Nuance Communications, Inc.
Form 10-Q
May 10, 2007

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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, 2007

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

Large accelerated filer þ Accelerated filer o Non-accelerated filer 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

176,390,889 shares of the registrant s Common Stock, $0.001 par value, were outstanding as of April 30, 2007.

NUANCE COMMUNICATIONS, INC.

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Part I. Financial Information

Item 1. ***Financial Statements***

NUANCE COMMUNICATIONS, INC.

CONSOLIDATED BALANCE SHEETS

	March 31, 2007 (Unaudited)	September 30, 2006
	(In thousands, except share and per share amounts)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 89,204	$ 112,334
Accounts receivable, less allowances of $18,364 and $20,207, respectively	117,267	110,778
Acquired unbilled accounts receivable	5,456	19,748
Inventories, net	8,352	6,795
Prepaid expenses and other current assets	14,589	13,245
Deferred tax assets	391	421
Total current assets	235,259	263,321
Land, building and equipment, net	31,755	30,700
Goodwill	750,835	699,333
Other intangible assets, net	230,490	220,040
Other long-term assets	25,818	21,680
Total assets	$ 1,274,157	$ 1,235,074
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term debt and obligations under capital leases	$ 4,310	$ 3,953
Accounts payable	32,886	27,768
Accrued expenses	57,228	52,674
Current portion of accrued business combination costs	13,582	14,810
Deferred maintenance revenue	64,660	63,269
Unearned revenue and customer deposits	31,879	30,320
Deferred acquisition payments, net		19,254
Total current liabilities	204,545	212,048

Long-term debt and obligations under capital leases, net of current portion	348,703	349,990
Accrued business combination costs, net of current portion	40,286	45,255
Deferred maintenance revenue, net of current portion	11,562	9,800
Deferred tax liability	31,064	19,926
Other liabilities	22,683	21,459
Total liabilities	658,843	658,478
Commitments and contingencies		
Stockholders equity:		
Series B preferred stock, $0.001 par value; 40,000,000 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; 178,023,654 and 173,182,430 shares issued and 174,895,599 and 170,152,247 shares outstanding, respectively	179	174
Additional paid-in capital	814,336	773,120
Treasury stock, at cost (3,128,055 and 3,030,183 shares, respectively)	(14,323)	(12,859)
Accumulated other comprehensive income	3,581	1,656
Accumulated deficit	(193,090)	(190,126)
Total stockholders equity	615,314	576,596
Total liabilities and stockholders equity	$ 1,274,157	$ 1,235,074

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

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NUANCE COMMUNICATIONS, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

	Three Months Ended March 31,		Six Months Ended March 31,	
	2007	**2006**	**2007**	**2006**
	(Unaudited) (In thousands, except per share amounts)			
Revenue:				
Product and licensing	$ 70,324	$ 48,553	$ 146,064	$ 101,736
Professional services, subscription and hosting	32,842	15,405	60,807	29,971
Maintenance and support	28,896	7,770	58,612	15,573
Total revenue	132,062	71,728	265,483	147,280
Costs and expenses:				
Cost of revenue:				
Cost of product and licensing	12,075	4,755	22,287	9,737
Cost of professional services, subscription and hosting	22,567	11,343	43,120	22,134
Cost of maintenance and support	6,560	1,648	13,538	3,537
Cost of revenue from amortization of intangible assets	2,956	2,476	5,842	4,951
Total cost of revenue	44,158	20,222	84,787	40,359
Gross Margin	87,904	51,506	180,696	106,921
Operating expenses:				
Research and development	17,575	12,902	34,087	25,059
Sales and marketing	41,861	25,351	85,721	53,684
General and administrative	17,540	10,906	32,925	25,553
Amortization of other intangible assets	5,116	1,984	10,266	3,984
Restructuring and other charges, net		(1,300)		(1,300)
Total operating expenses	82,092	49,843	162,999	106,980
Income (loss) from operations	5,812	1,663	17,697	(59)
Other income (expense):				
Interest income	1,310	636	2,715	1,384
Interest expense	(7,494)	(770)	(15,181)	(1,786)
Other (expense) income, net	(322)	(853)	(839)	(783)
Income (loss) before income taxes	(694)	676	4,392	(1,244)
Provision for income taxes	1,037	2,056	7,356	4,356
Loss before cumulative effect of accounting change	(1,731)	(1,380)	(2,964)	(5,600)
Cumulative effect of accounting change				(672)

Net loss	$ (1,731)	$ (1,380)	$ (2,964)	$ (6,272)
Basic and diluted earnings per share:				
Loss before cumulative effect of accounting change	$ (0.01)	$ (0.01)	$ (0.02)	$ (0.04)
Cumulative effect of accounting change				
Net loss per share	$ (0.01)	$ (0.01)	$ (0.02)	$ (0.04)
Weighted average common shares outstanding:				
Basic and diluted	171,747	163,407	170,501	159,859

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

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NUANCE COMMUNICATIONS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Six Months Ended March 31,	
	2007	**2006**
	(Unaudited) (In thousands, except share amounts)	
Cash flows from operating activities		
Net loss	$ (2,964)	$ (6,272)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation of property and equipment	5,468	3,429
Amortization of other intangible assets	16,108	8,935
Accounts receivable allowances	717	374
Share-based payments, including cumulative effect of accounting change	20,954	9,645
Non-cash interest expense	2,097	1,456
Deferred tax provision	4,225	2,490
Normalization of rent expense	531	663
Changes in operating assets and liabilities, net of effects from acquisitions:		
Accounts receivable	8,314	(3,308)
Inventories	(1,074)	15
Prepaid expenses and other assets	(3,096)	3,209
Accounts payable	5,475	1,497
Accrued expenses and other liabilities	(3,440)	(10,131)
Deferred maintenance revenue, unearned revenue and customer deposits	8,031	2,278
Net cash provided by operating activities	61,346	14,280
Cash flows from investing activities		
Capital expenditures for property and equipment	(5,055)	(3,930)
Payments for acquisitions, net of cash acquired	(59,087)	(376,828)
Proceeds from maturities of marketable securities		23,059
Purchases of certificates of deposit		(6,104)
Payments for capitalized patent defense costs	(3,399)	(1,778)
Decrease in restricted cash	674	
Net cash used in investing activities	(66,867)	(365,581)
Cash flows from financing activities		
Payments of notes payable and capital leases	(3,432)	(160)
Deferred acquisition payments	(18,650)	(14,433)
Proceeds from bank debt, net of issuance costs		346,032
Purchase of treasury stock	(1,463)	(978)
Repurchase shares from former MVC stockholders	(3,178)	
Payments on other long-term liabilities	(5,720)	(5,643)

Net proceeds from issuance of common stock under employee share-based payment plans		15,101		25,346
Net cash provided by (used in) financing activities		(17,342)		350,164
Effects of exchange rate changes on cash and cash equivalents		(267)		(370)
Net decrease in cash and cash equivalents		(23,130)		(1,507)
Cash and cash equivalents at beginning of period		112,334		71,687
Cash and cash equivalents at end of period	$	89,204	$	70,180
Supplemental disclosure of cash flow information:				
Cash paid for income taxes	$	1,672	$	1,343
Cash paid for interest	$	13,084	$	343
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	$	

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 March 26, 2007, the Company acquired Bluestar Resources Limited, the parent of Focus Enterprises Limited and Focus India Private Limited (collectively Focus), a provider of medical transcription services with operations in the United States and India (Note 3).

On December 29, 2006, the Company acquired Mobile Voice Control, Inc. (MVC), a provider of speech enabled mobile search and messaging services headquartered in Mason, Ohio (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, 2007, the results of operations for the three and six month periods ended March 31, 2007 and 2006, and cash flows for the six month periods ended March 31, 2007 and 2006. 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/A for the fiscal year ended September 30, 2006 filed with the Securities and Exchange Commission on December 15, 2006. The results for the six month period ended March 31, 2007 are not necessarily indicative of the results that may be expected for the fiscal year ending September 30, 2007, or any future period.

Reclassification

Certain 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 software revenue in accordance with Statement of Position (SOP) 97-2, Software Revenue Recognition, as amended by SOP 98-9 and all related interpretations. Non-software revenue is recognized in accordance with, the Securities and Exchange Commission s Staff Accounting Bulletin (SAB) 104, Revenue Recognition in Financial Statements, and SOP 81-1, Accounting for Performance of Construction Type and Certain Performance Type Contracts. 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 accounting based on their relative fair value. In select situations, we sell or license intellectual property in conjunction with, or in place of, embedding our intellectual property in software. In general, the Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, collectibility is probable, and vendor specific objective evidence (VSOE) of fair value exists for any undelivered elements. When contracts contain substantive customer acceptance provisions, revenue and related costs are deferred until such acceptance is obtained. The Company reduces recognized revenue for estimated future returns, price protection and rebates, and certain marketing allowances at the time the related revenue is recorded.

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 has not analyzed 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.

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.

Revenue from royalties on sales of the Company s 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.

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 maintenance and support services, it recognizes the revenue ratably over the term of the related contracts, typically one to three years. 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.

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Professional services are generally not considered essential to the functionality of the software and are recognized as revenue when the related services are performed. Professional services revenue is generally recognized based on the percentage-of-completion method in accordance with SOP 81-1. 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. When the Company provides services on a time and materials basis, it recognizes revenue as it performs the services based on actual time incurred.

The Company may sell, under one contract or related contracts, software licenses, professional services, and/or a maintenance and support arrangement. The total contract value is attributed first to the undelivered elements based on VSOE of their fair value. VSOE is established by the price charged when that element is sold separately. The remainder of the contract value is attributed to the delivered elements, typically software licenses, which are typically recognized as revenue upon delivery, provided all other revenue recognition criteria are met. When the Company provides professional services considered essential to the functionality of the software, such as custom application development for a fixed fee, it recognizes revenue from the services as well as any related software licenses on a percentage-of-completion basis.

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 the following:

- significant underperformance relative to historical or projected future operating results;
- significant changes in the manner of or use of the acquired assets or the strategy for the Company s overall business;

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

significant negative industry or economic trends;

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. No impairment charges were taken during the six month periods ended March 31, 2007 and 2006, based on the review of long-lived assets under SFAS 144. 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. As of March 31, 2007 and September 30, 2006, capitalized patent defense costs totaled $9.8 million and $6.4 million, respectively.

Comprehensive Income (Loss)

Comprehensive income (loss) consists of net income (loss) and other comprehensive income (loss), which includes current period foreign currency translation adjustments, unrealized gains (losses) related to derivatives reported as cash flow hedges, and unrealized gains (losses) on marketable securities. For the purposes of comprehensive income (loss) disclosures, the Company does not record tax provisions or benefits for the net

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NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

changes in the foreign currency translation adjustment, as the Company intends to reinvest undistributed earnings in its foreign subsidiaries permanently.

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

	Three Months Ended March 31,		Six Months Ended March 31,	
	2007	2006	2007	2006
Net loss	$ (1,731)	$ (1,380)	$ (2,964)	$ (6,272)
Other comprehensive income (loss):				
Foreign currency translation adjustment	1,083	379	1,956	605
Net unrealized losses on cash flow hedge derivatives	(235)		(31)	
Net unrealized losses on marketable securities		(15)		(39)
Other comprehensive income	848	364	1,925	566
Total comprehensive income (loss)	$ (883)	$ (1,016)	$ (1,039)	$ (5,706)

Net Income (Loss) Per Share

The Company computes net income (loss) per share under the provisions of SFAS 128, Earnings per Share, and EITF 03-06, Participating Securities and Two Class Method under FASB Statement No. 128, Earnings per Share. Accordingly, basic net income (loss) per share is computed by dividing net income (loss) available to common stockholders by the weighted-average number of common shares outstanding during the period.

Diluted net income (loss) per share is computed by dividing net income (loss) available to common stockholders by the weighted-average number of common shares outstanding for the period plus the dilutive effect of common equivalent shares, which include outstanding stock options, warrants, unvested shares of restricted stock using the treasury stock method 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 25.0 million and 21.5 million shares for the three month periods ended March 31, 2007 and 2006, respectively; and 24.4 million and 30.4 million shares for the six month periods ended March 31, 2007 and 2006, respectively, have been excluded from the computation of diluted net income (loss) per share because their inclusion would be anti-dilutive.

Accounting for Share-Based Payments

The Company adopted SFAS No. 123 (revised 2004), Share-Based Payment, (SFAS 123R) effective October 1, 2005. The Company has several equity instruments that are required to be evaluated under SFAS 123R, including: stock option plans, an employee stock purchase plan, awards in the form of restricted shares (Restricted Stock) and awards in the form of units of stock purchase rights (Restricted Units). 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 of the individual grantees, which generally equals the vesting period. Based on the provisions of SFAS 123R the Company s share-based payments awards are accounted for as equity instruments. In connection with the adoption of SFAS 123R, the Company is required to amortize stock-based instruments with performance-related vesting terms over the period from the grant date to the sooner of the date upon which the performance vesting condition will be met (when that condition is expected to be met), or the time-based vesting dates. The cumulative effect of the change in accounting as a result of the adoption of SFAS 123R in

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

fiscal 2006 was $0.7 million. 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,	
	2007	2006	2007	2006
Cost of product and licensing	$ 7	$ 27	$ 12	$ 48
Cost of professional services, subscription and hosting	906	419	1,450	709
Cost of maintenance and support	279	64	467	112
Research and development	1,819	1,208	3,026	2,060
Sales and marketing	4,853	1,644	8,302	2,755
General and administrative	4,500	1,868	7,697	3,289
Cumulative effect of accounting change				672
	$ 12,364	$ 5,230	$ 20,954	$ 9,645

Stock Options

The Company has several share-based payment plans under which employees, officers, directors and consultants may be granted stock options to purchase the Company s common stock generally at the fair market value on the date of grant. 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 original plans of the Company become exercisable over various periods, typically two to four years and have a maximum term of 7 years. The Company also assumed an option plan in connection with its acquisition of Nuance Communications, Inc. (Former Nuance) on September 15, 2005. These stock options are governed by the original agreement (the Former Nuance Stock Option Plan) that they were issued under, but are now exercisable for shares of the Company. No further stock options may be issued under the Former Nuance Stock Option Plan. 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, 2007:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value(1)
Outstanding at September 30, 2006	20,654,083	$ 4.80		
Granted	1,410,200	$ 11.22		
Exercised	(3,312,318)	$ 4.29		

Forfeited	(360,373)	$	6.52			
Expired	(10,509)	$	4.57			
Outstanding at March 31, 2007	18,381,083	$	5.35	5.2 years	$	183.0 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, 2007 ($15.31) and the exercise price of the underlying options. Stock options to purchase 12,345,137 shares of common stock were exercisable as of March 31, 2006.

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NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

As of March 31, 2007, the total unamortized fair value of stock options was $24.1 million with a weighted average remaining recognition period of 2.4 years. During the three and six month periods ended March 31, 2007 and 2006, the following activity occurred under the Company s plans:

	Three Months Ended March 31,		Six Months Ended March 31,	
	2007	2006	2007	2006
Weighted-average grant-date fair value per share	$ 5.67	$ 4.97	$ 5.04	$ 4.54
Total intrinsic value of stock options exercised (in millions)	$ 23.12	$ 19.60	$ 30.45	$ 28.70

The Company uses the Black-Scholes option pricing model to calculate the grant-date fair value of an award. The fair value of the stock options granted during the three and six month periods ended March 31, 2007 and 2006 were calculated using the following weighted-average assumptions:

	Three Months Ended March 31,		Six Months Ended March 31,	
	2007	2006	2007	2006
Dividend yield	0.0%	0.0%	0.0%	0.0%
Expected volatility	51.4%	63.0%	53.3%	63.0%
Average risk-free interest rate	4.7%	4.5%	4.7%	4.5%
Expected term (in years)	3.8	4.6	3.8	4.6

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. Upon the adoption of SFAS 123R, the Company used the simplified method provided for under SEC Staff Accounting Bulletin No. 107, which averages the contractual term of the Company s options (7.0 years) with the vesting term (2.2 years). Beginning in the fourth quarter of fiscal 2006 the Company has estimated the expected life 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 three years, and may have opportunities for

acceleration for achievement of defined goals. Beginning in fiscal 2006, the Company began to issue 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 vesting 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 those goals are not met, any unvested shares are forfeited and revert to the Company.

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Restricted Units are not included in issued and outstanding common stock until the shares are vested. The table below summarizes activity relating to Restricted Units for the six months ended March 31, 2007:

	Number of Shares Underlying Restricted Units	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value(1)
Outstanding at September 30, 2006	2,750,054		
Granted	2,003,231		
Vested	(671,522)		
Forfeited	(215,396)		
Outstanding at March 31, 2007	3,866,367	1.2 years	$ 59.2 million
Expected to become exercisable	3,397,979	1.2 years	$ 52.0 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, 2007 ($15.31) and the exercise price of the underlying Restricted Units.

The purchase price for vested Restricted Units is $0.001 per share. As of March 31, 2007, unearned share-based payment expense related to unvested Restricted Units is $21.8 million, which will, based on expectations of future performance vesting criteria, when applicable, be recognized over a weighted-average period of 1.2 years. 45% of the Restricted Units outstanding as of March 31, 2007 is subject to performance vesting acceleration conditions. During the three and six month periods ended March 31, 2007 and 2006 the following activity occurred related to Restricted Units:

	Three Months Ended March 31,		Six Months Ended March 31,	
	2007	2006	2007	2006
Weighted-average grant-date fair value per share	$ 12.09	$ 8.56	$ 11.02	$ 8.38
Total intrinsic value of shares vested (in millions)	$ 5.76	$ 0.88	$ 8.39	$ 2.01

Restricted Stock is included in the issued and outstanding common stock in these financial statements at date of grant. The table below summarizes activity relating to Restricted Stock for the six months ended March 31, 2007:

	Number of Shares Underlying Restricted Stock		Weighted Average Grant Date Fair Value
Nonvested balance at September 30, 2006	1,547,341	$	5.93
Granted	14,555	$	8.24
Vested	(304,935)	$	5.33
Nonvested balance at March 31, 2007	1,256,961	$	6.11

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The purchase price for vested Restricted Stock is $0.001 per share. As of March 31, 2007, unearned share-based payment expense related to unvested Restricted Stock is $4.5 million, which will, based on expectations of future performance vesting criteria, when applicable, be recognized over a weighted-average period of 1.3 years. 73% of the Restricted Stock outstanding as of March 31, 2007 are subject to performance vesting acceleration conditions. During the three and six month periods ended March 31, 2007 and 2006 the following activity occurred related to Restricted Stock:

	Three Months Ended March 31,		Six Months Ended March 31,	
	2007	2006	2007	2006
Weighted-average grant-date fair value per share	N/A	N/A	$ 8.24	N/A
Total intrinsic value of shares vested (in millions)	$ 4.62	$ 0.25	$ 4.62	$ 1.37

The Company has historically repurchased common stock upon its employees vesting in Restricted Awards, in order to allow the employees to cover their tax liability as a result of the Restricted Awards having vested. Assuming that the Company repurchased one-third of all vesting Restricted Awards outstanding as of March 31, 2007, such amount approximating a tax rate of its employees, and based on the weighted average recognition period of 1.3 years, the Company would repurchase approximately 1.0 million shares during the twelve month period ending March 31, 2008. During the six months ended March 31, 2007, the Company repurchased 227,637 shares of restricted awards at a cost of $3.1 million to cover employees tax obligations related to vesting of Restricted Awards.

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. Compensation expense for the employee stock purchase plan is recognized in accordance with SFAS 123R. Compensation expense related to the employee stock purchase plan was $0.5 million and $1.0 million for the three and six months ended March 31, 2007, respectively, and was $0.2 million and $0.4 million for the three and six months ended March 31, 2006, respectively.

Income Taxes

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 No. 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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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.

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 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 currently 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 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, 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). At March 31, 2007 and September 30, 2006, the fair value of the Swap was $0.6 million and was included in other liabilities.

Recently Issued Accounting Standards

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 as of the beginning of an entity s first fiscal year beginning after November 15, 2007. Early adoption is permitted as of the beginning of the previous fiscal year, provided that the entity makes that choice in the first 120 days of that fiscal year. The Company is evaluating the impact, if any, that SFAS 159 may have on its consolidated financial statements.

In December 2006, the FASB issued EITF 00-19-2, Accounting for Registration Payment Arrangements. EITF 00-19-2 specifies that the contingent obligation to make future payments or otherwise transfer consideration under a registration payment arrangement, whether issued as a separate agreement or included as a provision of a financial instrument or other agreement, should be separately recognized and measured in accordance with FASB Statement No. 5, Accounting for Contingencies. For registration payment arrangements and financial instruments subject to those arrangements that were entered into prior to the issuance of EITF 00-19-2, this guidance shall be effective for financial statements issued for fiscal years beginning after December 15, 2006. The Company is evaluating the

impact, if any, that EITF 00-19-2 may have on its consolidated financial statements.

In September 2006, the FASB issued SFAS 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements 87, 88, 106 and 132(R). SFAS 158 requires an employer to recognize the over-funded or under-funded status of a defined benefit postretirement plan (other than a multi-employer plan) as an asset or liability in its statement of financial position and to recognize changes in that

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

funded status in the year in which the changes occur through comprehensive income. SFAS 158 also requires the measurement of defined benefit plan assets and obligations as of the date of the employer s fiscal year-end statement of financial position (with limited exceptions). Under SFAS 158, the Company will be required to recognize the funded status of its defined benefit postretirement plan and to provide the required disclosures commencing as of September 30, 2007. The requirement to measure plan assets and benefit obligations as of the date of the employer s fiscal year-end is effective for the Company s fiscal year ended September 30, 2009. The Company is currently evaluating the impact that SFAS 158 will have on its consolidated financial statements.

In July 2006, the FASB issued Interpretation 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. FIN 48 is effective for its fiscal year beginning October 1, 2007. The Company is currently evaluating the effect that the adoption of FIN 48 will have on its consolidated financial statements.

3. Business Acquisitions

Acquisition of Focus

On March 26, 2007, the Company acquired all of the outstanding capital stock of Bluestar Resources Limited, the parent of Focus Enterprises Limited and Focus India Private Limited (collectively Focus) which provides medical transcription services with operations in the United States and India. The purchase price consists of $59.3 million in cash including transaction costs, and the assumption of certain obligations. The acquisition has been accounted for under the purchase method of accounting, and the results of operations have been included in the accompanying consolidated statements of operations from the date of acquisition. The following table summarizes the preliminary allocation of the purchase price (in thousands):

Total purchase consideration:	
Cash	$ 54,477
Debt assumed	2,060
Transaction costs	2,800
Total purchase consideration	$ 59,337
Allocation of the purchase consideration:	
Accounts receivable	$ 3,982
Property and equipment	1,452
Other current and non current assets	953
Identifiable intangible assets	23,700
Goodwill	40,733
Total assets acquired	70,820

Accounts payable and accrued expenses	(2,071)
Deferred income tax liabilities	(9,008)
Other liabilities	(404)
Total liabilities assumed	(11,483)
Net assets acquired	$ 59,337

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	$ 19,800	6.0
Core and completed technology	2,900	7.4
Non-competes	1,000	6.2
Total	$ 23,700	

Acquisition of Mobile Voice Control, Inc.

On December 29, 2006, the Company acquired all of the outstanding capital stock of Mobile Voice Control, Inc. (MVC), a provider of speech-enabled mobile search and messaging services, for $12.8 million. The purchase price consists of $4.5 million in cash including transaction costs, and 784,266 shares of the Company s common stock valued at $8.3 million. The acquisition has been accounted for under the purchase method of accounting, and the results of operations have been included in the accompanying consolidated statements of operations from the date of acquisition. The following table summarizes the preliminary allocation of the purchase price (in thousands):

Total purchase consideration:	
Common stock issued	$ 8,300
Cash	4,104
Transaction costs	386
Total purchase consideration	$ 12,790
Allocation of the purchase consideration:	
Current and non current assets	$ 79
Identifiable intangible assets	2,700
Goodwill	10,176
Total assets acquired	12,955
Total liabilities assumed	(165)
Net assets acquired	$ 12,790

Under the agreement, the Company agreed to make maximum additional payments of $18.0 million in contingent purchase price upon achievement of certain established financial targets through December 31, 2008. Additional payments, if any, related to this contingency will be accounted for as additional goodwill.

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	$ 1,300	5
Completed technology	1,100	4
Non-competes	300	3
Total	$ 2,700	

4. Accounts Receivable

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

	March 31, 2007	September 30, 2006
Accounts receivable	$ 119,242	$ 118,580
Unbilled accounts receivable	16,389	12,405
	135,631	130,985
Less allowance for doubtful accounts	(4,383)	(4,106)
Less reserve for distribution and reseller accounts receivable	(6,701)	(9,797)
Less allowance for sales returns	(7,280)	(6,304)
Total	$ 117,267	$ 110,778

Unbilled accounts receivable primarily relate to product revenue earned under royalty-based arrangements for which billing occurs in the month following receipt of the royalty report, and for professional services revenue earned under percentage of completion contracts that have not yet been billed based on the terms of the specific arrangement.

5. Inventories, net

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

	March 31, 2007	September 30, 2006
Components and parts	$ 2,923	$ 2,311
Inventory at customers	4,589	3,173
Finished products	840	1,311
Total	$ 8,352	$ 6,795

Inventory at customers reflects equipment related to in-process installations of solutions of Dictaphone contracts with customers. These contracts have not been recorded to revenue as of March 31, 2007, 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.

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

6. Goodwill and Other Intangible Assets

The changes in the carrying amount of goodwill during the six months ended March 31, 2007, are as follows (in thousands):

Balance as of September 30, 2006	$ 699,333
Goodwill acquired MVC acquisition	10,176
Goodwill acquired Focus acquisition	40,733
Purchase accounting adjustments	(1,790)
Effect of foreign currency translation	2,383
Balance as of March 31, 2007	$ 750,835

Goodwill adjustments during the six months ended March 31, 2007 included $2.0 million relating to the utilization of acquired deferred tax assets, offset by $0.2 million of purchase accounting adjustments related to previous acquisitions.

Other intangible assets consist of the following (dollars in thousands):

	At March 31, 2007			
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Weighted Average Remaining Life (Years)
Customer relationships	$ 168,939	$ 30,614	$ 138,325	8.2
Technology and patents	94,931	36,333	58,598	5.6
Tradenames and trademarks, subject to amortization	6,951	2,760	4,191	5.5
Non-competition agreement	1,886	310	1,576	5.1
Subtotal	272,707	70,017	202,690	
Tradename, indefinite life	27,800		27,800	n/a
Total	$ 300,507	$ 70,017	$ 230,490	

Amortization expense for the Company s other intangible assets with finite lives was $8.1 million and $16.1 million for the three and six months ended March 31, 2007, respectively, and was $4.5 million and $8.9 million for the three and six months ended March 31, 2006, respectively. Estimated future amortization expense for each of the five

succeeding years is as follows (in thousands):

Year Ending September 30,	Cost of Revenue	Other Operating Expenses	Total
2007 (April 1, 2007 to September 30, 2007)	$ 5,826	$ 12,295	$ 18,121
2008	11,446	23,381	34,827
2009	10,428	21,221	31,649
2010	9,642	18,477	28,119
2011	9,018	16,968	25,986
2012	6,940	15,823	22,763
Thereafter	5,298	35,927	41,225
Total	$ 58,598	$ 144,092	$ 202,690

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

7. Accrued Expenses

Accrued expenses consist of the following (in thousands):

	March 31, 2007	September 30, 2006
Accrued compensation	$ 19,709	$ 21,310
Accrued sales and marketing incentives	3,825	4,454
Accrued royalties	2,738	2,452
Accrued professional fees	4,580	3,823
Accrued acquisition costs and liabilities	1,670	747
Income taxes payable	4,958	3,857
Accrued other	19,748	16,031
Total	$ 57,228	$ 52,674

8. Deferred and Contingent Acquisition 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 in full to the former shareholders of Phonetic on February 1, 2007. Under the agreement, the Company also agreed to make maximum additional payments of $35.0 million in contingent purchase price upon achievement of certain established financial and performance targets through December 31, 2007. On June 1, 2006, the Company notified the former shareholders of Phonetic that the financial and performance targets for the first scheduled payment of up to $12.0 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. Additional payments, if any, related to this contingency will be accounted for as additional goodwill.

9. Pension and Other Postretirement Benefit Plans

In connection with the acquisition of Dictaphone on March 31, 2006, the Company assumed the assets and obligations related to its defined benefit pension plans, which provide certain retirement and death benefits for former Dictaphone employees located in the United Kingdom and Canada. The Company also assumed a post-retirement health care and life insurance benefit plan which 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. Amounts recognized in other assets and liabilities in the consolidated balance sheet as of March 31, 2007 are as follows (in thousands):

	Pension Benefits	Other Benefits
Prepaid benefit cost	$ 2,263	$

Accrued benefit liability	(7,159)	(1,442)
Net amount recognized	$ (4,896)	$ (1,442)

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NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The components of net periodic benefit cost of the benefit plans for the three and six months ended March 31, 2007 are as follows (in thousands):

	Three Months Ended March 31, 2007		Six Months Ended March 31, 2007	
	Pension Benefits	Other Benefits	Pension Benefits	Other Benefits
Service cost	$ 70	$ 26	$ 138	$ 53
Interest Cost	298	19	592	37
Amortization of net (gain) loss				
Expected return on plan assets	(302)		(602)	
Amortization of prior service cost				
Net period benefit cost	$ 66	$ 45	$ 128	$ 90

10. Credit Facilities and Debt

On March 31, 2006, the Company entered into a senior secured credit facility (the 2006 Credit Facility). The 2006 Credit Facility consists of a $355.0 million 7-year term loan which matures on March 31, 2013 and a $75.0 million revolving credit line which matures on March 31, 2012. The available revolving credit line capacity is reduced, as necessary, to account for certain letters of credit outstanding. As of March 31, 2007, there were $17.4 million of letters of credit issued under the revolving credit line and there were no other outstanding borrowings under the revolving credit line.

Borrowings under the 2006 Credit Facility bear interest at a rate equal to the applicable margin plus, at the Company s option, either (a) a 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 determined by reference to the British Bankers Association Interest Settlement Rates for deposits in U.S. dollars. The applicable margin for borrowings under the 2006 Credit Facility ranges from 0.50% to 1.00% per annum with respect to base rate borrowings and from 1.50% to 2.00% per annum with respect to LIBOR-based borrowings, depending upon the Company s leverage ratio. As of March 31, 2007, the Company s applicable margin was 1.00% for base rate borrowings and 2.00% 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 our leverage ratio. As of March 31, 2007, the commitment fee rate was 0.375%.

The Company capitalized approximately $9.0 million in debt issuance costs related to the opening of the 2006 Credit Facility. The costs associated with the revolving credit facility are being amortized as interest expense over six years, through March 2012, while the costs associated with the term loan are being amortized as interest expense over seven years, through March 2013, which are the maturity dates of the revolving line and term facility, respectively under the 2006 Credit Facility. The effective interest method is used to calculate the amortization of the debt issuance costs for both the revolving credit facility and the term loan. These debt issuance costs, net of accumulated amortization of

$1.3 million, are included in other assets in the consolidated balance sheet as of March 31, 2007.

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The $355.0 million term loan is subject to repayment consisting of a baseline amortization of 1% per annum ($3.55 million per year, due in four equal quarterly installments), and an annual excess cash flow sweep, as defined in the 2006 Credit Facility, which will be first payable beginning in the first quarter of fiscal 2008, based on the excess cash flow generated in fiscal 2007. As of March 31, 2007, we have repaid $3.6 million of principal under the term loan agreement. Any 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 aggregate annual maturities of the term loan would be as follows (in thousands):

Year Ending September 30,	**Amount**
2007 (April 1, 2007 to September 30, 2007)	$ 1,775
2008	3,550
2009	3,550
2010	3,550
2011	3,550
2012	3,550
Thereafter	331,925
Total	$ 351,450

The Company s obligations under the 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 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, material tangible and intangible assets, and present and future intercompany debt. The 2006 Credit Facility also contains provisions for mandatory prepayments of outstanding term loans, subject to certain exceptions, with: 100% of net cash proceeds of asset sales, 100% of net cash proceeds of issuance or incurrence of debt, and 100% of extraordinary receipts. The Company may voluntarily prepay the 2006 Credit Facility without premium or penalty other than customary breakage costs with respect to LIBOR-based loans.

The 2006 Credit Facility contains a number of covenants that, among other things, restrict, subject to certain exceptions, the ability of the Company and its subsidiaries to: incur additional indebtedness, create liens on assets, enter into certain sale and lease-back transactions, make investments, make certain acquisitions, sell assets, engage in mergers or consolidations, pay dividends and distributions or repurchase the Company s capital stock, engage in certain transactions with affiliates, change the business conducted by the Company and its subsidiaries, amend certain charter documents and material agreements governing subordinated indebtedness, prepay other indebtedness, enter into agreements that restrict dividends from subsidiaries and enter into certain derivatives transactions. The 2006 Credit Facility is governed by financial covenants that include, but are not limited to, maximum total leverage and minimum interest coverage ratios, as well as to a maximum capital expenditures limitation. The 2006 Credit Facility also contains certain customary affirmative covenants and events of default. As of March 31, 2007, the Company was

in compliance with the covenants under the 2006 Credit Facility.

On April 5, 2007, the Company amended and restated its 2006 Credit Facility to modify certain covenants as well as provide for an incremental $90 million term loan facility (Note 18).

11. Accrued Business Combination Costs

In connection with the acquisitions of SpeechWorks International, Inc. in August 2003 and Former Nuance in September 2005, the Company has assumed obligations relating to certain leased facilities expiring in 2016 and 2012, respectively, that 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

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

accordingly are included in the allocation of the purchase price, generally resulting in an increase to the recorded amount of the goodwill. The net payments have been discounted in calculating the fair value of the obligation as of the date of acquisition, and the discount is being accreted through expected maturity. 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, 2007, the total gross payments due from the Company to the landlords of the facilities is $82.7 million. This is reduced by $20.8 million of sublease income and a $5.5 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, 2007, total gross payments due from the Company to the landlords of the facilities is $2.6 million. This is reduced by $0.9 million of 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.

Current activity charged against the accrued business combination costs for the six months ended March 31, 2007 was as follows (in thousands):

	Facilities	Personnel	Total
Balance at September 30, 2006	$ 59,221	$ 844	$ 60,065
Charged to goodwill	35	(361)	(326)
Charged to interest expense	981		981
Cash payments, net of sublease receipts	(6,369)	(483)	(6,852)
Balance at March 31, 2007	$ 53,868	$	$ 53,868

12. Restructuring and Other Charges

Current activity charged against the restructuring accrual for the six months ended March 31, 2007 was as follows (in thousands):

	Facilities	Personnel	Total
Balance at September 30, 2006	$ 530	$ 374	$ 904
Cash payments and foreign exchange	(455)	(3)	(458)
Balance at March 31, 2007	$ 75	$ 371	$ 446

The remaining personnel-related accrual as of March 31, 2007 is primarily composed of amounts due under a restructuring charge taken in the fourth quarter of fiscal 2005 which is expected to be paid during fiscal 2007.

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

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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.

Common Stock

On March 22, 2007, the Company s shareholders approved an amendment to the Company s Amended and Restated Certificate of Incorporation to increase the number of shares of common stock the Company is authorized to issue from 280,000,000 shares to 560,000,000 shares.

On January 26, 2007, the Company repurchased 261,422 shares of the Company s common stock from former MVC stockholders which were originally issued in connection with the acquisition of MVC on December 29, 2006, for a total purchase price of $3.2 million.

On December 29, 2006, the Company issued 784,266 shares of its common stock in connection with the acquisition of MVC.

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 was $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. 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, 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.

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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, a global private equity firm, 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 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 with the following assumptions: expected volatility of 60%, a risk-free interest rate of 4.03%, an expected term of 8 years, no dividends and a stock price of $3.92, based on the Company s stock price at the time of issuance. During the six months ended March 31, 2007, 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, 2007, a warrant to purchase 24,380 shares of the Company s common stock remains outstanding.

Also in connection with the acquisition of SpeechWorks, the Company assumed outstanding warrants previously issued by SpeechWorks to America Online. These warrants allow for the purchase of up to 219,421 shares of the Company s common stock, and were issued in connection with a long-term marketing arrangement. The warrant is currently exercisable at a price of $14.49 per share and provides the holder with the option to exercise the warrants on a net, or cashless, basis. The warrant expires on June 30, 2007 and the value of the warrant was insignificant.

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.

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 12). The following table outlines the Company s gross future minimum payments under all non-cancelable operating leases as of March 31, 2007 (in thousands):

Year Ending September 30,	Operating Leases	Leases Under Restructuring	Other Contractual Obligations Assumed	Total
2007 (April 1, 2007 to September 30, 2007)	$ 3,574	$ 815	$ 6,185	$ 10,574
2008	8,267	1,558	12,780	22,605
2009	7,906	1,432	13,202	22,540
2010	6,757	523	13,639	20,919
2011	5,877	540	14,172	20,589
2012	4,844	557	12,661	18,062
Thereafter	14,764	332	10,093	25,189
Total	$ 51,989	$ 5,757	$ 82,732	$ 140,478

At March 31, 2007, 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 $24.9 million and which ranges from approximately $1.0 million to $3.8 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, 2007, the total outstanding financial guarantees related to real estate were $17.4 million and are secured by the 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 certain 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.

On April 10, 2007, Disc Link Corporation (Disc Link) filed a patent infringement action against the Company in the United States District Court for the Eastern District of Texas. Damages are sought in an unspecified amount. In this lawsuit, Disc Link alleges that the Company infringes U.S. Patent No. 6,314,574, titled Information Distribution System. The Company is in the early stages of evaluating these claims and intends to defend the action vigorously.

On November 8, 2006, VoiceSignal Technologies, Inc. filed an action against the Company and eleven of its resellers in the United States District Court for the Western District of Pennsylvania claiming patent infringement. Damages were sought in an unspecified amount. In the lawsuit, VoiceSignal alleges that the Company is infringing United States Patent No. 5,855,000 which relates to improving correction in a dictation application based on a two input analysis. The Company believes these claims have no merit and intends to defend the action vigorously.

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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. The Company believes these claims have no merit and intends to defend the action vigorously.

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 could be costly. Should the Company not prevail in these litigation matters, its operating results, financial position and cash flows could be adversely impacted.

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 accordance with the terms of the SpeechWorks merger agreement, the Company is required to indemnify the former members of the SpeechWorks board of directors, on similar terms as described above, for a period of six years from

the acquisition date. In connection with this indemnification, the Company was required to purchase a director and officer insurance policy related to this obligation for a period of three years from the date of acquisition. This three-year policy was purchased in 2003. In accordance with the terms of each of the Former Nuance and Dictaphone merger agreements, the Company is required to indemnify the former members of the Former Nuance and Dictaphone boards of directors, on similar terms as described above, for a period of six

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

years from the acquisition date. In connection with these indemnifications, the Company has purchased director and officer insurance policies related to these obligations covering the full period of six years.

At March 31, 2007, 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. 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.

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,	
	2007	**2006**	**2007**	**2006**
United States	$ 100,830	$ 47,750	$ 202,380	$ 97,661
International	31,232	23,978	63,103	49,619
Total	$ 132,062	$ 71,728	$ 265,483	$ 147,280

No country outside of the United States composed greater than 10% of total revenue.

The following table presents revenue information for principal product lines, which do not constitute separate segments (in thousands):

	Three Months Ended March 31,		Six Months Ended March 31,	
	2007	**2006**	**2007**	**2006**
Speech	$ 113,460	$ 55,556	$ 228,462	$ 113,724
Imaging	18,602	16,172	37,021	33,556

Total	$ 132,062	$ 71,728	$ 265,483	$ 147,280

No customer accounted for greater than 10% of revenue or accounts receivable as of March 31, 2007 or September 30, 2006.

The following table summarizes the Company s long-lived assets, including intangible assets and goodwill, by geographic location (in thousands):

	March 31, 2007	**September 30, 2006**
United States	$ 893,146	$ 865,884
International	145,752	105,869
Total	$ 1,038,898	$ 971,753

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

16. Pro Forma Results

The following table reflects unaudited pro forma results of operations of the Company assuming that the Dictaphone and Focus acquisitions had occurred on October 1, 2005 (in thousands, except per share amounts):

	Three Months Ended March 31,		Six Months Ended March 31,	
	2007	2006	2007	2006
Revenue	$ 136,822	$ 114,643	$ 274,885	$ 235,726
Net loss	$ (3,565)	$ (37,784)	$ (6,283)	$ (49,828)
Net loss per basic and diluted share	$ (0.02)	$ (0.23)	$ (0.04)	$ (0.31)

The Company has not furnished pro forma financial information relating to the MVC acquisition because such information is not material. The unaudited pro forma results of operations are not necessarily indicative of the actual results that would have occurred had the transactions actually taken place at the beginning of the periods indicated.

17. Related Parties

A member of the Company s Board of Directors is also a partner at Wilson Sonsini Goodrich & Rosati, Professional Corporation, a law firm that provides services to the Company. In the six months ended March 31, 2007 and the fiscal year 2006, the Company paid $0.3 million and $4.9 million, respectively, to Wilson Sonsini Goodrich & Rosati for professional services provided to the Company. As of March 31, 2007 and September 30, 2006, the Company had $3.4 million and $0.6 million, respectively, included in accounts payable and accrued expenses to Wilson Sonsini Goodrich & Rosati.

18. Subsequent Events

On February 12, 2007, the Company entered into an agreement and plan of merger to acquire BeVocal, Inc. (BeVocal), a provider of self-service customer care solutions that address the unique business requirements of the mobile communications market and its customers. The transaction closed on April 24, 2007. Under the terms of the agreement and plan of merger, the purchase price payable to BeVocal s stockholders consists of an initial payment of approximately $15.0 million in cash, net of the estimated cash closing balance of BeVocal, and approximately 8.3 million shares of the Company s common stock. Up to an additional $60.0 million in cash may also be paid, if at all, approximately 18 months following the closing, upon the achievement of certain performance objectives.

On April 5, 2007, the Company amended its 2006 Credit Facility, and received additional net proceeds of approximately $87.5 million. The 2006 Credit Facility and the amendment provide for the amendment and restatement of the Company s existing 7-year term facility and 6-year revolving credit facility (together, the Expanded 2006 Credit Facility). The Expanded 2006 Credit Facility includes $90 million of additional term debt resulting in a $442 million term facility due in March 2013 and a $75 million revolving credit facility due in March 2012. The additional funds net of debt issuance costs received by the Company under the Expanded 2006 Credit Facility was used to fund the cash portion of the merger consideration of Focus and BeVocal as discussed in Note 3 and above. The Expanded 2006

Credit Facility contains customary covenants, including, among other things, covenants that in certain cases restrict the ability of the Company and its subsidiaries to incur additional indebtedness, create or permit liens on assets, enter into sale-leaseback transactions, make loans or investments, sell assets, make acquisitions, pay dividends, or repurchase stock.

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Item 2. ***Management s Discussion and Analysis of Financial Condition and Results of Operations***

The following Management s Discussion and Analysis is intended to help the reader understand the results of operations and financial condition of our business. Management s Discussion and Analysis is provided as a supplement to, and should be read in conjunction with, our consolidated financial statements and related notes thereto included elsewhere in this Quarterly Report on Form 10-Q.

FORWARD-LOOKING STATEMENTS

This quarterly report contains forward-looking statements. These forward-looking statements include predictions regarding:

- our future revenue, cost of revenue, research and development expenses, selling, general and administrative expenses, amortization of other intangible assets and gross margin;
- our strategy relating to speech and imaging technologies;
- the potential of future product releases;
- our product development plans and investments in research and development;
- future acquisitions, and anticipated benefits from prior acquisitions;
- international operations and localized versions of our products; and
- legal proceedings and litigation matters.

You can identify these and other forward-looking statements by the use of words such as may, will, should, expects, plans, anticipates, believes, estimates, predicts, intends, potential, continue or the negative of such term comparable terminology. Forward-looking statements also include the assumptions underlying or relating to any of the foregoing statements. Our actual results could differ materially from those anticipated in these forward-looking statements for many reasons, including the risks described in Item 1A Risk Factors and elsewhere in this Quarterly Report.

You should not place undue reliance on these forward-looking statements, which speak only as of the date of this Quarterly Report on Form 10-Q. We undertake no obligation to publicly release any revisions to the forward-looking statements or reflect events or circumstances after the date of this document.

OVERVIEW

We are a leading provider of speech and imaging solutions for businesses and consumers around the world. Our technologies, applications and services are transforming the way people create, use and interact with information and make the experience of our end users a more compelling, convenient and satisfying one.

Our speech technologies enable voice-activated services over a telephone, transform speech into written word, and permit the control of devices and applications by simply speaking. With the acquisition of Dictaphone, we expanded our speech technologies in the automatic conversion of voice reports into electronic patient reports for a wide range of

users in the transcription and healthcare industry. Our imaging solutions offer cost-effective PDF applications for business users, convert paper and PDF into documents that can be easily edited, and simplify scanning and document management using multifunction scanners and networked digital copiers.

Our software can be delivered as part of a larger integrated system, such as systems for customer service call centers, or as an independent application, such as dictation, medical transcription, document or PDF conversion, navigation systems in automobiles or digital copiers on a network. In select situations we sell or license intellectual property in conjunction with, or in place of, embedding our intellectual property in software. Our products and technologies deliver a measurable return on investment to our customers and our goal is to help our customers optimize productivity and reduce costs.

We market and distribute our products indirectly through a global network of resellers comprising system integrators, independent software vendors, value-added resellers, hardware vendors, telecommunications carriers and distributors; and directly to businesses and consumers through a dedicated direct sales force and our e-commerce website *(www.nuance.com).*

Nuance was incorporated in 1992 as Visioneer, Inc. under the laws of the state of Delaware. In 1999, we changed our name to ScanSoft, Inc. and also changed our ticker symbol to SSFT. In October 2004, we changed our fiscal year end to September 30, resulting in a nine-month fiscal year for 2004. In October 2005, we changed our name to Nuance Communications, Inc., to reflect our core mission of being the world s most comprehensive and innovative provider of speech solutions, and in November 2005 we changed our ticker symbol to NUAN.

Our business is predicated on providing our partners and customers with a comprehensive portfolio of value-added solutions, ensuring technological leadership, promoting the broad adoption of our innovative technology and building global sales and channel relationships. We continue to execute on our strategy of maintaining leadership in speech and imaging through sustained growth in our ongoing operations as well as through strategic acquisitions that complement our existing capabilities.

Our focus on providing competitive and value-added solutions for our customers and partners requires a broad set of technologies, service offerings and channel capabilities. We have successfully completed approximately 17 acquisitions since 2000 and we expect to continue to make acquisitions of other companies, businesses and technologies to complement our internal investments. We have a team that focuses on evaluating market needs and potential acquisitions to fulfill them. In addition, we have a disciplined methodology for integrating acquired companies and businesses after the transaction is complete. In recent fiscal years, we completed a number of acquisitions, including the following significant transactions:

On January 30, 2003, we acquired Royal Philips Electronics Speech Processing Telephony and Voice Control business units to expand our solutions for speech in call centers and within automobiles and mobile devices.

On August 11, 2003, we acquired SpeechWorks International, Inc. to broaden our speech applications for telecommunications, call centers and embedded environments as well as establish a professional services organization.

On February 1, 2005, we acquired Phonetic Systems Ltd. to complement our solutions and expertise in automated directory assistance and enterprise speech applications.

On September 15, 2005, we acquired the former Nuance Communications, Inc., which we refer to as Former Nuance, to expand our portfolio of technologies, applications and services for call center automation, customer self service and directory assistance.

On March 31, 2006, we acquired Dictaphone Corporation, a leading healthcare information technology company, to broaden our range of digital dictation, transcription, and report management system solutions.

On March 26, 2007, we acquired Bluestar Resources Limited, the parent of Focus Enterprises Limited and Focus India Private Limited (collectively Focus), which provide medical transcription services, to enhance our hosted services offerings.

CRITICAL ACCOUNTING POLICIES

The preparation of financial statements in conformity with generally accepted accounting principles in the United States of America 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 dates of the financial statements and the reported amounts of revenue and expenses during the reporting periods. On an ongoing basis, we evaluate our estimates and judgments, in particular those related to revenue recognition; the costs to complete the development of custom software applications and valuation allowances (specifically sales returns and other allowances); accounting for patent legal defense costs; the valuation of goodwill, other intangible assets and tangible long-lived assets; estimates used in the accounting for acquisitions; assumptions used in valuing stock-

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based compensation instruments; assumptions used in determining the obligations and assets relating to pension and post-retirement benefit plans; judgment with respect to interest rate swaps which are characterized as derivative instruments; evaluating loss contingencies; and valuation allowances for deferred tax assets. Actual amounts could differ significantly from these estimates. Our management bases its estimates and judgments on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities and the amounts of revenue and expenses that are not readily apparent from other sources.

Additional information about these critical accounting policies may be found in the Management s Discussion & Analysis of Financial Condition and Results of Operations section included in our Annual Report on Form 10-K/A for the fiscal year ended September 30, 2006.

RESULTS OF OPERATIONS

The following table presents, as a percentage of total revenue, certain selected financial data for the periods indicated:

	Three Months Ended March 31,		Six Months Ended March 31,	
	2007	**2006**	**2007**	**2006**
Revenue:				
Product and licensing	53.2%	67.7%	55.0%	69.1%
Professional services, subscription and hosting	24.9	21.5	22.9	20.3
Maintenance and support	21.9	10.8	22.1	10.6
Total revenue	100.0	100.0	100.0	100.0
Costs and expenses:				
Cost of product and licensing	9.1	6.6	8.4	6.6
Cost of professional services, subscription and hosting	17.1	15.8	16.2	15.0
Cost of maintenance and support revenue	5.0	2.3	5.1	2.4
Cost of revenue from amortization of intangible assets	2.2	3.5	2.2	3.4
Gross margin	66.6	71.8	68.1	72.6
Research and development	13.3	18.0	12.8	17.0
Sales and marketing	31.7	35.3	32.3	36.5
General and administrative	13.3	15.2	12.4	17.3
Amortization of other intangible assets	3.9	2.8	3.9	2.7
Restructuring and other charges, net		(1.8)		(0.9)
Total operating expenses	62.2	69.5	61.4	72.6
Income from operations	4.4	2.3	6.7	
Other expense, net	(4.9)	(1.4)	(5.0)	(0.8)
Income (loss) before income taxes	(0.5)	0.9	1.7	(0.8)
Provision for income taxes	0.8	2.8	2.8	3.0

Loss before cumulative effect of accounting changes	(1.3)	(1.9)	(1.1)	(3.8)
Cumulative effect of accounting change				(0.5)
Net loss	(1.3)%	(1.9)%	(1.1)%	(4.3)%

Total Revenue

The following table shows total revenue by geographic location, based on the location of our customers, in absolute dollars and percentage change (dollars in millions):

	Three Months Ended March 31,				Six Months Ended March 31,			
	2007	2006	Dollar Change	Percent Change	2007	2006	Dollar Change	Percent Change
United States	$ 100.9	$ 47.7	$ 53.2	112%	$ 202.4	$ 97.7	$ 104.7	107%
International	31.2	24.0	7.2	30%	63.1	49.6	13.5	27%
Total revenue	$ 132.1	$ 71.7	$ 60.4	84%	$ 265.5	$ 147.3	$ 118.2	80%

The increase in total revenue for the three months ended March 31, 2007, as compared to the same period ended March 31, 2006, was primarily due to $45.7 million of revenue related to the acquisition of Dictaphone, and a $14.7 million, or 21%, increase in organic revenue. Included in this organic growth, network revenue increased by 16%, dictation revenue increased 33%, embedded revenue increased by 28% and imaging revenue increased by 16%.

Based on the location of our customers, the geographic split for the three months ended March 31, 2007 was 76% of total revenue in the United States and 24% internationally. This compares to 67% of total revenue in the United States and 33% internationally for the three months ended March 31, 2006. The increase in percentage of revenue generated in the United States was due to sales of Dictaphone products, which are substantially all in the United States.

The increase in total revenue for the six months ended March 31, 2007, as compared to the same period ended March 31, 2006 was primarily due to $88.8 million of revenue related to our acquisition of Dictaphone, and to a lesser extent was due to increases in network revenue, dictation revenue, embedded revenue and imaging revenue.

Based on the location of our customers, the geographic split for the six months ended March 31, 2007 was 76% of total revenue in the United States and 24% internationally. This compares to 66% of total revenue in the United States and 34% internationally for the six months ended March 31, 2006. The increase in percentage of revenue generated in the United States was due to sales of Dictaphone products, which are substantially all in the United States.

Product and Licensing Revenue

Product and licensing revenue primarily consists of sales and licenses of speech and imaging products and technology. The following table shows product and licensing revenue in absolute dollars and as a percentage of total revenue (dollars in millions):

	Three Months Ended March 31,				Six Months Ended March 31,			
	2007	2006	Dollar Change	Percent Change	2007	2006	Dollar Change	Percent Change
Product and licensing revenue	$ 70.3	$ 48.6	$ 21.7	45%	$ 146.1	$ 101.7	$ 44.4	44%

As a percentage of total revenue	53%	68%	55%	69%

The increase in product and licensing revenue for the three months ended March 31, 2007, as compared to the same period ended March 31, 2006, was primarily due to $13.0 million of revenue attributable to the acquisition of Dictaphone. Speech related product and licensing revenue increased $19.5 million, or 60%, for the three months ended March 31, 2007, as compared to the same period ended March 31, 2006. The growth in speech revenue resulted from the acquisition of Dictaphone, as well as increased sales of our dictation products, embedded products, and networked-based products. Product and licensing revenue from our imaging products increased by $2.3 million, or 15%, due to increased sales of our PDF product family. Due to a change in revenue mix driven primarily by the growth of maintenance and support revenue, product and licensing revenue as a percentage of total revenue declined 15% for the three month period ended March 31, 2007, as compared to the same period ended March 31, 2006.

The increase in speech related product and licensing revenue for the six months ended March 31, 2007, as compared to the same period ended March 31, 2006, was primarily due to $24.9 million of revenue attributable to the acquisition of Dictaphone. Speech related product and licensing revenue increased $41.0 million, or 60%, for the six months ended March 31, 2007, as compared to the same period ended March 31, 2006. The growth in speech revenue resulted from the acquisition of Dictaphone, as well as increased sales of our dictation products, embedded products and networked-based products. Product and licensing revenue from our imaging products increased by $3.3 million, or 10%, due to increased sales of our PDF product family. Due to a change in revenue mix driven primarily by the growth of maintenance and support revenue, product and licensing revenue as a percentage of total revenue declined 14% for the six month period ended March 31, 2007, as compared to the same period ended March 31, 2006.

Professional Services, Subscription and Hosting Revenue

Professional services revenue primarily consists of consulting, implementation and training services for speech customers. Subscription and hosting revenue primarily relates to delivering hosted and on-site directory assistance and transcription and dictation services over a specified term. The following table shows professional services, subscription and hosting revenue in absolute dollars and as a percentage of total revenue (dollars in millions):

	Three Months Ended March 31,				Six Months Ended March 31,			
	2007	2006	Dollar Change	Percent Change	2007	2006	Dollar Change	Percent Change
Professional services, subscription and hosting revenue	$ 32.8	$ 15.4	$ 17.4	113%	$ 60.8	$ 30.0	$ 30.8	103%
As a percentage of total revenue	25%	22%			23%	20%		

The increase in professional services, subscription and hosting revenue for the three months ended March 31, 2007, as compared to the same period ended March 31, 2006, was primarily due to a $13.3 million increase in revenue attributable to our acquisition of Dictaphone. The remaining increase is primarily attributable to an increase in combined network and embedded consulting services.

The increase in professional services revenue for the six months ended March 31, 2007, as compared to the same period ended March 31, 2006, was primarily due to a $25.0 million increase in revenue attributable to our acquisition of Dictaphone. The remaining increase is primarily attributable to an increase in combined network and embedded consulting services.

Maintenance and Support Revenue

Maintenance and support revenue primarily consists of technical support and maintenance service for speech products including network, embedded and dictation and transcription products. The following table shows maintenance and support revenue in absolute dollars and as a percentage of total revenue (dollars in millions):

	Three Months Ended March 31,				Six Months Ended March 31,			
	2007	2006	Dollar Change	Percent Change	2007	2006	Dollar Change	Percent Change
Maintenance and support revenue	$ 28.9	$ 7.8	$ 21.1	271%	$ 58.6	$ 15.6	$ 43.0	276%
As a percentage of total revenue	22%	11%			22%	11%		

The increase in maintenance and support revenue for the three months ended March 31, 2007, as compared to the same period ended March 31, 2006, was primarily due to a $19.3 million increase in revenue attributable to the acquisition of Dictaphone, which has a significant number of maintenance and support contracts. The remaining $1.8 million increase in maintenance and support revenue is primarily attributable to an increase in network maintenance and support contracts.

The increase in maintenance and support revenue for the six months ended March 31, 2007, as compared to the same period ended March 31, 2006, was primarily due to a $38.9 million increase in revenue attributable to the

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acquisition of Dictaphone, which has a significant number of maintenance and support contracts. The remaining $4.1 million increase in maintenance and support revenue is primarily attributable to an increase in network maintenance and support contracts.

Cost of Product and Licensing Revenue

Cost of product and licensing revenue primarily consists of material and fulfillment costs, manufacturing and operations costs, third-party royalty expenses, and share-based payments. The following table shows cost of product and licensing revenue, in absolute dollars and as a percentage of product and licensing revenue (dollars in millions):

	Three Months Ended March 31,				Six Months Ended March 31,			
	2007	2006	Dollar Change	Percent Change	2007	2006	Dollar Change	Percent Change
Cost of product and licensing revenue	$ 12.1	$ 4.8	$ 7.3	152%	$ 22.3	$ 9.7	$ 12.6	130%
As a percentage of product and licensing revenue	17%	10%			15%	10%		

The increase in cost of product and licensing revenue for the three months ended March 31, 2007, as compared to the same period ended March 31, 2006, was primarily due to $5.8 million of costs attributable to the acquired Dictaphone business. As a percentage of product and licensing revenue, cost of revenue increased 7% for the three months ended March 31, 2007, as compared to the same period ended March 31, 2006. The increase was largely due to the higher cost of our Dictaphone healthcare products resulting from the inclusion of third party hardware in the solutions licensed to customers.

The increase in cost of product and licensing revenue for the six months ended March 31, 2007, as compared to the same period ended March 31, 2006, was primarily due to $10.1 million of costs attributable to the acquired Dictaphone business. As a percentage of product and licensing revenue, cost of revenue increased 5% for the six months ended March 31, 2007, as compared to the same period ended March 31, 2006. The increase was largely due to the higher cost of our Dictaphone healthcare products resulting from the inclusion of third party hardware in the solutions licensed to customers.

Cost of Professional Services, Subscription and Hosting Revenue

Cost of professional services, subscription and hosting revenue primarily consists of compensation for consulting personnel, outside consultants, overhead, and share-based payments, as well as the hardware and communications fees that support our subscription and hosted solutions. The following table shows cost of professional services, subscription and hosting revenue, in absolute dollars and as a percentage of professional services, subscription and hosting revenue (dollars in millions):

Three Months Ended March 31,				Six Months Ended March 31,			
2007	2006	Dollar Change	Percent Change	2007	2006	Dollar Change	Percent Change

Cost of professional services, subscription and hosting revenue	$ 22.6	$ 11.3	$ 11.3	100%	$ 43.1	$ 22.1	$ 21.0	95%
As a percentage of professional services, subscription and hosting revenue	69%	74%			71%	74%		

The increase in cost of professional services, subscription and hosting revenue for the three months ended March 31, 2007, as compared to the same period ended March 31, 2006, was primarily due to a $10.7 million increase in cost attributable to the acquisition of Dictaphone, which has a large subscription-based licensing and hosted application customer base.

The increase in cost of professional services, subscription and hosting revenue for the six months ended March 31, 2007, as compared to the same period ended March 31, 2006, was primarily due to a $21.2 million increase in cost attributable to the acquisition of Dictaphone, which has a large subscription-based licensing and hosted application customer base.

Cost of Maintenance and Support Revenue

Cost of maintenance and support revenue primarily consists of compensation for product support personnel and overhead, as well as share-based payments. The following table shows cost of maintenance and support revenue, in absolute dollars and as a percentage of maintenance and support revenue (dollars in millions):

	Three Months Ended March 31,				Six Months Ended March 31,			
	2007	2006	Dollar Change	Percent Change	2007	2006	Dollar Change	Percent Change
Cost of maintenance and support revenue	$ 6.6	$ 1.6	$ 5.0	313%	$ 13.5	$ 3.5	$ 10.0	286%
As a percentage of maintenance and support revenue	23%	21%			23%	23%		

The increase in cost of maintenance and support revenue for the three months ended March 31, 2007, as compared to the same period ended March 31, 2006, was primarily due to a $4.1 million increase in cost attributable to the acquisition of Dictaphone, which has a significant number of maintenance and support contracts.

The increase in cost of maintenance and support revenue for the six months ended March 31, 2007, as compared to the same period ended March 31, 2006, was primarily due to an $8.5 million increase in cost attributable to the acquisition of Dictaphone, which has a significant number of maintenance and support contracts.

Cost of Revenue from Amortization of Intangible Assets

Cost of revenue from amortization of intangible assets consists of the amortization of acquired patents and core and completed technology using the straight-line basis over their estimated useful lives. We evaluate the recoverability of intangible assets periodically or whenever events or changes in business circumstances indicate that the carrying value of our intangible assets may not be recoverable. The following table shows cost of revenue from amortization of intangible assets in absolute dollars and as a percentage of total revenue (dollars in millions):

	Three Months Ended March 31,				Six Months Ended March 31,			
	2007	2006	Dollar Change	Percent Change	2007	2006	Dollar Change	Percent Change
Cost of revenue from amortization of intangible assets	$ 3.0	$ 2.5	$ 0.5	20%	$ 5.8	$ 5.0	$ 0.8	16%

As a percentage of total revenue	2%	3%		2%	3%

The increase in amortization of other intangible assets for the three months ended March 31, 2007, as compared to the same period ended March 31, 2006, was attributable to a $0.9 million increase in the amortization of identifiable technology acquired in connection with our acquisitions of Dictaphone and MVC, net of a $0.4 million decrease in amortization expense related to a purchased technology that was written down to its net realizable value during the fourth quarter of fiscal 2006.

The increase in amortization of other intangible assets for the six months ended March 31, 2007, as compared to the same period ended March 31, 2006, was attributable to a $1.7 million increase in the amortization of identifiable technology acquired in connection with our acquisitions of Dictaphone and MVC, net of a $0.9 million decrease in amortization expense related to a purchased technology that was written down to its net realizable value during the fourth quarter of fiscal 2006.

Research and Development Expense

Research and development expense primarily consists of salaries and benefits, overhead, as well as share-based payments relating to our engineering staff. The following table shows research and development expense, in absolute dollars and as a percentage of total revenue (dollars in millions):

	Three Months Ended March 31,				Six Months Ended March 31,			
	2007	2006	Dollar Change	Percent Change	2007	2006	Dollar Change	Percent Change
Total research and development expense	$ 17.6	$ 12.9	$ 4.7	36%	$ 34.1	$ 25.1	$ 9.0	36%
As a percentage of total revenue	13%	18%			13%	17%		

The increase in research and development expense for the three months ended March 31, 2007, as compared to the same period ended March 31, 2006, was primarily due to a $2.5 million increase in compensation related expenses associated with increased average headcount of 55 employees, mainly resulting from our acquisition of Dictaphone. The remaining increase was due to a $1.1 million increase in outside contractor related expenses and a $1.1 million increase primarily due to headcount related expenses, including share-based payments, travel and infrastructure related expenses. While continuing to increase in absolute dollars, research and development expense decreased as a percentage of total revenue. This decrease primarily reflects synergies resulting from the integration of the research and development organizations of acquired businesses into our research and development organization.

The increase in research and development expense for the six months ended March 31, 2007, as compared to the same period ended March 31, 2006, was primarily due to a $4.9 million increase in compensation related expenses associated with increased average headcount of 42 employees mainly resulting from our acquisition of Dictaphone. The remaining increase was due to an increase of $2.3 million in outside contractor related expenses and a $1.8 million increase primarily due to other headcount related expenses, including share-based payments, travel and infrastructure related expenses. While continuing to increase in absolute dollars, research and development expense decreased as a percentage of total revenue. This decrease primarily reflects synergies resulting from the integration of the research and development organizations of acquired businesses into our research and development organization.

Sales and Marketing Expense

Sales and marketing expense includes salaries and benefits, share-based payments, commissions, advertising, direct mail, public relations, tradeshows and other costs of marketing programs, travel expenses associated with our sales organization and overhead. The following table shows sales and marketing expense in absolute dollars and as a percentage of total revenue (dollars in millions):

	Three Months Ended March 31,				Six Months Ended March 31,			
	2007	2006	Dollar Change	Percent Change	2007	2006	Dollar Change	Percent Change

Total sales and marketing expense	$ 41.9	$ 25.4	$ 16.5	65%	$ 85.7	$ 53.7	$ 32.0	60%
As a percentage of total revenue	32%	35%			32%	36%		

The increase in sales and marketing expense for the three months ended March 31, 2007, compared to the same period ended March 31, 2006, was primarily due to an increase of $11.0 million in compensation and headcount related expenses, including salaries and commissions, temporary employees, travel and infrastructure related expenses associated with increased average headcount of 144 sales employees and 28 marketing employees, mainly resulting from our acquisition of Dictaphone. The remaining increase was due to a $3.2 million increase in share-based payments and a $2.3 million increase in advertising and marketing spending for existing products as well as healthcare products for Dictaphone. While continuing to increase in absolute dollars, sales and marketing expense decreased relative to our total revenue. This decrease primarily reflects synergies resulting from the integration of the sales and marketing organizations of acquired businesses into our sales and marketing organization.

The increase in sales and marketing expense for the six months ended March 31, 2007, compared to the same period ended March 31, 2006, was primarily due to an increase of $21.8 million in compensation and headcount related expenses, including salaries and commissions, temporary employees, travel and infrastructure related expenses associated with increased average headcount of 132 sales employees and 24 marketing employees, mainly resulting from our acquisition of Dictaphone. The remaining increase was due to a $5.5 million increase in share-based payments and a $4.7 million increase in advertising and marketing spending for existing products as well as healthcare products for Dictaphone. While continuing to increase in absolute dollars, sales and marketing expense decreased relative to our total revenue. This decrease primarily reflects synergies resulting from the integration of the sales and marketing organizations of acquired businesses into our sales and marketing organization.

General and Administrative Expense

General and administrative expense primarily consists of personnel costs (including share-based payments and other overhead) for administration, finance, human resources, information systems, facilities and general management, fees for external professional advisors including accountants and attorneys, insurance, and provisions for doubtful accounts. The following table shows general and administrative expense in absolute dollars and as a percentage of total revenue (dollars in millions):

	Three Months Ended March 31,				Six Months Ended March 31,			
	2007	2006	Dollar Change	Percent Change	2007	2006	Dollar Change	Percent Change
Total general and administrative expense	$ 17.5	$ 10.9	$ 6.6	61%	$ 32.9	$ 25.6	$ 7.3	29%
As a percentage of total revenue	13%	15%			12%	17%		

The increase in general and administrative expense for the three months ended March 31, 2007, as compared to the same period ended March 31, 2006, was due primarily to an increase of $2.8 million in compensation related expense for increased headcount and external contractors, and an increase of $2.6 million in share-based payments. While general and administrative expense increased in absolute dollars, the expense decreased as a percent of total revenue. This decrease primarily reflects synergies resulting from the integration of the general and administrative organizations of acquired businesses into our general and administrative organization.

The increase in general and administrative expense for the six months ended March 31, 2007, as compared to the same period ended March 31, 2006 was due primarily to an increase of $4.4 million in share-based payments, and an increase of $3.9 million in compensation expense for increased headcount and external contractors. These increases were partially offset by a decrease of $1.8 million in legal and professional service fees. While general and administrative expense increased in absolute dollars, the expense decreased as a percent of total revenue. This decrease primarily reflects synergies resulting from the integration of the general and administrative organizations of acquired businesses into our general and administrative organization, as well as lower legal and professional service fees.

Amortization of Other Intangible Assets

Amortization of other intangible assets into operating expense includes amortization of acquired customer and contractual relationships, non-competition agreements and acquired trade names and trademarks. Customer relationships are amortized on an accelerated basis based upon the pattern in which the economic benefit of customer relationships are being utilized. Other identifiable intangible assets are amortized on a straight-line basis over their estimated useful lives. We evaluate these assets for impairment and for appropriateness of their remaining

life on an ongoing basis. The following table shows amortization of other intangible assets in absolute dollars and as a percentage of total revenue (dollars in millions):

	Three Months Ended March 31,				Six Months Ended March 31,			
	2007	2006	Dollar Change	Percent Change	2007	2006	Dollar Change	Percent Change
Total amortization and other intangible assets	$ 5.1	$ 2.0	$ 3.1	155%	$ 10.3	$ 4.0	$ 6.3	158%
As a percentage of total revenue	4%	3%			4%	3%		

The increase in amortization of other intangible assets for the three months ended March 31, 2007, as compared to the same period ended March 31, 2006, was attributable to the amortization of identifiable intangible assets acquired from our acquisition of Dictaphone on March 31, 2006.

The increase in amortization of other intangible assets for the six months ended March 31, 2007, as compared to the same period ended March 31, 2006, was primarily attributable to a $5.9 million increase in the amortization of identifiable intangible assets acquired from our acquisition of Dictaphone on March 31, 2006.

Restructuring and Other Charges (Credits), Net

Current activity charged against the restructuring accrual for the six months ended March 31, 2007 was as follows (dollars in millions):

	Facilities	Personnel	Total
Balance at September 30, 2006	$ 0.5	$ 0.4	$ 0.9
Cash payments and foreign exchange	(0.5)		(0.5)
Balance at March 31, 2007	$	$ 0.4	$ 0.4

The remaining personnel-related accrual as of March 31, 2007 is primarily composed of amounts due under a restructuring charge taken in the fourth quarter of fiscal 2005 which is expected to be paid during fiscal 2007.

Other Income (Expense), Net

The following table shows other income (expense), net in absolute dollars and as a percentage of total revenue (dollars in millions):

	Three Months Ended March 31,				Six Months Ended March 31,			
	2007	2006	Dollar Change	Percent Change	2007	2006	Dollar Change	Percent Change

Interest income	$ 1.3	$ 0.6	$ 0.7	117%	$ 2.7	$ 1.4	$ 1.3	93%
Interest expense	(7.5)	(0.8)	(6.7)	838%	(15.2)	(1.8)	(13.4)	744%
Other income (expense), net	(0.3)	(0.8)	0.5	63%	(0.9)	(0.8)	(0.1)	13%
Total other income (expense), net	$ (6.5)	$ (1.0)	$ (5.5)	550%	$ (13.4)	$ (1.2)	$ (12.2)	1017%
As a percentage of total revenue	(5)%	(1)%			(5)%	(1)%		

The increase in interest income was primarily due to higher cash balances and increased interest rates during the three and six month periods ended March 31, 2007, as compared to the same periods ended March 31, 2006. The increase in interest expense was mainly due to interest expense paid, as well as the amortization of debt issuance costs, associated with the credit facility we entered into on March 31, 2006. Other income (expense) principally consisted of foreign exchange gains (losses) as a result of the changes in foreign exchange rates on certain of our foreign subsidiaries whose operations are denominated in other than their local currencies, as well as the translation of certain of our intercompany balances.

Provision for Income Taxes

The following table shows the provision for income taxes in absolute dollars and the effective income tax rate (dollars in millions):

	Three Months Ended March 31,				Six Months Ended March 31,			
	2007	2006	Dollar Change	Percent Change	2007	2006	Dollar Change	Percent Change
Provision for income taxes	$ 1.0	$ 2.1	$ (1.1)	52%	$ 7.4	$ 4.4	$ 3.0	68%
Effective income tax rate	(149)%	304%			167%	(350)%		

The provision for income taxes includes provisions for current and deferred federal, state, and foreign taxes of approximately $0.9 million and $3.6 million for the three and six month periods ended March 31, 2007, respectively, and an increase in the valuation allowance of approximately $0.1 million and $3.7 million for the same periods, respectively.

The difference between our effective income tax rate and the federal statutory rate of 35% is due primarily to state income taxes, the disallowance for tax purposes of certain share-based compensation charges, and the increase in our valuation allowance with respect to certain deferred tax assets.

Valuation allowances have been established for our net deferred tax assets which we believe do not meet the more likely than not realization criteria established by SFAS 109, Accounting for Income Taxes. The U.S. deferred tax assets relate primarily to net operating loss and tax credit carryforwards (resulting both from business combinations and from operations). Deferred tax liabilities have been recorded that relate primarily to intangible assets established in connection with business combinations. Certain of these intangible assets have indefinite lives, and the resulting deferred tax liability associated with these assets is not allowed as an offset to our net deferred tax assets for purposes of determining the required amount of our valuation allowance. At March 31, 2007, the amount of deferred tax liability associated with certain goodwill and indefinite lived intangibles was approximately $19.5 million.

The utilization of deferred tax assets that were acquired in a business combination results in a reduction of our valuation allowance and an increase to goodwill. Our establishment of new deferred tax assets as a result of operating activities requires an increase in our valuation allowance and a corresponding increase to tax expense.

The tax provision also includes state and foreign tax expense as determined on a legal entity and tax jurisdiction basis.

LIQUIDITY AND CAPITAL RESOURCES

Cash and cash equivalents totaled $89.2 million as of March 31, 2007, a decrease of $23.1 million as compared to $112.3 million as of September 30, 2006. This decrease was composed of cash provided by operating activities of $61.3 million, offset by the net impact of cash used in investing of $66.9 million and financing activities of $17.3 million. Our working capital was $30.7 million at March 31, 2007 and our accumulated deficit was $193.1 million. In April 2007, we amended our 2006 Credit Agreement, and received additional net proceeds of

approximately $87.5 million from this amendment, we also consummated our acquisition of BeVocal in April 2007 and paid $15.0 million in cash, net of the estimated cash closing balance of BeVocal, to BeVocal s former shareholders. We do not expect our accumulated deficit will impact our future ability to operate given our strong cash and financial position.

Cash provided by operating activities

Cash provided by operating activities for the six months ended March 31, 2007 was $61.3 million, an increase of $47.0 million, or 329%, as compared to net cash provided by operating activities of $14.3 million for the six months ended March 31, 2006. The increase was primarily composed of $26.4 million, or 127%, relating to the net loss after adding back non-cash items such as depreciation and amortization, and share-based payments; in the six

months ended March 31, 2007, this amount was $47.1 million compared to $20.7 million in the comparable period in fiscal 2006.

Changes in working capital accounts in the fiscal 2007 period contributed an additional $20.7 million net increase to cash provided by operating activities. Notably included in the improved cash flows were: accounts receivable which changed by $11.6 million, having changed from a use of $3.3 million in the fiscal 2006 period to a source of $8.3 million in the fiscal 2007 period; and, accounts payable and accrued expenses which changed by $10.7 million in the comparative periods, having changed from a use of $8.6 million in the fiscal 2006 period to a source of $2.0 million in the fiscal 2007 period.

Cash used in investing activities

Cash used in investing activities for the six months ended March 31, 2007 was $66.9 million, as compared to net cash used in investing activities of $365.6 million for the six months ended March 31, 2006. The change in cash used in investing activities was primarily driven by the net cash paid for acquisitions in each period; in the fiscal 2006 period $376.8 million was paid, largely relating to the acquisition of Dictaphone, and in the fiscal 2007 period $59.1 million was paid, largely relating to the acquisition of Focus. In fiscal 2006, net proceeds of $17.0 million relating to net maturities of short-term investments partially offset the payments made for acquisitions, including the acquisition of Dictaphone.

Cash provided by (used in) financing activities

Cash used in financing activities for the six months ended March 31, 2007 was $17.3 million, as compared to net cash provided by financing activities of $350.2 million for the six months ended March 31, 2006. The change was composed primarily of the net receipts of $346.0 million on the 2006 Credit Facility. Our proceeds from stock option and other share-based employee benefit plans decreased in the comparable periods by $10.2 million, from $25.3 million in the fiscal 2006 period to $15.1 million in the fiscal 2007 period. Debt payments increased by $3.3 million in the fiscal 2007 period, due to payments made under the 2006 Credit Facility discussed above. Deferred payments on acquisitions increased by $4.2 million to $18.6 million in the fiscal 2007 period relating to our 2005 acquisitions of ART and Phonetic from $14.4 million in the fiscal 2006 period. Our repurchase of shares also contributed to increased cash outflows of $3.7 million in the fiscal 2007 period.

Credit Facility

On March 31, 2006 we entered into a senior secured credit facility, the 2006 Credit Facility. The 2006 Credit Facility consists of a $355.0 million, 7-year term loan which matures on March 31, 2013 and a $75.0 million revolving credit line which matures on March 31, 2012. The available revolving credit line capacity is reduced, as necessary, to account for letters of credit outstanding. As of March 31, 2007, there were $17.4 million of letters of credit issued under the revolving credit line and there were no outstanding borrowings under the revolving credit line.

Borrowings under the 2006 Credit Facility bear interest at a rate equal to the applicable margin plus, at our option, either (a) a 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 determined by reference to the British Bankers Association Interest Settlement Rates for deposits in U.S. dollars. The applicable margin for borrowings under the 2006 Credit Facility ranges from 0.50% to 1.00% per annum with respect to base rate borrowings and from 1.50% to 2.00% per annum with respect to LIBOR-based borrowings, depending upon our leverage ratio. As of March 31, 2007, our applicable margin was 1.00% for base rate borrowings and 2.00% for LIBOR-based borrowings. We are 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 our leverage ratio. As of March 31, 2007, our commitment fee rate was 0.375%.

We capitalized approximately $9.0 million in debt issuance costs related to the opening of the 2006 Credit Facility. The costs associated with the revolving credit facility are being amortized as interest expense over six years, through March 2012, while the costs associated with the term loan are being amortized as interest expense over seven years, through March 2013, which is the maturity date of the revolving line and term facility, respectively under the 2006 Credit Facility. The effective interest rate method is used to calculate the amortization of the debt

issuance costs for both the revolving credit facility and the term loan. These debt issuance costs, net of accumulated amortization of $1.3 million, are included in other assets in the consolidated balance sheet as of March 31, 2007.

The $355.0 million term loan is subject to repayment consisting of a baseline amortization of 1% per annum ($3.55 million per year, due in four equal quarterly installments), and an annual excess cash flow sweep, as defined in the 2006 Credit Facility, which will be first payable beginning in the first quarter of fiscal 2008, based on the excess cash flow generated in fiscal 2007. As of March 31, 2007, we have repaid $3.6 million of principal under the term loan agreement. Any borrowings not paid through the baseline repayment, the excess cash flow sweep, or any other mandatory or optional payments that we may make, will be repaid upon maturity. If only the baseline repayments are made, the aggregate annual maturities of the term loan would be as follows (in thousands):

Year Ending September 30,	Amount
2007 (April 1, 2007 to September 30, 2007)	$ 1,775
2008	3,550
2009	3,550
2010	3,550
2011	3,550
2012	3,550
Thereafter	331,925
Total	$ 351,450

Our obligations under the 2006 Credit Facility are unconditionally guaranteed by, subject to certain exceptions, each of our existing and future direct and indirect wholly-owned domestic subsidiaries. The 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 our domestic subsidiaries and 65% of the outstanding voting equity interests and 100% of the non-voting equity interests of first-tier foreign subsidiaries, material tangible and intangible assets, and present and future intercompany debt. The 2006 Credit Facility also contains provisions for mandatory prepayments of outstanding term loans, subject to certain exceptions, with: 100% of net cash proceeds of asset sales, 100% of net cash proceeds of issuance or incurrence of debt, and 100% of extraordinary receipts. We may voluntarily prepay the 2006 Credit Facility without premium or penalty other than customary breakage costs with respect to LIBOR-based loans.

The 2006 Credit Facility contains a number of covenants that, among other things, restrict, subject to certain exceptions, our ability to: incur additional indebtedness, create liens on assets, enter into certain sale and lease-back transactions, make investments, make certain acquisitions, sell assets, engage in mergers or consolidations, pay dividends and distributions or repurchase our capital stock, engage in certain transactions with affiliates, change the business conducted by us, amend certain charter documents and material agreements governing subordinated indebtedness, prepay other indebtedness, enter into agreements that restrict dividends from subsidiaries and enter into certain derivatives transactions. The 2006 Credit Facility is governed by financial covenants that include, but are not limited to, maximum total leverage and minimum interest coverage ratios, as well as to a maximum capital expenditures limitation. The 2006 Credit Facility also contains certain customary affirmative covenants and events of default. As of March 31, 2007, we were in compliance with the covenants.

On April 5, 2007, we amended our 2006 Credit Facility, and received additional net proceeds of approximately $87.5 million. The 2006 Credit Facility and the amendment provide for the amendment and restatement of our existing 7-year term facility and 6-year revolving credit facility (together, the Expanded 2006 Credit Facility). The

Expanded 2006 Credit Facility includes $90 million of additional term debt resulting in a $442 million term facility due in March 2013 and a $75 million revolving credit facility due in March 2012. The additional funds net of debt issuance costs received by us under the Expanded 2006 Credit Facility was used to fund the cash portion of the merger consideration for the Focus and BeVocal acquisitions. The Expanded 2006 Credit Facility contains customary covenants, including, among other things, covenants that in certain cases restrict our ability and that of our subsidiaries to incur additional indebtedness, create or permit liens on assets, enter into sale-leaseback transactions, make loans or investments, sell assets, make acquisitions, pay dividends, or repurchase stock.

We believe that cash flows from future operations in addition to cash and marketable securities on hand, will be sufficient to meet our working capital, investing, financing and contractual obligations, as they become due for the foreseeable future. We also believe that in the event future operating results are not as planned, that we could take actions, including restructuring actions and other cost reduction initiatives, to reduce operating expenses to levels which, in combination with expected future revenue, will continue to generate sufficient operating cash flow. In the event that these actions are not effective in generating operating cash flows we may be required to issue equity or debt securities on less than favorable terms.

Off-Balance Sheet Arrangements, Contractual Obligations, Contingent Liabilities and Commitments

Contractual Obligations

The following table outlines our contractual payment obligations as of March 31, 2007 (in millions):

	Payments Due by Period					
Contractual Obligations	**Total**	**Remaining Fiscal 2007**	**Fiscal 2008**	**Fiscal 2009 and 2010**	**Fiscal 2011 and 2012**	**Thereafter**
Term loan under credit facility	$ 351.5	$ 1.8	$ 3.6	$ 7.1	$ 7.1	$ 331.9
Lease obligations and other term loan:						
Capital leases and other term loan	1.6	0.6	0.6	0.4		
Operating leases	52.0	3.6	8.2	14.7	10.7	14.8
Other lease obligations associated with the closing of duplicate facilities related to restructurings and acquisitions(1)	5.8	0.8	1.6	2.0	1.1	0.3
Pension, minimum funding requirement(2)	6.9	0.9	1.6	3.4	1.0	
Purchase commitments(3)	4.1	4.1				
Other long-term liabilities assumed(4)	82.7	6.2	12.8	26.8	26.8	10.1
Total contractual cash obligations	$ 504.6	$ 18.0	$ 28.4	$ 54.4	$ 46.7	$ 357.1

(1) Obligations include contractual lease commitments related to a facility that was part of a 2005 restructuring plan. As of March 31, 2007, total gross lease obligations are $3.2 million and are included in the contractual obligations herein. The remaining obligations represent contractual lease commitments associated with the implemented plans to eliminate duplicate facilities in conjunction with our acquisition of Former Nuance during fiscal 2005 and our acquisition of Dictaphone during fiscal 2006, and have been included as liabilities in our consolidated balance sheet as part of purchase accounting. As of March 31, 2007, we have subleased two of the facilities to unrelated third parties with total sublease income of $4.1 million through fiscal 2013.

(2) Our U.K. pension plan has a minimum funding requirement of £859,900 (approximately $1,687 million based on the exchange rate at March 31, 2007) for each of the next 4 years, through fiscal 2011.

(3) These amounts include non-cancelable purchase commitments for inventory in the normal course of business to fulfill customers orders currently scheduled in our backlog.

(4) Obligations include assumed long-term liabilities relating to restructuring programs initiated by the predecessor companies prior to our acquisition of SpeechWorks International, Inc. in August 2003, and our acquisition of Former Nuance in September 2005. These restructuring programs related to the closing of two facilities with lease terms set to expire in 2016 and 2012, respectively. Total contractual obligations under these two leases are $82.7 million. As of March 31, 2007, we have sub-leased certain of the office space related to these two facilities to unrelated third parties. Total sublease income under contractual terms is expected to be $20.8 million, which ranges from $2.7 million to $2.9 million on an annualized basis through 2016.

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Contingent Liabilities and Commitments

In connection with our acquisition of Phonetic, we agreed to make contingent payments of up to $35.0 million upon the achievement of certain performance targets in accordance with the purchase agreement. On June 1, 2006, we notified the former shareholders of Phonetic that the performance targets for the first scheduled payment of up to $12.0 million were not achieved. The former shareholders of Phonetic have objected to this determination. We are currently in discussions with the former shareholders of Phonetic in regards to this matter.

In connection with our acquisition BeVocal, we agreed to make contingent payments of up to $60.0 million upon the achievement of certain performance objectives.

Financial Instruments

During fiscal 2006, we entered into an interest rate swap with a notional value of $100 million. The interest rate swap was entered into as a hedge of the 2006 Credit Facility to effectively change the characteristics of the interest rate without actually changing the debt instrument. At its inception, we documented the hedging relationship and determined that the hedge is perfectly effective and designated it as a cash flow hedge. The interest rate swap will hedge the variability of the cash flows caused by changes in U.S. dollar LIBOR interest rates. The swap was marked to market at each reporting date. The fair value of the swap at March 31, 2007 was $0.6 million which was included in other liabilities. Changes in the fair value of the cash flow hedge are reported in stockholders equity as a component of other comprehensive income.

Off-Balance Sheet Arrangements

Through March 31, 2007, we have not entered into any off balance sheet arrangements or transactions with unconsolidated entities or other persons.

RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In February 2007, the FASB issued SFAS 159, The Fair Value Option for Financial Assets and Financial Liabilities. SFAS No. 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 as of the beginning of an entity s first fiscal year beginning after November 15, 2007. Early adoption is permitted as of the beginning of the previous fiscal year, provided that the entity makes that choice in the first 120 days of that fiscal year. We are currently evaluating the impact, if any, that SFAS 159 may have on our consolidated financial statements.

In December 2006, the FASB issued EITF 00-19-2, Accounting for Registration Payment Arrangements. EITF 00-19-2 specifies that the contingent obligation to make future payments or otherwise transfer consideration under a registration payment arrangement, whether issued as a separate agreement or included as a provision of a financial instrument or other agreement, should be separately recognized and measured in accordance with FASB Statement No. 5, Accounting for Contingencies. For registration payment arrangements and financial instruments subject to those arrangements that were entered into prior to the issuance of EITF 00-19-2, this guidance shall be effective for financial statements issued for fiscal years beginning after December 15, 2006. We are evaluating the impact, if any, that EITF 00-19-2 may have on our consolidated financial statements.

In September 2006, the FASB issued SFAS 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements 87, 88, 106 and 132(R). SFAS 158 requires an employer to recognize the over-funded or under-funded status of a defined benefit postretirement plan (other than a multi-employer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. SFAS 158 also requires the measurement of defined benefit plan assets and obligations as of the date of the employer s fiscal year-end statement of financial position (with limited exceptions). Under SFAS 158, we are required to recognize the funded status of its defined benefit postretirement plan and to provide the required disclosures commencing as of September 30, 2007. The requirement to measure plan assets and benefit obligations as of the date of the

employer s fiscal year-end is effective for our fiscal year ended September 30, 2009. We are evaluating the impact that SFAS 158 will have on our consolidated financial statements.

In July 2006, the FASB issued Interpretation 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. FIN 48 is effective for our fiscal year beginning October 1, 2007. We are evaluating the effect that the adoption of FIN 48 will have on our consolidated financial statements.

Item 3. *Quantitative and Qualitative Disclosures about Market Risk*

We are exposed to market risk from changes in foreign currency exchange rates and interest rates, which could affect our operating results, financial position and cash flows. We manage our exposure to these market risks through our regular operating and financing activities and, when appropriate, through the use of derivative financial instruments.

Exchange Rate Sensitivity

We are exposed to changes in foreign currency exchange rates. Any foreign currency transaction, defined as a transaction denominated in a currency other than the U.S. dollar, will be reported in U.S. dollars at the applicable exchange rate. Assets and liabilities are translated into U.S. dollars at exchange rates in effect at the balance sheet date and income and expense items are translated at average rates for the period. The primary foreign currency denominated transactions include revenue and expenses and the resulting accounts receivable and accounts payable balances reflected on our balance sheet. Therefore, the change in the value of the U.S. dollar as compared to foreign currencies will have either a positive or negative effect on our financial position and results of operations. Historically, our primary exposure has related to transactions denominated in the Euro, British Pound, Canadian Dollar, Japanese Yen, Israeli New Shekel, Indian Rupee and Hungarian Forint.

Assuming a 10% appreciation or depreciation in foreign currency exchange rates from the quoted foreign currency exchange rates at March 31, 2007, such an appreciation or depreciation could have an adverse impact on our revenue, operating results or cash flows.

Interest Rate Sensitivity

We are exposed to interest rate risk as a result of our significant cash and cash equivalents, and the outstanding debt under the 2006 Credit Facility, as amended.

At March 31, 2007, we held approximately $89.2 million of cash and cash equivalents primarily consisting of cash and money-market funds. Due to the low current market yields and the short-term nature of our investments, a hypothetical change in market rates is not expected to have a material effect on the fair value of our portfolio or results of operations.

At March 31, 2007, our total outstanding debt balance exposed to variable interest rates was $351.5 million. To partially offset this variable interest rate exposure, we entered into a $100 million interest rate swap derivative contract. The interest rate swap is structured to offset period changes in the variable interest rate without changing the characteristics of the underlying debt instrument. A hypothetical change in market rates would have a significant impact on the interest expense and amounts payable relating to the $251.5 million of debt that is not offset by the interest rate swap; assuming a 1.0% change in interest rates, the interest expense would increase $2.5 million per

annum.

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Item 4. ***Controls and Procedures***

Evaluation of disclosure controls and procedures

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures (as required by Rule 13a-15(e) of the Exchange Act) as of the end of the period covered by this report. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures were effective to provide reasonable assurance that we record, process, summarize and report the information we must disclose in reports that we file or submit under the Securities Exchange Act of 1934, as amended, within the time periods specified in the Securities and Exchange Commission s rules and forms.

Changes in internal control over financial reporting

There was no change in our internal control over financial reporting (as defined in Rule 13a-15(f) of the Exchange Act) that occurred during the fiscal quarter covered by this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Part II. Other Information

Item 1. *Legal Proceedings*

This information is included in Note 14, Commitments and Contingencies, in the accompanying notes to consolidated financial statements is incorporated herein by reference from Item 1 of Part I hereof.

Item 1A. *Risk Factors*

You should carefully consider the risks described below when evaluating our company and when deciding whether to invest in our company. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties not presently known to us or that we do not currently believe are important to an investor may also harm our business operations. If any of the events, contingencies, circumstances or conditions described in the following risks actually occurs, our business, financial condition or our results of operations could be seriously harmed. If that happens, the trading price of our common stock could decline and you may lose part or all of the value of any of our shares held by you.

Risks Related to Our Business

Our operating results may fluctuate significantly from period to period, and this may cause our stock price to decline.

Our revenue and operating results have fluctuated in the past and we expect our revenue and operating results to continue to fluctuate in the future. Given this fluctuation, we believe that quarter to quarter comparisons of our revenue and operating results are not necessarily meaningful or an accurate indicator of our future performance. As a result, our results of operations may not meet the expectations of securities analysts or investors in the future. If this occurs, the price of our stock would likely decline. Factors that contribute to fluctuations in our operating results include the following:

- slowing sales by our distribution and fulfillment partners to their customers, which may place pressure on these partners to reduce purchases of our products;
- volume, timing and fulfillment of customer orders;
- our efforts to generate additional revenue from our portfolio of intellectual property;
- concentration of operations with one manufacturing partner and ability to control expenses related to the manufacture, packaging and shipping of our boxed software products;
- customers delaying their purchasing decisions in anticipation of new versions of our products;
- customers delaying, canceling or limiting their purchases as a result of the threat or results of terrorism;
- introduction of new products by us or our competitors;
- seasonality in purchasing patterns of our customers;

reduction in the prices of our products in response to competition or market conditions;

returns and allowance charges in excess of accrued amounts;

timing of significant marketing and sales promotions;

impairment charges against goodwill and other intangible assets;

write-offs of excess or obsolete inventory and accounts receivable that are not collectible;

increased expenditures incurred pursuing new product or market opportunities;

general economic trends as they affect retail and corporate sales; and

higher than anticipated costs related to fixed-price contracts with our customers.

Due to the foregoing factors, among others, our revenue and operating results are difficult to forecast. Our expense levels are based in significant part on our expectations of future revenue, and we may not be able to reduce our expenses quickly to respond to a shortfall in projected revenue. Therefore, our failure to meet revenue expectations would seriously harm our operating results, financial condition and cash flows.

We have grown, and may continue to grow, through acquisitions, which could dilute our existing shareholders and could involve substantial integration risks.

As part of our business strategy, we have in the past acquired, and expect to continue to acquire, other businesses and technologies. In connection with past acquisitions, we issued a substantial number of shares of our common stock as transaction consideration and also incurred significant debt to finance the cash consideration used for our acquisitions of Dictaphone Corporation, Focus and BeVocal. We may continue to issue equity securities for future acquisitions, which would dilute our existing stockholders, perhaps significantly depending on the terms of the acquisition. We may also incur additional debt in connection with future acquisitions, which, if available at all, may place additional restrictions on our ability to operate our business. Furthermore, our prior acquisitions required substantial integration and management efforts. Acquisitions of this nature involve a number of risks, including:

- difficulty in transitioning and integrating the operations and personnel of the acquired businesses, including different and complex accounting and financial reporting systems;
- potential disruption of our ongoing business and distraction of management;
- potential difficulty in successfully implementing, upgrading and deploying in a timely and effective manner new operational information systems and upgrades of our finance, accounting and product distribution systems;
- difficulty in incorporating acquired technology and rights into our products and technology;
- unanticipated expenses and delays in completing acquired development projects and technology integration;
- management of geographically remote units both in the United States and internationally;
- impairment of relationships with partners and customers;
- customers delaying purchases of our products pending resolution of product integration between our existing and our newly acquired products;
- entering markets or types of businesses in which we have limited experience; and
- potential loss of key employees of the acquired company.

As a result of these and other risks, we may not realize anticipated benefits from our acquisitions. Any failure to achieve these benefits or failure to successfully integrate acquired businesses and technologies could seriously harm our business.

Purchase accounting treatment of our acquisitions could decrease our net income in the foreseeable future, which could have a material and adverse effect on the market value of our common stock.

Under accounting principles generally accepted in the United States of America, we have accounted for our acquisitions using the purchase method of accounting. Under purchase accounting, we record the market value of our common stock or other form of consideration issued in connection with the acquisition and the amount of direct transaction costs as the cost of acquiring the company or business. We have allocated that cost to the individual assets acquired and liabilities assumed, including various identifiable intangible assets such as acquired technology, acquired trade names and acquired customer relationships based on their respective fair values. Intangible assets generally will be amortized over a five to ten year period. Goodwill and certain intangible assets with indefinite lives, are not subject to amortization but are subject to at least an annual impairment analysis, which may result in an impairment charge if the carrying value exceeds its implied fair value. As of March 31, 2007, we had identified intangible assets amounting to approximately $230.5 million and goodwill of approximately $750.8 million.

Our significant debt could adversely affect our financial health and prevent us from fulfilling our obligations under our credit facility.

We have a significant amount of debt. On April 5, 2007, we entered into an amended and restated credit facility which consists of a $442.0 million term loan due March 2013 and a $75.0 million revolving credit line due March 2012. As of April 30, 2007, $441.5 million remained outstanding under the term loan and there were no outstanding borrowings under the revolving credit line. Our debt level could have important consequences, for example it could:

- require us to use of a large portion of our cash flow to pay principal and interest on the credit facility, which will reduce the availability of our cash flow to fund working capital, capital expenditures, research and development expenditures and other business activities;
- restrict us from making strategic acquisitions or exploiting business opportunities;
- place us at a competitive disadvantage compared to our competitors that have less debt; and
- limit, along with the financial and other restrictive covenants in our debt, our ability to borrow additional funds, dispose of assets or pay cash dividends.

In addition, a substantial portion of our debt bears interest at variable rates. If market interest rates increase, our debt service requirements will increase, which would adversely affect our cash flow. While we have entered into an interest rate swap agreement limiting our exposure for a portion of our debt, such agreement does not offer complete protection from this risk.

We have a history of operating losses, and we may incur losses in the future, which may require us to raise additional capital on unfavorable terms.

We reported net losses of approximately $3.0 million for the six months ended March 31, 2007 and $22.9 million, $5.4 million and $9.4 million for fiscal years 2006, 2005 and 2004, respectively. We had an accumulated deficit of approximately $193.1 million at March 31, 2007. If we are unable to achieve and maintain profitability, the market price for our stock may decline, perhaps substantially. We cannot assure you that our revenue will grow or that we will achieve or maintain profitability in the future. If we do not achieve profitability, we may be required to raise additional capital to maintain or grow our operations. The terms of any additional capital, if available at all, may be highly dilutive to existing investors or contain other unfavorable terms, such as a high interest rate and restrictive covenants.

We depend on limited or sole source suppliers for critical components. The inability to obtain sufficient components as required, and under favorable purchase terms, would harm our business.

We are dependent on certain suppliers, including limited and sole source suppliers, to provide key components used in our products. We have experienced, and may continue to experience, delays in component deliveries, which in turn could cause delays in product shipments and require the redesign of certain products. In addition, if we are unable to procure necessary components under favorable purchase terms, including at favorable prices and with the order lead-times needed for the efficient and profitable operation of our business, our results of operations could suffer.

Speech technologies may not achieve widespread acceptance by businesses, which could limit our ability to grow our speech business.

We have invested and expect to continue to invest heavily in the acquisition, development and marketing of speech technologies. The market for speech technologies is relatively new and rapidly evolving. Our ability to increase revenue in the future depends in large measure on acceptance of speech technologies in general and our products in particular. The continued development of the market for our current and future speech solutions will also depend on the following factors:

- consumer demand for speech-enabled applications;
- development by third-party vendors of applications using speech technologies; and
- continuous improvement in speech technology.

Sales of our speech products would be harmed if the market for speech technologies does not continue to develop or develops more slowly than we expect, and, consequently, our business could be harmed and we may not recover the costs associated with our investment in our speech technologies.

The markets in which we operate are highly competitive and rapidly changing, and we may be unable to compete successfully.

There are a number of companies that develop or may develop products that compete in our targeted markets. The individual markets in which we compete are highly competitive, and are rapidly changing. Within imaging, we compete directly with ABBYY, Adobe, I.R.I.S. and NewSoft. Within speech, we compete with AT&T, Fonix, IBM, Microsoft and Philips. Within healthcare dictation and transcription, we compete with Philips Medical, Spheris and other smaller providers. In speech, some of our partners such as Avaya, Cisco, Edify, Genesys and Nortel develop and market products that can be considered substitutes for our solutions. In addition, a number of smaller companies in both speech and imaging produce technologies or products that are in some markets competitive with our solutions. Current and potential competitors have established, or may establish, cooperative relationships among themselves or with third parties to increase the ability of their technologies to address the needs of our prospective customers.

The competition in these markets could adversely affect our operating results by reducing the volume of the products we license or the prices we can charge. Some of our current or potential competitors, such as Adobe, IBM and Microsoft, have significantly greater financial, technical and marketing resources than we do. These competitors may be able to respond more rapidly than we can to new or emerging technologies or changes in customer requirements. They may also devote greater resources to the development, promotion and sale of their products than we do.

Some of our customers, such as IBM and Microsoft, have developed or acquired products or technologies that compete with our products and technologies. These customers may give higher priority to the sale of these competitive products or technologies. To the extent they do so, market acceptance and penetration of our products, and therefore our revenue, may be adversely affected.

Our success will depend substantially upon our ability to enhance our products and technologies and to develop and introduce, on a timely and cost-effective basis, new products and features that meet changing customer requirements and incorporate technological advancements. If we are unable to develop new products and enhance functionalities or technologies to adapt to these changes, or if we are unable to realize synergies among our acquired products and technologies, our business will suffer.

The failure to successfully maintain the adequacy of our system of internal control over financial reporting could have a material adverse impact on our ability to report our financial results in an accurate and timely manner.

Our management s assessment of the effectiveness of our internal control over financial reporting, as of September 30, 2005, identified a material weakness in our internal controls related to tax accounting, primarily as a result of a lack of necessary corporate accounting resources and ineffective execution of certain controls designed to prevent or detect actual or potential misstatements in the tax accounts. While we have taken remediation measures to correct this material weakness, which measures are more fully described in Item 9A of our Annual Report on Form 10-K/A, we cannot assure you that we will not have material weaknesses in our internal controls in the future. Any failure in the effectiveness of our system of internal control over financial reporting could have a material adverse impact on our ability to report our financial results in an accurate and timely manner.

A significant portion of our revenue and a significant portion of our research and development are conducted internationally. Our results could be harmed by economic, political, regulatory and other risks associated with

these international regions.

Because we license our products worldwide, our business is subject to risks associated with doing business internationally. We anticipate that revenue from international operations will continue to increase in the remainder of fiscal 2007. Reported international revenue, classified by the major geographic areas in which our customers are

located, represented approximately $63.1 million for the six months ended March 31, 2007 and approximately $100.2 million, $71.5 million and $39.4 million, for fiscal 2006, 2005 and 2004 respectively. Most of our international revenue is generated by sales in Europe and Asia. In addition, some of our products are developed and manufactured outside the United States. A significant portion of the development and manufacturing of our speech products are completed in Belgium, and a significant portion of our imaging research and development is conducted in Hungary. In connection with prior acquisitions we have added research and development resources in Aachen, Germany, Montreal, Canada and Tel Aviv, Israel. Accordingly, our future results could be harmed by a variety of factors associated with international sales and operations, including:

- changes in a specific country s or region s economic conditions;
- geopolitical turmoil, including terrorism and war;
- trade protection measures and import or export licensing requirements imposed by the United States or by other countries;
- compliance with foreign and domestic laws and regulations;
- negative consequences from changes in applicable tax laws;
- difficulties in staffing and managing operations in multiple locations in many countries;
- difficulties in collecting trade accounts receivable in other countries; and
- less effective protection of intellectual property.

We are exposed to fluctuations in foreign currency exchange rates.

Because we have international subsidiaries and distributors that operate and sell our products outside the United States, we are exposed to the risk of changes in foreign currency exchange rates or declining economic conditions in these countries. In certain circumstances, we have entered into forward exchange contracts to hedge against foreign currency fluctuations on intercompany balances with our foreign subsidiaries. We use these contracts to reduce our risk associated with exchange rate movements, as the gains or losses on these contracts are intended to offset any exchange rate losses or gains on the hedged transaction. We do not engage in foreign currency speculation. Hedges are designated and documented at the inception of the hedge and are evaluated for effectiveness monthly. Forward exchange contracts hedging firm commitments qualify for hedge accounting when they are designated as a hedge of the foreign currency exposure and they are effective in minimizing such exposure. With our increased international presence in a number of geographic locations and with international revenue projected to increase in the remainder of fiscal 2007, we are exposed to changes in foreign currencies including the Euro, British Pound, Canadian Dollar, Japanese Yen, Israeli New Shekel, Indian Rupee and the Hungarian Forint. Changes in the value of the Euro or other foreign currencies relative to the value of the U.S. dollar could adversely affect future revenue and operating results.

Impairment of our intangible assets could result in significant charges which would adversely impact our future operating results.

We have significant intangible assets, including goodwill and intangibles with indefinite lives, which are susceptible to valuation adjustments as a result of changes in various factors or conditions. The most significant intangible assets are patents and core technology, completed technology, customer relationships and trademarks. Customer relationships are amortized on an accelerated basis based upon the pattern in which the economic benefit of customer

relationships are being utilized. Other identifiable intangible assets are amortized on a straight-line basis over their estimated useful lives. We assess the potential impairment of identifiable intangible assets whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors which could trigger an impairment of such assets, include the following:

significant underperformance relative to historical or projected future operating results;

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

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- significant negative industry or economic trends;
- significant decline in our stock price for a sustained period; and
- a decline in our market capitalization below net book value.

Future adverse changes in these or other unforeseeable factors could result in an impairment charge that would impact our results of operations and financial position in the reporting period identified. As of March 31, 2007, we had identified intangible assets amounting to approximately $230.5 million and goodwill of approximately $750.8 million.

If we are unable to attract and retain key personnel, our business could be harmed.

If any of our key employees were to leave us, we could face substantial difficulty in hiring qualified successors and could experience a loss in productivity while any successor obtains the necessary training and experience. Our employment relationships are generally at-will and we have had key employees leave us in the past. We cannot assure you that one or more key employees will not leave us in the future. We intend to continue to hire additional highly qualified personnel, including software engineers and operational personnel, but we may not be able to attract, assimilate or retain qualified personnel in the future. Any failure to attract, integrate, motivate and retain these employees could harm our business.

Our medical transcription services may be subject to legal claims for failure to comply with laws governing the confidentiality of medical records.

Healthcare professionals who use our medical transcription services deliver to us health information about their patients including information that constitutes a record under applicable law that we may store on our computer systems. Numerous federal and state laws and regulations, the common law and contractual obligations govern collection, dissemination, use and confidentiality of patient-identifiable health information, including:

- state and federal privacy and confidentiality laws;
- our contracts with customers and partners;
- state laws regulating healthcare professionals;
- Medicaid laws; and
- the Health Insurance Portability and Accountability Act of 1996 and related rules proposed by the Health Care Financing Administration.

The Health Insurance Portability and Accountability Act of 1996 establishes elements including, but not limited to, federal privacy and security standards for the use and protection of protected health information. Any failure by us or by our personnel or partners to comply with applicable requirements may result in a material liability to us.

Although we have systems and policies in place for safeguarding protected health information from unauthorized disclosure, these systems and policies may not preclude claims against us for alleged violations of applicable requirements. There can be no assurance that we will not be subject to liability claims which could have a material adverse affect on our business, results of operations and financial condition.

Risks Related to Our Intellectual Property and Technology

Unauthorized use of our proprietary technology and intellectual property could adversely affect our business and results of operations.

Our success and competitive position depend in large part on our ability to obtain and maintain intellectual property rights protecting our products and services. We rely on a combination of patents, copyrights, trademarks, service marks, trade secrets, confidentiality provisions and licensing arrangements to establish and protect our intellectual property and proprietary rights. Unauthorized parties may attempt to copy aspects of our products or to obtain, license, sell or otherwise use information that we regard as proprietary. Policing unauthorized use of our

products is difficult and we may not be able to protect our technology from unauthorized use. Additionally, our competitors may independently develop technologies that are substantially the same or superior to ours and that do not infringe our rights. In these cases, we would be unable to prevent our competitors from selling or licensing these similar or superior technologies. In addition, the laws of some foreign countries do not protect our proprietary rights to the same extent as the laws of the United States. Although the source code for our proprietary software is protected both as a trade secret and as a copyrighted work, litigation may be necessary to enforce our intellectual property rights, to protect our trade secrets, to determine the validity and scope of the proprietary rights of others, or to defend against claims of infringement or invalidity. Litigation, regardless of the outcome, can be very expensive and can divert management efforts.

Third parties have claimed and may claim in the future that we are infringing their intellectual property, and we could be exposed to significant litigation or licensing expenses or be prevented from selling our products if such claims are successful.

From time to time, we are subject to claims that we or our customers may be infringing or contributing to the infringement of the intellectual property rights of others. We may be unaware of intellectual property rights of others that may cover some of our technologies and products. If it appears necessary or desirable, we may seek licenses for these intellectual property rights. However, we may not be able to obtain licenses from some or all claimants, the terms of any offered licenses may not be acceptable to us, and we may not be able to resolve disputes without litigation. Any litigation regarding intellectual property could be costly and time-consuming and could divert the attention of our management and key personnel from our business operations. In the event of a claim of intellectual property infringement, we may be required to enter into costly royalty or license agreements. Third parties claiming intellectual property infringement may be able to obtain injunctive or other equitable relief that could effectively block our ability to develop and sell our products.

On April 10, 2007, Disc Link Corporation (Disc Link) filed a patent infringement action against us in the United States District Court for the Eastern District of Texas. Damages are sought in an unspecified amount. In this lawsuit, Disc Link alleges that we infringe U.S. Patent No. 6,314,574, titled Information Distribution System. We are in the early stages of evaluating these claims and intend to defend the action vigorously.

On November 8, 2006, VoiceSignal Technologies, Inc. filed an action against us and eleven of our resellers in the United States District Court for the Western District of Pennsylvania claiming patent infringement. Damages were sought in an unspecified amount. In the lawsuit, VoiceSignal alleges that we are infringing United States Patent No. 5,855,000 which relates to improving correction in a dictation application based on a two input analysis. We believe these claims have no merit and intend to defend the action vigorously.

On May 31, 2006 GTX Corporation (GTX), filed an action against us 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 we are infringing United States Patent No. 7,016,536 entitled Method and Apparatus for Automatic Cleaning and Enhancing of Scanned Documents. We believe these claims have no merit and intend to defend the action vigorously.

On November 27, 2002, AllVoice Computing plc (AllVoice) filed an action against us in the United States District Court for the Southern District of Texas claiming patent infringement. In the lawsuit, AllVoice alleges that we are 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 we have several products in the speech recognition technology field, we believe that our 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. We 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 Nuance on February 21, 2006. AllVoice filed a notice of appeal from this judgment on April 26, 2006. We believe these claims have no merit and intend to defend the action vigorously.

We believe that the final outcome of the current litigation matters described above will not have a significant adverse effect on our financial position and results of operations. However, even if our defense is successful, the

litigation could require significant management time and could be costly. Should we not prevail in these litigation matters, we may be unable to sell and/or license certain of our technologies we consider to be proprietary, and our operating results, financial position and cash flows could be adversely impacted.

Our software products may have bugs, which could result in delayed or lost revenue, expensive correction, liability to our customers and claims against us.

Complex software products such as ours may contain errors, defects or bugs. Defects in the solutions or products that we develop and sell to our customers could require expensive corrections and result in delayed or lost revenue, adverse customer reaction and negative publicity about us or our products and services. Customers who are not satisfied with any of our products may also bring claims against us for damages, which, even if unsuccessful, would likely be time-consuming to defend, and could result in costly litigation and payment of damages. Such claims could harm our reputation, financial results and competitive position.

Risks Related to Our Corporate Structure, Organization and Common Stock

The holdings of our two largest stockholders may enable them to influence matters requiring stockholder approval.

On March 19, 2004, Warburg Pincus, a global private equity firm agreed to purchase all outstanding shares of our stock held by Xerox Corporation for approximately $80 million. Additionally, on May 9, 2005 and September 15, 2005 we sold shares of common stock, and warrants to purchase common stock to Warburg Pincus for aggregate gross proceeds of approximately $75.1 million. As of March 31, 2007, Warburg Pincus beneficially owned approximately 23% of our outstanding common stock, including warrants exercisable for up to 7,066,538 shares of our common stock and 3,562,238 shares of our outstanding Series B Preferred Stock, each of which is convertible into one share of our common stock. Friess Associates LLC. is our second largest stockholder, owning approximately 5% of our common stock as of March 31, 2007. Because of their large holdings of our capital stock relative to other stockholders, each of these two stockholders acting individually, or together, have a strong influence over matters requiring approval by our stockholders.

The market price of our common stock has been and may continue to be subject to wide fluctuations.

Our stock price historically has been, and may continue to be, volatile. Various factors contribute to the volatility of our stock price, including, for example, quarterly variations in our financial results, new product introductions by us or our competitors and general economic and market conditions. While we cannot predict the individual effect that these factors may have on the market price of our common stock, these factors, either individually or in the aggregate, could result in significant volatility in our stock price during any given period of time. Moreover, companies that have experienced volatility in the market price of their stock often are subject to securities class action litigation. If we were the subject of such litigation, it could result in substantial costs and divert management s attention and resources.

Compliance with changing regulation of corporate governance and public disclosure may result in additional expenses.

Changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new regulations promulgated by the Securities and Exchange Commission and the rules of the NASDAQ Global Select Market, are resulting in increased general and administrative expenses for companies such as ours. These new or changed laws, regulations and standards are subject to varying interpretations in many cases, and as a result, their application in practice may evolve over time as new guidance is provided by regulatory and governing bodies, which could result in higher costs necessitated by ongoing revisions to disclosure and governance practices. We are committed to maintaining high standards of corporate governance and public disclosure.

As a result, we intend to invest resources to comply with evolving laws, regulations and standards, and this investment may result in increased general and administrative expenses and a diversion of management time and attention from revenue-generating activities to compliance activities. If our efforts to comply with new or

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changed laws, regulations and standards differ from the activities intended by regulatory or governing bodies, our business may be harmed.

We have implemented anti-takeover provisions, which could discourage or prevent a takeover, even if an acquisition would be beneficial to our stockholders.

Provisions of our certificate of incorporation, bylaws and Delaware law, as well as other organizational documents could make it more difficult for a third party to acquire us, even if doing so would be beneficial to our stockholders. These provisions include:

- authorized blank check preferred stock;
- prohibiting cumulative voting in the election of directors;
- limiting the ability of stockholders to call special meetings of stockholders;
- requiring all stockholder actions to be taken at meetings of our stockholders; and
- establishing advance notice requirements for nominations of directors and for stockholder proposals.

Item 2. ***Unregistered Sales of Equity Securities and Use of Proceeds***

(c)

We have not publicly announced any currently effective authorization to repurchase shares of our common stock. However, following our acquisition of Mobile Voice Control, Inc. we agreed to repurchase a portion of the shares issued to the former shareholders of Mobile Voice Control, Inc. as consideration in the transaction. The following table summarizes the repurchases of our common stock during the quarter ended March 31, 2007:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares that May Yet be Purchased Under the Plans or Programs
January 1, 2007 through January 31, 2007	261,422	$ 12.16		
February 1, 2007 through February 28, 2007				
March 1, 2007 through March 31, 2007				
Total	261,422	$ 12.16		

Item 3. ***Defaults Upon Senior Securities***

None.

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

On March 22, 2007, we held our annual meeting of stockholders. At that meeting the following actions were voted upon:

(a) To elect a Board of nine (9) directors to hold office until the next annual meeting of stockholders or until their respective successors have been elected and qualified:

Director	Votes For	Votes Withheld
Paul A. Ricci	155,120,794	3,050,455
Charles W. Berger	146,393,058	11,778,191
Robert J. Frankenberg	148,312,822	9,858,427
Jeffrey A. Harris	156,759,460	1,411,789
William H. Janeway	156,606,431	1,564,818
Katharine A. Martin	146,399,522	11,771,727
Mark B. Myers	157,014,532	1,156,717
Philip J. Quigley	157,026,084	1,145,165
Robert G. Teresi	155,529,670	2,641,579

(b) To approve the amended and restated 2000 Stock Plan:

Votes For	Votes Against	Abstained	Broker Non-Votes
89,362,966	17,910,473	250,519	50,647,291

(c) To approve an amendment to our certificate of incorporation to increase the number of shares of common stock we are authorized to issue from 280 million shares to 560 million shares:

Votes For	Votes Against	Abstained	Broker Non-Votes
141,793,99	16,114,478	262,772	

(d) To ratify the appointment of BDO Seidman, LLP as the Company s independent registered public accounting firm for the fiscal year ending September 30, 2007:

Votes For	Votes Against	Abstained	Broker Non-Votes
157,445,900	555,067	170,282	

Item 5. ***Other Information***

None.

Item 6. ***Exhibits***

The exhibits listed on the Exhibit Index hereto are filed or incorporated by reference (as stated therein) as part of this Quarterly Report on Form 10-Q.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this Quarterly Report on Form 10-Q to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Burlington, Commonwealth of Massachusetts, on May 10, 2007.

Nuance Communications, Inc.

By: /s/ James R. Arnold, Jr.

James R. Arnold, Jr.
Chief Financial Officer

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EXHIBIT INDEX

Exhibit Number	Exhibit Description	Incorporated by Reference				Filed Herewith
		Form	File No.	Exhibit	Filing Date	
2.1	Agreement and Plan of Merger by and among Nuance Communications, Inc., Beryllium Acquisition Corporation, Beryllium Acquisition LLC and BeVocal, Inc. dated as of February 21, 2007.	8-K	0-27038	2.1	2/27/2007	
2.2	Share Purchase Agreement dated March 13, 2007 by and among Nuance Communications, Inc., Bethany Advisors Inc., Focus Softek India (Private) Limited and U.S. Bank National Association, as Escrow Agent.	8-K	0-27038	2.1	3/22/2007	
2.3	Agreement and Plan of Merger by and among Nuance Communications, Inc., Phoenix Merger Sub, Inc. and Dictaphone Corporation dated as of February 7, 2006.	8-K	0-27038	2.1	2/9/2006	
3.1	Amended and Restated Certificate of Incorporation of the Registrant.	10-Q	0-27038	3.2	5/11/2001	
3.2	Certificate of Amendment of the Amended and Restated Certificate of Incorporation of the Registrant.	10-Q	0-27038	3.1	8/9/2004	
3.3	Certificate of Ownership and Merger.	8-K	0-27038	3.1	10/19/2005	
3.4	Certificate of Amendment of the Amended and Restated Certificate of Incorporation of the Registrant.	S-8	333-142182	3.3	4/18/2007	
3.5	Amended and Restated Bylaws of the Registrant.	10-K	0-27038	3.2	3/15/2004	
10.1*	Amended and Restated 2000 Stock Plan	8-K	0-27038	10.1	3/28/2007	
10.2	Amended and Restated Credit Agreement dated as of April 5, 2007, among Nuance Communications, Inc., the Lenders party thereto from time to time, UBS AG, Stamford Branch,	8-K	0-27038	10.1	4/10/2007	

as administrative agent, Citicorp North America, Inc., as syndication agent, Credit Suisse Securities (USA) LLC, as documentation agent, Citigroup Global Markets Inc. and UBS Securities LLC, as joint lead arrangers, Credit Suisse Securities (USA) LLC and Banc Of America Securities LLC, as co-arrangers, and Citigroup Global Markets INC., UBS Securities LLC and Credit Suisse Securities (USA) LLC, as joint bookrunners.

Exhibit Number	Exhibit Description	Incorporated by Reference Form	File No.	Exhibit	Filing Date	Filed Herewith
10.3	Amendment Agreement, dated as of April 5, 2007, among Nuance, UBS AG, Stamford Branch, as administrative agent, Citicorp North America, INC., as syndication agent, Credit Suisse Securities (USA) LLC, as documentation agent, the Lenders, Citigroup Global Markets Inc. and UBS Securities LLC, as joint lead arrangers and joint bookrunners, Credit Suisse Securities (USA) LLC, as joint bookrunner and co-arranger, and Banc Of America Securities LLC, as co-arranger.	8-K	0-27038	10.2	4/10/2007	
31.1	Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) or 15d-14(a).					X
31.2	Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) or 15d-14(a).					X
32.1	Certification Pursuant to 18 U.S.C. Section 1350.					X

* Denotes management compensatory plan of arrangement.