined Captaris in September 2003. Prior to joining Captaris, Mr. Papano served as Chief Financial Officer of Evant, Inc., an enterprise software company, from 2000 to 2003; QRS Corporation, a publicly traded e-commerce company, from 1998 to 2000; and The Dialog Corporation, an electronic information company, from 1991 to 1998. Mr. Papano is a certified public accountant. He holds a B.S. degree in business with an emphasis in finance and an M.B.A. degree in accounting from the University of Colorado.

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CAPTARIS, INC.

Item 1A. RISK FACTORS

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

Our stock price has been highly volatile.

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

- new product announcements or changes in product pricing policies;
- quarterly fluctuations in our operating results;
- announcements of technical innovations;
- announcements relating to strategic relationships or acquisitions;
- changes in earnings estimates by securities analysts; and
- general conditions in the economy and/or levels of information technology spending.

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

Our quarterly sales operating results vary. These operating results may fall below expectations of securities analysts and investors.

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

- fluctuations in quarterly sales patterns;
- 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;
- pricing pressures;
- costs related to the acquisition of technologies or businesses;
- costs of maintaining, integrating or expanding our operations;
- costs of hiring qualified personnel;
- technological changes in our market, including changes in standards for protocols, platforms and operating systems applicable to software, hardware and networking environments;
- costs associated with outside service providers, such as legal counsel and auditors, and taxes owed by us;
- general economic conditions; and
- exchange rate fluctuations.

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

CAPTARIS, INC.

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

We depend on third parties for a key component of our Rightfax product.

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

We rely heavily on independent distributors, value-added resellers and IT service partners.

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

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

Creating and maintaining OEM and strategic relationships is important to our success, because these relationships enable us to market and distribute our products to a larger customer base than we could otherwise reach through our direct marketing efforts. We may not be successful in creating new OEM or strategic relationships on acceptable terms, if at all. Moreover, although we view our OEM and strategic relationships as an important factor in the successful commercialization of our products, our current strategic partners may not view their relationships with us as significant for their own businesses and any one of them could reassess their commitment to us in the future. Further, our OEM and strategic relationships are generally non-exclusive, which means our OEM and strategic partners may develop relationships with some of our competitors. Failure of one or more of our OEM and strategic partners to successfully develop and sustain a market for our products, or the termination of one or more of our OEM and strategic relationships, could adversely affect our ability to maintain or increase revenue.

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

Our market is highly competitive.

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

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

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

(ApplicationXtender, EmailXtender products) and Compulink Business Systems, Inc. (Laserfiche product).

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

Technology and customer demands change rapidly in our industry.

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

Our Workflow product runs exclusively on the Microsoft.NET platform.

Our Workflow product runs exclusively on the .NET platform. Thus, we are subject to certain risks associated with the use of the .NET platform. These risks include, but are not limited to, the following:

- the .NET platform may not become or continue to be a widely accepted industry standard;
- Microsoft may not continue its commitment to enhancing and marketing the .NET platform;
- we may not be successful in continuing to develop the Workflow product in connection with the .NET platform; and
- changes in the .NET platform may affect our development of the Workflow product, including our ability to timely make necessary updates to the Workflow product for our customers based on changes to the .NET platform.

If any of the foregoing occurs, our Workflow product may become obsolete or sales of Workflow may be negatively impacted, which may adversely impact our revenue and operating results.

We face risks from our international operations.

Maintaining or growing our revenue depends, in part, on our international product sales. We focus significant management attention and financial resources to our international operations. It is costly to establish international facilities and operations to promote our brand internationally and to develop localized systems. We may not succeed in these efforts. Our net sales from international market segments may not offset the expense of establishing and maintaining the related operations and, therefore, these operations may not be profitable on a sustained basis. Significant portions of our revenue are subject to the risks associated with international operations, which include:

difficulty adapting products to local languages and technologies;

inability to respond to changes in regulatory requirements;

inability to meet special standards requirements;

exposure to exchange rate fluctuations;

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

import or export licensing requirements;

limitations on the repatriation of funds;

longer receivables cycles;

difficulties in staffing and managing international operations;

potentially adverse tax consequences; and

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

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

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

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

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

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

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

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

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

We were named as third-party defendants in two pending lawsuits alleging violations of the Telephone Consumer Protection Act in connection with the receipt by the plaintiffs of facsimile advertisements that were transmitted by MediaTel Corporation, our wholly owned subsidiary, before its business was sold in September 2003. A detailed description of these cases, including the status of each, is included under Legal Proceedings in this Annual Report on Form 10-K. The complaints sought injunctive relief and unspecified damages and certification as a class action on behalf of the plaintiff and others similarly situated throughout the United States that received the facsimile advertisements. Under the Telephone Consumer Protection Act, a court can impose liability of $500 per fax on a party that sends a fax without consent of the recipient and can increase the liability to $1,500 per fax if the sending of the fax is willful. On January 30, 2006, in one of the cases (referred to as Melrose), the court approved a preliminary settlement between the plaintiff class and the defendant. That settlement became final later in 2006. This settlement did not terminate the defendant s third-party claim against Captaris and MediaTel. Melrose subsequently settled these claims with Captaris and MediaTel and all claims against Captaris and MediaTel were dismissed with prejudice on January 24, 2007, bringing to a close the Melrose litigation.

In the other case (referred to as Mediterranean), the defendant, Mediterranean, and third-party defendants Captaris and MediaTel moved for summary judgment against the plaintiff, prior to any class certification. On September 29, 2006, the court in the Mediterranean case granted summary judgment in favor of Mediterranean and Captaris and dismissed the case. In granting summary judgment, the court ruled that the plaintiff, Travel 100, had invited the facsimile advertisements and there was no violation of the Telephone Consumer Protection Act. Travel 100 filed a motion for reconsideration, which the court denied. Travel 100 then filed a notice of appeal on December 29, 2006. Briefing for the appeal has not begun and no date has been set for a hearing at this time. There can be no assurance that we will be successful in defending the appeal.

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We are vigorously defending the Mediterranean case, but litigation is subject to numerous uncertainties and we are unable to predict the ultimate outcome of this case. Moreover, even if the plaintiff prevails on the appeal, the plaintiff will still need to certify a class. The amount of any potential liability in connection with the case, will depend, to a large extent, on whether a class is certified, and if one is certified, on what the scope of that class will be, neither of which can be predicted at this time.

We have not recorded a liability related to the Mediterranean case. However, there is no guarantee that we will not determine in the future that an accrual is required or that we will not be required to pay damages in respect of the Mediterranean case in the future, which could materially and adversely affect our results of operations, cash flows and financial condition for the quarter or year in which any accrual is recorded or any damages are paid. We have tendered this claim to our general liability insurance carrier and the carrier has agreed to pay defense costs. However, the carrier has reserved its rights to contest their duty to indemnify Captaris with respect to the matter. Even if coverage is determined to apply, since the potential liability of the claim is substantially in excess of our coverage limits, there can be no assurance that our coverage will be sufficient to satisfy any damages we are required to pay.

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

Our products may suffer from defect or errors, which could result in loss of revenue, delayed or limited market acceptance of our products, increased costs and damage to our reputation.

Software products as complex as ours may contain errors or defects, especially when first introduced or when new versions are released. Commercial release of past versions of our products were delayed until software problems were corrected, and in some cases, we have provided product updates to correct errors in released products. Our new products or releases may not be free from errors after commercial shipments have begun. Any errors that are discovered after commercial release could result in loss of revenue or delay in market acceptance, diversion of development resources, damages to our reputation, increased service and warranty costs or claims against us.

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

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

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

We may be unable to adequately protect our proprietary rights.

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

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

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

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We periodically receive letters and other communications from third parties asserting patent rights and requesting royalty payments, among other remedies, and will probably receive additional claims in the future. Some of these claims are unresolved and continue to be outstanding, even after several years of intermittent communications. The ultimate outcome of any of these matters that continue to be outstanding or that may arise in the future cannot be determined, and there can be no assurance that the ultimate resolution of these matters will not have a material adverse effect on our results of operations, cash flows and financial condition. Any litigation, regardless of our success, would probably be costly and require significant time and attention of our key management and technical personnel. Litigation could also force us to:

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

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

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

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Item 1B. UNRESOLVED STAFF COMMENTS

None.

Item 2. PROPERTIES

We are headquartered in Bellevue, Washington and have offices in Tucson, Arizona; Englewood, Colorado; Calgary, Alberta, Canada; Sydney, Australia and European headquarters in Nieuwegein, the Netherlands. The Bellevue location consists of approximately 61,500 square feet of space under a lease that expires in February 2008, which includes 13,600 square feet of subleased space. Our other offices include 27,300 square feet in Englewood, Colorado, which includes 6,200 square feet of subleased space; 23,900 square feet of leased space in Tucson, Arizona; 12,400 square feet of leased space in Calgary, Alberta, Canada; 3,200 square feet of leased space in Sydney, Australia; and 5,600 square feet of leased space in Nieuwegein, the Netherlands. In addition, we have sales and support personnel in the United Kingdom, Germany, Hong Kong and Dubai. Starting in April 2007, we will reduce our office space in Englewood, Colorado to 15,000 square feet. Later in 2007, we plan to enter new leases for both Tucson, Arizona and Bellevue, Washington offices.

We believe that these facilities are adequate to meet our current needs and that suitable additional or alternative space will be available, as needed, in the future on commercially reasonable terms.

Item 3. LEGAL PROCEEDINGS

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

Each of the Travel 100 complaints sought injunctive relief and unspecified damages and certification as a class action on behalf of Travel 100 and others similarly situated throughout the United States that received the facsimile advertisements. Both Mediterranean and Melrose named Captaris as a third-party defendant and asserted that, to the extent that they are liable, Captaris should be liable under theories of indemnification, contribution or breach of contract for any damages suffered by them. Both Captaris and MediaTel have denied any liability in the cases because, among other facts and defenses, MediaTel understood that the database and lists of travel agent recipients to whom faxes were sent had authorized that information could be sent to them by fax.

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

On September 29, 2006, the court in the Mediterranean case granted summary judgment in favor of Mediterranean and Captaris and dismissed the case. In granting summary judgment, the court ruled that Travel 100 had invited the facsimile advertisements and there was no violation of the Telephone Consumer Protection Act. Travel 100 filed a motion for reconsideration, which the court denied. Travel 100 then filed a notice of appeal on December 29, 2006. Briefing for the appeal has not begun and no date has been set for a hearing at this time. There can be no assurance that we will be successful in defending the appeal.

Our insurance carrier paid the settlement amount in the Melrose matter. In the Mediterranean matter, our carrier has agreed to pay defense costs, but has reserved its rights to contest their duty to indemnify Captaris with respect to this matter. We intend to vigorously defend the appeal of the Mediterranean summary judgment ruling; however, litigation is subject to numerous uncertainties and we are unable to predict the ultimate outcome of the Mediterranean case. There is no guarantee that we will not be required to pay damages in respect of this case in the future, which could materially and adversely affect our results of operations, cash flows and financial condition for the quarter or year in which any accrual is recorded or any damages are paid.

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

There were no matters submitted to a vote of security holders during the fourth quarter of 2006.

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PART II

Item 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED SHAREHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock is traded on The Nasdaq Global Market under the symbol CAPA . As of March 1, 2007, there were approximately 109 shareholders of record of our common stock. Many of our shares are held by brokers and other institutions on behalf of shareholders, therefore, we are unable to estimate the total number of shareholders represented by these record holders. The following table sets forth the high and low prices for our common stock for the periods indicated. In determining the high and low prices for the periods indicated, we used the high and low sales prices as reported by The Nasdaq Global Market.

Quarterly Common Stock Price Ranges

	2006		2005	
Quarter	**High**	**Low**	**High**	**Low**
1st	$ 4.65	$ 3.56	$ 5.33	$ 3.95
2nd	4.71	4.00	4.49	3.45
3rd	5.90	4.30	4.24	3.54
4th	8.13	5.08	4.25	3.52

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Stock Performance Graph

This performance graph shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended or otherwise subject to the liabilities under that Section, and shall not be deemed to be incorporated by reference into any filing of Captaris under the Securities Act of 1933, as amended or the Exchange Act.

The following graph compares the five year cumulative total return for our common stock to the cumulative total return of the Nasdaq Composite Index and the S&P Small Cap 600-Application Software Index for the period beginning December 31, 2001 and ending December 31, 2006.

COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN*

Among Captaris, Inc., The Nasdaq Composite Index

And The S & P SmallCap 600-Application Software Index

	Cumulative Total Return					
	12/01	**12/02**	**12/03**	**12/04**	**12/05**	**12/06**
Captaris, Inc.	$ 100.00	$ 65.04	$ 152.30	$ 139.84	$ 100.00	$ 210.57
Nasdaq Composite Index	100.00	71.97	107.18	117.07	120.50	137.02
S&P Smallcap 600 Application Software Index	100.00	73.80	106.68	131.88	119.21	136.32

This comparison assumes $100 was invested on December 31, 2001 in (a) Captaris common stock (b) the Nasdaq Composite Index, and (c) the Smallcap 600 Application Software Index, with all dividends reinvested. The stock price and returns above for Captaris common stock are historical and do not necessarily predict future price performance.

Dividends

We have not paid any cash dividends on our common stock. We intend to retain any future earnings to fund the development and growth of our business and the repurchase of our common stock. Therefore, we do not currently anticipate paying any cash dividends in the foreseeable future.

Stock Repurchase Plan

Pursuant to a stock repurchase plan approved by our Board of Directors, we repurchased $11.3 million (2,099,506 shares), $4.9 million (1,285,778 shares) and $13.5 million (2,649,098 shares) of our common stock in 2006, 2005 and 2004, respectively.

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In 2006, our Board of Directors authorized us to enter into a Rule 10b5-1 plan to facilitate the repurchase of our common stock at times when we ordinarily would not be in the market because of self-imposed trading blackout periods. Transactions under the Rule 10b5-1 plan began on September 18, 2006, the first trading day after the trading window closed in the third quarter of 2006. Also in 2006, our Board of Directors approved two separate increases to our previously announced stock repurchase program. As of December 31, 2006, $12.6 million remains available to repurchase shares. We may repurchase shares in the future subject to overall market conditions, stock prices, rules of our 10b5-1 plan and our cash position and requirements going forward. The repurchase program will continue until the earlier of (a) such time when the maximum dollar amount authorized has been utilized or (b) the Board of Directors elects to discontinue the repurchase program.

The following table summarizes information regarding shares purchased during the quarter ended December 31, 2006.

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of the Publicly Announced Purchase Program	Maximum Approximate Dollar Value of Shares that May Yet Be Purchased Under the Program
October 1 through 31, 2006	220,000	$ 5.82	220,000	$ 14,881,829
November 1 through 30, 2006	330,000	$ 6.87	330,000	12,615,676
December 1 through 31, 2006				12,615,676
Three Months Ended December 31, 2006	550,000	$ 6.45	550,000	$ 12,615,676

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Item 6. SELECTED CONSOLIDATED FINANCIAL DATA

The following selected historical financial data is derived from our audited historical financial statements. The consolidated balance sheet data at December 31, 2006 and 2005 and the consolidated statement of operations data for the years ended December 31, 2006, 2005 and 2004 are derived from the audited historical financial statements and related notes that are included elsewhere in this report. The consolidated balance sheet data at December 31, 2004, 2003 and 2002 and the consolidated statement of operations data for the year ended December 31, 2003 and 2002 are derived from the audited historical financial statements and related notes which are not included in this report. The information set forth below should be read in conjunction with our historical financial statements, including the notes thereto and Management s Discussion and Analysis of Financial Condition and Results of Operations, included elsewhere in this report. Historical results are not necessarily indicative of future results.

	Year Ended December 31,				
(in thousands, except per share data)	**2006**	**2005**	**2004**	**2003**	**2002**
Consolidated Statement of Operations Data:					
Net revenue	$ 91,986	$ 86,380	$ 78,036	$ 83,286	$ 71,256
Gross profit	64,266	59,455	50,954	57,548	44,264
Operating expenses	60,434	67,702	55,104	49,307	59,766
Income (loss) from continuing operations before income tax expense (benefit)	5,781	(7,336)	(3,203)	9,898	(13,280)
Income (loss) from discontinued operations, net of income tax expense (benefit)	16	38	647	6,315	2,535
Cumulative effect of change in accounting principle					(2,695)
Net income (loss)	3,981	(3,979)	107	12,533	(7,404)
Basic net income (loss) per common share:					
Income (loss) from continuing operations	$ 0.14	$ (0.14)	$ (0.02)	$ 0.20	$ (0.23)
Income from discontinued operations			0.02	0.21	0.08
Cumulative effect of change in accounting principle					(0.08)
Basic net income (loss) per share	$ 0.14	$ (0.14)	$ 0.00	$ 0.41	$ (0.23)
Diluted net income (loss) per common share:					
Income (loss) from continuing operations	$ 0.14	$ (0.14)	$ (0.02)	$ 0.20	$ (0.23)
Income from discontinued operations			0.02	0.20	0.08
Cumulative effect of change in accounting principle					(0.08)
Diluted net income (loss) per share	$ 0.14	$ (0.14)	$ 0.00	$ 0.40	$ (0.23)
Weighted average shares used in computation of:					
Basic net income (loss) per share	27,899	28,907	31,346	30,849	31,780
Diluted net income (loss) per share	28,514	28,907	31,346	31,543	31,780

	December 31,				
(in thousands)	**2006**	**2005**	**2004**	**2003**	**2002**
Consolidated Balance Sheet Data:					
Cash, cash equivalents and total investments	$ 59,363	$ 51,527	$ 57,339	$ 95,661	$ 73,089
Restricted cash[1]	$ 1,000	$ 1,000	$ 1,000	$ 1,000	$ 1,000
Working capital, plus long-term investments available-for-sale	$ 55,424	$ 47,734	$ 52,408	$ 92,198	$ 76,704
Total assets	$ 135,948	$ 131,203	$ 138,346	$ 144,755	$ 121,277
Redeemable common stock	$	$	$	$ 3,000	$
Total shareholders equity	$ 97,827	$ 97,779	$ 106,241	$ 117,828	$ 98,301
Shares outstanding	27,556	28,367	29,452	32,358	30,218

(1) A cash deposit supports a $1.0 million letter of credit that serves as collateral pursuant to a lease agreement for our corporate headquarters. This collateral is required through February 29, 2008.

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Item 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This Annual Report on Form 10-K and the documents incorporated herein by reference contain forward-looking statements. These statements relate to future events or our future financial performance. In some cases, you can identify forward-looking statements by terminology such as may, will, should, expect, plan, intend, anticipate, believe, estimate, predict, potential, continue, could, future, seek, target or the negative of these terms or other terminology. These statements are only predictions. Actual events or results may differ materially. In evaluating these statements, you should specifically consider various factors, including the risks outlined under Item 1A Risk Factors. These factors may cause our actual results to differ materially from any forward-looking statements. Except as required by law, we undertake no obligation to publicly release any revisions to these forward-looking statements that may be made to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

Overview

Captaris develops software products that automate business processes, manage documents electronically and provide efficient information delivery. With a comprehensive suite of software and services, Captaris specializes in automating paper and other document-centric processes that are found in most organizations. Our customers use our products to reduce costs, comply with regulations and increase the performance of critical business processes and system investments.

Our products and services address business needs in several related markets: the fax server and electronic document delivery market; the business process management market; and the enterprise content management market. We distribute our products primarily through independent distributors, value-added resellers, direct sales professionals and information technology (IT) service providers. Our products run on off-the-shelf hardware servers, networked personal computers and Microsoft software platforms including Microsoft® Windows NT, Windows 2000, Windows 2003, Windows XP and we plan on compatibility with Windows Vista in the second quarter of 2007. We utilize Microsoft.NET development tools in our suite of products and integrate with a wide variety of hardware equipment and enterprise software products. Captaris is a corporation formed in the State of Washington in 1982. Our principal executive offices are located in Bellevue, Washington.

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

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

Executive Summary

In November 2006, we released RightFax 9.3 Feature Pack 1 which offers new features and support for fax boards. In the second quarter of 2006, we released RightFax 9.3 which improved server performance, enhanced user experience and improved administration capabilities. RightFax 9.3 is the first significant release of this product since November of 2004, when RightFax 9.0 introduced the new open database architecture. Also in the second quarter, we released Captaris Alchemy 8.2 and Workflow 6.0. Captaris Alchemy 8.2 includes stronger document control and security, enhanced document history and auditing, a new software developer kit and expanded language support. Workflow 6.0, released in 2005, offers a complete workflow development system to enable organizations to standardize and automate business processes.

We derive net revenue primarily from licensing software as well as follow-on sales of add-on software modules and the sale of maintenance and support agreements. The driver of our revenue growth over the prior year was attributable to the continuing growth of maintenance, support and service revenue and an increase in the volume of software licenses sold, which we believe to be the result of increased customer deployments of RightFax throughout their organizations. We expect revenue increases in all three revenue categories, software, hardware, and services in 2007 compared to 2006, as a result of increased customer demand from increased investment in our sales organization. No single customer represented more than 10% of our net revenue for each of the years ended December 31, 2006, 2005 or 2004.

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During 2006, we received $1.8 million of revenue from a strategic license agreement with Xpedite Systems, Inc (Xpedite). A portion of our revenue is derived from strategic license arrangements and this revenue is difficult to predict and has inherent fluctuations based on the partner s own business cycle which may or may not correlate with our business cycle.

Our gross margins for 2006 increased over 2005, primarily due to increased revenue from maintenance, support and service agreements, and software licenses including the $1.8 million from Xpedite which was 100% margin. This increase was partially offset by lower gross margins from professional service sales and costs associated with the consolidation of our international product support in 2006. We anticipate gross profit as a percentage of revenue for 2007 to remain consistent or moderately improve over 2006. Our gross margins for the year ended December 31, 2005 increased over the year ended December 31, 2004, primarily due to increased sales of our Workflow and Captaris Alchemy lines which contribute higher gross margins compared to the RightFax product line which contributes lower gross margins as it is bundled with lower margin hardware components.

Our net income from continuing operations for the year ended December 31, 2006 was $4.0 million, compared to a net loss of $4.0 million for the year ended December 31, 2005 and a net loss of $540,000 for the year ended December 31, 2004. The increase in net income from 2005 to 2006 was primarily attributable to revenue growth and an overall reduction in operating expenses in 2006. In addition, 2005 operating expenses included corporate reorganizations charges as well as non-cash impairment charges. We did not incur these charges in 2006. The increased loss from 2004 to 2005 was primarily attributable to lower than expected revenue and to an increase in operating expenses resulting from increased staffing and related costs to support the Captaris Alchemy product line.

We recognized income tax expense of $1.8 million on income from continuing operations in the year ended December 31, 2006. We recorded an income tax benefit of $3.3 million and $2.7 million in the years ended December 31, 2005 and 2004, respectively, on losses from continuing operations. The income tax benefits in 2005 and 2004 included the reversal of tax liabilities of $523,000 and $1.4 million, respectively, which management determined were no longer probable based on updated information surrounding the related tax returns. In 2006, we received income tax refunds of $1.9 million that primarily resulted from the carry-back of our 2005 net operating loss to 2003.

Our principal sources of liquidity are cash, cash equivalents and short and long-term investments. Our investments are classified as available-for-sale. Our portfolio consists primarily of money market funds, adjustable rate mortgage-backed securities and municipal and U.S. government agency-backed securities. Consolidated cash, cash equivalents and investments at December 31, 2006, totaled $59.4 million, up $7.8 million from December 31, 2005. This increase was primarily due to our net cash flow provided by operations of $13.9 million, which includes $1.9 million of tax refunds that primarily resulted from the carry-back of our 2005 net operating loss, proceeds of $5.3 million from the exercise of stock options, as well as excess tax benefits from stock-based compensation of $1.1 million. These increases were partially offset by the repurchase of our common stock of $11.3 million and capital purchases of $1.3 million. Capital expenditures during the year ended December 31, 2006, consisted primarily of an enterprise resource management system to support the growth of our core business activities. In the first quarter of 2007, we plan to pay out $1.0 million for management incentive bonuses we accrued in 2006.

Our order fulfillment operations consist primarily of compact disc duplication, documentation fulfillment and distribution of fax boards. The majority of our products are installed by third parties. In cases where the customer buys installation services from us, we typically contract with outside vendors to provide full systems integration and assembly.

Our RightFax products incorporate a number of commercially available application cards and fax cards that enable integration with certain fax servers. We currently purchase and resell fax boards from Cantata, Inc., and Dialogic Corporation, formerly known as Eicon Networks Corporation. We depend upon these third-party manufacturers to supply fax boards to us. If our manufacturers terminate their relationships with us or are unable to fill orders on a timely basis or experience quality performance issues, we may be unable to meet customer demand, which would delay or decrease our revenue and our operations may be negatively affected.

Our RightFax and Captaris Alchemy product lines include third-party software for which we pay royalties. Our royalty expense was less than 1% of net revenue in 2006 and 2004, and 1.0% of net revenue in 2005.

We have extensive service offerings that are sold in conjunction with our products, including maintenance, support, professional services and solutions. All of these offerings are designed to help customers protect and extend their software investment.

We work with resellers and distributors located throughout the world. These resellers and distributors sell and install our products and they receive discounts based on the volume of sales. Within our selling and marketing groups, we dedicate significant resources to monitoring our resellers and distributors and to generating demand and providing market positioning and support.

Utilizing the indirect channel approach provides several advantages, including minimizing the investment in office facilities and personnel in field locations and applying greater resources to sales and implementation efforts. However, with a channel sales model,

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it is more difficult to track the number and locations of all end-users utilizing our products. This also somewhat limits our ability to capture information around product usage, system integration characteristics, and deployment satisfaction directly from the customer s perspective in order to enhance or build new products, solutions and services.

Professional services include implementation consulting, training and other service support. The vast majority of product implementation is performed by our channel partners. In some instances, customers request high-level installation and consulting services directly from us.

In July 2006, in an effort to improve the cost effectiveness and efficiency of our support operations, we centralized our international Technical Support Group. These changes primarily included a reduction in our workforce and, as a result, we recorded a charge of $243,000 for severance payments made in the third quarter of 2006.

On January 1, 2006, we adopted the provisions of Financial Accounting Standards Board (FASB) Statement No. 123(R), *Share-Based Payment*, (SFAS No. 123R), which, among other things, requires us to measure and recognize compensation expense for all share-based payment awards made to employees and directors including stock options and deferred stock units. In 2006, we recorded $677,000 in stock compensation expense relating to stock options. Prior to 2006, the Company had only shown, as permitted by Statement of Financial Accounting Standards (SFAS) No. 123, pro forma financial results including the effects of share-based compensation expense in the footnotes to the financial statements. For the years ended December 31, 2005 and 2004, the pro forma stock compensation expense was $3.9 million and $3.2 million, respectively. The decrease in stock compensation expense in 2006, compared to our pro forma stock compensation expense in 2005 and 2004, can be attributed to accelerating the vesting of underwater options in 2005, the reduction in number of shares granted in 2006 compared to 2005 and 2004 and differences between accounting for options under SFAS No. 123R in 2006 and SFAS No. 123 in 2005 and 2004.

In January 2005, we made the decision to incorporate the mobility technology associated with our Infinite product line directly into RightFax. Accordingly, in January 2005, we made an end-of-life announcement of our stand-alone Infinite mobile delivery product line. As a result we deemed that the intangible asset related to the Infinite Technology trade name was impaired and an impairment charge of $488,000 was recorded in selling and marketing expenses in the fourth quarter of 2004.

On November 3, 2005, we announced a corporate reorganization intended to improve the efficiency and cost structure of our business. These changes included a reduction in our workforce and the consolidation of office facilities, which included the impairment of furniture and equipment in those office facilities. The workforce reduction included certain founders of Teamplate, who joined the Company when we acquired Teamplate, Inc. in September 2003, and this triggered the acceleration of the remaining Teamplate management incentive plan obligation associated with the acquisition. We recorded a charge of $1.8 million in the fourth quarter of 2005 related to this reorganization, of which $1.2 million was for the Teamplate incentive plan obligation, $455,000 was for severance and other incentive payments for the workforce reduction and $147,000 was for the consolidation of office facilities. In relation to these 2005 charges, we recorded $1.1 million in selling and marketing expenses, $487,000 in research and development expenses and $163,000 in general and administrative expenses.

Concurrent with the announcement of the November 3, 2005 reorganization, we announced that we would record a non-cash impairment charge in the fourth quarter of 2005 of $607,000, which included a $559,000 charge for impairment of application systems software projects that would not be completed and $48,000 of assets that would be abandoned with the office consolidation. In relation to these charges, $447,000 was recorded in selling and marketing expense and $160,000 was recorded in general and administrative expenses.

Acquisitions and Divestitures

2006 and 2005

We had no acquisitions or significant divestitures during 2006 and 2005.

2004

On October 28, 2004, we acquired Information Management Research, Inc. (IMR), an Englewood, Colorado company. IMR s Alchemy product line (now marketed as Captaris Alchemy), which helps organizations capture, archive and retrieve business information enabling us to provide complete solutions for our worldwide enterprise customers. Under the terms of the acquisition agreement, we acquired IMR for a total of $31.9 million. We paid $26.4 million in cash, including transaction costs of $1.2 million and assumed liabilities of $5.6 million, net of cash acquired of

$142,000. The assumed liabilities included $3.1 million of deferred tax liabilities related to purchased intangibles not deductible for tax purposes, deferred revenue of $1.2 million and accounts payable and other accrued liabilities of $1.3 million. The acquisition of IMR has been accounted for as a purchase.

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In connection with the acquisition we consolidated all IMR finance and administrative functions to our Bellevue headquarters. As such, as part of the purchase price allocation, we paid $116,000 for severance expenses related to the involuntary termination of fourteen IMR employees in 2004.

2003

We acquired Teamplate, Inc. (Teamplate) on September 30, 2003 to expand our business information delivery product offerings as an extension and complement to our existing RightFax product line and to further penetrate the business process automation market (Workflow). In connection with the acquisition, we executed an incentive plan that allowed the Teamplate management team to earn a minimum of $2.8 million and up to $8.3 million over the thirteen quarters following the acquisition, subject to their continued employment and our success in achieving certain revenue performance targets. In November 2005, we announced a reduction in staff, which included certain founders of Teamplate and triggered the acceleration of our remaining minimum incentive plan obligation. We recorded a charge of approximately $2.1 million for the year ended December 31, 2005 related to this incentive program and $654,000 and $300,000 for the years ended December 31, 2004 and 2003, respectively.

On September 29, 2003, we sold the CallXpress product line for $2.5 million to Applied Voice and Speech Technologies, Inc. (AVST). Concurrent with the transaction, we entered into an earn-out agreement with AVST which entitles us to receive additional payments of up to $1.0 million per year for each of the three years following the sale, depending on AVST s success in achieving certain revenue targets. Since many activities related to CallXpress were shared with the RightFax product line, these earn out payments are classified on our income statements as a reduction to operating expenses in each of the years received. On March 2, 2005, we received a report from AVST and payment of $1.0 million, confirming achievement of the revenue target for 2004. In February of 2006, we received notification confirming that AVST had achieved their revenue target for 2005. We received a payment of $1.0 million in March of 2006 and accordingly, recorded an additional gain on the sale of the CallXpress product line within operating expenses in the first quarter of 2006.

We sold the assets of MediaTel Corporation (MediaTel), our wholly-owned subsidiary that operated the MediaLinq business, our outsource e-document services division, on September 15, 2003, for $14.9 million in cash to Xpedite Systems, Inc. (Xpedite), a division of PTEK Holdings, Inc. (PTEK). In accordance with generally accepted accounting principles, MediaTel s results of operations, net of income taxes, have been classified as discontinued operations. Concurrent with this transaction, we entered into license and reseller agreements with Xpedite, under which we licensed our fax-to-mail technology to Xpedite over a three-year period following the sale for a minimum aggregate license fee of $2.0 million. In 2004, we recognized $250,000 of revenue in connection with these agreements. We did not record any revenue in 2005 relating to the license agreement due to a dispute with Xpedite relating to the outstanding minimum licenses fee. In February 2006, we resolved the dispute regarding the revenue relating to 2005. As a result, in the first quarter of 2006, we recorded an additional $750,000 of revenue related to the 2005 commitment and in the third quarter of 2006, we recorded another $1.0 million of revenue in accordance with the license agreement.

Critical Accounting Judgments and Estimates

The preparation of our consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of our financial statements and the reported amounts of revenue and expenses during the reporting period. We base our estimates on historical experience, current conditions and various other assumptions we believe to be reasonable under the circumstances. Our estimates form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources, as well as identifying and assessing our accounting treatment with respect to commitments and contingencies. Actual results may differ significantly from these estimates. To the extent that there are material differences between these estimates and actual results, our presentation of our financial condition or results of operations may be affected.

On an ongoing basis, we evaluate our estimates used, including those related to the valuation of goodwill and other intangible assets, useful lives of intangible assets and equipment and leasehold improvements, inventory valuation allowances, revenue recognition, the estimated allowances for sales returns and doubtful accounts and income tax accruals. We believe that the following accounting policies are critical to understanding our historical and future performance, as these policies may involve a higher degree of judgment and complexity than others. For a detailed discussion on the application of these and other accounting policies, see Note 1 in Notes to Consolidated Financial Statements in Item 8 of this Annual Report on Form 10-K.

Our most critical accounting judgments and estimates relate to the following areas:

- Revenue recognition;

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- Allowances for sales returns and doubtful accounts;
- Valuation of inventory at lower of cost or market value;
- Classification of investments and assessment of related unrealized losses;
- Valuation of acquired businesses, assets and liabilities;
- Impairment of goodwill;
- Impairment of equipment, leasehold improvements, long-lived assets and other intangible assets;
- Useful lives of equipment, leasehold improvements and intangible assets;
- Contingencies;
- Stock-based compensation plans; and
- Accounting for income taxes.

Revenue recognition. Our revenue recognition policies follow the guidelines of the American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) No. 97-2, *Software Revenue Recognition*, as amended. We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred, the selling price is fixed or determinable and collection is reasonably assured.

We sell products through resellers, OEMs and other channel partners, as well as directly to end-users. Generally our resellers do not stock product, and except for OEM sales described below, we recognize product revenue upon shipment, net of estimated returns, provided that collection is determined to be probable and no significant obligations remain. If a reseller does stock product, we defer this revenue until the reseller sells the software through to end-users. All software licenses are bundled with 30 days of telephone support. We consider revenue associated with this telephone support to be insignificant, and therefore, we recognize this revenue when the software is shipped and record an estimate for the related cost of the telephone support. Revenue from perpetual software licenses is recognized when the software has been shipped, provided that collection for such revenue is deemed probable. Revenue from term software licenses is recognized over the term of the license, generally twelve months. Whenever a software license, hardware, installation and post-contract customer support or PCS elements are sold together, we allocate the total arrangement fee among each element based on its respective fair value, which is the price charged when that element is sold separately. The amount of revenue assigned to each element is impacted by our judgment as to whether an arrangement includes multiple elements and, if so, whether vendor-specific objective evidence (VSOE) of fair value exists for those elements. Changes to the elements in an arrangement and our ability to establish VSOE for those elements could affect the timing of revenue recognition for these items. Revenue for PCS is recognized on a straight-line basis over the service contract term, ranging from one to five years. PCS includes rights to unspecified upgrades and updates, when and if available, and bug fixes. Installation revenue is recognized when the product has been installed at the customer s site and accepted by the customer. Recognition of revenue from software sold with installation services is recognized either when the software is shipped or when the installation services are completed, depending on our agreement with the customer and whether the installation services are integral to the functionality of the software.

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

In general, customers are not granted return rights at the time of sale. However, historically, we have accepted returns and therefore, we reduce revenue recognized for estimated product returns. If we do grant return rights and we cannot reasonably estimate returns, we defer the revenue until the return rights lapse. For software sold to resellers in which we have granted exchange rights, we defer the revenue until the reseller sells the software through to end-users. When customer acceptance provisions are present and we cannot reasonably estimate returns, we recognize revenue upon the earlier of customer acceptance or expiration of the acceptance period.

Professional services are customarily billed at fixed rates, plus out-of-pocket expenses and revenue is recognized when the service has been completed. However, if it is determined that a consulting engagement will be unprofitable, we recognize the loss at the time of such determination. Training revenue is recognized when the training is completed.

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

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Allowance for doubtful accounts. We make ongoing assumptions as to the collectibility of our accounts receivable in our calculation of the allowance for doubtful accounts. In determining the amount of the allowance, we make estimates based on our historical bad debts, the aging of customer accounts, customer concentrations, customer credit-worthiness, current economic trends and changes in our customer payment patterns. Our reserves historically have been adequate to cover our actual credit losses. However, if actual credit losses were to fluctuate significantly from the reserves we have established, our general and administrative expenses could be adversely affected.

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

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

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

Valuation of acquired businesses, assets and liabilities. Our business acquisitions typically result in goodwill and other intangible assets, and the recorded values of those assets may become impaired in the future. As of December 31, 2006 our goodwill and intangible assets, net of accumulated amortization, were $38.8 million. The determination of the fair value of such intangible assets and goodwill is a critical and complex consideration that involves significant assumptions and estimates. These assumptions and estimates are based on our best judgments and could materially affect our financial condition and results of operations.

Impairment of goodwill. Goodwill is tested for impairment on an annual basis in the first quarter of the year, and on an interim basis in certain circumstances. We conducted our annual assessment during the first quarter of 2006 and determined our goodwill at March 31, 2006, was not impaired. No conditions or events have occurred during 2006 which would require us to update the assessment. Our judgments regarding the existence of impairment indicators include our assessment of the impacts of legal factors; market and economic conditions; the results of our operational performance and strategic plans; competition and market share; and any potential for the sale or disposal of a significant portion of our principal operations. If we conclude that indicators of impairment exist, we then assess the fair value of goodwill. Our valuation process provides an estimate of a fair value of goodwill using a discounted cash flow model and includes many assumptions and estimates. Once the valuation is determined, we will write-down goodwill to its determined fair value, if necessary. Any write-down could have a material adverse effect on our financial condition and results of operations.

On November 3, 2005, we announced a corporate reorganization that included the layoff of certain Teamplate founders and triggered the acceleration of the remaining Teamplate management incentive plan obligation. During this time we also assessed the effect this layoff had on the valuation of the goodwill recorded with the Teamplate acquisition. It was determined that goodwill was not impaired as a result of this layoff.

Impairment of equipment, leasehold improvements, long-lived assets and other intangible assets. We periodically review long-lived assets, other intangibles and product lines that we may sell or otherwise dispose of before the end of the asset s previously estimated useful life to determine if there is any impairment of these assets. We assess the impairment of these assets, or the need to accelerate amortization, whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Our judgments regarding the existence of impairment indicators are based on legal factors, market conditions and operational performance

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of our long-lived assets and other intangibles. Future events could cause us to conclude that impairment indicators exist and that the assets should be reviewed to determine their fair value. We assess the assets for impairment based on the estimated future undiscounted cash flows expected to result from the use of the assets and their eventual disposition. If the carrying amount of an asset exceeds its estimated future undiscounted cash flows, an impairment loss is recorded for the excess of the asset s carrying amount over its fair value. Fair value is generally determined based on a valuation process that provides an estimate of a fair value of these assets using a discounted cash flow model, which includes many assumptions and estimates. Once the valuation is determined, we will write-down these assets to their determined fair value, if necessary. Any write-down could have a material adverse effect on our financial condition and results of operations.

In January 2005, we made the decision to incorporate the mobility technology associated with our Infinite product line directly into our RightFax product. Accordingly, in January 2005, we made an end-of-life announcement of our standalone Infinite mobile delivery product line. As a result, we deemed that the intangible asset related to the Infinite Technology trade name was impaired and an impairment charge of $488,000 was recorded as a selling and marketing expense in December 2004.

On November 3, 2005, we announced a corporate reorganization that included the layoff of certain Teamplate founders and triggered the acceleration of the remaining Teamplate management incentive plan obligation. During this time, we also assessed the effect this layoff had on the valuation of the intangibles related to the Teamplate acquisition and determined that the intangibles were not impaired as a result of the layoff.

Concurrent with the announcement of the reorganization, we announced that we would record a non-cash impairment charge of $607,000 in the fourth quarter of 2005. This impairment charge included $559,000 of impairment of application systems software projects that would no longer be completed and $48,000 of assets that would be abandoned with the office consolidation. We do not anticipate future cash expenditures in connection with this impairment.

Useful lives of equipment, leasehold improvements and intangible assets. Equipment and leasehold improvements, identifiable intangible assets and certain other long-lived assets are recorded at cost less accumulated amortization and are amortized over their useful lives on a straight-line basis. Useful lives for equipment and leasehold improvements are based on our estimates of the period that the equipment or leasehold improvement will be used, which typically range from two to five years. Useful lives for intangible assets are based on our estimates of the period that the intangible assets will generate cash. Changes in estimated useful lives could have a material effect on our financial condition and results of operations.

Contingencies. We are periodically involved in litigation or claims, including patent infringement claims, in the normal course of our business. We follow the provisions of SFAS No. 5, *Accounting for Contingencies,* to record litigation or claim-related expenses. We evaluate, among other factors, the degree of probability of an unfavorable outcome and the ability to make a reasonable estimate of the amount of loss. We accrue for settlements when the outcome is probable and the amount or range of the settlement can be reasonably estimated. In addition to our judgments and use of estimates, there are inherent uncertainties surrounding litigation and claims that could result in actual settlement amounts that differ materially from estimates. We expense our legal costs associated with these matters when incurred.

Stock-based compensation plans. Our stock-option plans are long-term retention programs that are intended to enhance our log-term shareholder value by offering opportunities to both directors and officers, as well as selected persons to participate in our growth and success and to provide incentives and encourage retention.

The 2006 Equity Incentive Plan *(formerly the 1989 Plan)*

On June 8, 2006, at the 2006 Annual Meeting of Shareholders of Captaris, Inc., our shareholders approved the Captaris, Inc. 2006 Equity Incentive Plan (the 2006 Plan), which amended and restated the Captaris, Inc. 1989 Restated Stock Option Plan (the 1989 Plan) to, among other things, expand the types of awards available for grant to include, in addition to stock options, stock appreciation rights, stock awards, restricted stock, restricted stock units and other stock or cash-based awards. The 2006 Plan authorizes the issuance of options to purchase up to 12,900,000 shares of Captaris common stock, the same number authorized under the 1989 Plan. The options under the 2006 Plan are generally granted at an exercise price of the average of the high and low market value of our common stock on the date of grant, and generally vest over four years. They have a term of one to ten years from the date of grant and vest at the rate of 25% after one year and 2.0833% per month thereafter. As of December 31, 2006, there were 2,451,776 options and awards outstanding pursuant to the 2006 Plan. We granted 474,302 stock options and awards under the 2006 Plan, in the year ended December 31, 2006.

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Equity Grant Program for Non-employee Directors

Effective upon shareholder approval of the 2006 Plan and upon recommendation of the Compensation Committee, the Board of Directors implemented the Terms of Equity Grant Program for Non-employee Directors (the NED Equity Program) under the 2006 Plan. The NED Equity Program provides for: 1) initial and annual stock option grants with a Black-Scholes or binomial (whichever method is then being used by the Company to value its stock options for financial reporting purposes) value of $10,000 on the date of grant; and 2) initial and annual restricted deferred stock unit awards (DSU Awards) with a $25,000 value based on the fair market value which we currently calculate using the average of the high and low stock price, as reported by The Nasdaq Global Market, of our common stock on the date of grant. The stock options will vest in full one year after the date of grant and have a ten-year term, as long as the non-employee director remains on the Board. The DSU Awards will be automatically deferred under the Captaris, Inc. Deferred Compensation Plan for Non-employee Directors (the NED Deferred Compensation Plan) and will vest in full one year after the date of grant. The compensation expense associated with the NED Equity Program is included in our stock compensation expense.

Deferred Compensation Program

Effective upon shareholder approval of the 2006 Plan and upon recommendation of the Compensation Committee, the Board of Directors also implemented the NED Deferred Compensation Plan, the purpose of which is to further long-term growth of the Company by allowing non-employee directors to defer receipt of certain compensation, keeping their financial interests aligned with the Company, and providing them with a long-term incentive to continue providing services. The NED Deferred Compensation Plan is administered by the Compensation Committee of the Board of Directors.

Directors who are not also employees of the Company or its affiliates are eligible to participate in the NED Deferred Compensation Plan. Non-employee directors may elect to defer receipt of 25%, 50%, 75% or 100% of any cash compensation paid to the non-employee director for his or her service on the Board of Directors or any committee of the Board of Directors. Deferred cash compensation will be credited to the non-employee director s account as of the date on which it would have been paid had it not been deferred, and will be deemed to be invested in our common stock at a value equal to the closing price of our common stock on such date. Deferred cash compensation is fully vested upon receipt. In general, a non-employee director s vested account balance will be distributed in a lump sum as soon as administratively practicable after his or her separation from service on the Board of Directors. The compensation expense associated with the NED Deferred Compensation Plan is included in our compensation expense.

The 2000 Plan

Upon the adoption of the 2006 Plan on June 8, 2006, no further awards will be granted under the Captaris, Inc. 2000 Non-Officer Employee Stock Compensation Plan (the 2000 Plan), which resulted in a reduction in the number of options available for grant by 1,050,115 shares. Under the 2000 Plan, options generally were granted at the fair market value of our common stock at the date of grant and generally vest over four years. Options under the 2000 Plan have a term of ten years from the date of grant and vest at the rate of 25% after one year and 2.0833% per month thereafter. As of December 31, 2006, there were 1,616,972 options outstanding under the 2000 Plan. In 2006, prior to the adoption of the 2006 Plan, we granted 632,133 stock options under the 2000 Plan.

Non-plan Option Grants

As an inducement to employment, on November 15, 2000, we granted our President, Chief Executive Officer and Director of Captaris, a nonqualified stock option grant outside of any Captaris Equity incentive plans. In addition, as an inducement to employment, on October 22, 1997, we granted two former employees of Captaris a nonqualified stock option grant outside of any of Captaris equity incentive plans. At December 31, 2006, 1,012,572 of these options were outstanding.

Stock-Based Compensation Expense. On January 1, 2006, we adopted the provisions of SFAS No. 123R, which requires us to measure and recognize compensation expense for all share-based payment awards made to employees and directors including employee stock options and director grants. Prior to January 1, 2006, we accounted for stock-based compensation under the recognition and measurement provisions of Accounting Principle Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees* (APB No. 25), and related Interpretations, as permitted by FASB Statement No. 123, *Accounting for Stock-Based Compensation* (SFAS No. 123). In accordance with APB No. 25, no compensation cost was required to be recognized for options granted that had an exercise price equal to the market value of the underlying common stock on the date of grant.

We adopted SFAS No. 123R using the modified prospective transition method. Under this transition method, compensation cost recognized for the year ended December 31, 2006 includes: a) compensation cost for all stock-based compensation granted prior to, but not vested as of January 1, 2006, based on the grant-date fair value estimated in accordance with the original provisions of SFAS No. 123, and b) compensation cost for all stock-based compensation granted subsequent to January 1, 2006, based on the grant-date

CAPTARIS, INC.

fair value estimated in accordance with the provisions of SFAS No. 123R. The stock-based compensation expense includes an estimate for forfeitures and is recognized over the requisite service period of the options, which is generally the option vesting term. SFAS No. 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In accordance with the modified prospective transition method, our consolidated financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS No. 123R.

Concurrent with the adoption of SFAS No. 123R, we elected to adopt the alternative transition approach provided in Staff Position No. 123R-3, *Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards,* for calculating the tax effects of stock-based compensation under SFAS No. 123R. The alternative transition approach includes simplified methods to establish the beginning balance of the additional paid-in-capital-pool (APIC pool) related to the tax effects of stock-based compensation, and for determining the subsequent impact on the APIC pool and consolidated statements of cash flows of the tax effects of stock-based compensation awards that are outstanding upon adoption of SFAS No. 123R.

Prior to adopting SFAS No. 123R, we presented all tax benefits resulting from the exercise of stock options as operating cash flows in the consolidated statement of cash flows. SFAS No. 123R requires cash flows resulting from excess tax benefits to be classified as a part of cash flows from financing activities. Excess tax benefits are realized tax benefits from tax deductions for exercised options in excess of the deferred tax asset attributable to stock compensation costs for such options. As a result of adopting SFAS No. 123R, $1.1 million of excess tax benefits for the year ended December 31, 2006 was classified as a financing cash inflow.

In accordance with the adoption of SFAS No. 123R, we chose the straight-line method for recognizing compensation expense. Previously under the disclosure-only provisions of SFAS No. 123, we used the accelerated method of expense recognition pursuant to FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans* (FIN No. 28). For all unvested options outstanding as of January 1, 2006, the previously measured but unrecognized compensation expense, based on the fair value at the original grant date, will be recognized on an accelerated basis over the remaining vesting period. For stock-based compensation granted subsequent to January 1, 2006, compensation expense, based on the fair value on the date of grant, will be recognized on a straight-line basis over the vesting period.

Our stock-based compensation expense includes expense related to both our stock options and our deferred stock units. The amount of stock-based compensation expense, net of forfeitures, recognized in the quarter and year ended December 31, 2006 was $201,000 and $677,000, respectively, of which $16,000 and $191,000, respectively, related to options granted prior to January 1, 2006. Total unamortized compensation expense at December 31, 2006 was $1.6 million, net of estimated forfeitures. Total unamortized deferred compensation cost will be adjusted for future changes in estimated forfeitures and is expected to be recognized over a weighted average period of two years.

On September 1, 2005, our Compensation Committee and Board of Directors approved the acceleration of vesting of certain unvested stock options granted to our employees and officers under our stock option plans that had an exercise price greater than $3.73 per share, the closing price of our common stock on September 1, 2005. There were 241 employees affected by this modification. Options held by non-employee directors were not included in the acceleration. Previously unvested options to purchase 2.3 million shares of our common stock became immediately exercisable. The Board also imposed a holding period that requires all executive officers and certain other members of senior management to refrain from selling shares acquired upon the exercise of these options, other than shares needed to cover the exercise price and to satisfy withholding taxes and shares transferred by will or by the applicable laws of descent and distribution, until the date on which the exercise would have been permitted under the option s original vesting terms.

The accelerated vesting eliminated future compensation expenses that we would otherwise recognize in our financial statements with respect to these options as a result of adopting SFAS No. 123R. In accordance with APB No. 25 and FASB Interpretation No. 44, no compensation expense was recorded within the financial statements as a result of this modification in 2005 because the options had no intrinsic value on the date of the modification due to the exercise price being in excess of the current market price of the stock. Had the options not been accelerated, option expense for the year ended December 31, 2006 would have increased by $748,000, net of estimated forfeitures and income taxes, and the unamortized compensation expense for these options would have been $568,000, net of estimated forfeitures and income taxes, to be recorded in 2007 through 2009.

During the second quarter of 2001, we offered a limited non-compulsory exchange of employee stock options on a less than one-for-one basis. The exchange (which closed on July 10, 2001) resulted in the voluntary cancellation of employee stock options to purchase 3,135,720 shares of our common stock with varying exercise prices greater than $10.00 per share in exchange for 1,286,790 employee stock options with an exercise price of $2.11. The option exchange offer resulted in variable accounting treatment for a total of 1,993,250 options, representing the 1,286,790 new options granted in the exchange as well as all employee options modified during the year. Variable accounting treatment, in accordance with APB No. 25, resulted in charges or credits recorded to stock-based compensation, depending on fluctuations in quoted prices for our common stock and the number of stock options subject to variable accounting. As of January 1, 2006, charges or benefits related to these fully vested options subject to variable accounting ceased due to the adoption of SFAS No. 123R.

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Accounting for income taxes. We follow the asset and liability method of accounting for income taxes as set forth by SFAS No. 109, *Accounting for Income Taxes*, and the provisions of SFAS No. 5 *Accounting for Contingencies*. Accordingly, we are required to estimate our potential income tax claims in each of the jurisdictions in which we operate as part of the process of preparing our consolidated financial statements. Significant judgment is required in evaluating our tax positions and in determining our provision for income taxes. During the ordinary course of business, there are transactions and calculations for which the ultimate tax determination is uncertain. We establish accruals for tax-related uncertainties based on estimates of whether, and to the extent which, additional taxes, penalties and interest will be due. These accruals are established when, despite our belief that our tax return positions are fully supportable, we believe that certain positions may not be sustained on review by tax authorities. We adjust these accruals in light of changing facts and circumstances, such as the closing of a tax audit or the expiration of a statute of limitations. We will establish a valuation allowance to reduce deferred tax assets unless it is more likely than not that we will generate sufficient taxable income to allow for the realization of our deferred net tax assets. The provision for income taxes includes the impact of potential tax claims and changes to accruals and valuation allowances that we consider appropriate, as well as the related penalties and interest expense. In addition to our judgments and use of estimates, there are inherent uncertainties surrounding income taxes that could result in actual amounts that differ materially from our estimates. Any adjustments in our tax provision related to these contingencies could have a material effect on our financial condition, results of operations and cash flow.

Consolidated Results of Operations

The following table sets forth, for the periods indicated, the percentage of net revenue represented by certain items in our consolidated statements of operations.

	Year Ended December 31,		
	2006	**2005 (1)**	**2004 (1)**
Net revenue	100.0%	100.0%	100.0%
Cost of revenue	30.1	31.2	34.7
Gross profit	69.9	68.8	65.3
Operating expenses:			
Research and development	13.3	16.2	13.2
Selling and marketing	34.6	39.9	36.5
General and administrative	17.5	21.5	20.1
Amortization of intangible assets	1.4	2.0	0.9
Gain on sale of discontinued product line CallXpress	(1.1)	(1.2)	
Total operating expenses	65.7	78.3	70.6
Operating income (loss)	4.2	(9.5)	(5.3)
Other income, net	2.1	1.1	1.2
Income (loss) from continuing operations before income tax expense (benefit)	6.3	(8.4)	(4.1)
Income tax expense (benefit)	2.0	(3.8)	(3.4)
Income (loss) from continuing operations	4.3	(4.6)	(0.7)
Income from discontinued operations			0.8
Net income (loss)	4.3%	(4.6)%	0.1%

(1)

For the years ended December 31, 2005 and 2004, percentages from operating expense line items do not sum to total operating expense percentage due to rounding.

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Net Revenue

	2006	Percent Change from 2005	2005 (in thousands)	Percent Change from 2004	2004
Net Revenue:					
Software revenue	$ 34,428	4.8%	$ 32,860	2.2%	$ 32,159
Maintenance, support and services revenue	36,183	13.1%	31,997	38.6%	23,083
Hardware revenue	21,375	(0.7)%	21,523	(5.6)%	22,794
Net revenue	$ 91,986	6.5%	$ 86,380	10.7%	$ 78,036

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

Years ended December 31, 2006 and 2005. Net revenue for the year ended December 31, 2006 increased by $5.6 million compared to the year ended December 31, 2005. The increase in net revenue was due primarily to the growth of maintenance, support and service agreements and an increase in the volume of our software licenses sold, which we believe to be the result of increased customer deployment of RightFax throughout their organizations. In addition, $1.8 million of the increase in revenue was due to a strategic licensing arrangement with Xpedite. This strategic license arrangement began in September 2003. In accordance with this arrangement, Xpedite agreed to pay a minimum of $2.0 million over a three-year period for a license to use and resell our fax-to-mail technology. In September 2004 we recognized $250,000 of revenue in connection with this arrangement but due to a dispute with Xpedite, did not record any revenue in 2005 relating to this arrangement. In February 2006, we resolved the dispute regarding the revenue for 2005. As a result, we recorded $750,000 of revenue related to the 2005 commitment. During the third quarter of 2006 we received an additional $1.0 million from Xpedite.

Revenue from our RightFax product line in the year ended December 31, 2006 increased compared to the year ended December 31, 2005. This increase was due primarily to $1.8 million from the Xpedite strategic licensing arrangement and to the growth of professional services sold and an increase in the volume of RightFax licenses sold resulting from what we believe to be increased capacity needs from existing customers as they further deploy RightFax throughout their organizations. RightFax product revenue, which includes revenue from software licenses and hardware sales, was $77.5 million for the year ended December 31, 2006, up 6.7% from the year ended December 31, 2005. Revenue from RightFax software for the year ended December 31, 2006 was $27.1 million, an increase of $1.4 million or 5.4% from the year ended December 31, 2005. RightFax maintenance, support and services revenue was $29.0 million for the year ended December 31, 2006, up $3.6 million or 14.4% from the prior year. Rightfax hardware sales for the year ended December 31, 2006 was $21.4 million, relatively flat compared to the prior year.

Revenue from the Captaris Alchemy and Workflow product lines increased $711,000 to $14.5 million in the year ended December 31, 2006 compared to $13.8 million the year ended December 31, 2005. This increase was primarily due to increased international Workflow sales. This increase was partially offset by the decrease in sales of the Alchemy product line. The decrease in sales of Alchemy was primarily due to customer support issues relating to the consolidation of worldwide technical support that took place in 2006. We believe these issues have been resolved as year-over-year fourth quarter results have improved in 2006 for the Captaris Alchemy product line.

	Year Ended December 31, 2006	2005 (in thousands)	2004
Revenue:			
United States of America	$ 66,206	$ 64,076	$ 58,414

Canada	3,551	3,404	3,193
Europe	10,562	9,874	7,982
Other	11,667	9,026	8,447
Total net revenue	$ 91,986	$ 86,380	$ 78,036

International net revenue, excluding Canada, represented 24.2% of total net revenue for the year ended December 31, 2006 compared to 21.9% for the year ended December 31, 2005, representing an increase of $3.3 million. This increase was attributable to overall growth in software, maintenance and services, and hardware sales. International revenue from software, maintenance and services, and hardware sales increased 11.9%, 24.7% and 22.7%, respectively, for the year ended December 31, 2006 compared to the

CAPTARIS, INC.

year ended December 31, 2005. The overall increase in revenue from our international regions was due to our continued investment and expansion into international markets and to a higher distribution of sales outside North America from our Captaris Alchemy product line. We expect the portion of our revenue derived from international markets to remain relatively consistent or improve modestly in 2007.

We believe that our revenue growth for the year ended December 31, 2006 compared to the prior year was largely attributable to the changes we introduced into the sales channels in 2005, and our continued investments in our sales organizations. We plan to invest in our sales organization in 2007 and as a result of this investment we anticipate that consolidated net revenue will grow at a relatively consistent rate as the growth in 2006. Historically, our business experiences seasonality with a decline in revenue during the first quarter compared to the prior year s fourth quarter, building gradually during the second and third quarters, and ending with the fourth quarter as our largest quarter for revenue. We anticipate this pattern to continue in 2007.

Years ended December 31, 2005 and 2004. Net revenue for the year ended December 31, 2005 increased $8.3 million compared to the year ended December 31, 2004. The increase in net revenue was attributable to revenue from our newer product lines, Captaris Alchemy and Workflow. We acquired the Captaris Alchemy product line in October 2004 and the Workflow product line in September 2003. Revenue from these product lines increased $8.6 million in the year ended December 31, 2005 compared to the year ended December 31, 2004. This increase is due to the inclusion of twelve months of sales from our Captaris Alchemy product line in 2005 compared to two months in 2004 and growth of our Workflow product line.

Revenue from our RightFax product line in the year ended December 31, 2005 remained relatively flat compared to the year ended December 31, 2004. RightFax product revenue, which includes revenue from software licenses and hardware sales, was $47.2 million for the year ended December 31, 2005, down 7.9% from the year ended 2004. RightFax maintenance, support and services revenue was $25.6 million for the year ended December 31, 2005, up $3.8 million or 17.3% from the year ended December 31, 2004.

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

International net revenue, excluding Canada, represented 21.9% of total net revenue for the year ended December 31, 2005 compared to 21.1% for the year ended December 31, 2004. The overall increase in revenue from our international regions was due to our continued investment and expansion into international markets and to a higher distribution of sales outside North America from our Captaris Alchemy product line.

Gross Profit

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

	2006	Percent Change from 2005	2005 (in thousands)	Percent Change from 2004	2004
Gross profit	$ 64,266	8.1%	$ 59,455	16.7%	$ 50,954
Percentage of revenue	69.9%		68.8%		65.3%

Years ended December 31, 2006 and 2005. The increase in gross profit for the year ended December 31, 2006 compared to the year ended December 31, 2005 was primarily due to increased revenue from maintenance, support and service agreements and software licenses including the $1.8 million from Xpedite which was 100% margin. This increase was partially offset by lower margins contributed by professional services and costs associated with our consolidation of our international product support. We anticipate gross profit as a percentage of revenue for 2007 will remain consistent or moderately improve over 2006.

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CAPTARIS, INC.

Years ended December 31, 2005 and 2004. The increase in gross profit for the year ended December 31, 2005 compared to the year ended December 31, 2004 was primarily attributable to increased sales of our Captaris Alchemy and Workflow product lines which contribute higher gross margins compared to the RightFax product line which contributes lower gross margins as it is bundled with lower margin hardware components.

Research and Development

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

	2006	Percent Change from 2005	2005 (in thousands)	Percent Change from 2004	2004
Research and development	$ 12,227	(12.5%)	$ 13,976	35.8%	$ 10,288
Percentage of revenue	13.3%		16.2%		13.2%

Years ended December 31, 2006 and 2005. For the year ended December 31, 2006, research and development expenses decreased $1.7 million compared to the year ended December 31, 2005, primarily due to a reduction of $852,000 in staffing cost due to a lower headcount, a reduction of $724,000 in compensation cost due to the minimum incentive plan obligation for certain Teamplate founders, which was discontinued in late 2005, a reduction of $276,000 for outsourced research and development and a reduction of $17,000 in other expenses. These decreases were partially offset by an increase of $120,000 in stock compensation expense. We expect overall research and development expenses to remain relatively flat in absolute dollars in 2007 compared to 2006 as we continue to maintain our investments in research and development.

Years ended December 31, 2005 and 2004. For the year ended December 31, 2005, research and development expenses increased compared to the year ended December 31, 2004, primarily due to additional staff related to the Alchemy product line, which we acquired in our acquisition of IMR in late October 2004 and to the additional expenses incurred relating to the reorganization of our workforce, which triggered the acceleration of our remaining minimum incentive plan obligation for certain Teamplate founders. The amount of reorganization expense included in research and development in 2005 was $487,000.

Selling and Marketing

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

	2006	Percent Change from 2005	2005 (in thousands)	Percent Change from 2004	2004	
Selling and marketing	$ 31,830	(7.6%)	$ 34,448		619	(556)
Net cash provided by operating activities	33,682	28,533	38,782			
CASH FLOWS FROM INVESTING ACTIVITIES:						
Additions to property, plant, and equipment	(20,057)	(12,421)	(8,331)			
Purchases of investments	(14,165)	(14,210)	(41,240)			

Sale and maturities of investments	15,270	30,545	6,450
Proceeds from property disposals	255	143	148
Acquisition of Vertex	(1,709)	(25,500)	
Net cash used in investing activities	(20,406)	(21,443)	(42,973)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Cash dividends paid	(6,417)	(7,005)	(6,573)
New Shares Issued	752		
Stock Options Exercised	1,466		
Excess tax benefit from share-based compensation	699	281	
Shares surrendured for payroll taxes	(150)	(198)	
Net cash used in financing activities	(3,650)	(6,922)	(6,573)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	9,626	168	(10,764)
CASH AND CASH EQUIVALENTS- Beginning of period	18,940	18,772	29,536
CASH AND CASH EQUIVALENTS- End of period	$ 28,566	$ 18,940	$ 18,772
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION-			
Cash paid during the year for income taxes	$ 10,788	$ 9,771	$ 10,654
Noncash investing activities-			
Acquisition purchase price in accounts payable	$	$ 1,709	$
Capital expenditures in accounts payable	$ 279	$ 1,450	$ 1,118

See accompanying notes to consolidated financial statements.

HAWKINS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 Nature of Business and Significant Accounting Policies

Nature of Business We have two reportable segments: Industrial and Water Treatment. The Industrial Group operates our Industrial segment and specializes in providing industrial chemicals, products and services to the agriculture, energy, electronics, food, chemical processing, pulp and paper, pharmaceutical, medical device and plating industries. The group also manufactures and sells certain food-grade products, including our patented Cheese Phos® liquid phosphate, lactates and other blended products. The Water Treatment Group operates our Water Treatment segment and specializes in providing chemicals, equipment and solutions for potable water, municipal and industrial wastewater, industrial process water and non-residential swimming pool water. The group has the resources and flexibility to treat systems ranging in size from a small single well to a multi-million gallon-per-day facility.

Fiscal Year Our fiscal year is a 52/53-week year ending on the Sunday closest to March 31. Our fiscal year ending April 1, 2012 (fiscal 2012) is a 52-week year. The fiscal year ended April 3, 2011 (fiscal 2011) was a 53-week year, and the fiscal year ended March 28, 2010 (fiscal 2010) was a 52-week year. The fiscal year ending on March 31, 2013 (fiscal 2013) will be a 52-week year. Beginning in fiscal 2012, we changed our quarterly interim reporting to a 13-week convention.

Principles of Consolidation The consolidated financial statements include the accounts of Hawkins, Inc. and its wholly-owned subsidiaries. All intercompany transactions and accounts have been eliminated.

Estimates The preparation of financial statements in conformity with U.S. generally accepted accounting principles (GAAP) 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 reported period. Actual results could differ from those estimates.

Revenue Recognition We recognize revenue when there is evidence that the customer has agreed to purchase the product, the price and terms of the sale are fixed, the product has shipped and title passes to our customer, performance has occurred, and collection of the receivable is reasonably assured.

Shipping and Handling All shipping and handling amounts billed to customers are included in revenues. Costs incurred related to the shipping and handling of products are included in cost of sales.

Fair Value Measurements The Financial Accounting Standards Board (FASB) issued an accounting standard codified in ASC 820 Fair Value Measurements and Disclosures that provides a single definition for fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. Under this standard, fair value is defined as the exit price, or the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants as of the measurement date. This standard also establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs are inputs market participants would use in valuing the asset or liability developed based on market data obtained from sources independent of us. Unobservable inputs are inputs that reflect our assumptions about the factors market participants would use in valuing the asset or liability developed based upon the best information available in the circumstances.

The financial assets and liabilities that are re-measured and reported at fair value for each reporting period include marketable securities. Other than the application of purchase accounting as a result of the Vertex acquisition, there were no fair value measurements with respect to nonfinancial assets or liabilities that are

HAWKINS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

recognized or disclosed at fair value in our consolidated financial statements on a recurring basis subsequent to the effective date of this standard.

Assets and liabilities measured at fair value are classified using the following hierarchy, which is based upon the transparency of inputs to the valuation as of the measurement date:

Level 1: Valuation is based on observable inputs such as quoted market prices (unadjusted) for identical assets or liabilities in active markets.

Level 2: Valuation is based on inputs such as quoted market prices for similar assets or liabilities in active markets or other inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3: Valuation is based upon other unobservable inputs that are significant to the fair value measurement.

In making fair value measurements, observable market data must be used when available. When inputs used to measure fair value fall within different levels of the hierarchy, the level within which the fair value measurement is categorized is based on the lowest level input that is significant to the fair value measurement.

Cash Equivalents Cash equivalents include all liquid debt instruments (primarily cash funds, money market accounts and certificates of deposit) purchased with an original maturity of three months or less. The balances maintained at financial institutions may, at times, exceed federally insured limits.

Investments Available-for-sale securities consist of certificates of deposit and are valued at current market value, with the resulting unrealized gains and losses excluded from earnings and reported, net of tax, as a separate component of shareholders equity until realized. Any impairment loss to reduce an investment s carrying amount to its fair market value is recognized in income when a decline in the fair market value of an individual security below its cost or carrying value is determined to be other than temporary.

Trade Receivables and Concentrations of Credit Risk Financial instruments, which potentially subject us to a concentration of credit risk, principally consist of trade receivables. We sell our principal products to a large number of customers in many different industries. There are no concentrations of business transacted with a particular customer or sales from a particular service or geographic area that would significantly impact us in the near term. To reduce credit risk, we routinely assess the financial strength of our customers. We record an allowance for doubtful accounts to reduce our receivables to an amount we estimate is collectible from our customers. Estimates used in determining the allowance for doubtful accounts are based on historical collection experience, current trends, aging of accounts receivable and periodic evaluations of our customers financial condition. We invest our excess cash balances at times in certificates of deposit and a money market account at two separate financial institutions where the cash balances may exceed federally insured limits. The institutions are two of the largest commercial banking institutions in the country and both have maintained a AA credit rating.

Inventories Inventories, consisting primarily of finished goods, are primarily valued at the lower of cost or net realizable value, with cost being determined using the last-in, first-out (LIFO) method. Vertex s inventory cost, which represents approximately 10% of the total FIFO inventory balance at April 1, 2012, is determined using the first-in, first-out (FIFO) method.

HAWKINS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Property, Plant and Equipment Property is stated at cost and depreciated or amortized over the lives of the assets, using straight-line method. Estimated lives are: 10 to 40 years for buildings and improvements; 3 to 20 years for machinery and equipment; 3 to 10 years for transportation equipment; and 3 to 10 years for office furniture and equipment including computer systems.

Significant improvements that add to productive capacity or extend the lives of properties are capitalized. Costs for repairs and maintenance are charged to expense as incurred. When property is retired or otherwise disposed of, the cost and related accumulated depreciation or amortization are removed from the accounts and any related gains or losses are included in income.

We review the recoverability of long-lived assets to be held and used, such as property, plant and equipment, when events or changes in circumstances occur that indicate the carrying value of the asset or asset group may not be recoverable, such as prolonged industry downturn or significant reductions in projected future cash flows. The assessment of possible impairment is based on our ability to recover the carrying value of the asset or asset group from the expected future pre-tax cash flows (undiscounted) of the related operations. If these cash flows are less than the carrying value of such asset or asset group, an impairment loss would be measured by the amount the carrying value exceeds the fair value of the long-lived assets. The measurement of impairment requires us to estimate future cash flows and the fair value of long-lived assets. No material long-lived assets were determined to be impaired during fiscal 2012, 2011, or 2010.

Goodwill and Identifiable Intangible Assets Goodwill represents the excess of the cost of acquired businesses over the fair value of identifiable tangible net assets and identifiable intangible assets purchased. Goodwill is tested at least annually for impairment, and is tested for impairment more frequently if events or changes in circumstances indicate that the asset might be impaired. The impairment test is performed using a two-step process. In the first step, the fair value of the reporting unit is compared with the carrying amount of the reporting unit, including goodwill. If the estimated fair value is less than the carrying amount of the reporting unit, an indication that goodwill impairment exists and a second step must be completed in order to determine the amount of the goodwill impairment, if any, which should be recorded. In the second step, an impairment loss would be recognized for any excess of the carrying amount of the reporting unit s goodwill over the implied fair value of that goodwill. The implied fair value of goodwill is determined by allocating the fair value of the reporting unit in a manner similar to a purchase price allocation. The fair value of the reporting unit is determined using a discounted cash flow analysis. Projecting discounted future cash flows requires us to make significant estimates regarding future revenues and expenses, projected capital expenditures, changes in working capital and the appropriate discount rate. The projections also take into account several factors including current and estimated economic trends and outlook, costs of raw materials, consideration of our market capitalization in comparison to the estimated fair values of our reporting units determined using discounted cash flow analyses and other factors which are beyond our control.

Our primary identifiable intangible assets include customer lists, trade secrets, non-compete agreements, trademarks, and trade names acquired in previous business acquisitions. Identifiable intangibles with finite lives are amortized and those identifiable intangibles with indefinite lives are not amortized. The values assigned to the intangible assets with finite lives are being amortized on average over approximately 14 years. Identifiable intangible assets that are subject to amortization are evaluated for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. Identifiable intangible assets not subject to amortization are tested for impairment annually or more frequently if events warrant. The impairment test consists of a comparison of the fair value of the intangible asset with its carrying amount.

We completed step one of our annual goodwill impairment evaluation during the fourth quarter of fiscal 2012 and determined that our reporting units fair value substantially exceeded their carrying value. Accordingly,

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

step two of the impairment analysis was not required. We also completed an impairment test of infinite-life intangible assets during the fourth quarter, in which the fair value exceeded the carrying amount. Additionally, no impairment charges were required for fiscal 2011 or 2010.

Income Taxes In the preparation of our consolidated financial statements, management calculates income taxes based upon the estimated effective rate applicable to operating results for the full fiscal year. This includes estimating the current tax liability as well as assessing differences resulting from different treatment of items for tax and book accounting purposes. These differences result in deferred tax assets and liabilities, which are recorded on the balance sheet. These assets and liabilities are analyzed regularly and management assesses the likelihood that deferred tax assets will be recovered from future taxable income. We record any interest and penalties related to income taxes as income tax expense in the statements of income.

The effect of income tax positions are recognized only if those positions are more likely than not of being sustained. Changes in recognition or measurement are made as facts and circumstances change.

Stock-Based Compensation We account for stock-based compensation on a fair value basis. The estimated grant date fair value of each stock-based award is recognized in expense over the requisite service period (generally the vesting period). The estimated fair value of each option is calculated using the Black-Scholes option-pricing model. Non-vested share awards are recorded as compensation expense over the requisite service periods based on the market value on the date of grant.

Earnings Per Share Basic earnings per share (EPS) are computed by dividing net income by the weighted-average number of common shares outstanding. Diluted EPS are computed by dividing net income by the weighted-average number of common shares outstanding including the incremental shares assumed to be issued upon the exercise of stock options and the incremental shares assumed to be issued as performance units and restricted stock. Basic and diluted EPS were calculated using the following:

	April 1, 2012	April 3, 2011	March 28, 2010
Weighted average common shares outstanding basic	10,339,391	10,260,135	10,250,978
Dilutive impact of stock options, performance units, and restricted stock	69,182	92,498	32,015
Weighted average common shares outstanding diluted	10,408,573	10,352,633	10,282,993

There were no shares or stock options excluded from the calculation of weighted average common shares for diluted EPS for fiscal 2012 or fiscal 2011. Stock options totaling 70,665 in fiscal 2010 have been excluded from the calculation of diluted EPS because the effect of including the shares would be anti-dilutive.

Derivative Instruments and Hedging Activities We do not have any freestanding or embedded derivatives and it is our policy to not enter into contracts that contain them.

Recently Issued Accounting Pronouncements

Intangibles Goodwill and Other In September 2011, the FASB issued Accounting Standards Update (ASU) No. 2011-08, Testing Goodwill for Impairment which amended the guidance on goodwill impairment testing to allow companies to first assess qualitative factors to determine whether it is necessary to perform the two-step quantitative goodwill impairment test. If, as a result of the qualitative assessment, an entity determines that it is more-likely-than-not that the fair value of a reporting unit is less than its carrying amount,

HAWKINS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

the quantitative impairment test is required. Otherwise, no further testing is required. The amendment is effective for fiscal years beginning after December 15, 2011, which is our fiscal year 2013, but early adoption is permitted. We intend to adopt the amendment in fiscal 2013 and do not expect it to materially affect our financial position or results of operations.

Multiemployer Pension Plans In September 2011, FASB issued ASU No. 2011-09, *Disclosures about an Employer s Participation in a Multiemployer Plan* , to require expanded disclosures for entities participating in multiemployer plans. The expanded disclosures are designed to assist financial statement users in assessing the potential impact of an entity s participation in multiemployer plans on future cash flow. This guidance is effective for annual reporting periods ending after December 15, 2011. We adopted this ASU during fiscal 2012. This ASU does not change the accounting for an employer s participation in a multiemployer plan. See Note 8 Profit Sharing, Employee Stock Ownership and Employee Stock Purchase Plans for disclosures related to this ASU.

Note 2 Business Combinations

In the fourth quarter of fiscal 2011, we completed the acquisition of the assets of Vertex Chemical Corporation, Novel Wash Co. Inc. and R.H.A. Corporation, (collectively, Vertex), pursuant to an Asset Purchase Agreement dated as of January 10, 2011 (the Asset Purchase Agreement). As provided in the Asset Purchase Agreement, we acquired substantially all of the assets used in Vertex s business, which is primarily the manufacture and distribution of sodium hypochlorite and the distribution of caustic soda, hydrochloric acid and related products. We paid cash of $25.5 million at closing and assumed certain liabilities of Vertex. The purchase price was revised to $27.2 million as provided in the Asset Purchase Agreement to reflect a final working capital adjustment of $1.7 million, which was paid in early fiscal 2012. In connection with the acquisition we incurred acquisition related costs during fiscal 2011 of $0.7 million, which were recorded as selling, general and administrative expenses in the Consolidated Statements of Income.

The acquisition has been accounted for under the acquisition method of accounting in accordance with ASC Topic 805, *Business Combinations*. Under the acquisition method of accounting, the total estimated purchase price is allocated to the net tangible and intangible assets of Vertex acquired in connection with the acquisition, based on their estimated fair values.

The allocation of the purchase price to assets acquired and liabilities assumed follows:

(In thousands)	Amount
Accounts receivable	$ 4,975
Inventories	4,486
Other current assets	198
Property, plant and equipment	8,991
Goodwill	5,291
Intangibles	5,490
Accounts payable	(2,012)
Accrued employee benefits	(210)
Total purchase price	$ 27,209

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The allocation of the purchase price to the assets acquired and liabilities assumed resulted in the recognition of the following intangible assets:

(In thousands)	Amount	Weighted Average Life
Customer relationships	$ 3,450	20 years
Trademark	1,240	10 years
Carrier relationships	800	10 years
Intangible assets acquired	$ 5,490	

The fair value of the identified intangible assets was estimated using an income approach. Under the income approach an intangible asset s fair value is equal to the present value of future economic benefits to be derived from ownership of an asset. Indications of value are developed by discounting future net cash flows to their present value at market-based rates of return.

The goodwill recognized as a result of the Vertex acquisition is primarily attributable to expected synergies, as well as Vertex s assembled work force.

Vertex operating results are included in our Consolidated Statements of Income in our Industrial segment from the date of acquisition.

The following unaudited pro forma condensed consolidated financial results of operations for the year ended April 3, 2011 is presented as if the Vertex acquisition had been completed at the beginning of the period. The amounts shown for the year ended April 1, 2012 are based on actual results for the period:

	Years Ended	
(In thousands, except share and per-share data)	**April 1, 2012**	**April 3, 2011**
Pro forma net sales	$ 343,834	$ 329,653
Pro forma net earnings	22,685	21,888
Pro forma earnings per share:		
Basic	$ 2.19	$ 2.13
Diluted	2.18	2.11
Weighted average common shares outstanding:		
Basic	10,339,391	10,260,135
Diluted	10,408,573	10,352,633

These unaudited pro forma condensed consolidated financial results have been prepared for illustrative purposes only and do not purport to be indicative of the results of operations that actually would have resulted had the acquisition occurred on the first day of each fiscal period presented, or of future results of the consolidated entities. The unaudited pro forma condensed consolidated financial information does not reflect any operating efficiencies and cost savings that may have been realized from the integration of the acquisition.

HAWKINS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3 Cash and Cash Equivalents and Investments

The following table presents information about our financial assets and liabilities that are measured at fair value on a recurring basis as of April 1, 2012 and April 3, 2011, and indicates the fair value hierarchy of the valuation techniques utilized to determine such fair value.

Description **(In thousands)**	**April 1, 2012**	**Level 1**	**Level 2**	**Level 3**
Assets:				
Cash	$ 28,006	$ 28,006	$	$
Certificates of deposit	17,349		17,349	
Money market securities	560	560		

Description **(In thousands)**	**April 3, 2011**	**Level 1**	**Level 2**	**Level 3**
Assets:				
Cash	$ 18,485	$ 18,485	$	$
Certificates of deposit	18,461		18,461	
Money market securities	455	455		

Our financial assets that are measured at fair value on a recurring basis are certificates of deposit (CD s), with maturities ranging from three months to two years which fall within valuation technique Level 2. The CD s are classified as investments in current assets and noncurrent assets on the Consolidated Balance Sheets. As of April 1, 2012, the CD s in current assets have a fair value of $12.2 million, and in noncurrent assets, the CD s have a fair value of $5.1 million.

The carrying value of cash and cash equivalents accounts approximates fair value, as maturities are three months or less. We did not have any financial liability instruments subject to recurring fair value measurements as of April 1, 2012 and April 3, 2011.

The contractual maturities of available-for-sale securities at April 1, 2012 are shown in the table below.

(In thousands)	**Amortized Cost**	**Fair Value**	**Unrealized Gain/(loss)**
Within one year	$ 12,205	$ 12,210	$ 5
Between one and two years	5,145	5,139	(6)
Total available-for-sale securities	$ 17,350	$ 17,349	$ (1)

The contractual maturities of available-for-sale securities at April 3, 2011 are shown in the table below.

(In thousands)	**Amortized Cost**	**Fair Value**	**Unrealized Gain/(loss)**
Within one year	$ 15,270	$ 15,286	$ 16
Between one and two years	3,185	3,175	(10)

Total available-for-sale securities	$ 18,455	$ 18,461	$ 6

Realized gains and losses were not material for fiscal 2012, fiscal 2011 and fiscal 2010.

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HAWKINS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 4 Inventories

Inventories at April 1, 2012 and April 3, 2011 consisted of the following:

(In thousands)	2012	2011
Finished goods (FIFO basis)	$ 35,072	$ 35,071
LIFO reserve	(7,439)	(5,854)
Net inventory	$ 27,633	$ 29,217

The FIFO value of inventories accounted for under the LIFO method were $30.6 million at April 1, 2012 and $28.6 million at April 3, 2011. The remainder of the inventory was valued and accounted for under the FIFO method.

We increased the LIFO reserve by $1.6 million in fiscal 2012 due primarily to the volume and mix of commodity chemicals in inventory at the end of the year. In fiscal 2011 we increased the LIFO reserve by $3.9 million due primarily to rising inventory costs, as well as higher inventory volumes at the end of fiscal 2011.

Note 5 Goodwill and Other Identifiable Intangible Assets

The changes in the carrying amount of goodwill were as follows:

(In thousands)	Amount
Balance as of March 28, 2010	$ 1,204
Vertex acquisition	5,027
Balance as of April 3, 2011	6,231
Fiscal 2012 adjustment	264
Balance as of April 1, 2012	$ 6,495

The increase in goodwill during fiscal 2012 relates to the finalization of the determination of the fair value of inventory acquired as part of the acquisition of Vertex.

A summary of our intangible assets as of April 1, 2012 and April 3, 2011 were as follows:

		2012	
(In thousands)	Gross Carrying Amount	Accumulated Amortization	Net
Finite-life intangible assets:			
Customer relationships	$ 5,508	$ (706)	$ 4,802

Trademark	1,240	(150)	1,090
Trade secrets	862	(521)	341
Carrier relationships	800	(96)	704
Other finite-life intangible assets	339	(317)	22
Total finite-life intangible assets	8,749	(1,790)	6,959
Indefinite-life intangible assets	1,227		1,227
Total intangible assets, net	$ 9,976	$ (1,790)	$ 8,186

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HAWKINS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands)	2011 Gross Carrying Amount	2011 Accumulated Amortization	2011 Net
Finite-life intangible assets:			
Customer relationships	$ 5,508	$ (423)	$ 5,085
Trademark	1,240	(26)	1,214
Trade secrets	862	(413)	449
Carrier relationships	800	(18)	782
Other finite-life intangible assets	339	(285)	54
Total finite-life intangible assets	8,749	(1,165)	7,584
Indefinite-life intangible assets	1,227		1,227
Total intangible assets, net	$ 9,976	$ (1,165)	$ 8,811

Intangible asset amortization expense was $0.6 million during fiscal 2012, $0.3 million during fiscal 2011, and $0.2 million during fiscal 2010.

The estimated future amortization expense for identifiable intangible assets during the next five years is as follows:

(In thousands)	2013	2014	2015	2016	2017
Estimated amortization expense	$ 596	$ 592	$ 592	$ 502	$ 479

Note 6 Accumulated Other Comprehensive Income (Loss)

Components of accumulated other comprehensive income (loss), net of tax, were as follows:

(In thousands)	2012	2011	2010
Unrealized gain (loss) on:			
Available-for-sale investments	$ (4)	$ 3	$ 66
Post-retirement plan liability adjustments	26	(148)	(29)
Accumulated other comprehensive income (loss)	$ 22	$ (145)	$ 37

Note 7 Share-Based Compensation

Stock Option Awards. Our Board of Directors has approved a long-term incentive equity compensation arrangement for our executive officers. This long-term incentive arrangement provides for the grant of nonqualified stock options that vest at the end of a three-year period and expire no later than 10 years after the grant date. We used the Black-Scholes valuation model to estimate the fair value of the options at grant date based on the following assumptions:

	Fiscal 2010 grant	Fiscal 2009 grant
Dividend yield	2.5%	3.2%
Volatility	31.4%	28.0%

Risk-free interest rate	2.1%	3.0%
Expected life in years	4	4

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HAWKINS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Volatility was calculated using the past four years of historical stock prices of our common stock. The expected life is estimated based on expected future trends and the terms and vesting periods of the options granted. The risk-free interest rate is an interpolation of the relevant U.S. Treasury Bond Rate as of the grant date.

The following table represents the stock option activity for fiscal 2012 and fiscal 2011:

	2012					
	Total Outstanding			Exercisable		
(In thousand, except share data)	**Shares**	**Weighted-Average Exercise Price**	**Aggregate Intrinsic Value**	**Shares**	**Weighted-Average Exercise Price**	**Aggregate Intrinsic Value**
Outstanding at beginning of year	131,997	$ 17.82	$ 4,908	66,666	$ 17.67	$ 2,482
Granted						
Vested				27,999	15.43	
Exercised	(85,332)	17.18		(85,332)	17.18	
Forfeited or expired						
Outstanding at end of year	46,665	$ 19.01	$ 1,547	9,333	$ 15.43	$ 320

	2011					
	Total Outstanding			Exercisable		
(In thousand, except share data)	**Shares**	**Weighted-Average Exercise Price**	**Aggregate Intrinsic Value**	**Shares**	**Weighted-Average Exercise Price**	**Aggregate Intrinsic Value**
Outstanding at beginning of year	131,997	$ 17.82	$ 2,607		$	$
Granted						
Vested				66,666	17.67	
Exercised						
Forfeited or expired						
Outstanding at end of year	131,997	$ 17.82	$ 4,908	66,666	$ 17.67	$ 2,482

The weighted average grant date fair value of options was estimated to be $4.33 and $2.95 for options granted in fiscal 2010 and fiscal 2009, respectively. The weighted average remaining life of all outstanding and exercisable options is 6.1 years.

Annual expense related to the value of stock options was $0.1 million for fiscal 2012, $0.2 million for fiscal 2011 and $0.1 million for fiscal 2010, substantially all of which was recorded in SG&A expense in the Consolidated Statements of Income. Options awarded to John Hawkins, former Chief Executive Officer, became fully vested and exercisable upon his death in March 2011, resulting in the acceleration of expense of $0.1 million. The total fair value of options vested during fiscal 2012 was $0.1 million compared to $0.2 million during fiscal 2011. Unrecognized compensation expense related to outstanding stock options as of April 1, 2012 was not material and is expected to be recognized over a weighted average period of 0.2 years.

Performance-Based Restricted Stock Units. Our Board of Directors has approved a performance-based equity compensation arrangement for our executive officers. This performance-based arrangement provides for the grant of performance-based restricted stock units that represent a possible future issuance of restricted shares

HAWKINS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

of our common stock based on our pre-tax income target for the applicable fiscal year. The actual number of restricted shares to be issued to each executive officer will be determined when our final financial information becomes available after the applicable fiscal year and will be between zero shares and 43,022 shares in the aggregate for fiscal 2012. The restricted shares issued will fully vest two years after the last day of the fiscal year on which the performance is based. We are recording the compensation expense for the outstanding performance share units and then-converted restricted stock over the life of the awards.

Performance-based restricted stock units were awarded to our executive officers on June 8, 2011, June 2, 2010 and June 10, 2009 under this arrangement. The following table represents the restricted stock activity for fiscal 2012 and fiscal 2011:

	2012		2011	
	Shares	Weighted-Average Grant Date Fair Value	Shares	Weighted-Average Grant Date Fair Value
Outstanding at beginning of year	11,667	$ 25.81	23,000	$ 19.90
Granted	33,321	35.39	41,320	30.02
Vested	(11,667)	25.81	(52,653)	26.53
Forfeited or expired				
Outstanding at end of year	33,321	$ 35.39	11,667	$ 25.81

We recorded compensation expense related to the shares issued for fiscal 2010 and fiscal 2011 and the potential issuance of shares for fiscal 2012 of approximately $0.8 million for fiscal 2012, $1.6 million for fiscal 2011 and $0.4 million for fiscal 2010, substantially all of which was recorded in SG&A expense in the Consolidated Statements of Income. The performance-based restricted stock units previously awarded to John Hawkins, totaling 39,820 shares, became fully vested and payable upon his death in March 2011, resulting in the acceleration of compensation expense of $0.4 million. The total fair value of performance-based restricted stock units vested in fiscal 2012 was $0.3 million compared to $1.4 million in fiscal 2011.

Until the performance-based restricted stock units result in the issuance of restricted stock, the amount of expense recorded each period is dependent upon our estimate of the number of shares that will ultimately be issued and our then current common stock price. Upon issuance of restricted stock, we record compensation expense over the remaining vesting period using the award date closing price, which was $25.81 per share on June 2, 2010 and $35.39 per share on June 8, 2011. Unrecognized compensation expense related to non-vested restricted share units as of April 1, 2012 was $1.1 million and is expected to be recognized over a weighted average period of 1.4 years.

In conjunction with the vesting of restricted stock held by certain of our executive officers, 3,980 shares were forfeited during fiscal 2012 to cover the executive officers statutory minimum income tax withholding.

The benefits of tax deductions in excess of recognized compensation costs (excess tax benefits) are recorded as a change in additional paid in capital rather than a deduction of taxes paid. The amount of excess tax benefit recognized and recorded in additional paid in capital resulting from share-based compensation cost was $0.7 million in fiscal 2012 and $0.3 million during fiscal 2011.

Restricted Stock Awards. As part of their retainer, the Board of Directors receives restricted stock for their Board services. The restricted stock awards are expensed over the requisite vesting period, which begins on the

HAWKINS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

date of issuance and ends on the date of the next Annual Meeting of Shareholders, based on the market value on the date of grant. The following table represents the Board s restricted stock activity for fiscal 2012 and fiscal 2011:

	2012		2011	
	Shares	Weighted-Average Grant Date Fair Value	Shares	Weighted-Average Grant Date Fair Value
Outstanding at beginning of period	6,996	$ 30.00	6,000	$ 18.68
Granted	6,120	34.31	6,966	30.00
Vested	(6,996)	30.00	(6,000)	18.68
Forfeited or expired				
Outstanding at end of period	6,120	$ 34.31	6,966	$ 30.00

Annual expense related to the value of restricted stock was $0.2 million for fiscal 2012 and $0.2 million for fiscal 2011 and $0.1 million for fiscal 2010, all of which was recorded in SG&A expense in the Consolidated Statements of Income. Unrecognized compensation expense related to non-vested restricted stock awards as of April 1, 2012 was $0.1 million and is expected to be recognized over a weighted average period of 0.3 years.

Note 8 Profit Sharing, Employee Stock Ownership, Employee Stock Purchase and Pension Plans

Effective April 1, 2009, we converted our defined contribution pension plan covering substantially all of our non-bargaining unit employees to a profit sharing plan. It is our policy to fund all costs accrued. Contributions are made at our discretion subject to a maximum amount allowed under the Internal Revenue Code. Our cost for the profit sharing and pension plan was 15% of each employee s eligible compensation in each of the fiscal years 2012, 2011 and 2010. Beginning in fiscal 2013, profit sharing plan contributions are variable and aligned with company performance with a targeted contribution of between 2.5% and 5% of an employee s eligible compensation, depending upon date of hire. In addition to the changes in the profit sharing plan for fiscal 2013, we introduced a 401(k) plan that will allow employees to contribute pre-tax earnings up to the maximum amount allowed under the Internal Revenue Code, with an employer match of up to 5% of the employee s eligible compensation.

We have an employee stock ownership plan (ESOP) covering substantially all of our non-bargaining unit employees. Contributions are made at our discretion subject to a maximum amount allowed under the Internal Revenue Code. Our cost for the ESOP was 5% of each employee s eligible compensation in each of the fiscal years 2012, 2011 and 2010. Beginning in fiscal 2013, ESOP contributions are variable and aligned with company performance with a targeted contribution of between 2.5% and 5% of an employee s eligible compensation, depending upon date of hire.

We have an employee stock purchase plan (ESPP) covering substantially all of our employees. The ESPP allows employees to purchase newly-issued shares of the Company s common stock at a discount from market, with no employee contribution match from the Company. Prior to fiscal 2012, this plan had a monthly employer match of 75% of each employee s contribution, up to a maximum of $375 per month, with the ESPP shares of the Company purchased on the open market.

In fiscal 2012, Vertex employees participated in a 401(k) plan that included an employer match of up to 3% of the employee s eligible compensation and a discretionary Company contribution. The total company contribution to this plan was $0.2 million. Beginning in fiscal 2013, Vertex employees are included within the Company s retirement plans outlined above.

HAWKINS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following represents the contribution expense for the profit sharing, ESOP, ESPP and 401(k) plans:

Benefit Plan **(In thousands)**	**2012**	**2011**	**2010**
Profit sharing	$ 2,616	$ 2,675	$ 2,844
ESOP	802	815	899
ESPP	262	648	650
Vertex plan	175		
Total contribution expense	$ 3,855	$ 4,138	$ 4,393

Multiemployer pension plan. We participate in a union sponsored, collectively bargained multiemployer pension plan (Union Plan). Contributions are determined in accordance with the provisions of negotiated labor contracts and generally are based on the number of hours worked. The risks of participating in multiemployer pension plans are different from single-employer plans in the following aspects: (i) Assets contributed to a multiemployer plan by one employer may be used to provide benefits to employees of other participating employers; (ii) If a participating employer stops contributing to the plan, the unfunded obligations of the plan may be borne by the remaining participating employers; and (iii) if we stop participating in the multiemployer plan, we may be required to pay the plan an amount based on the underfunded status of the plan, referred to as a withdrawal liability.

The Company s participation in the Central States, Southeast and Southwest Areas Pension Fund (Central States) is outlined in the table below. The Pension Protection Act (PPA) Zone Status available in fiscal 2012 and fiscal 2011 is for the plan s year ended December 31, 2010 and December 31, 2009, respectively. The zone status is based on information that we obtained from Central States and is certified by the plan s actuary. Among other factors, plans in the red zone are generally less than 65% funded. The FIP/RP Status Pending/Implemented column indicates if a funding improvement plan (FIP) or a rehabilitation plan (RP) is either pending or has been implemented.

			PPA Zone Status				
Pension Fund	**Employer Identification Number**	**Pension Plan Number**	**April 1, 2012**	**April 3, 2011**	**FIP/RP Status Pending/ Implemented**	**Surcharge Imposed**	**Expiration Date of Collective Bargaining Agreements**
Central States, Southeast and Southwest Areas Pension Fund	36-6044243	001	Red	Red	Implemented	Yes	02/28/2013

Based upon the most recent information available from the trustees managing CSS, our share of the unfunded vested benefit liability for the plan was estimated to be approximately $7.9 million if the withdrawal had occurred in calendar year 2011, an increase from an estimate of approximately $5.1 million if the withdrawal had occurred in calendar year 2009. These estimates were calculated by the trustees managing CSS. Although we believe the most recent plan data available from CSS was used in computing this 2011 estimate, the actual withdrawal liability amount is subject to change based on, among other things, the plan s investment returns and benefit levels, interest rates, financial difficulty of other participating employers in the plan such as bankruptcy, and continued participation by the company and other employers in the plan, each of which could impact the ultimate withdrawal liability. If withdrawal liability were to be triggered, we would have the option to make payments over a period of 20 years instead of paying the withdrawal liability in a lump sum.

HAWKINS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

We made contribution to the plan of approximately $0.4 million in fiscal 2012, 2011 and 2010 and expect to make contributions to the plan of approximately $0.5 million during fiscal 2013.

Note 9 Commitments and Contingencies

Leases We have various operating leases for trucks and land and buildings on which some of our operations are located. Future minimum lease payments due under operating leases with an initial term of one year or more at April 1, 2012 are as follows:

(In thousands)	2013	2014	2015	2016	2017	Thereafter
Minimum lease payment	$ 709	$ 723	$ 712	$ 657	$ 598	$ 3,381

Total rental expense for the fiscal years 2012, 2011 and 2010 were as follows:

(In thousands)	2012	2011	2010
Minimum rentals	$ 617	$ 552	$ 577
Contingent rentals	102	114	102
Total rental expense	$ 719	$ 666	$ 679

Litigation We are a party from time to time in litigation arising in the ordinary course of our business. To date, none of the litigation has had a material effect on us. Legal fees associated with such matters are expensed as incurred.

On November 3, 2009, ICL Performance Products, LP (ICL), a chemical supplier to us, filed a lawsuit in the United States District Court for the Eastern District of Missouri, asserting breach of a contract for the sale of 75% purified phosphoric acid in 2009 (the 2009 Contract). ICL seeks to recover $7.3 million in damages and pre-judgment interest, and additionally seeks to recover its costs and attorneys fees. ICL also claimed that we breached a contract for the sale of 75% purified phosphoric acid in 2008 (the 2008 Contract). ICL has since dropped its claim for breach of the 2008 Contract. We have counterclaimed against ICL alleging that ICL falsely claimed to have a shortage of raw materials that prevented it from supplying us with the contracted quantity of 75% purified phosphoric acid for 2008. We claim that ICL used this alleged shortage and the threat of discontinued shipments of 75% purified phosphoric acid to force us to pay increased prices for the remainder of 2008, and to sign the 2009 Contract. Based on this alleged conduct, we have brought four alternate causes of action including: (1) breach of contract, (2) breach of the implied covenant of good faith and fair dealing, (3) negligent misrepresentation, and (4) intentional misrepresentation. We seek to recover $1.5 million in damages, and additionally seek to recover punitive damages, pre- and post-judgment interest, and our costs and attorneys fees. After the completion of discovery, both parties moved for summary judgment in their favor. On February 7, 2012, the Court denied both parties motions for summary judgment. ICL moved for reconsideration of parts of its motion for summary judgment. On April 24, 2012, the Court granted ICL s motion for reconsideration in part, and denied it in part. In its April 24, 2012 Memorandum and Order, the Court interpreted the meaning and effect of a specific phrase in the 2009 Contract, and concluded that, if the 2009 Contract is a legally enforceable contract, Hawkins remained obligated to purchase 50% of its requirements for 75% purified phosphoric acid from ICL in 2009. Trial is scheduled to begin on July 23, 2012. We are not able to predict the ultimate outcome of this litigation, but legal proceedings such as this can result in substantial costs and divert our management s attention and resources, which may have a material adverse effect on our business and results of operations, including cash flows.

HAWKINS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Asset Retirement Obligations We have three leases of land (two relate to Hawkins and one relates to Vertex), and at the end of the lease term (currently 2014 for the Vertex lease and 2018 for the Hawkins leases if the leases are not renewed), we have a specified amount of time to remove the property and buildings. At the end of the specified amount of time, anything that remains on the land becomes the property of the lessor, and the lessor has the option to either maintain the property or remove the property at our expense. We have not been able to reasonably estimate the fair value of the asset retirement obligations, primarily due to the combination of the following factors: The Hawkins leases do not expire in the near future; we have a history of extending the leases with the lessors and currently intend to do so at expiration of the lease periods; the lessors do not have a history of terminating leases with its tenants; and because it is more likely than not that the buildings will have value at the end of the lease life and therefore, may not be removed by either the lessee or the lessor. We are currently in negotiations with the landlord regarding the Vertex land lease which expires in 2014 and expect to sign a long-term extension in the near future. Therefore, in accordance with ASC 410-20, Asset Retirement and Environmental Obligations, we have not recorded an asset retirement obligation as of April 1, 2012. We will continue to monitor the factors surrounding the requirement to record an asset retirement obligation and will recognize the fair value of a liability in the period in which it is incurred and a reasonable estimate can be made.

Note 10 Income Taxes

The provisions for income taxes for fiscal 2012, 2011 and 2010 are as follows:

(In thousands)	**2012**	**2011**	**2010**
Federal current	$ 8,632	$ 9,818	$ 6,601
State current	2,546	2,531	1,634
Total current	11,178	12,349	8,235
Federal deferred	2,796	(69)	5,739
State deferred	316	(299)	1,413
Total deferred	3,112	(368)	7,152
Total provision	$ 14,290	$ 11,981	$ 15,387

Reconciliations of the provisions for income taxes, based on income from continuing operations, to the applicable federal statutory income tax rate of 35% are listed below.

	2012	**2011**	**2010**
Statutory federal income tax	35.0%	35.0%	35.0%
State income taxes, net of federal deduction	5.0	4.7	5.0
ESOP dividend deduction on allocated shares	(0.7)	(1.2)	(1.0)
Domestic production deduction	(0.9)	(1.3)	(0.6)
Other net	0.2	(0.1)	0.9
Total	38.6%	37.1%	39.3%

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HAWKINS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The tax effects of items comprising our net deferred tax asset (liability) as of April 1, 2012 and April 3, 2011 are as follows:

(In thousands)	2012	2011
Deferred tax assets:		
Trade receivables	$ 184	$ 162
Stock compensation accruals	601	490
Other accruals	756	919
Other	82	169
Total deferred tax assets	$ 1,623	$ 1,740
Deferred tax liabilities:		
Inventories	$ (3,556)	$ (3,190)
Prepaid	(703)	(283)
Excess of tax over book depreciation	(10,807)	(8,762)
Amortization of intangibles	(149)	
Total deferred tax liabilities	$ (15,215)	$ (12,235)
Net deferred tax liabilities	$ (13,592)	$ (10,495)

As of April 1, 2012, the Company has determined that it is more likely than not that the deferred tax assets at April 1, 2012 will be realized either through future taxable income or reversals of taxable temporary differences. As of April 1, 2012 and April 3, 2011, there were no unrecognized tax benefits. Accordingly, a tabular reconciliation from beginning to ending periods is not provided.

We are subject to U.S. federal income tax as well as income tax of multiple state jurisdictions. The tax years beginning with 2007 remain open to examination by the Internal Revenue Service, and with few exceptions, state and local income tax jurisdictions.

Note 11 Discontinued Operations

In February 2009, we agreed to sell our inventory and entered into a marketing agreement regarding the business of our Pharmaceutical segment, which provided pharmaceutical chemicals to retail pharmacies and small-scale pharmaceutical manufacturers. The inventory was sold in fiscal 2010 for cash of approximately $1.8 million which approximated its carrying value. The marketing agreement provides for annual payments based on a percentage of gross profit on future sales up to a maximum of approximately $3.5 million. We have no significant remaining obligations to fulfill under the agreement. Amounts received under the marketing agreement in excess of $1.7 million, the carrying value of intangible assets related to this business at the time of sale, have been recorded as a gain on sale of discontinued operations. Through fiscal 2012, we have recorded gains of approximately $1.7 million before taxes and expect to accrue a nominal amount in fiscal 2013 which will finalize the agreement. To date, we have received $2.2 million in cash under this marketing agreement and expect to collect the remaining $1.3 million in fiscal 2013. The results of the Pharmaceutical segment have been reported as discontinued operations for all periods presented.

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HAWKINS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 12 Segment Information

We have two reportable segments: Industrial and Water Treatment. The accounting policies of the segments are the same as those described in the summary of significant accounting policies. Product costs and expenses for each segment are based on actual costs incurred along with cost allocation of shared and centralized functions. We evaluate performance based on profit or loss from operations before income taxes not including nonrecurring gains and losses. Reportable segments are defined by product and type of customer. Segments are responsible for the sales, marketing and development of their products and services. The segments do not have separate accounting, administration, customer service or purchasing functions. There are no intersegment sales and no operating segments have been aggregated. Given our nature, it is not practical to disclose revenues from external customers for each product or each group of similar products. No single customer s revenues amount to 10% or more of our revenue. No single customer represents 10% or more of either of our segments sales. Sales are primarily within the United States and all assets are located within the United States.

Reportable Segments (In thousands)	Industrial	Water Treatment	Total
Fiscal Year Ended April 1, 2012:			
Sales	$ 251,451	$ 92,383	$ 343,834
Gross profit	40,357	25,511	65,868
Operating income	20,552	14,557	35,109
Identifiable assets*	$ 129,782	$ 23,543	$ 153,325
Fiscal Year Ended April 3, 2011:			
Sales	$ 208,724	$ 88,917	$ 297,641
Gross profit	36,938	24,964	61,902
Operating income	17,110	14,852	31,962
Identifiable assets*	$ 121,250	$ 21,139	$ 142,389
Fiscal Year Ended March 28, 2010:			
Sales	$ 174,901	$ 82,198	$ 257,099
Gross profit	37,288	27,157	64,445
Operating income	20,937	17,903	38,840
Identifiable assets*	$ 79,602	$ 19,152	$ 98,754

* Unallocated assets consisting primarily of cash and cash equivalents, investments and prepaid expenses were $48.0 million at April 1, 2012, $41.7 million at April 3, 2011 and $60.5 million at March 28, 2010. Additionally, assets associated with the discontinued operations of the Pharmaceutical segment were $1.2 million at April 1, 2012, $0.9 million at April 3, 2011 and $1.0 million at March 28, 2010.

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HAWKINS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 13 Selected Quarterly Financial Data (Unaudited)

(In thousands, except per share data)

	Fiscal 2012			
	First	**Second**	**Third**	**Fourth**
Sales	$ 88,594	$ 87,870	$ 84,160	$ 83,210
Gross profit	17,927	18,750	15,679	13,512
Operating income	10,070	10,906	8,516	5,617
Income from continuing operations, net of tax	6,353	6,717	5,285	3,273
Income from discontinued operations, net of tax	374	184	267	232
Net income	$ 6,727	$ 6,901	$ 5,552	$ 3,505
Basic net income per share	$ 0.65	$ 0.67	$ 0.54	$ 0.34
Diluted net income per share	$ 0.65	$ 0.67	$ 0.53	$ 0.34

	Fiscal 2011			
	First	**Second**	**Third**	**Fourth**
Sales	$ 74,665	$ 70,398	$ 70,620	$ 81,957
Gross profit	18,447	17,742	13,726	11,986
Operating income	11,786	10,928	6,833	2,414
Income from continuing operations, net of tax	7,337	6,832	4,254	1,891
Income from discontinued operations, net of tax				
Net income	$ 7,337	$ 6,832	$ 4,254	$ 1,891
Basic net income per share	$ 0.72	$ 0.67	$ 0.41	$ 0.18
Diluted net income per share	$ 0.71	$ 0.66	$ 0.41	$ 0.18

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ITEM 9. ***CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE***
Not applicable.

ITEM 9A. ***CONTROLS AND PROCEDURES***
Evaluation of disclosure controls and procedures

As of the end of the period covered by this Annual Report on Form 10-K, we conducted an evaluation, under supervision and with the participation of management, including the chief executive officer and chief financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rules 13a-15(f) and 15d-15(f) of the Exchange Act. Based upon that evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures are effective. Disclosure controls and procedures are defined by Rules 13a-15(e) and 15d-15(e) of the Exchange Act as controls and other procedures that are designed to ensure that information required to be disclosed by us in reports filed with the SEC under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in reports filed under the Exchange Act is accumulated and communicated to our management, including our principal executive and principal financial officers, or person performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

Management s Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) of the Securities Exchange Act. Our internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Our internal control over financial reporting includes those policies and procedures that (1) pertain to maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of our assets; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of the financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with authorizations of our management and directors; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of the effectiveness of internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Our management assessed the effectiveness of our internal control over financial reporting as of April 1, 2012, based on the criteria described in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission. Based on this assessment, management believes that our internal control over financial reporting was effective as of April 1, 2012.

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Our independent registered public accounting firm has issued an attestation report on our internal control over financial reporting for April 1, 2012. That attestation report is set forth immediately following this management report.

/s/ Patrick H. Hawkins	/s/ Kathleen P. Pepski
Patrick H. Hawkins	Kathleen P. Pepski
Chief Executive Officer and President	Vice President, Chief Financial Officer, and Treasurer
June 1, 2012	June 1, 2012

Attestation Report of Registered Public Accounting Firm

The attestation report required under this Item 9A is contained in Item 8 of this Annual Report on 10-K under the caption Report of Independent Registered Public Accounting Firm.

Changes in Internal Control Procedures

There was no change in our internal control over financial reporting during the fourth quarter of fiscal 2012 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting. Beginning in fiscal 2012 management has included Vertex in management s assessment of the effectiveness of our internal control over financial reporting.

ITEM 9B. ***OTHER INFORMATION***

Not Applicable

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PART III

Certain information required by Part III is incorporated by reference from Hawkins definitive Proxy Statement for the Annual Meeting of Shareholders to be held on August 2, 2012 (the 2012 Proxy Statement). Except for those portions specifically incorporated in this Form 10-K by reference to the 2012 Proxy Statement, no other portions of the 2012 Proxy Statement are deemed to be filed as part of this Form 10-K.

ITEM 10. *DIRECTORS, EXECUTIVE OFFICERS, AND CORPORATE GOVERNANCE*

Our executive officers, their ages and offices held, as of May 25, 2012 are set forth below:

Name	Age	Office
Patrick H. Hawkins	41	Chief Executive Officer and President
Kathleen P. Pepski	57	Vice President, Chief Financial Officer, and Treasurer
Mark A. Beyer	50	Vice President Operations
Richard G. Erstad	48	Vice President, General Counsel and Secretary
Thomas J. Keller	52	Vice President Water Treatment Group
Theresa R. Moran	49	Vice President Quality and Support
John R. Sevenich	54	Vice President Industrial Group

Patrick H. Hawkins was appointed to serve as our Chief Executive Officer and President in March 2011. He had previously been promoted to the position of President in March 2010 as part of the Board s succession planning efforts. He joined the Company in 1992 and served as the Business Director Food and Pharmaceuticals, a position he held from 2009 to 2010. Previously he served as Business Manager Food and Co-Extrusion Products from 2007 to 2009 and Sales Representative Food Ingredients from 2002 to 2007. He previously served the Company in various other capacities, including Plant Manager, Quality Director and Technical Director.

Kathleen P. Pepski has been the Company s Vice President, Chief Financial Officer and Treasurer since February 2008 and was Secretary from February 2008 to November 2008. She was the Executive Vice President and Chief Financial Officer of PNA Holdings, LLC and Katun Corporation, a supplier of business equipment parts, from 2003 to 2007, the Vice President of Finance of Hoffman Enclosures, a manufacturer of systems enclosures and a subsidiary of Pentair, Inc., from 2002 to 2003, Senior Vice President and Chief Financial Officer of BMC Industries, Inc., a manufacturer of lenses and aperture masks, from 2000 to 2001, and Vice President and Controller at Valspar Corporation, a paint and coatings manufacturer, from 1994 to 2000.

Mark A. Beyer has been the Company s Vice President of Operations since September 2009. Mr. Beyer previously held operations leadership positions with Boston Scientific Corporation, a medical device manufacturer, and General Mills, Inc., a diversified food company. He was self-employed as a consultant from January 2005 to September 2009.

Richard G. Erstad has been the Company s Vice President, General Counsel and Secretary since November 2008. He was General Counsel and Secretary of BUCA, Inc., a restaurant company, from 2005 to 2008. Mr. Erstad had previously been an attorney with the corporate group of Faegre & Benson LLP, a law firm, from 1996 to 2005, where his practice focused on securities law and mergers and acquisitions. He is a member of the Minnesota Bar.

Thomas J. Keller has been the Company s Vice President Water Treatment Group since April 2012. Prior to attaining this position, Mr. Keller held various positions during his 32-year tenure with the Company, most recently as its Water Treatment General Manager, a position he held since June 2011. Previously, Mr. Keller served as a Regional Manager of the Water Treatment Group from 2002 to 2011.

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Theresa R. Moran has been the Company s Vice President Quality and Support since February 2010. Since joining the Company in 1981, Ms. Moran has served the Company in a variety of positions, including Administration Operations Manager from 1999 to 2007 and most recently as Director Process Improvement, a position she held from 2007 until the time of her promotion.

John R. Sevenich has been the Company s Vice President Industrial Group since May 2000. He was the Business Unit Manager of Manufacturing from 1998 to 2000 and was a Sales Representative with the Company from 1989 to 1998.

Election of Directors, Corporate Governance, and Section 16(a) Beneficial Ownership Reporting Compliance of the 2011 Proxy Statement are incorporated herein by reference.

We have adopted a Code of Business Conduct and Ethics that applies to all of our directors and employees, including our principal executive officer, principal financial officer, controller and other persons performing similar functions. We have posted the Code of Business Conduct and Ethics on our website located at http://www.hawkinsinc.com. Hawkins Code of Business Conduct and Ethics is also available in print to any shareholder who requests it in writing from our Corporate Secretary. We intend to post on our website any amendment to, or waiver from, a provision of our Code of Business Conduct and Ethics that applies to our principal executive officer, principal financial officer, controller and other persons performing similar functions within four business days following the date of such amendment or waiver. We are not including the information contained on our website as part of, or incorporating it by reference into, this report.

ITEM 11. ***EXECUTIVE COMPENSATION***

Compensation of Executive Officers and Directors of the 2012 Proxy Statement is incorporated herein by this reference.

ITEM 12. ***SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS***

Security Ownership of Management and Beneficial Ownership and Equity Compensation Plan Information of the 2012 Proxy Statement are incorporated herein by this reference.

ITEM 13. ***CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE***

Election of Directors and Related Party Transactions of the 2012 Proxy Statement are incorporated herein by this reference.

ITEM 14. ***PRINCIPAL ACCOUNTANT FEES AND SERVICES***

Independent Registered Public Accounting Firm s Fees of the 2012 Proxy Statement is incorporated herein by this reference.

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PART IV

ITEM 15. *EXHIBITS AND FINANCIAL STATEMENT SCHEDULES*

(a)(1) FINANCIAL STATEMENTS OF THE COMPANY

The following financial statements of Hawkins, Inc. are filed as part of this Annual Report on Form 10-K:

Reports of Independent Registered Public Accounting Firms.

Consolidated Balance Sheets at April 1, 2012 and April 3, 2011.

Consolidated Statements of Income for the fiscal years ended April 1, 2012, April 3, 2011, and March 28, 2010.

Consolidated Statements of Shareholders Equity for the fiscal years ended April 1, 2012, April 3, 2011, and March 28, 2010.

Consolidated Statements of Cash Flows for the fiscal years ended April 1, 2012, April 3, 2011, and March 28, 2010.

Notes to Consolidated Financial Statements.

(a)(2) FINANCIAL STATEMENT SCHEDULES OF THE COMPANY

The additional financial data listed below is included as a schedule to this Annual Report on Form 10-K and should be read in conjunction with the financial statements presented in Part II, Item 8. Schedules not included with this additional financial data have been omitted because they are not required or the required information is included in the financial statements or the notes.

The following financial statement schedule for the fiscal years 2012, 2011 and 2010.

Schedule II Valuation and Qualifying Accounts.

(a)(3) EXHIBITS

The exhibits of this Annual Report on Form 10-K included herein are set forth on the attached Exhibit Index.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Company has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

HAWKINS, INC.

Date: June 1, 2012

By /s/ Patrick H. Hawkins
Patrick H. Hawkins,

Chief Executive Officer and President

POWER OF ATTORNEY

Each of the undersigned directors of the Company, does hereby make, constitute and appoint Patrick H. Hawkins and Kathleen P. Pepski, and either of them, the undersigned s true and lawful attorney-in-fact and agent, acting alone, with full power of substitution, for the undersigned and in the undersigned s name, place and stead, to sign and affix the undersigned s name as such director of the Company, in any and all capacities, to any and all amendments to this Annual Report on Form 10-K and to file the same, with all exhibits thereto, and other documents in connection wherewith, with the Securities and Exchange Commission, granting unto said attorney-in-fact, and either of them, full power and authority to do and perform each and every act necessary or incidental to the performance and execution of the powers herein expressly granted.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has also been signed below by the following persons on behalf of the Company and in the capacities indicated on the date set forth beside their signature.

/s/ Patrick H. Hawkins Patrick H. Hawkins, Chief Executive Officer and President (Principal Executive Officer) and Director	Date: June 1, 2012
/s/ Kathleen P. Pepski Kathleen P. Pepski, Vice President, Chief Financial Officer, and Treasurer (Principal Financial Officer and Principal Accounting Officer)	Date: June 1, 2012
/s/ John S. McKeon John S. McKeon, Director, Chairman of the Board	Date: June 1, 2012
/s/ Duane M. Jergenson Duane M. Jergenson, Director	Date: June 1, 2012
/s/ Daryl I. Skaar Daryl I. Skaar, Director	Date: June 1, 2012
/s/ James A. Faulconbridge James A. Faulconbridge, Director	Date: June 1, 2012
/s/ James T. Thompson James T. Thompson, Director	Date: June 1, 2012

/s/ Jeffrey L. Wright Jeffrey L. Wright, Director	Date: June 1, 2012

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Schedule VALUATION AND QUALIFYING ACCOUNTS

SCHEDULE II

HAWKINS, INC.

VALUATION AND QUALIFYING ACCOUNTS

FOR THE FISCAL YEARS ENDED APRIL 1, 2012, APRIL 3, 2011, AND MARCH 28, 2010

		Additions			
Description	Balance at Beginning of Year	Charged to Costs and Expenses	Charged to Other Accounts	Deductions Write-Offs	Balance at End of Year
		(In thousands)			
Reserve deducted from asset to which it applies:					
Year Ended April 1, 2012:					
Allowance for doubtful accounts	$ 406	$ 78	$	$ 24	$ 460
Year Ended April 3, 2011:					
Allowance for doubtful accounts	$ 300	$ 120	$	$ 14	$ 406
Year Ended March 28, 2010:					
Allowance for doubtful accounts	$ 350	$ (29)	$	$ 21	$ 300

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Exhibit Index

Unless otherwise indicated, all documents incorporated into this Annual Report on Form 10-K by reference to a document filed with the SEC are located under file number 0-7647.

Exhibit	Description	Method of Filing
3.1	Amended and Second Restated Articles of Incorporation.(1)	Incorporated by Reference
3.2	Amended and Restated By-Laws.(2)	Incorporated by Reference
10.1*	Description of Consulting Arrangement with John S. McKeon.(3)	Incorporated by Reference
10.2*	Hawkins, Inc. 2004 Omnibus Stock Plan.(4)	Incorporated by Reference
10.3*	Form of Restricted Stock Agreement under the Company s 2004 Omnibus Stock Plan.(5)	Incorporated by Reference
10.4*	Form of Restricted Stock Agreement (Directors) under the Company s 2004 Omnibus Stock Plan.(6)	Incorporated by Reference
10.5*	Form of Non-Statutory Stock Option Agreement under the Company s 2004 Omnibus Stock Plan.(7)	Incorporated by Reference
10.6*	Form of Performance-Based Restricted Stock Unit Award Notice and Restricted Stock Agreement under the Company s 2004 Omnibus Stock Plan.(8)	Incorporated by Reference
10.7*	Hawkins, Inc. 2010 Omnibus Incentive Plan.(9)	Incorporated by Reference
10.8*	Form of Performance-Based Unit Award Notice and Restricted Stock Agreement under the Company s 2010 Omnibus Incentive Plan.(10)	Incorporated by Reference
10.9*	Form of Restricted Stock Agreement under the Company s 2010 Omnibus Incentive Plan.(11)	Incorporated by Reference
10.10*	Hawkins, Inc. Executive Severance Plan.(12)	Incorporated by Reference
23.1	Consent of Independent Registered Public Accounting Firm.	Filed Electronically
31.1	Certification by Chief Executive Officer pursuant to Rule 13a-14(a) of the Exchange Act.	Filed Electronically
31.2	Certification by Chief Financial Officer pursuant to Rule 13a-14(a) of the Exchange Act.	Filed Electronically
32.1	Section 1350 Certification by Chief Executive Officer.	Filed Electronically
32.2	Section 1350 Certification by Chief Financial Officer.	Filed Electronically
101	Financial statements from the Annual Report on Form 10-K of Hawkins, Inc. for the period ended April 1, 2012, filed with the SEC on June 1, 2012, formatted in Extensible Business Reporting Language (XBRL); (i) the Condensed Consolidated Balance Sheets at April 1, 2012 and April 3, 2011, (ii) the Condensed Consolidated Statements of Income for the fiscal years ended April 1, 2012, April 3, 2011 and March 28, 2010, (iii) the Condensed Consolidated Statements of Cash Flows for the fiscal years ended April 1, 2012, April 3, 2011 and March 28, 2010, and (iv) Notes to Condensed Consolidated Financial Statements.	Filed Electronically

* Management contract or compensation plan or arrangement required to be filed as an exhibit to this Annual Report on Form 10-K.

(1) Incorporated by reference to Exhibit 3.1 to the Company s Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2010.
(2) Incorporated by reference to Exhibit 3.1 to the Company s Current Report on Form 8-K dated October 28, 2009 and filed November 3, 2009.
(3) Incorporated by reference to Item 1.01 of the Company s Current Report on Form 8-K dated August 5, 2009 and filed August 11, 2009.
(4) Incorporated by reference to Appendix B to the Company s Proxy Statement for the 2004 Annual Meeting of Shareholders filed July 23, 2004.
(5) Incorporated by reference to Exhibit 10.2 to the Company s Quarterly Report on Form 10-Q for the quarterly period ended September 30.
(6) Incorporated by reference to Exhibit 10.1 to the Company s Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2008.
(7) Incorporated by reference to Exhibit 10.1 to the Company s Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2008.
(8) Incorporated by reference to Exhibit 10.2 to the Company s Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2008.
(9) Incorporated by reference to Exhibit 10.1 to the Company s Registration Statement on Form S-8 filed June 6, 2011 (file no. 333-174735).
(10) Incorporated by reference to Exhibit 10.1 to the Company s Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2010.
(11) Incorporated by reference to Exhibit 10.2 to the Company s Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2010.
(12) Incorporated by reference to Exhibit 10.1 to the Company s Quarterly Report on Form 10-Q for the quarterly period ended July 3, 2011.