Nuance Communications, Inc.
Form 10-Q
May 12, 2008

Table of Contents

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

þ	**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934** **For the quarterly period ended March 31, 2008**
	or
o	**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Commission file number 0-27038

NUANCE COMMUNICATIONS, INC.
(Exact name of registrant as specified in its charter)

Delaware	**94-3156479**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification Number)*

1 Wayside Road
Burlington, MA 01803
(Address of principal executive office)

Registrant s telephone number, including area code:
781-565-5000

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer þ	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act of 1934). Yes o No þ

211,503,232 shares of the registrant s Common Stock, $0.001 par value, were outstanding as of April 30, 2008.

NUANCE COMMUNICATIONS, INC.

INDEX

Table of Contents

Part I. Financial Information

Item 1. ***Financial Statements***

NUANCE COMMUNICATIONS, INC.

CONSOLIDATED BALANCE SHEETS

	March 31, 2008 (Unaudited)	September 30, 2007
	(In thousands, except share and per share amounts)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 354,182	$ 184,335
Marketable securities	56	2,628
Accounts receivable, less allowances of $20,368 and $22,074, respectively	185,462	174,646
Acquired unbilled accounts receivable	32,373	35,061
Inventories, net	7,536	8,013
Prepaid expenses and other current assets	15,690	16,489
Deferred tax assets	408	444
Total current assets	595,707	421,616
Land, building and equipment, net	37,715	37,618
Goodwill	1,345,477	1,249,642
Other intangible assets, net	393,632	391,190
Other assets	73,998	72,721
Total assets	$ 2,446,529	$ 2,172,787
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term debt and obligations under capital leases	$ 7,037	$ 7,430
Contingent acquisition payment	49,784	
Accounts payable	51,315	55,659
Accrued expenses	82,939	83,245
Current portion of accrued business combination costs	12,046	14,547
Deferred maintenance revenue	77,547	68,075
Unearned revenue and customer deposits	37,925	27,787
Total current liabilities	318,593	256,743

Long-term debt and obligations under capital leases, net of current portion	897,051	899,921
Accrued business combination costs, net of current portion	33,705	35,472
Deferred revenue, net of current portion	13,936	13,185
Deferred tax liability	26,027	26,038
Other liabilities	29,827	63,161
Total liabilities	1,319,139	1,294,520
Commitments and contingencies		
Stockholders equity:		
Series B preferred stock, $0.001 par value; 15,000,000 shares authorized; 3,562,238 shares issued and outstanding (liquidation preference $4,631)	4,631	4,631
Common stock, $0.001 par value; 560,000,000 shares authorized; 213,668,148 and 196,368,445 shares issued and 210,445,829 and 193,178,708 shares outstanding, respectively	212	196
Additional paid-in capital	1,363,765	1,078,020
Treasury stock, at cost (3,222,319 and 3,189,737 shares, respectively)	(16,070)	(15,418)
Accumulated other comprehensive income	22,136	14,979
Accumulated deficit	(247,284)	(204,141)
Total stockholders equity	1,127,390	878,267
Total liabilities and stockholders equity	$ 2,446,529	$ 2,172,787

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents

NUANCE COMMUNICATIONS, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

	Three Months Ended March 31, 2008	Three Months Ended March 31, 2007	Six Months Ended March 31, 2008	Six Months Ended March 31, 2007
	(Unaudited) (In thousands, except per share amounts)			
Revenue:				
Product and licensing	$ 94,254	$ 70,324	$ 192,190	$ 146,064
Professional services, subscription and hosting	72,203	32,842	134,623	60,807
Maintenance and support	36,845	28,896	71,513	58,612
Total revenue	203,302	132,062	398,326	265,483
Costs and expenses:				
Cost of revenue:				
Cost of product and licensing	10,686	12,075	22,271	22,287
Cost of professional services, subscription and hosting	56,443	22,567	101,267	43,120
Cost of maintenance and support	8,908	6,560	16,353	13,538
Cost of revenue from amortization of intangible assets	7,759	2,956	12,746	5,842
Total cost of revenue	83,796	44,158	152,637	84,787
Gross margin	119,506	87,904	245,689	180,696
Operating expenses:				
Research and development	30,908	17,575	58,753	34,087
Sales and marketing	56,766	41,861	112,773	85,721
General and administrative	28,074	17,540	53,309	32,925
Amortization of other intangible assets	14,155	5,116	25,654	10,266
Restructuring and other charges	3,326		5,478	
Total operating expenses	133,229	82,092	255,967	162,999
Income (loss) from operations	(13,723)	5,812	(10,278)	17,697
Other income (expense):				
Interest income	2,859	1,310	4,513	2,715
Interest expense	(14,640)	(7,494)	(29,925)	(15,181)
Other expense, net	(518)	(322)	(1,131)	(839)
Income (loss) before income taxes	(26,022)	(694)	(36,821)	4,392
Provision for income taxes	769	1,037	5,394	7,356
Net loss	$ (26,791)	$ (1,731)	$ (42,215)	$ (2,964)

Basic and diluted earnings per share:

Basic and diluted	$ (0.13)	$ (0.01)	$ (0.21)	$ (0.02)
Weighted average common shares outstanding:				
Basic and diluted	206,348	171,747	200,280	170,501

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents

NUANCE COMMUNICATIONS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Six Months Ended March 31, 2008	Six Months Ended March 31, 2007
	(Unaudited) (In thousands, except share amounts)	
Cash flows from operating activities		
Net loss	$ (42,215)	$ (2,964)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation of property and equipment	7,898	5,468
Amortization of other intangible assets	38,400	16,108
Restructuring and other charges	4,080	
Accounts receivable allowances	1,426	717
Share-based payments	38,419	20,954
Non-cash interest expense	2,648	2,097
Deferred tax provision	1,730	4,225
Excess tax benefits from share-based payments	(1,288)	
Other	(21)	531
Changes in operating assets and liabilities, net of effects from acquisitions:		
Accounts receivable	43,642	8,314
Inventories	554	(1,074)
Prepaid expenses and other assets	6,666	(3,096)
Accounts payable	(3,735)	5,475
Accrued expenses and other liabilities	(18,713)	(3,440)
Deferred maintenance revenue, unearned revenue and customer deposits	2,512	8,031
Net cash provided by operating activities	82,003	61,346
Cash flows from investing activities		
Capital expenditures for property and equipment	(7,004)	(5,055)
Payments for acquisitions, net of cash acquired	(22,078)	(59,087)
Proceeds from maturities of marketable securities	2,575	
Payments for minority investment	(2,172)	
Payments for capitalized patent defense costs and licensing agreements	(4,006)	(3,399)
Change in restricted cash balances	219	674
Net cash used in investing activities	(32,466)	(66,867)
Cash flows from financing activities		
Payments of notes payable and capital leases	(4,243)	(3,432)
Deferred acquisition payments		(18,650)
Purchase of treasury stock	(652)	(1,463)
Repurchase of shares		(3,178)

Payments on other long-term liabilities	(6,032)	(5,720)
Proceeds from issuance of common stock, net of issuance costs	131,118	
Excess tax benefits from share-based payments	1,288	
Net proceeds (uses) from employee share-based payment activity	(2,211)	15,101
Net cash provided by (used in) financing activities	119,268	(17,342)
Effects of exchange rate changes on cash and cash equivalents	1,042	(267)
Net increase (decrease) in cash and cash equivalents	169,847	(23,130)
Cash and cash equivalents at beginning of period	184,335	112,334
Cash and cash equivalents at end of period	$ 354,182	$ 89,204
Supplemental disclosure of cash flow information:		
Cash paid for income taxes	$ 817	$ 1,672
Cash paid for interest	$ 28,743	$ 13,084
Non cash investing and financing activities:		
Issuance of 784,266 shares of common stock in connection with the acquisition of Mobile Voice Control, Inc.	$	$ 8,300
Issuance of 866,356 shares and 4,432,202 shares of common stock in connection with the acquisition of Vocada, Inc. and Viecore, Inc., respectively	$ 100,870	$

The accompanying notes are an integral part of these consolidated financial statements.

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Organization and Presentation

Nuance Communications, Inc. (the Company or Nuance) offers businesses and consumers competitive and value-added speech, dictation and imaging solutions that facilitate the way people access, share, manage and use information in business and daily life. The Company was incorporated in 1992 as Visioneer, Inc. In 1999, the Company changed its name to ScanSoft, Inc., and changed its ticker symbol to SSFT. In October 2005, the Company changed its name to Nuance Communications, Inc. and changed its ticker symbol to NUAN in November 2005.

On November 2, 2007, the Company acquired Vocada, Inc. (Vocada), a provider of software and other products for managing critical medical test results, and on November 26, 2007, the Company acquired Viecore, Inc. (Viecore), a consulting and systems integration firm (Note 3).

The accompanying unaudited interim consolidated financial statements of the Company have been prepared in accordance with U.S. generally accepted accounting principles. In the opinion of management, these unaudited interim consolidated financial statements reflect all adjustments, consisting of normal recurring adjustments, necessary for a fair presentation of the financial position of the Company at March 31, 2008, the results of operations for the three and six month periods ended March 31, 2008 and 2007, and cash flows for the six month periods ended March 31, 2008 and 2007. Although the Company believes that the disclosures in these financial statements are adequate to make the information presented not misleading, certain information normally included in the footnotes prepared in accordance with U.S. generally accepted accounting principles has been omitted as permitted by the rules and regulations of the Securities and Exchange Commission. The accompanying financial statements should be read in conjunction with the audited financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the fiscal year ended September 30, 2007 filed with the Securities and Exchange Commission on November 29, 2007. The consolidated balance sheet as of September 30, 2007 is derived from the audited financial statements included in the Annual Report included on Form 10-K. The results for the six month period ended March 31, 2008 are not necessarily indicative of the results that may be expected for the fiscal year ending September 30, 2008, or any future period.

Reclassification

Certain accounts receivable reserve amounts presented in prior periods consolidated financial statements have been reclassified to conform to the current periods presentation.

2. Summary of Significant Accounting Policies

Use of Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles, requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the reporting period. On an ongoing basis, the Company evaluates its estimates, assumptions and judgments, including those related to revenue recognition; allowance for doubtful accounts and returns; accounting for patent legal defense costs; the costs to complete the development of custom software applications; the valuation of goodwill, other intangible assets and tangible long-lived assets; accounting for acquisitions; share-based payments; the obligation relating to pension and post-retirement benefit plans; interest rate swaps which are characterized as derivative instruments; income tax reserves and valuation allowances; and loss contingencies. The Company bases its estimates on historical experience and various other factors that are believed to be reasonable under the circumstances. Actual amounts could differ significantly from these estimates.

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Basis of Consolidation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. Intercompany transactions and balances have been eliminated.

Revenue Recognition

The Company recognizes revenue from the sale of software products and licensing of technology in accordance with Statement of Position (SOP) 97-2, Software Revenue Recognition, and SOP 98-9, Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transactions, and related authoritative literature. In select situations, the Company sells or licenses intellectual property in conjunction with, or in place of, embedding our intellectual property in software. In accordance with SOP 97-2, revenue is recognized when (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred, (iii) the fee is fixed or determinable and (iv) collectibility is probable. The Company has established vendor-specific objective evidence (VSOE) of fair value of post-contract customer support (PCS), professional services, and training based on the prices charged by the Company when the same elements are sold separately.

Revenue from royalties on sales of the Company s software products by original equipment manufacturers (OEMs), where no services are included, is recognized in the quarter earned so long as the Company has been notified by the OEM that such royalties are due, and provided that all other revenue recognition criteria are met.

Software arrangements generally include post contract support which includes telephone support and the right to receive unspecified upgrades/enhancements on a when-and-if-available basis, typically for one to three years. Revenue from post contract support is recognized ratably on a straight-line basis over the term that the maintenance service is provided.

Non-software revenue is recognized in accordance with the Securities and Exchange Commission s Staff Accounting Bulletin (SAB) 104, Revenue Recognition in Financial Statements. Under SAB 104, the Company recognizes revenue when (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred or services have been rendered, (iii) the fees are fixed or determinable and (iv) collectibility is reasonably assured.

For revenue arrangements with multiple elements outside of the scope of SOP 97-2, the Company accounts for the arrangements in accordance with Emerging Issues Task Force (EITF) Issue 00-21, Revenue Arrangements with Multiple Elements, and allocates an arrangement s fees into separate units of accounting based on fair value. The Company supports fair value of its deliverables based upon the prices the Company charges when it sells similar elements separately.

Revenue from products offered on a subscription and/or hosting basis is recognized in the period the services are provided, based on a fixed minimum fee and/or variable fees based on the volume of activity. Subscription and hosting revenue is recognized as the Company is notified by the customer or through management reports that such revenue is due, provided that all other revenue recognition criteria are met.

When the Company provides professional services considered essential to the functionality of the software, it recognizes revenue from the professional services as well as any related software licenses on a percentage-of-completion basis in accordance with SOP 81-1, Accounting for Performance of Construction Type and Certain Performance Type Contracts. In these circumstances, the Company separates license revenue from professional service revenue for income statement presentation by classifying the VSOE of the fair value of professional service revenue as professional service revenue and the residual portion as license revenue. The Company generally determines the percentage-of-completion by comparing the labor hours incurred to date to the estimated total labor hours required to complete the project. The Company considers labor hours to be the most reliable, available measure of progress on these projects. Adjustments to estimates to complete are made in the periods in which facts resulting in a change become known. When the estimate indicates that a loss will be incurred, such loss is recorded in the period identified. Significant judgments and estimates are involved in determining the percent complete of each contract. Different assumptions could yield materially different results.

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

When products are sold through distributors or resellers, title and risk of loss generally passes upon shipment, at which time the transaction is invoiced and payment is due. Shipments to distributors and resellers without right of return are recognized as revenue upon shipment by the Company. Certain distributors and value-added resellers have been granted rights of return for as long as the distributors or resellers hold the inventory. The Company cannot estimate historical returns from these distributors and resellers to have a basis upon which to estimate future sales returns. As a result, the Company recognizes revenue from sales to these distributors and resellers when the products are sold through to retailers and end-users. Based on reports from distributors and resellers of their inventory balances at the end of each period, the Company records an allowance against accounts receivable and reduces revenue for all inventories subject to return at the sales price.

When products are sold directly to end-users, the Company also makes an estimate of sales returns based on historical experience. In accordance with Statement of Financial Accounting Standards (SFAS) 48, Revenue Recognition When Right of Return Exists, the provision for these estimated returns is recorded as a reduction of revenue and accounts receivable at the time that the related revenue is recorded. If actual returns differ significantly from the Company s estimates, such differences could have a material impact on the Company s results of operations for the period in which the actual returns become known.

When maintenance and support contracts renew automatically, the Company provides a reserve based on historical experience for contracts expected to be cancelled for non-payment. All known and estimated cancellations are recorded as a reduction to revenue and accounts receivable.

The Company follows the guidance of EITF 01-09, Accounting for Consideration Given by a Vendor (Including a Reseller of the Vendor s Products), and records consideration given to a reseller as a reduction of revenue to the extent the Company has recorded cumulative revenue from the customer or reseller. However, when the Company receives an identifiable benefit in exchange for the consideration and can reasonably estimate the fair value of the benefit received, the consideration is recorded as an operating expense.

The Company follows the guidance of EITF 01-14, Income Statement Characterization of Reimbursements for Out-of-Pocket Expenses Incurred, and records reimbursements received for out-of-pocket expenses as revenue, with offsetting costs recorded as cost of revenue. Out-of-pocket expenses generally include, but are not limited to, expenses related to transportation, lodging and meals.

The Company follows the guidance of EITF 00-10, Accounting for Shipping and Handling Fees and Costs, and records shipping and handling costs billed to customers as revenue with offsetting costs recorded as cost of revenue.

Goodwill and Other Intangible Assets

The Company has significant long-lived tangible and intangible assets, including goodwill and intangible assets with indefinite lives, which are susceptible to valuation adjustments as a result of changes in various factors or conditions. The most significant long-lived tangible and other intangible assets are fixed assets, patents and core technology, completed technology, customer relationships and trademarks. All finite-lived intangible assets are amortized based upon patterns in which the economic benefits of such assets are expected to be utilized. The values of intangible assets, with the exception of goodwill and intangible assets with indefinite lives, were initially determined by a risk-adjusted, discounted cash flow approach. The Company assesses the potential impairment of identifiable intangible assets and fixed assets whenever events or changes in circumstances indicate that the carrying values may not be recoverable. Factors it considers important, which could trigger an impairment of such assets, include but are not limited to the following:

significant underperformance relative to historical or projected future operating results;

significant changes in the manner or use of the acquired assets or the strategy for the Company s overall business;

significant negative industry or economic trends;

Table of Contents

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

significant decline in the Company s stock price for a sustained period; and

a decline in the Company s market capitalization below net book value.

Future adverse changes in these or other unforeseeable factors could result in an impairment charge that would impact future results of operations and financial position in the reporting period identified.

In accordance with SFAS 142, Goodwill and Other Intangible Assets, goodwill and intangible assets with indefinite lives are tested for impairment on an annual basis as of July 1, and between annual tests if indicators of potential impairment exist. The impairment test compares the fair value of the reporting unit to its carrying amount, including goodwill and intangible assets with indefinite lives, to assess whether impairment is present. The Company has reviewed the provisions of SFAS 142 with respect to the criteria necessary to evaluate the number of reporting units that exist. Based on its review, the Company has determined that it operates in one reporting unit. Based on this assessment, the Company has not had any impairment charges during its history as a result of its impairment evaluation of goodwill and other indefinite-lived intangible assets under SFAS 142.

In accordance with SFAS 144, Accounting for the Impairment or Disposal of Long-Lived Assets, the Company periodically reviews long-lived assets for impairment whenever events or changes in business circumstances indicate that the carrying amount of the assets may not be fully recoverable or that the useful lives of those assets are no longer appropriate. Each impairment test is based on a comparison of the undiscounted cash flows to the recorded value for the asset. If impairment is indicated, the asset is written down to its estimated fair value based on a discounted cash flow analysis. The Company may make business decisions in the future which may result in the impairment of intangible assets.

Significant judgments and estimates are involved in determining the useful lives and amortization patterns of long-lived assets, determining what reporting units exist and assessing when events or circumstances would require an interim impairment analysis of goodwill or other long-lived assets to be performed. Changes in the organization or the Company s management reporting structure, as well as other events and circumstances, including but not limited to technological advances, increased competition and changing economic or market conditions, could result in (a) shorter estimated useful lives, (b) additional reporting units, which may require alternative methods of estimating fair values or greater disaggregation or aggregation in our analysis by reporting unit, and/or (c) other changes in previous assumptions or estimates. In turn, this could have a significant impact on the consolidated financial statements through accelerated amortization and/or impairment charges.

Capitalized Patent Defense Costs

The Company monitors the anticipated outcome of legal actions, and if it determines that the success of the defense of a patent is probable, and so long as the Company believes that the future economic benefit of the patent will be increased, the Company capitalizes external legal costs incurred in the defense of these patents, up to the level of the expected increased future economic benefit. If changes in the anticipated outcome occur, the Company writes off any capitalized costs in the period the change is determined. Upon successful defense of litigation, the amounts previously capitalized are amortized over the remaining life of the patent. As of March 31, 2008 and September 30, 2007, capitalized patent defense costs totaled $6.4 million.

Comprehensive loss

Comprehensive loss consists of net loss, current period foreign currency translation adjustments, and unrealized gains (losses) on cash flow hedge derivatives. For the purposes of comprehensive loss disclosures, the Company does not record tax provisions or benefits for the net changes in the foreign currency translation adjustment, as the Company intends to reinvest undistributed earnings in its foreign subsidiaries permanently.

Table of Contents

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The components of comprehensive loss are as follows (in thousands):

	Three Months Ended March 31, 2008	Three Months Ended March 31, 2007	Six Months Ended March 31, 2008	Six Months Ended March 31, 2007
Net loss	$ (26,791)	$ (1,731)	$ (42,215)	$ (2,964)
Other comprehensive income (loss):				
Foreign currency translation adjustment	5,757	1,083	9,242	1,956
Net unrealized (loss) gain on cash flow hedge derivatives	(1,396)	(235)	(2,087)	(31)
Net unrealized gains on investments			2	
Other comprehensive income	4,361	848	7,157	1,925
Total comprehensive loss	$ (22,430)	$ (883)	$ (35,058)	$ (1,039)

Net Income (Loss) Per Share

The Company computes net income (loss) per share in accordance with SFAS 128, Earnings per Share, and EITF 03-06, Participating Securities and Two Class Method under FASB Statement No. 128, Earnings per Share. EITF 03-06 provides guidance on the meaning of participating security for purposes of computing earnings per share including when using the two-class method for computing basic earnings per share. The Company has determined that its outstanding Series B convertible preferred stock represents a participating security.

Under the two-class method, basic net income per share is computed by dividing the net income available to common stockholders by the weighted-average number of common shares outstanding during the period. Net losses are not allocated to preferred stockholders.

Diluted net income per share is computed using the more dilutive of (a) the two-class method, or (b) the if-converted method. The Company allocates net income first to preferred stockholders based on dividend rights and then to common and preferred stockholders based on ownership interests. The weighted-average number of common shares outstanding gives effect to all potentially dilutive common equivalent shares, including outstanding stock options using the treasury stock method, unvested restricted stock, shares held in escrow, warrants, and the convertible debenture using the as-converted method. Common equivalent shares are excluded from the computation of diluted net income (loss) per share if their effect is anti-dilutive. Potentially dilutive common equivalent shares aggregating 23.4 million shares and 25.0 million shares for the three month periods ended March 31, 2008 and 2007, respectively; and 24.3 million and 24.4 million shares for the six month periods ended March 31, 2008 and 2007, respectively, have been excluded from the computation of diluted net loss per share because their inclusion would be anti-dilutive.

Accounting for Share-Based Payments

The Company accounts for share-based payments to employees, including grants of employee stock options, purchases under employee stock purchase plans, awards in the form of restricted shares (Restricted Stock) and awards in the form of units of stock purchase rights (Restricted Units) in accordance with SFAS 123 (revised 2004), Share-Based Payment, (SFAS 123R). The Restricted Stock and Restricted Units are collectively referred to as Restricted Awards. SFAS 123R requires the recognition of the fair value of share-based payments as a charge against earnings. The Company recognizes share-based payment expense over the requisite service period. Based on the provisions of SFAS 123R the Company s share-based payment awards are accounted for as equity

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

instruments. The amounts included in the consolidated statements of operations relating to share-based payments are as follows (dollars in thousands):

	Three Months Ended March 31,		Six Months Ended March 31,	
	2008	2007	2008	2007
Cost of product and licensing	$ 10	$ 7	14	$ 12
Cost of professional services, subscription and hosting	3,416	906	5,021	1,450
Cost of maintenance and support	580	279	906	467
Research and development	5,520	1,819	9,104	3,026
Sales and marketing	6,523	4,853	11,563	8,302
General and administrative	7,195	4,500	11,811	7,697
Total	$ 23,244	$ 12,364	$ 38,419	$ 20,954

Stock Options

The Company has several share-based compensation plans under which employees, officers, directors and consultants may be granted stock options to purchase the Company s common stock generally at fair market value. The Company s plans do not allow for options to be granted at below fair market value nor can they be re-priced at anytime. Options granted under plans adopted by the Company become exercisable over various periods, typically two to four years and have a maximum term of seven years. The Company has also assumed options and option plans in connection with certain of its acquisitions. These stock options are governed by the plans and agreements that they were originally issued under, but are now exercisable for shares of the Company s common stock. All stock options have been granted with exercise prices equal to or greater than the fair market value of the Company s common stock on the date of grant. The table below summarizes activity relating to stock options for the six months ended March 31, 2008:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value(1)
Outstanding at September 30, 2007	18,240,722	$ 6.48		
Granted	231,000	$ 19.82		
Exercised	(1,536,617)	$ 4.94		
Forfeited	(619,976)	$ 11.24		
Expired	(30,026)	$ 3.88		
Outstanding at March 31, 2008	16,285,103	$ 6.63	4.7 years	$ 176.2 million

Exercisable at March 31, 2008	11,242,691	$	4.65	4.2 years	$	143.5 million
Exercisable at March 31, 2007	11,641,376	$	4.13	4.9 years	$	130.2 million

(1) The aggregate intrinsic value on this table was calculated based on the positive difference between the closing market value of the Company s common stock on March 31, 2008 ($17.41) and the purchase price of the underlying options.

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

As of March 31, 2008, the total unamortized fair value of stock options was $31.0 million with a weighted average remaining recognition period of 2.2 years. A summary of weighted-average grant-date fair value and intrinsic value of stock options exercised is as follows:

	Three Months Ended, March 31,		Six Months Ended, March 31,	
	2008	**2007**	**2008**	**2007**
Weighted-average grant-date fair value per share	n/a	$ 5.67	$ 9.38	$ 5.04
Total intrinsic value of stock options exercised (in millions)	$ 9.90	$ 23.12	$ 20.88	$ 30.45

The Company uses the Black-Scholes option pricing model to calculate the grant-date fair value of options. There were no new stock options granted during the three month period ended March 31, 2008. The fair value of the stock options granted during the three and six month periods ended March 31, 2008 and 2007 were calculated using the following weighted-average assumptions:

	Three Months Ended, March 31,		Six Months Ended, March 31,	
	2008	**2007**	**2008**	**2007**
Dividend yield	n/a	0.0%	0.0%	0.0%
Expected volatility	n/a	51.4%	50.1%	53.3%
Average risk-free interest rate	n/a	4.7%	4.3%	4.7%
Expected term (in years)	n/a	3.8	4.8	3.8

The dividend yield of zero is based on the fact that the Company has never paid cash dividends and has no present intention to pay cash dividends. Expected volatility is based on the historical volatility of the Company s common stock over the period commensurate with the expected life of the options and the historical implied volatility from traded options with a term of 180 days or greater. The risk-free interest rate is derived from the average U.S. Treasury STRIPS rate during the period, which approximates the rate in effect at the time of grant, commensurate with the expected life of the instrument. The Company estimates the expected term based on the historical exercise behavior.

Restricted Awards

The Company is authorized to issue equity incentive awards in the form of Restricted Awards, including Restricted Units and Restricted Stock, which are individually discussed below. Unvested Restricted Awards may not be sold, transferred or assigned. The fair value of the Restricted Awards is measured based upon the market price of the underlying common stock as of the date of grant, reduced by the purchase price of $0.001 per share of the awards. The Restricted Awards generally are subject to vesting over a period of two to four years, and may have opportunities for acceleration for achievement of defined goals. The Company also issued certain Restricted Awards with vesting solely dependent on the achievement of specified performance targets. The fair value of the Restricted Awards is amortized to expense over its applicable requisite service period using the straight-line method. In the event that the employees employment with the Company terminates, or in the case of awards with only performance goals, if those goals are not met, any unvested shares are forfeited and revert to the Company.

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Restricted Units are not included in issued and outstanding common stock until the shares are vested and released. The table below summarizes activity relating to Restricted Units for the six months ended March 31, 2008:

	Number of Shares Underlying Restricted Units	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value(1)
Outstanding at September 30, 2007	6,808,800		
Granted	4,186,517		
Released	(2,205,828)		
Forfeited	(489,375)		
Outstanding at March 31, 2008	8,300,114	1.5 years	$ 144.5 million
Vested and expected to vest	7,282,765	1.5 years	$ 126.8 million

(1) The aggregate intrinsic value on this table was calculated based on the positive difference between the closing market value of the Company s common stock on March 31, 2008 ($17.41) and the purchase price of the underlying Restricted Units.

The purchase price for vested Restricted Units is $0.001 per share. As of March 31, 2008, unearned share-based payment expense related to unvested Restricted Units is $109.6 million, which will, based on expectations of future performance vesting criteria, where applicable, be recognized over a weighted-average period of 2.0 years. 32.7% of the Restricted Units outstanding as of March 31, 2008 are subject to performance vesting acceleration conditions. A summary of weighted-average grant-date fair value and intrinsic value of Restricted Units vested is as follows:

	Three Months Ended, March 31,		Six Months Ended, March 31,	
	2008	2007	2008	2007
Weighted-average grant-date fair value per share	$ 16.58	$ 12.09	$ 18.51	$ 11.02
Total intrinsic value of shares vested (in millions)	$ 21.01	$ 5.76	$ 40.95	$ 8.39

Restricted Stock is included in the issued and outstanding common stock in these financial statements at the date of grant. The table below summarizes activity relating to Restricted Stock for the six months ended March 31, 2008:

	Number of Shares Underlying Restricted Stock	Weighted Average Grant Date Fair Value
Outstanding at September 30, 2007	1,195,902	$ 6.17
Granted	250,000	$ 15.89
Vested	(376,124)	$ 7.58
Outstanding at March 31, 2008	1,069,778	$ 7.95

Table of Contents

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The purchase price for vested Restricted Stock is $0.001 per share. As of March 31, 2008, unearned share-based payment expense related to unvested Restricted Stock is $2.2 million, which will, based on expectations of future performance vesting criteria, when applicable, be recognized over a weighted-average period of 0.8 years. 35.1% of the Restricted Stock outstanding as of March 31, 2008 are subject to performance vesting acceleration conditions. A summary of weighted-average grant-date fair value and intrinsic value of Restricted Stock vested is as follows:

	Three Months Ended, March 31,		Six Months Ended, March 31,	
	2008	**2007**	**2008**	**2007**
Weighted-average grant-date fair value per share	$ 15.89	n/a	$ 15.89	$ 8.24
Total intrinsic value of shares vested (in millions)	n/a	$ 4.62	$ 7.52	$ 4.62

The Company has historically repurchased common stock upon its employees vesting in the Restricted Stock, and cancelled a portion of the employees vested Restricted Units. This has been done to satisfy the employees withholding tax liability as a result of the Restricted Awards having vested. In the six months ended March 31, 2008, the Company paid cash of $14.7 million relating to 0.8 million shares of common stock that were cancelled or repurchased. Assuming that one-third of all Restricted Awards outstanding as of March 31, 2008, such amount approximating the tax rate of the Company s employees, and based on the weighted average recognition period of 1.9 years, were purchased or cancelled, the Company would have an obligation to pay cash relating to approximately 0.9 million shares during the twelve month period ending March 31, 2009.

Employee Stock Purchase Plan

The Company s 1995 Employee Stock Purchase Plan (the Plan), as amended and restated on March 31, 2006, authorizes the issuance of a maximum of 3,000,000 shares of common stock in semi-annual offerings to employees at a price equal to the lower of 85% of the closing price on the applicable offering commencement date or 85% of the closing price on the applicable offering termination date. On April 21, 2008, the Company s stockholders approved a 3,000,000 share increase in the shares authorized for issuance under the Plan, such that the Plan currently authorizes the issuance of a maximum of 6,000,000 shares of common stock. Compensation expense related to the employee stock purchase plan was $0.9 million and $1.6 million for the three and six months ended March 31, 2008, respectively, and was $0.5 million and $1.0 million for the three and six months ended March 31, 2007, respectively.

Income Taxes

Effective October 1, 2007, the Company adopted the provisions of FASB Interpretation (FIN) 48, Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company s financial statements in accordance with SFAS 109, Accounting for Income Taxes. FIN 48 prescribes the recognition and measurement of a tax position taken or expected to be taken in a tax return. It also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. As a result of the implementation of FIN 48, the Company recognized an adjustment of $0.9 million in the liability for unrecognized tax benefits. In addition, the Company reduced its deferred tax assets and valuation allowance each by $52.0 million primarily with respect to net operating loss and research credit carryforwards that are in excess of applicable limitations related to ownership changes.

The liability for unrecognized tax benefits related to various federal, state, and foreign income tax matters was $2.5 million at October 1, 2007. At March 31, 2008, the liability for income taxes associated with uncertain tax positions was $2.6 million. Included in this amount is approximately $0.7 million of unrecognized tax benefits, which if recognized, would impact the effective tax rate. The difference between the total amount of unrecognized

Table of Contents

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

tax benefits and the amount that would impact the effective tax rate consists of items that would be offset through goodwill. The Company does not expect a significant change in the amount of unrecognized tax benefits within the next 12 months.

Upon adoption of FIN 48, the Company s policy to include interest and penalties related to gross unrecognized tax benefits as part of the provision for income taxes did not change. As of March 31, 2008, the Company had accrued $0.3 million of interest and penalties related to uncertain tax positions. Interest and penalties included in the provision for income taxes were not material in all periods presented.

The Company is subject to U.S. federal income tax and various state, local and international income taxes in numerous jurisdictions. The federal and state tax returns are generally subject to tax examinations for the tax years ended in 2004 through 2007. In addition, amounts reported on federal tax returns filed for earlier tax periods from which operating losses and tax credits are carried to future periods may be adjusted upon the utilization of such carryovers, but only to the extent such carryovers are applied. The Company has carryforwards from most federal tax years occurring between 1994 and 2007.

Deferred tax assets and liabilities are determined based on differences between the financial statement and tax bases of assets and liabilities using enacted tax rates in effect in the years in which the differences are expected to reverse. The Company does not provide for U.S. income taxes on the undistributed earnings of its foreign subsidiaries, which the Company considers to be indefinitely reinvested outside of the U.S. in accordance with Accounting Principles Board (APB) Opinion 23, Accounting for Income Taxes Special Areas.

The Company makes judgments regarding the realizability of its deferred tax assets. In accordance with SFAS 109, Accounting for Income Taxes, the carrying value of the net deferred tax assets is based on the belief that it is more likely than not that the Company will generate sufficient future taxable income to realize these deferred tax assets after consideration of all available evidence. The Company regularly reviews its deferred tax assets for recoverability considering historical profitability, projected future taxable income, and the expected timing of the reversals of existing temporary differences and tax planning strategies.

Valuation allowances have been established for U.S. deferred tax assets, which the Company believes do not meet the more likely than not criteria established by SFAS 109. If the Company is subsequently able to utilize all or a portion of the deferred tax assets for which a valuation allowance has been established, then the Company may be required to recognize these deferred tax assets through the reduction of the valuation allowance which would result in a material benefit to its results of operations in the period in which the benefit is determined, excluding the recognition of the portion of the valuation allowance which relates to net deferred tax assets acquired in a business combination and created as a result of share-based payments. The recognition of the portion of the valuation allowance which relates to net deferred tax assets resulting from share-based payments will be recorded as additional paid-in-capital; the recognition of the portion of the valuation allowance which relates to net deferred tax assets acquired in a business combination will reduce goodwill, other intangible assets, and to the extent remaining, the provision for income taxes.

Minority Investment

In the first quarter of fiscal 2008, the Company invested $2.2 million in a third-party company that offers advertiser-supported free directory assistance services. This investment entitles the Company to a minority interest, approximating 1% of the voting shares of the third-party, and is accounted for using the cost method. This investment is included in other assets in the Company s accompanying balance sheet as of March 31, 2008.

Financial Instruments and Hedging Activities

The Company follows the requirements of SFAS 133, Accounting for Derivative Instruments and Hedging Activities, which establishes accounting and reporting standards for derivative instruments. To achieve hedge accounting, the criteria specified in SFAS 133, must be met, including (i) ensuring at the inception of the hedge that

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

formal documentation exists for both the hedging relationship and the entity s risk management objective and strategy for undertaking the hedge and (ii) at the inception of the hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value attributed to the hedged risk during the period that the hedge is designated. Further, an assessment of effectiveness is required whenever financial statements or earnings are reported. Absent meeting these criteria, changes in fair value are recognized in other expense, net of tax, in the income statement. Once the underlying forecasted transaction is realized, the gain or loss from the derivative designated as a hedge of the transaction is reclassified from accumulated other comprehensive income (loss) to the income statement, in the related revenue or expense caption, as appropriate. Any ineffective portion of the derivatives designated as cash flow hedges is recognized in current earnings. As of March 31, 2008 and September 30, 2007, there was a $100 million interest rate swap (the Swap) outstanding. The Swap was entered into in conjunction with a term loan on March 31, 2006. The Swap was designated as a cash flow hedge, and changes in the fair value of this cash flow hedge derivative are recorded in stockholders equity as a component of accumulated other comprehensive income (loss). The Swap has resulted in cumulative losses of $3.0 million and $0.9 million as of March 31, 2008 and September 30, 2007, respectively. These losses are included in other liabilities in the Company s accompanying balance sheets.

Recently Issued Accounting Standards

In March 2008, the FASB issued SFAS 161, Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133. SFAS 161 improves financial reporting about derivative instruments and hedging activities by requiring enhanced disclosures to enable investors to better understand their effects on an entity s financial position, financial performance, and cash flows. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. The Company expects to adopt SFAS 161 in the second quarter of fiscal 2009.

In December 2007, the FASB issued SFAS 141 (revised), Business Combinations, (SFAS 141R). The standard changes the accounting for business combinations including the measurement of acquirer shares issued in consideration for a business combination, the recognition of contingent consideration, the accounting for pre-acquisition gain and loss contingencies, the recognition of capitalized in-process research and development, the accounting for acquisition-related restructuring cost accruals, the treatment of acquisition related transaction costs and the recognition of changes in the acquirer s income tax valuation allowance. SFAS 141R is effective for fiscal years beginning after December 15, 2008, with early adoption prohibited. The Company expects to adopt SFAS 141R for any business combinations entered into beginning in fiscal 2010.

In February 2007, the FASB issued SFAS 159, The Fair Value Option for Financial Assets and Financial Liabilities. SFAS 159 has as its objective to reduce both complexity in accounting for financial instruments and volatility in earnings caused by measuring related assets and liabilities differently. It also establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. The statement is effective for fiscal years beginning after November 15, 2007, with early adoption permitted provided that the entity makes that choice in the first 120 days of that fiscal year. The Company did not elect early adoption and expects to adopt SFAS 159 at the beginning of fiscal 2009. The Company is evaluating the impact, if any, that SFAS 159 may have on its consolidated financial statements.

In September 2006, the FASB issued SFAS 157, Fair Value Measurements. SFAS 157 establishes a framework for measuring fair value and expands fair value measurement disclosures. SFAS 157 is effective for fiscal years beginning after November 15, 2007. In February 2008, the FASB agreed to a one-year deferral for the implementation of SFAS 157 for other non-financial assets and liabilities. The Company expects to adopt SFAS 157 at the beginning of fiscal 2009. The Company is evaluating the impact, if any, that SFAS 157 may have on its consolidated financial statements.

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. Business Acquisitions

Acquisition of Viecore

On November 26, 2007, the Company acquired all of the outstanding capital stock of Viecore, a consulting and systems integration firm, for total purchase consideration of approximately $109.2 million, including 4.4 million shares of the Company s common stock valued at $21.01 per share, cash to shareholders of $8.9 million, transaction costs of $6.8 million and the assumption of $0.4 million of debt. In connection with the Company s acquisition of Viecore, the purchase and sale agreement required 0.6 million shares of the Company s common stock, valued at $12.3 million as of the date of acquisition, to be placed into escrow for 15 months from the date of acquisition, to satisfy any claims the Company may have. The Company cannot make a determination, beyond a reasonable doubt, that the escrow will become payable to the former shareholders of Viecore, and accordingly has not included the escrow as a component of the purchase price. Upon satisfaction of the contingency, the escrowed amount may be recorded as additional purchase price and allocated to goodwill. The merger was a non-taxable event for the Company. The results of operations of the acquired business have been included in the consolidated financial statements of the Company since the date of acquisition. The Company is currently finalizing the valuation of the assets acquired and liabilities assumed; therefore the fair values set forth below are subject to adjustment as additional information is obtained. A summary of the preliminary purchase price allocation for the acquisition of Viecore is as follows (in thousands):

Total purchase consideration:	
Common stock issued	$ 93,132
Cash	8,874
Transaction costs	6,809
Debt assumed	384
Total purchase consideration	$ 109,199
Allocation of the purchase consideration:	
Cash	$ 5,491
Accounts receivable	13,616
Acquired unbilled accounts receivable	18,599
Other assets	603
Property and equipment	1,327
Identifiable intangible assets	22,770
Goodwill	71,593
Total assets acquired	133,999
Accounts payable and accrued expenses	(8,585)
Deferred revenue	(16,215)
Total liabilities assumed	(24,800)

Net assets acquired	$ 109,199

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Customer relationships are amortized based upon patterns in which the economic benefits of customer relationships are expected to be utilized. Other finite-lived identifiable intangible assets are amortized on a straight-line basis. The following are the identifiable intangible assets acquired and their respective weighted average lives (dollars in thousands):

	Amount	Weighted Average Life (In years)
Customer relationships	$ 22,390	8.0
Tradename	380	1.0
Total	$ 22,770	

Acquisition of Vocada

On November 2, 2007, the Company acquired all of the outstanding capital stock of Vocada, a provider of software and services for managing critical medical test results for total purchase consideration of approximately $22.1 million including 0.9 million shares of the Company s common stock valued at $20.47 per share, cash to shareholders of $3.2 million and transaction costs of $1.2 million. In connection with the Company s acquisition of Vocada, the purchase and sale agreement required 0.1 million shares of the Company s common stock, valued at $1.2 million as of the date of acquisition, to be placed into escrow for 15 months from the date of acquisition, to satisfy any claims the Company may have. The Company cannot make a determination, beyond a reasonable doubt, that the escrow will become payable to the former shareholders of Vocada, and accordingly has not included the escrow as a component of the purchase price. Upon satisfaction of the contingency, the escrowed amount may be recorded as additional purchase price and allocated to goodwill. The merger was a non-taxable event for the Company. The results of operations of the acquired business have been included in the consolidated financial statements of the Company since the date of acquisition. The Company is currently finalizing the valuation of the assets acquired and liabilities assumed; therefore the fair values set forth below are subject to adjustment as additional information is obtained. A summary of the preliminary purchase price allocation for the acquisition of Vocada is as follows (in thousands):

Total purchase consideration:	
Common stock issued	$ 17,738
Cash	3,186
Transaction costs	1,158
Total purchase consideration	$ 22,082
Allocation of the purchase consideration:	
Accounts receivable and acquired unbilled accounts receivable	$ 3,559
Other assets	429

Identifiable intangible assets	5,930
Goodwill	14,917
Total assets acquired	24,835
Accounts payable and other liabilities	(366)
Deferred revenue	(2,387)
Total liabilities assumed	(2,753)
Net assets acquired	$ 22,082

Table of Contents

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Customer relationships are amortized based upon patterns in which the economic benefits of customer relationships are expected to be utilized. Other finite-lived identifiable intangible assets are amortized on a straight-line basis. The following are the identifiable intangible assets acquired and their respective weighted average lives (dollars in thousands):

	Amount	Weighted Average Life (In years)
Customer relationships	$ 3,800	10.0
Core and completed technology	2,000	5.0
Trademark	90	5.0
Non-compete	40	3.0
Total	$ 5,930	

Proforma Results of Operations

The following table sets forth the unaudited pro forma results of operations of the Company as if the Company had acquired Bluestar Resources Limited, the parent of Focus Enterprises Limited and Focus India Private Limited (collectively, Focus), BeVocal, Inc. (BeVocal), Tegic Communications, Inc. (Tegic), Voice Signal Technologies, Inc. (VoiceSignal), Commissure Inc. (Commissure) and Viecore on October 1, 2006 (in thousands, except per share data):

	Three Months Ended March 31,		Six Months Ended March 31,	
	2008	2007	2008	2007
Revenue	$ 203,302	$ 189,003	$ 411,897	$ 374,124
Net loss	(26,791)	(6,550)	(46,153)	(13,270)
Net loss per basic and diluted share	$ (0.13)	$ (0.03)	$ (0.23)	$ (0.07)

The Company has not furnished pro forma financial information relating to the Mobile Voice Control, Inc. (MVC) and Vocada acquisitions because such information is not material.

4. Accounts Receivable

Accounts receivable, excluding acquired unbilled accounts receivable, consisted of the following (in thousands):

	March 31, 2008	September 30, 2007

Gross accounts receivable		$ 205,830	$ 196,720
Less	allowance for doubtful accounts	(6,574)	(6,155)
Less	reserve for distribution and reseller accounts receivable	(7,107)	(8,596)
Less	allowance for sales returns	(6,687)	(7,323)
Total		$ 185,462	$ 174,646

18

Table of Contents

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. Inventories, net

Inventories, net of allowances, consisted of the following (in thousands):

	March 31, 2008	September 30, 2007
Components and parts	$ 3,935	$ 4,605
Inventory at customers	2,280	2,726
Finished products	1,321	682
Total	$ 7,536	$ 8,013

Inventory at customers reflects equipment related to in-process installations of solutions with customers. These contracts have not been recorded to revenue as of March 31, 2008, and therefore the inventory is on the balance sheet until such time as the contract is recorded to revenue and the inventory will be expensed to cost of sales.

6. Goodwill and Other Intangible Assets

The changes in the carrying amount of goodwill during the six months ended March 31, 2008, are as follows (in thousands):

Balance as of September 30, 2007	$ 1,249,642
Goodwill acquired Viecore acquisition	71,593
Goodwill acquired Vocada acquisition	14,917
Purchase accounting adjustments	1,792
Effect of foreign currency translation	7,533
Balance as of March 31, 2008	$ 1,345,477

Goodwill adjustments during the six months ended March 31, 2008 consisted primarily of a decrease of $17.3 million due to additional acquired unbilled accounts receivable identified in connection with the acquisition of Tegic and an incremental $1.5 million utilization of acquired deferred tax assets. These decreases were offset by an increase in incremental purchase price relating to additional earnout achievement of $7.0 million related to the MVC acquisition and an estimated $5.7 million preliminary estimate of additional earnout achievement related to the BeVocal acquisition and $5.8 million related to the expected settlement of the Focus escrow. In addition, the Company adjusted goodwill by $2.8 million to correct an error in the acquired balance sheet of Dictaphone for contractual liabilities to a certain customer incurred prior to the acquisition date of March 31, 2006. In the three month period ended March 31, 2008, the Company recorded additional contractual liabilities of $0.9 million for the same customer related to these contractual liabilities since the date of acquisition. The resulting quarterly error was determined to be immaterial to each period since the acquisition.

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Intangible assets consist of the following (in thousands):

	At March 31, 2008			
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Weighted Average Remaining Life (Years)
Customer relationships	$ 335,377	$ (68,605)	$ 266,772	6.7
Technology and patents	148,073	(55,994)	92,079	5.9
Tradenames and trademarks, subject to amortization	8,785	(3,650)	5,135	6.2
Non-competition agreement	2,724	(878)	1,846	4.5
Subtotal	494,959	(129,127)	365,832	
Tradename, indefinite life	27,800		27,800	n/a
Total	$ 522,759	$ (129,127)	$ 393,632	

Amortization expense for the acquired patents, core and completed technology are included in the cost of revenue from amortization of intangible assets in the accompanying statements of operations. Estimated amortization expense for succeeding years is as follows (in thousands):

Year Ending September 30,	Cost of Revenue	Other Operating Expenses	Total
2008 (April 1, 2008 to September 30, 2008)	$ 10,155	$ 27,512	$ 37,667
2009	18,669	55,733	74,402
2010	16,817	49,253	66,070
2011	15,354	40,631	55,985
2012	11,564	32,998	44,562
2013	8,340	24,968	33,308
Thereafter	11,180	42,658	53,838
Total	$ 92,079	$ 273,753	$ 365,832

7. Accrued Expenses

Accrued expenses consist of the following (in thousands):

	March 31, 2008	September 30, 2007
Accrued compensation	$ 30,636	$ 35,875
Accrued sales and marketing incentives	4,820	4,067
Accrued professional fees	7,615	5,591
Accrued acquisition costs and liabilities	3,939	4,153
Income taxes payable	7,670	6,853
Accrued other	28,259	26,706
Total	$ 82,939	$ 83,245

Table of Contents

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

8. Deferred and Contingent Acquisition Payments

Earnout Payments

In connection with the Company s acquisition of Phonetic Systems Ltd. (Phonetic) in February 2005, a deferred payment of $17.5 million was due and paid to the former shareholders of Phonetic on February 1, 2007. The Company also agreed to make contingent earnout payments of $35.0 million upon achievement of certain established financial and performance targets through December 31, 2007, in accordance with the purchase agreement. The Company has notified the former shareholders of Phonetic that the financial and performance targets for the scheduled payments for calendar 2005 and 2006, totaling $24.0 million, were not achieved. The former shareholders of Phonetic have objected to this determination. The Company and the former shareholders of Phonetic are discussing this matter. The Company has not recorded any obligations relative to the calendar 2005 and 2006 measures as of March 31, 2008. The Company is currently evaluating the calculations relative to the calendar 2007 financial and performance targets, and has not recorded any obligations relative to these measures as of March 31, 2008.

In connection with the Company s acquisition of MVC on December 29, 2006, it agreed to make contingent earnout payments of up to 1.7 million shares of the Company s common stock upon the achievement of certain financial targets through December 31, 2008, in accordance with the purchase agreement. As of March 31, 2008, the Company has determined that 377,964 shares of the Company s common stock, with a total value of $7.0 million, were earned based upon the achievement of certain financial targets for the calendar 2007. The contingent earnout payment has been recorded as additional purchase price and allocated to goodwill as of March 31, 2008 and the 377,964 shares of the Company s common stock were issued to former shareholders of MVC on April 2, 2008. The former shareholders of MVC may still earn up to approximately 1.1 million shares of the Company s common stock based on the achievement of performance measures in calendar 2008.

In connection with the Company s acquisition of BeVocal on April 24, 2007, it agreed to make payments pursuant to the earnout of up to $65.1 million upon the achievement of certain financial targets through December 31, 2007, in accordance with the merger agreement. The Company has accrued $49.8 million, based on the preliminary measurement of this amount as of March 31, 2008, of which $46.4 million would be payable in cash and $3.4 million would be payable either as an adjustment to the exchange ratio of the assumed stock options, or as a cash payment in lieu of such an adjustment, at the Company s option. $8.6 million of the earnout is being recorded to compensation expense over the period of service required under the merger agreement, and $41.2 million has been recorded as an increase to purchase price. These preliminary earnout estimates are included in current liabilities as of March 31, 2008 and long-term liabilities as of September 30, 2007. The Company s final determination regarding the actual amount of the earnout payments will be made in October 2008. The Company will seek agreement on the determination with the shareholder representative and pay the amount shortly after agreement is reached.

In connection with the Company s acquisition of Commissure on September 28, 2007, it agreed to make contingent earnout payments of up to $8.0 million upon the achievement of certain financial targets for the fiscal years ended September 30, 2008, 2009 and 2010. The Company has not recorded any obligation relative to these measures as of March 31, 2008. Payments, if any, may be made in the form of cash or shares of the Company s common stock, at the sole discretion of the Company.

In connection with the Company s acquisition of Vocada on November 2, 2007, it agreed to make contingent earnout payments of up to $21.0 million upon the achievement of certain financial targets measured over defined periods through December 31, 2010. The Company has not recorded any obligation relative to these measures as of March 31, 2008. Payments, if any, may be made in the form of cash or shares of the Company s common stock, at the sole discretion of the Company.

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Escrow Arrangements

In connection with certain of the Company s acquisitions it has placed either cash or shares of its common stock in escrow to satisfy any claims the Company may have. If no claims are made, the escrowed amounts will be released to the former shareholders of the acquired company. Generally, the Company cannot make a determination, beyond a reasonable doubt, whether the escrow will become payable to the former shareholders of these companies until the escrow period has expired. Accordingly these amounts have been treated as contingent purchase price until it is determined that the escrow will be payable to the former shareholders, at which time the escrowed amounts may be recorded as additional purchase price and allocated to goodwill. The $35.8 million in cash escrows were deposited with a third party agent at the consummation of the relevant acquisition, and the amounts are included in other assets as of September 30, 2007 and March 31, 2008.

The following table summarizes the terms of the escrow arrangements that are not finalized as of March 31, 2008 (dollars in thousands):

	Initially Scheduled Escrow Release Date	Cash Payment	Share Payment Number of Shares
Focus	March 26, 2008	$ 5,800	n/a
BeVocal	July 24, 2008	n/a	1,225,490
VoiceSignal	August 24, 2008	30,000	n/a
Commissure	December 28, 2008	n/a	174,601
Vocada	January 2, 2009	n/a	56,205
Viecore	February 26, 2009	n/a	584,924
Total		$ 35,800	2,041,220

The escrow relating to the Focus acquisition was scheduled to be paid on March 26, 2008. The Company has filed a $5.8 million claim against the escrow related to the breach of certain representations and warranties made in the share purchase agreement for the transaction. The Company expects the entire $5.8 million that is held in escrow, upon the settlement of the claim, to either be paid to satisfy liabilities indemnified under the agreement or paid directly to the former shareholders of Focus. Accordingly, a liability for this payment and corresponding adjustment to goodwill of $5.8 million has been established as of March 31, 2008.

In connection with the escrow relating to the Viecore acquisition, the Company guaranteed a minimum market value of $20.43 per share when the escrow shares are released. If the market value is less than $20.43 per share on the date of release, the Company is required to pay the difference, if any, in cash. Based on the closing market value per share of $17.41 on March 31, 2008, the Company would be required to pay to the former shareholders of Viecore approximately $1.8 million, which would be recorded as incremental purchase price reflected in goodwill.

9. Pension and Other Postretirement Benefit Plans

In connection with the acquisition of Dictaphone in 2006, the Company assumed the assets and obligations related to Dictaphone s defined benefit pension plans, which provide certain retirement and death benefits for former Dictaphone employees located in the United Kingdom and Canada. These two pension plans are closed to new participants. The Company also assumed a post-retirement benefit plan, which is closed to new participants and provides certain post-retirement health care and life insurance benefits, as well as a fixed subsidy for qualified former employees in the United States and Canada.

Table of Contents

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table represents the components of the net periodic benefit cost associated with the respective plans for the three and six months ended March 31, 2008 and 2007:

	Three Months Ended March 31,			
	Pension Benefits		Other Benefits	
	2008	2007	2008	2007
Service cost	$	$ 70	$	$ 26
Interest cost	330	298	10	19
Amortization of net (gain) loss				
Expected return on plan assets	(394)	(302)		
Amortization of unrecognized gain	(10)		(10)	
Net period benefit cost (credit)	$ (74)	$ 66	$	$ 45

	Six Months Ended March 31,			
	Pension Benefits		Other Benefits	
	2008	2007	2008	2007
Service cost	$	$ 138	$	$ 53
Interest cost	663	592	20	37
Amortization of net (gain) loss				
Expected return on plan assets	(793)	(602)		
Amortization of unrecognized gain	(21)		(20)	
Net period benefit cost (credit)	$ (151)	$ 128	$	$ 90

10. Credit Facilities and Debt

The Company had the following borrowing obligations (in thousands):

	March 31, 2008	September 30, 2007
Expanded 2006 Credit Facility	$ 660,313	$ 663,663
2.75% Convertible Debentures (net of unamortized debt discount of $6.8 million and $7.4 million, respectively)	243,170	242,634
Obligations under capital leases	520	841
Other	85	213

Total long-term debt	904,088	907,351
Less: current portion	7,037	7,430
Non-current portion of long-term debt	$ 897,051	$ 899,921

2.75% Convertible Debentures

On August 13, 2007, the Company issued $250 million of 2.75% convertible senior debentures due in 2027 (the 2027 Debentures) in a private placement to Citigroup Global Markets Inc. and Goldman, Sachs & Co. (the Initial Purchasers). Total proceeds, net of debt discount of $7.5 million and deferred debt issuance costs of $1.1 million, were $241.4 million. The 2027 Debentures bear an interest rate of 2.75% per annum, payable semi-annually in arrears beginning on February 15, 2008, and mature on August 15, 2027 subject to the right of the holders of the 2027 Debentures to require the Company to redeem the 2027 Debentures on August 15, 2014, 2017 and 2022. The related debt discount and debt issuance costs are being amortized to interest expense using the

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

effective interest rate method through August 2014. As of March 31, 2008, the ending unamortized deferred debt issuance costs were $1.1 million and are included in other long-term assets in the Company s accompanying balance sheet. The 2027 Debentures are general senior unsecured obligations, ranking equally in right of payment to all of the Company s existing and future unsecured, unsubordinated indebtedness and senior in right of payment to any indebtedness that is contractually subordinated to the 2027 Debentures. The 2027 Debentures are effectively subordinated to the Company s secured indebtedness to the extent of the value of the collateral securing such indebtedness and are structurally subordinated to indebtedness and other liabilities of the Company s subsidiaries. If converted, the principal amount of the 2027 Debentures is payable in cash and any amounts payable in excess of the $250 million principal amount, will (based on an initial conversion rate, which represents an initial conversion price of $19.47 per share, subject to adjustment as defined) be paid in cash or shares of the Company s common stock, at the Company s election, only in the following circumstances and to the following extent: (i) on any date during any fiscal quarter beginning after September 30, 2007 (and only during such fiscal quarter) if the closing sale price of the Company s common stock was more than 120% of the then current conversion price for at least 20 trading days in the period of the 30 consecutive trading days ending on the last trading day of the previous fiscal quarter; (ii) during the five consecutive business-day period following any five consecutive trading-day period in which the trading price for $1,000 principal amount of the Debentures for each day during such five trading-day period was less than 98% of the closing sale price of our common stock multiplied by the then current conversion rate; (iii) upon the occurrence of specified corporate transactions, as described in the indenture for the 2027 Debentures; and (iv) at the option of the holder at any time on or after February 15, 2027. Additionally, the Company may redeem the 2027 Debentures, in whole or in part, on or after August 20, 2014 at par plus accrued and unpaid interest; each holder shall have the right, at such holder s option, to require the Company to repurchase all or any portion of the 2027 Debentures held by such holder on August 15, 2014, August 15, 2017 and August 15, 2022. Upon conversion, the Company will pay cash and shares of its common stock (or, at its election, cash in lieu of some or all of such common stock), if any. If the Company undergoes a fundamental change (as described in the indenture for the 2027 Debentures) prior to maturity, holders will have the option to require the Company to repurchase all or any portion of their debentures for cash at a price equal to 100% of the principal amount of the debentures to be purchased plus any accrued and unpaid interest, including any additional interest to, but excluding, the repurchase date. As of March 31, 2008, no conversion triggers were met. If the conversion triggers were met, the Company could be required to repay all or some of the principal amount in cash prior to the maturity date.

Expanded 2006 Credit Facility

The Company has entered into a credit facility which consists of a $75 million revolving credit line including letters of credit, a $355 million term loan entered into on March 31, 2006, a $90 million term loan entered into on April 5, 2007 and a $225 million term loan entered into on August 24, 2007 (the Expanded 2006 Credit Facility). The term loans are due March 2013 and the revolving credit line is due March 2012. As of March 31, 2008, $660.3 million remained outstanding under the term loans, there were $17.2 million of letters of credit issued under the revolving credit line and there were no other outstanding borrowings under the revolving credit line.

The Expanded 2006 Credit Facility contains covenants, including, among other things, covenants that restrict the ability of the Company and its subsidiaries to incur certain additional indebtedness, create or permit liens on assets, enter into sale-leaseback transactions, make loans or investments, sell assets, make certain acquisitions, pay dividends, or repurchase stock. The agreement also contains events of default, including failure to make payments of principal or interest, failure to observe covenants, breaches of representations and warranties, defaults under certain other material indebtedness, failure to satisfy material judgments, a change of control and certain insolvency events. As of March 31, 2008, the Company was in compliance with the covenants under the Expanded 2006 Credit Facility.

Borrowings under the Expanded 2006 Credit Facility bear interest at a rate equal to the applicable margin plus, at the Company s option, either (a) the base rate (which is the higher of the corporate base rate of UBS AG, Stamford Branch, or the federal funds rate plus 0.50% per annum) or (b) LIBOR (equal to (i) the British Bankers Association

Table of Contents

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Interest Settlement Rates for deposits in U.S. dollars divided by (ii) one minus the statutory reserves applicable to such borrowing). The applicable margin for term loan borrowings under the Expanded 2006 Credit Facility ranges from 0.75% to 1.50% per annum with respect to base rate borrowings and from 1.75% to 2.50% per annum with respect to LIBOR-based borrowings, depending on our leverage ratio. The applicable margin for revolving loan borrowings under the Expanded 2006 Credit Facility ranges from 0.50% to 1.25% per annum with respect to base rate borrowings and from 1.50% to 2.25% per annum with respect to LIBOR-based borrowings, depending upon the Company s leverage ratio. As of March 31, 2008, the Company s applicable margin for the term loan was 1.50% for base rate borrowings and 2.50% for LIBOR-based borrowings. The Company is required to pay a commitment fee for unutilized commitments under the revolving credit facility at a rate ranging from 0.375% to 0.50% per annum, based upon the Company s leverage ratio. As of March 31, 2008, the commitment fee rate was 0.5% and the interest rate was 5.63%.

The Company capitalized debt issuance costs related to the Expanded 2006 Credit Facility and is amortizing the costs to interest expense using the effective interest rate method through March 2012 for costs associated with the revolving credit facility and through March 2013 for costs associated with the term loan. As of March 31, 2008, the ending unamortized deferred financing fees were $11.2 million and are included in other assets in the Company s accompanying balance sheets.

The Expanded 2006 Credit Facility is subject to repayment in four equal quarterly installments of 1% per annum ($6.7 million per year, not including interest, which is also payable quarterly), and an annual excess cash flow sweep, as defined in the Expanded 2006 Credit Facility, which is payable beginning in the first quarter of each fiscal year, beginning in fiscal 2008, based on the excess cash flow generated in the previous fiscal year. No payment under the excess cash flow sweep provision was due in the first quarter of fiscal 2008 as there was no excess cash flow generated in fiscal 2007. The Company will continue to evaluate the extent to which a payment is due in the first quarter of fiscal 2009 based upon 2008 excess cash flow generation. At the current time, the Company is unable to predict the amount of the outstanding principal, if any, that it may be required to repay during the first quarter of fiscal 2009 pursuant to the excess cash flow sweep provisions. Any term loan borrowings not paid through the baseline repayment, the excess cash flow sweep, or any other mandatory or optional payments that the Company may make, will be repaid upon maturity. If only the baseline repayments are made, the annual aggregate principal amount of the term loans repaid would be as follows (in thousands):

Year Ending September 30,	**Amount**
2008 (April 1, 2008 to September 30, 2008)	$ 3,350
2009	6,700
2010	6,700
2011	6,700
2012	6,700
2013	630,163
Total	$ 660,313

The Company s obligations under the Expanded 2006 Credit Facility are unconditionally guaranteed by, subject to certain exceptions, each of its existing and future direct and indirect wholly-owned domestic subsidiaries. The Expanded 2006 Credit Facility and the guarantees thereof are secured by first priority liens and security interests in the following: 100% of the capital stock of substantially all of the Company s domestic subsidiaries and 65% of the outstanding voting equity interests and 100% of the non-voting equity interests of first-tier foreign subsidiaries, all material tangible and intangible assets of the Company and the guarantors, and any present and future intercompany debt. The Expanded 2006 Credit Facility also contains provisions for mandatory prepayments of outstanding term loans upon receipt of the following, and subject to certain exceptions: 100% of net cash proceeds from asset sales, 100% of net cash proceeds from issuance or incurrence of debt, and 100% of

Table of Contents

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

extraordinary receipts. The Company may voluntarily prepay borrowings under the Expanded 2006 Credit Facility without premium or penalty other than breakage costs, as defined with respect to LIBOR-based loans.

11. Accrued Business Combination Costs

In connection with the Company s acquisitions of SpeechWorks International, Inc. in August 2003 and the company originally named Nuance Communications, Inc., which the Company acquired in September 2005, (and refers to as Former Nuance,) the Company assumed obligations relating to certain leased facilities expiring in 2016 and 2012, respectively, and were abandoned by the acquired companies prior to the acquisition date. The fair value of the obligations, net of estimated sublease income, are recognized as liabilities assumed by the Company and accordingly are included in the allocation of the final purchase price. During fiscal 2008, subsequent to the finalization of the purchase price allocation, and in connection with revised information relative to sublease activity for one of the facilities obligations assumed from Former Nuance, the net cash flows expectation changed and the Company recorded $1.9 million to restructuring and other charges related to that facility. The net payments have been discounted in calculating the fair value of these obligations, and the discount is being accreted through the term of the lease. Cash payments net of sublease receipts are presented as cash used in financing activities on the consolidated statements of cash flows. As of March 31, 2008, the total gross payments due from the Company to the landlords of the facilities was $71.8 million. This is reduced by $21.5 million of projected sublease income and a $4.0 million present value discount.

Additionally, the Company has implemented restructuring plans to eliminate duplicate facilities, personnel or assets in connection with the business combinations. In accordance with EITF 95-3, Recognition of Liabilities in Connection with a Purchase Business Combination, costs such as these are recognized as liabilities assumed by the Company, and accordingly are included in the allocation of the purchase price, generally resulting in an increase to the recorded amount of the goodwill. As of March 31, 2008, the total gross payments due from the Company to the landlords of the facilities are $1.8 million. This is reduced by $0.6 million of projected sublease income. The gross value of the lease exit costs will be paid through fiscal 2009. These gross payment obligations are included in the commitments disclosed in Note 14.

The activity for the six months ended March 31, 2008, relating to facilities and personnel recorded in accrued business combination costs, is as follows (in thousands):

	Facilities	Personnel	Total
Balance at September 30, 2007	$ 49,240	$ 779	$ 50,019
Charged to restructuring and other expense	1,880		1,880
Charged to interest expense	877		877
Charged to goodwill	(12)		(12)
Cash payments, net of sublease receipts	(6,354)	(659)	(7,013)
Balance at March 31, 2008	$ 45,631	$ 120	$ 45,751

Accrued business combination costs are presented on the balance sheets as follows (in thousands):

	March 31, 2008	September 30, 2007
Reported as:		
Current	$ 12,046	$ 14,547
Long-term	33,705	35,472
Total	$ 45,751	$ 50,019

26

Table of Contents

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

12. Restructuring and Other Charges

In the second quarter of fiscal 2008, the Company recorded restructuring and other charges of $3.3 million. $2.8 million of this amount relates to the elimination of approximately 110 personnel across multiple functions within the Company, and $0.5 million relates to the consolidation of two pre-existing facilities in California into a single combined facility. In the first quarter of fiscal 2008, the Company recorded restructuring and other charges of $2.2 million, of which $1.9 million relates to revised information regarding sublease activity discussed in Note 11, Accrued Business Combination Costs. The remaining amount relates to the consolidation of certain facilities at its headquarters location.

The following table sets forth the activity relating to restructuring and other charges for the six months ended March 31, 2008 (in thousands):

	Personnel	Facilities	Total
Balance at September 30, 2007	$ 308	$	$ 308
Restructuring and other charges	2,835	763	3,598
Non-cash adjustment		140	140
Cash payments	(1,364)	(28)	(1,392)
Balance at March 31, 2008	$ 1,779	$ 875	$ 2,654

13. Stockholders Equity

Preferred Stock

The Company is authorized to issue up to 40,000,000 shares of preferred stock, par value $0.001 per share. The Company has designated 100,000 shares as Series A Preferred Stock and 15,000,000 shares as Series B Preferred Stock. In connection with the acquisition of ScanSoft from Xerox Corporation (Xerox), the Company issued 3,562,238 shares of Series B Preferred Stock to Xerox. On March 19, 2004, the Company announced that Warburg Pincus, a global private equity firm, had agreed to purchase all outstanding shares of the Company s stock held by Xerox Corporation for approximately $80 million, including the 3,562,238 shares of Series B Preferred Stock. The Series B Preferred Stock is convertible into shares of common stock on a one-for-one basis. The Series B Preferred Stock has a liquidation preference of $1.30 per share plus all declared but unpaid dividends. The holders of Series B Preferred Stock are entitled to non-cumulative dividends at the rate of $0.05 per annum per share, payable when, and if declared by the Board of Directors. To date, no dividends have been declared by the Board of Directors. Holders of Series B Preferred Stock have no voting rights, except those rights provided under Delaware law. The undesignated shares of preferred stock will have rights, preferences, privileges and restrictions, including voting rights, dividend rights, conversion rights, redemption privileges and liquidation preferences, as shall be determined by the Board of Directors upon issuance of the preferred stock. The Company has reserved 3,562,238 shares of its common stock for issuance upon conversion of the Series B Preferred Stock. Other than the 3,562,238 shares of Series B Preferred Stock that are issued and outstanding, there are no other shares of preferred stock issued or outstanding as of March 31, 2008 or September 30, 2007.

Common Stock

In December 2007, the Company completed an underwritten public offering in which it sold 7,823,000 shares of its common stock. Gross proceeds from this sale were $136.9 million, and the net proceeds after underwriting commissions and other offering expenses were $130.3 million.

On November 26, 2007, in connection with its acquisition of Viecore, the Company issued 5,017,126 shares of its common stock, including 584,924 shares held in an escrow account. The shares not subject to escrow have been valued at $93.1 million and represent a component of the purchase price of Viecore.

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

On November 2, 2007, in connection with its acquisition of Vocada, the Company issued 922,561 shares of its common stock, including 56,205 shares held in an escrow account. The shares not subject to escrow have been valued at $17.7 million and represent a component of the purchase price of Vocada.

On May 5, 2005, the Company entered into a Securities Purchase Agreement (the Securities Purchase Agreement) by and among the Company, Warburg Pincus Private Equity VIII, L.P. and certain of its affiliated entities (collectively Warburg Pincus) pursuant to which Warburg Pincus agreed to purchase, and the Company agreed to sell, 3,537,736 shares of its common stock and warrants to purchase 863,236 shares of its common stock for an aggregate purchase price of $15.1 million. The warrants have an exercise price of $5.00 per share and a term of four years. On May 9, 2005, the sale of the shares and the warrants pursuant to the Securities Purchase Agreement was completed. The Company also entered into a Stock Purchase Agreement (the Stock Purchase Agreement) by and among the Company and Warburg Pincus pursuant to which Warburg Pincus agreed to purchase and the Company agreed to sell 14,150,943 shares of the Company s common stock and warrants to purchase 3,177,570 shares of the Company s common stock for an aggregate purchase price of $60.0 million. The warrants have an exercise price of $5.00 per share and a term of four years. The warrants provide the holder with the option to exercise the warrants on a net, or cashless, basis. On September 15, 2005, the sale of the shares and the warrants pursuant to the Securities Purchase Agreement was completed. The net proceeds from these two fiscal 2005 financings were $73.9 million. In connection with the financings, the Company granted Warburg Pincus registration rights giving Warburg Pincus the right to request that the Company use commercially reasonable efforts to register some or all of the shares of common stock issued to Warburg Pincus under both the Securities Purchase Agreement and Stock Purchase Agreement, including shares of common stock underlying the warrants. The Company has evaluated these warrants under EITF 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company s Own Stock and has determined that the warrants should be classified within the stockholders equity section of the accompanying consolidated balance sheets.

Common Stock Warrants

In fiscal 2005, the Company issued several warrants for the purchase of its common stock. Warrants were issued to Warburg Pincus as described above. Additionally, on November 15, 2004, in connection with the acquisition of Phonetic, the Company issued unvested warrants to purchase 750,000 shares of its common stock at an exercise price of $4.46 per share that will vest, if at all, upon the achievement of certain performance targets. Based on the Company s assessment of the results relative to the financial and performance measures, warrants to purchase 500,000 shares of common stock have not vested; warrants to purchase 250,000 shares of common stock still may vest depending on future performance. The former shareholders of Phonetic have objected to this assessment. The Company and the former shareholders of Phonetic are discussing this matter. The warrants provide the holder with the option to exercise the warrants on a net, or cashless, basis. The initial valuation of the warrants occurred upon closing of the Phonetic acquisition on February 1, 2005, and was treated as purchase consideration in accordance with EITF 97-8, Accounting for Contingent Consideration Issued in a Purchase Business Combination.

In March 1999, the Company issued Xerox a ten-year warrant with an exercise price for each warrant share of $0.61. This warrant is exercisable for the purchase of 525,732 shares of the Company s common stock. On March 19, 2004, the Company announced that Warburg Pincus had agreed to purchase all outstanding shares of the Company s stock held by Xerox Corporation, including this warrant, for approximately $80 million. In connection with this transaction, Warburg Pincus acquired new warrants to purchase 2.5 million additional shares of the Company s common stock from the Company for total consideration of $0.6 million. The warrants have a six-year life and an exercise price of $4.94. The warrants provide the holder with the option to exercise the warrants on a net, or cashless, basis.

In connection with the acquisition of SpeechWorks in 2003, the Company issued a warrant to its investment banker, expiring on August 11, 2011, for the purchase of 150,000 shares of the Company s common stock at an

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

exercise price of $3.98 per share. The warrant provides the holder with the option to exercise the warrants on a net, or cashless, basis. The warrant became exercisable on August 11, 2005, and was valued at its issuance at $0.2 million based upon the Black-Scholes option pricing model. In October 2006, the warrant was exercised to purchase 125,620 shares of the Company s common stock. The holder of the warrant elected a cashless exercise resulting in a net issuance of 75,623 shares of the Company s common stock. As of March 31, 2008, a warrant to purchase 24,380 shares of the Company s common stock remains outstanding.

Based on its review of EITF 00-19, the Company has determined that each of the above-noted warrants should be classified within the stockholders equity section of the accompanying consolidated balance sheets.

14. Commitments and Contingencies

Operating Leases

The Company has various operating leases for office space around the world. In connection with many of its acquisitions, the Company assumed facility lease obligations. Among these assumed obligations are lease payments related to certain office locations that were vacated by certain of the acquired companies prior to the acquisition date (Note 11). Additionally, certain of the Company s lease obligations have been included in various restructuring charges (Note 11 and Note 12). The following table outlines the Company s gross future minimum payments under all non-cancelable operating leases as of March 31, 2008 (in thousands):

Year Ending September 30,	Operating Leases	Leases Under Restructuring	Other Contractual Obligations Assumed	Total
2008 (April 1, 2008 to September 30, 2008)	$ 8,628	$ 1,186	$ 6,588	$ 16,402
2009	17,084	2,043	13,572	32,699
2010	15,271	598	14,012	29,881
2011	14,381	616	14,549	29,546
2012	12,007	636	12,977	25,620
2013	10,576	379	2,879	13,834
Thereafter	38,030		7,214	45,244
Total	$ 115,977	$ 5,458	$ 71,791	$ 193,226

At March 31, 2008, the Company has subleased certain office space that is included in the above table to third parties. Total sub-lease income under contractual terms is $25.3 million and ranges from approximately $1.9 million to $4.6 million on an annual basis through February 2016.

In connection with certain of its acquisitions, the Company assumed certain financial guarantees that the acquired companies had committed to the landlords. As of March 31, 2008, the total outstanding financial guarantees related to real estate were $17.2 million and are secured by letters of credit issued under the Expanded 2006 Credit Facility.

Litigation and Other Claims

Like many companies in the software industry, the Company has, from time to time been notified of claims that it may be infringing, or contributing to the infringement of, the intellectual property rights of others. These claims have been referred to counsel, and they are in various stages of evaluation and negotiation. If it appears necessary or desirable, the Company may seek licenses for these intellectual property rights. There is no assurance that licenses will be offered by all claimants, that the terms of any offered licenses will be acceptable to the Company or that in all cases the dispute will be resolved without litigation, which may be time consuming and expensive, and may result in injunctive relief or the payment of damages by the Company.

Table of Contents

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

On May 31, 2006, GTX Corporation (GTX) filed an action against the Company in the United States District Court for the Eastern District of Texas claiming patent infringement. Damages were sought in an unspecified amount. In the lawsuit, GTX alleged that the Company is infringing United States Patent No. 7,016,536 entitled Method and Apparatus for Automatic Cleaning and Enhancing of Scanned Documents. The Company believes these claims have no merit and intends to defend the action vigorously.

On November 27, 2002, AllVoice Computing plc (AllVoice) filed an action against the Company in the United States District Court for the Southern District of Texas claiming patent infringement. In the lawsuit, AllVoice alleges that the Company is infringing United States Patent No. 5,799,273 entitled Automated Proofreading Using Interface Linking Recognized Words to their Audio Data While Text is Being Changed (the 273 Patent). The 273 Patent generally discloses techniques for manipulating audio data associated with text generated by a speech recognition engine. Although the Company has several products in the speech recognition technology field, the Company believes that its products do not infringe the 273 Patent because, in addition to other defenses, they do not use the claimed techniques. Damages are sought in an unspecified amount. The Company filed an Answer on December 23, 2002. The United States District Court for the Southern District of Texas entered summary judgment against AllVoice and dismissed all claims against the Company on February 21, 2006. AllVoice filed a notice of appeal from this judgment on April 26, 2006. On October 12, 2007, the U.S. Court of Appeals for the Federal Circuit reversed and remanded the summary judgment. On April 4, 2008, the Company entered into a settlement agreement with AllVoice regarding this action. (See Note 17).

In August 2001, the first of a number of complaints was filed in the United States District Court for the Southern District of New York, on behalf of a purported class of persons who purchased Former Nuance stock between April 12, 2000 and December 6, 2000. Those complaints have been consolidated into one action. The complaint generally alleges that various investment bank underwriters engaged in improper and undisclosed activities related to the allocation of shares in Former Nuance s initial public offering of securities. The complaint makes claims for violation of several provisions of the federal securities laws against those underwriters, and also against Former Nuance and some of Former Nuance s directors and officers. Similar lawsuits, concerning more than 250 other companies initial public offerings, were filed in 2001. In February 2003, the Court denied a motion to dismiss with respect to the claims against Former Nuance. In the third quarter of 2003, a proposed settlement in principle was reached among the plaintiffs, issuer defendants (including Former Nuance) and the issuers insurance carriers. The settlement called for the dismissal and release of claims against the issuer defendants, including Former Nuance, in exchange for a contingent payment to be paid, if necessary, by the issuer defendants insurance carriers and an assignment of certain claims. The settlement was not expected to have any material impact upon the Company, as payments, if any, were expected to be made by insurance carriers, rather than by the Company. On December 5, 2006, the Court of Appeals for the Second Circuit reversed the Court s order certifying a class in several test cases that had been selected by the underwriter defendants and the plaintiffs in the coordinated proceeding. The plaintiffs petitioned the Second Circuit for rehearing of the Second Circuit s decision, however, on April 6, 2007, the Second Circuit denied the petition for rehearing. At a status conference on April 23, 2007, the district court suggested that the issuers settlement could not be approved in its present form, given the Second Circuit s ruling. On June 25, 2007, the district court issued an order terminating the settlement agreement. The plaintiffs in the case have since filed amended master allegations and amended complaints and have moved for class certification, while the defendants have moved to dismiss the complaints and have filed oppositions to the motion for class certification. The Company intends to defend the litigation vigorously and believes it has meritorious defenses to the claims against Former Nuance.

The Company believes that the final outcome of the current litigation matters described above will not have a significant adverse effect on its financial position and results of operations. However, even if the Company s defense is successful, the litigation could require significant management time and will be costly. Should the Company not prevail in these litigation matters, its operating results, financial position and cash flows could be adversely impacted.

Table of Contents

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Guarantees and Other

The Company currently includes indemnification provisions in the contracts into which it enters with its customers and business partners. Generally, these provisions require the Company to defend claims arising out of its products infringement of third-party intellectual property rights, breach of contractual obligations and/or unlawful or otherwise culpable conduct on its part. The indemnity obligations imposed by these provisions generally cover damages, costs and attorneys fees arising out of such claims. In most, but not all, cases, the Company s total liability under such provisions is limited to either the value of the contract or a specified, agreed upon amount. In some cases its total liability under such provisions is unlimited. In many, but not all, cases, the term of the indemnity provision is perpetual. While the maximum potential amount of future payments the Company could be required to make under all the indemnification provisions in its contracts with customers and business partners is unlimited, it believes that the estimated fair value of these provisions is minimal due to the low frequency with which these provisions have been triggered.

The Company has entered into agreements to indemnify its directors and officers to the fullest extent authorized or permitted under applicable law. These agreements, among other things, provide for the indemnification of its directors and officers for expenses, judgments, fines, penalties and settlement amounts incurred by any such person in his or her capacity as a director or officer of the Company, whether or not such person is acting or serving in any such capacity at the time any liability or expense is incurred for which indemnification can be provided under the agreements. In connection with the terms of certain of its acquisitions that have been consummated, the Company is required to indemnify the former members of the boards of directors of those companies, on similar terms as described above, for a period of six years from the acquisition date. In certain cases the Company has been required to, under the terms of the sale and purchase agreements, purchase director and officer insurance policies related to these obligations, which fully cover the six year periods. In connection with the acquisition of SpeechWorks, the Company indemnified the former members of the SpeechWorks board of directors for a period of six years from the acquisition date, and purchased a director and officer policy that covered a period of three years from the acquisition date. To the extent that the Company does not purchase a director and officer insurance policy for the full period of any contractual indemnification, it would be required to pay for costs incurred, if any, as described above.

At March 31, 2008, the Company has $4.1 million of non-cancelable purchase commitments for inventory to fulfill customers orders currently scheduled in its backlog.

15. Segment and Geographic Information and Significant Customers

The Company has reviewed the provisions of SFAS 131, Disclosures about Segments of an Enterprise and Related Information, with respect to the criteria necessary to evaluate the number of operating segments that exist. Based on its review, the Company has determined that it operates in one segment.

Revenue, classified by the major geographic areas in which the Company s customers are located, were as follows (in thousands):

	Three Months Ended March 31,	Six Months Ended March 31,

2008	**2007**	**2008**	&