

Nuance Communications, Inc.

Form 10-K

November 29, 2007

Table of Contents

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

Form 10-K

(Mark One)

- ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended September 30, 2007**
- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to**

Commission file number 0-27038

NUANCE COMMUNICATIONS, INC.
(Exact name of Registrant as Specified in its Charter)

Delaware
*(State or Other Jurisdiction of
Incorporation or Organization)*

94-3156479
*(I.R.S. Employer
Identification No.)*

1 Wayside Road
Burlington, Massachusetts
(Address of Principal Executive Offices)

01803
(Zip Code)

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

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:
None

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:
Common Stock, par value \$0.001 per share

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

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

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

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

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 Accelerated filer Non-accelerated filer

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

The aggregate market value of the outstanding common equity held by non-affiliates of the Registrant as of the last business day of the Registrant's most recently completed second fiscal quarter was approximately \$2,168,279,194 based upon the last reported sales price on the Nasdaq National Market for such date. For purposes of this disclosure, shares of Common Stock held by officers and directors of the Registrant and by persons who hold more than 5% of the outstanding Common Stock have been excluded because such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily conclusive.

The number of shares of the Registrant's Common Stock, outstanding as of October 31, 2007, was 193,459,481.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's definitive Proxy Statement to be delivered to stockholders in connection with the Registrant's 2008 Annual Meeting of Stockholders are incorporated by reference into Part III of this Form 10-K.

NUANCE COMMUNICATIONS, INC.

TABLE OF CONTENTS

Page

PART I

<u>Item 1.</u>	<i><u>Business</u></i>	1
<u>Item 1A.</u>	<i><u>Risk Factors</u></i>	9
<u>Item 1B.</u>	<i><u>Unresolved Staff Comments</u></i>	18
<u>Item 2.</u>	<i><u>Properties</u></i>	19
<u>Item 3.</u>	<i><u>Legal Proceedings</u></i>	19
<u>Item 4.</u>	<i><u>Submission of Matters to a Vote of Security Holders</u></i>	21

PART II

<u>Item 5.</u>	<i><u>Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u></i>	21
<u>Item 6.</u>	<i><u>Selected Consolidated Financial Data</u></i>	22
<u>Item 7.</u>	<i><u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u></i>	23
<u>Item 7A.</u>	<i><u>Quantitative and Qualitative Disclosures about Market Risk</u></i>	48
<u>Item 8.</u>	<i><u>Financial Statements and Supplementary Data</u></i>	49
<u>Item 9.</u>	<i><u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u></i>	114
<u>Item 9A.</u>	<i><u>Controls and Procedures</u></i>	114
<u>Item 9B.</u>	<i><u>Other Information</u></i>	115

PART III

<u>Item 10.</u>	<i><u>Directors and Executive Officers of the Registrant</u></i>	115
<u>Item 11.</u>	<i><u>Executive Compensation</u></i>	116
<u>Item 12.</u>	<i><u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u></i>	116
<u>Item 13.</u>	<i><u>Certain Relationships and Related Transactions</u></i>	116
<u>Item 14.</u>	<i><u>Principal Accountant Fees and Services</u></i>	116

PART IV

<u>Item 15.</u>	<i><u>Exhibits and Financial Statement Schedules</u></i>	116
-----------------	---	-----

<u>Ex-21.1</u>	Subsidiaries of the Registrant
<u>Ex-23.1</u>	Consent of BDO Seidman, LLP
<u>Ex-31.1</u>	Section 302 Certification of CEO
<u>Ex-31.2</u>	Section 302 Certification of CFO
<u>Ex-32.1</u>	Section 906 Certification of CEO & CFO

Table of Contents

PART I

This Annual Report on Form 10-K contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 that involve risks, uncertainties and assumptions that, if they never materialize or if they prove incorrect, could cause our results to differ materially from those expressed or implied by such forward-looking statements. All statements other than statements of historical fact are statements that could be deemed forward-looking, including statements pertaining to: our revenue, earnings, cash flows and liquidity; 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; international operations and localized versions of our products; our contractual commitments; our fiscal 2008 revenue and expense expectations 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, or other 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 as a result of various factors, including those set forth in this Annual Report under the heading Risk Factors. All forward-looking statements included in this document are based on information available to us on the date hereof. We will not undertake and specifically decline any obligation to update any forward-looking statements.

Item 1. Business

Overview

Nuance Communications, Inc. is a leading provider of speech-based solutions for businesses and consumers worldwide. Our speech solutions are designed to transform the way people interact with information systems, mobile devices and services. We have designed our solutions to make the user experience more compelling, convenient, safe and satisfying; unlocking the full potential of these systems, devices and services.

The vast improvements in the power and features of information systems and mobile devices have increased their complexity and reduced their ease of use. Many of the systems, devices and services designed to make our lives easier are cumbersome to use, involving complex touch-tone menus in call centers, counterintuitive and inconsistent user interfaces on computers and mobile devices, inefficient manual processes for transcribing medical records and automobile dashboards overrun with buttons and dials. These complex interfaces often limit the ability of the average user to take full advantage of the functionality and convenience offered by these products and services. By using the spoken word, our speech solutions help people naturally obtain information, interact with mobile devices and access services such as navigation, online banking and medical transcription.

We provide speech solutions to several rapidly growing markets:

Enterprise Speech. We deliver a portfolio of speech-enabled customer care solutions that improve the quality and consistency of customer communications. Our solutions are used to automate a wide range of customer services and business processes in a variety of information and process-intensive vertical markets such as telecommunications, financial services, travel and entertainment, and government.

Mobility. Our mobile speech solutions add voice control capabilities to mobile devices and services, allowing people to use spoken words or commands to dial a mobile phone, enter destination information into an automotive navigation system, dictate a text message or have emails and screen information read aloud. Our mobile solutions are used by many of the world's leading mobile device and automotive manufacturers.

Healthcare Dictation and Transcription. We provide comprehensive dictation and transcription solutions and services that improve the way patient data is captured, processed and used. Our healthcare dictation and transcription solutions automate the input and management of medical information and are used by many of the largest hospitals in the United States.

Table of Contents

In addition to our speech offerings, we provide PDF and document solutions that reduce the time and cost associated with creating, using and sharing documents. Our solutions benefit from the widespread adoption of the PDF format and the increasing demand for networked solutions for managing electronic documents. Our solutions are used by millions of professionals and within large enterprises.

We leverage our global professional services organization and our extensive network of partners to design and deploy innovative speech and imaging solutions for businesses and organizations around the globe. We market and distribute our products indirectly through a global network of resellers, including system integrators, independent software vendors, value-added resellers, hardware vendors, telecommunications carriers and distributors, and directly through our dedicated sales force and through our e-commerce website.

We have built a world-class portfolio of speech solutions through both internal development and acquisitions. We expect to continue to pursue opportunities to broaden our solutions and customer base through acquisitions. Our recently completed transactions include:

On November 26, 2007, we acquired Viacore, Inc., a consulting and systems integration firm. The Viacore acquisition expands our professional services capabilities and complements our existing partnerships, allowing us to deliver end-to-end speech solutions and system integration for speech-enabled customer care in key vertical markets including financial services, telecommunications, healthcare, utilities and government.

On November 2, 2007, we acquired Vocada, Inc., a provider of software and services for managing critical medical test results. The Vocada acquisition allows us to broaden the capabilities of our Dictaphone Healthcare solutions for the medical imaging industry, enhance our domain expertise within diagnostic specialties (including radiology, laboratory tests, pathology and cardiology), and increase our recurring revenue base derived from a software-as-a-service business model.

On September 28, 2007, we acquired Commissure Inc., a provider of speech-enabled radiology workflow optimization and data analysis solutions. The Commissure acquisition enhances the capabilities of our Dictaphone Healthcare solutions for the medical imaging industry, extends our domain expertise in the radiology market and increases our recurring revenue base derived from a term-based license model.

On August 24, 2007, we acquired Voice Signal Technologies, Inc., a global provider of speech technology for mobile devices. The VoiceSignal acquisition enhances our solutions and expertise to address the accelerating demand for speech-enabled mobile devices and services that allow people to use spoken commands to simply and effectively navigate and retrieve information and to control and operate mobile phones.

On August 24, 2007, we acquired Tegic Communications, Inc., a wholly owned subsidiary of AOL LLC and a developer of embedded software for mobile devices. The Tegic acquisition expands our presence in the mobile device industry and accelerates the delivery of a new mobile user interface that combines voice, text and touch to improve the user experience for consumers and mobile professionals.

On April 24, 2007, we acquired BeVocal, Inc., a provider of hosted self-service customer care solutions that address business requirements of wireless carriers and their customers. The BeVocal acquisition provides us with a portfolio of applications that serve the needs of wireless carriers and their customers and a recurring revenue base derived from a software-as-a-service business model.

On March 26, 2007, we acquired Focus Enterprises Limited, a leading healthcare transcription company. The Focus acquisition complements our Dictaphone iChart Web-based transcription solutions and expands our

ability to deliver Web-based speech recognition solutions and to provide scalable Internet delivery of automated transcription.

On December 29, 2006, we acquired Mobile Voice Control, Inc. a provider of speech-enabled mobile search and messaging services. The Mobile Voice Control acquisition further accelerates our deployment of speech-enabled solutions in the wireless industry.

Table of Contents

Market Opportunity

Confronted by dramatic increases in electronic information, consumers, business personnel and healthcare professionals must use a variety of resources to retrieve information, transcribe patient records, conduct transactions and perform other job-related functions. We believe that the power of the spoken word will transform the way people use the Internet, telecommunications systems, wireless and mobile networks and related corporate infrastructure to conduct business. We believe that several key market trends will enhance our market position and create new business opportunities:

More than 90% of all customer service interactions begin with a phone call. With personnel expenditures representing approximately 75% of call center budgets, our solutions automate customer interactions to deliver significant cost savings to call centers that must reduce expenses and improve customer service to remain competitive.

With 80% of consumers reporting that quality of service is extremely or very influential, and with only 40% of consumers reporting that they were satisfied with their customer service experiences, customer care operations must address these challenges. Our speech-based solutions have significant advantages over more traditional automation capabilities using touchtone menus and are recognized for ease of use, clarity, speed of transaction and completeness of service.

Consumers in North America make approximately 6.1 billion calls to directory assistance each year. The emergence of new directory assistance business models such as free directory assistance services is expected to generate 1.5 billion calls per year. We provide tailored speech recognition solutions for this industry.

Mobile handset shipments are expected to reach 1.1 billion units in 2007, which represents approximately 12% growth over shipments in 2006. We provide an intuitive user interface based on voice commands that helps unlock the rich feature sets of mobile devices and services, thereby improving the customer experience.

Currently there are approximately 20 million users of wireless email globally and the number of users is expected to reach 350 million users by 2010. Our speech enabled mobile solutions provide a natural way to interact with wireless email services.

Approximately \$12 billion is spent annually in North America on both in-house and outsourced medical transcription labor. Our healthcare dictation solutions reduce the cost of manual transcription while improving turnaround time and accuracy.

On average, an organization of 1,000 employees spends \$5.7 million each year on reformatting and recreating documents from multiple sources. Our PDF and document conversion and management solutions enable businesses to more efficiently create, manage and share documents.

Nuance Solutions

Our speech solutions enable enterprises, professionals and consumers to increase productivity, reduce costs and save time by using voice control to improve the user experience. Our imaging solutions build on decades of experience and technology development to deliver businesses, manufacturers and consumers a broad set of PDF and document offerings. We provide a broad set of speech and imaging offerings to our customers in the following areas:

Enterprise Speech

To remain competitive, organizations must improve the quality of customer care while reducing costs and ensuring a positive customer experience. Technological innovation, competitive pressures and rapid commoditization have made it increasingly difficult for organizations to achieve enduring market differentiation or to secure customer loyalty. In this environment, organizations need to satisfy the expectations of increasingly savvy and mobile consumers who demand high levels of customer service. This increase in consumer expectations necessitates a change in the way organizations approach customer care and respond to customer needs.

Table of Contents

We deliver a portfolio of customer service and business intelligence solutions enabled by speech that are designed to help companies better support, understand and communicate with their customers. Our solutions improve the customer experience, increase the use of self-service and enable new revenue opportunities. We also offer business intelligence solutions, which allow companies to draw knowledge from their customer care interactions to improve overall business performance.

Our portfolio of enterprise speech solutions includes:

Customer Self Service. Our self-service solutions help companies improve the user experience, reduce costs through increased use of self-service solutions and create new revenue opportunities. Our solutions support applications such as flight information, personal banking, equipment repair and claims processing.

Voice-Driven Call Steering. Unlike touchtone systems that use complex menus that may lead to misrouted calls and poor customer experiences, our call steering solutions allow customers to describe their needs in their own words to navigate automated customer care systems, enabling organizations to direct inbound calls more accurately, more efficiently, and with higher caller satisfaction.

Authentication. Our voice authentication software enables businesses to provide secure access to sensitive information over the telephone, unobtrusively confirming a caller's identity using the unique characteristics of each voice, thereby providing enterprises a powerful defense against fraudulent activity.

Auto Attendant. Our auto attendant application, a natural speech-enabled turnkey solution, allows callers to speak the name of a person, department, service or location and be automatically transferred to the requested party, without the hassle of searching for phone numbers or waiting to speak to an operator.

Analytics. Our business intelligence solutions help enterprises draw knowledge from customer interactions. Powered by specialized customer behavior intelligence software, we offer tools and services that deliver fact-based insight about who is calling, why they are calling, and the quality of the caller experience.

We license our solutions to a wide variety of enterprises in customer-service intensive sectors, including telecommunications, financial services, travel and entertainment, and government, where customers include AOL, AT&T, Comcast, Charles Schwab and United Health. Our speech solutions are designed to serve our global partners and customers and are available in up to 49 languages and dialects worldwide. Although in certain cases we sell directly to end users, the majority of our solutions are fulfilled through our channel network that includes providers such as Avaya, Cisco, Genesys, Intervoice and Nortel, that integrate our solutions into their hardware and software platforms.

We complement our solutions and products with a global professional services organization that supports customers and partners with business and systems consulting project management, user-interface design, speech science, application development, and business performance optimization. Our acquisition of BeVocal expanded our existing product portfolio with a unique set of solutions for lifecycle management of customers of wireless carriers and a range of premium services for the wireless consumer, such as the Web and Short Message Service (SMS). The BeVocal acquisition also added numerous wireless carrier relationships to our network. Our recent acquisition of Viecore expands our professional services capabilities and complements our existing partnerships, allowing us to deliver end-to-end speech solutions and system integration for speech-enabled customer care in key vertical markets including financial services, telecommunications, healthcare, utilities and government.

Mobility

Today, an increasing number of people worldwide rely on mobile devices to stay connected, informed and productive. We see an expanding opportunity in helping consumers use the powerful capabilities of their phones, cars and personal navigation devices by using voice commands to control these devices and to access the array of content and services available on the Internet through wireless mobile devices. We expect to serve more than one billion consumers within the next three years with voice-based mobile solutions that allow them to simply and effectively navigate and retrieve information and conduct transactions using these devices.

Table of Contents

We offer solutions and expertise that help satisfy the accelerating demand for speech-enabled mobile devices and services. Our portfolio of mobile solutions includes:

Voice Search. Our voice search solutions allow users to quickly search local information databases such as business listings, yellow pages, restaurant guides and movie schedules, by naturally speaking their requests through a speech-enabled search interface that simplifies search capabilities and increases usage.

Voice-Activated Dialing. Our voice-activated dialing allows users to call anyone with just one command, avoiding the need to navigate complex menus and sort through an extensive list of contacts.

Voice Control. Offered on a subscription basis through wireless carriers, our Nuance Voice Control service lets mobile consumers use their voice to dictate and send email or text messages, create calendar entries, dial a contact, and search the Web for business listings, news, weather, stock quotes, sport scores and more.

Mobile Messaging. Nuance Mobile provides users a more natural way to enter SMS messages, mobile instant messages, and mobile email into mobile wireless devices, significantly faster than with the traditional keypad.

Voice-Controlled MP3 Player Applications. An increasing number of phones on the market today are equipped with MP3 capabilities, allowing users to store and play hundreds of songs. Our speech-controlled MP3 applications provide a simple voice-activated interface to select a song, an artist or a playlist.

Automotive Solutions. Our integrated suite of automotive solutions enable voice-activated dialing, voice destination entry for navigation systems, and vehicle command and control for in-vehicle entertainment systems.

Our mobile solutions are used by mobile phone, automotive, personal navigation device and other consumer electronic manufacturers and their suppliers, including Mitsubishi Electronics, LG Electronics, Group Sense and Delphi. In addition, telecommunications carriers, Web search companies and content providers are increasingly using our mobile search and communication solutions to offer value-added services to their subscribers and customers.

The recent acquisitions of VoiceSignal and Tegic will enhance our offerings to mobile device manufacturers. The VoiceSignal acquisition provides voice-recognition technologies in mobile search, messaging, and command and control that complement our current capabilities. The Tegic acquisition provides us with predictive text and touch technologies. The combination of Nuance, VoiceSignal and Tegic sets the stage for a new mobile user interface that integrates predictive text, speech and touch inputs. This multimodal interface will provide easier access for users of mobile devices and will be available to all manufacturers across their product lines.

Healthcare Dictation and Transcription

The healthcare industry is under significant pressure to streamline operations and reduce costs and improve patient care. In recent years, healthcare organizations such as hospitals, clinics, medical groups, physicians' offices, and insurance providers have increasingly turned to speech solutions to automate manual processes such as the dictation and transcription of patient records.

We provide comprehensive dictation and transcription solutions and services that automate the input and management of medical information. Since 2004, we have steadily increased our investments in solutions for the healthcare industry. We are dedicating substantial resources to product development, sales, business development and marketing in an effort to replace traditional manual transcription before the end of the decade.

Our healthcare dictation and transcription solutions include:

Dictation and Transcription Workflow Solutions. Our enterprise solutions provide centralized platforms to generate and distribute speech-driven medical documentation through the use of advanced dictation and transcription features.

Table of Contents

Hosted Dictation Services. Dictaphone iChart, our subscription-based service, allows us to deliver hosted dictation, transcription and speech recognition solutions to customers seeking to outsource this function entirely.

Departmental Solutions. Dictaphone PowerScribe, a speech recognition solution for radiology, cardiology, pathology and related specialties, enables the healthcare providers to dictate, edit, and sign reports without manual transcription, enhancing report turnaround time.

Dragon NaturallySpeaking Medical. This dictation software provides front-end speech recognition that is used by physicians and clinicians to create and navigate medical records.

Hospitals, clinics and group practices, including Adventist Health, Allina Health, Guthrie Healthcare, Mt. Kisco Medical, and Sarasota Memorial, and approximately 300,000 physicians use our Dictaphone healthcare solutions to manage the dictation and transcription of patient records. We utilize a focused, enterprise sales team and professional services organization to address the market and implementation requirements of the healthcare industry.

The acquisition of Focus expanded our ability to deliver healthcare transcription solutions. The combination of Focus proven technology portfolio and services capability and the Dictaphone iChart Web-based transcription solutions creates an efficient, scalable Web-based automated transcription service. Focus serves some of the largest U.S. healthcare organizations, combining the use of speech recognition, a Web-based editing platform and manual transcription services based in India to achieve superior customer satisfaction, turnaround time and cost efficiency. Our recent acquisitions of Commissure and Vocada expand the capabilities of our Dictaphone Healthcare solutions for the medical imaging industry, enhance our domain expertise in the radiology market and reporting of clinical test results, respectively, and increase our recurring revenue base derived from a software-as-a-service business model.

In addition to our healthcare-oriented dictation solutions, we also offer *Dragon NaturallySpeaking*, a suite of general purpose desktop dictation applications that increases productivity by using speech to create documents, streamline repetitive and complex tasks, input data, complete forms and automate manual transcription processes.

Our *Dragon NaturallySpeaking* family of products delivers enhanced productivity for professionals and consumers who need to create documents and transcripts. These solutions allow users to automatically convert speech into text at up to 160 words-per-minute, with support for over 300,000 words and with an accuracy rate of up to 99%. This vocabulary can be expanded by users to include specialized words and phrases and can be adapted to recognize individual voice patterns. Our desktop dictation software is currently available in eleven languages. We utilize a combination of our global reseller network and direct sales to distribute our speech recognition and dictation products.

PDF and Document Imaging

The proliferation of the Internet, email and other networks have greatly simplified the ability to share electronic documents, resulting in an ever-growing volume of documents to be used and stored. Our solutions reduce the costs associated with paper documents through easy to use scanning, document management and electronic document routing solutions. We offer versions of our products to hardware vendors, home offices, small businesses and enterprise customers.

Our PDF and document solutions include:

PDF Applications. Our PDF solutions offer comprehensive PDF capabilities for business users, including a combination of creation, editing and conversion features. Our PDF Converter product family is used to create

PDF files and turn existing PDF files into fully-formatted documents that can be edited.

Optical Character Recognition and Document Conversion. Our OmniPage product uses optical character recognition technology to deliver highly accurate document and PDF conversion, replacing the need to manually recreate documents.

Table of Contents

Digital Paper Management. Our PaperPort applications combine PDF creation with network scanning, allowing individuals to work quickly with scanned paper documents, PDF files and digital documents. Our software is typically used in conjunction with network scanning devices to preserve an image of a document and allows for easy archiving, indexing and retrieval.

We utilize a combination of our global reseller network and direct sales to distribute our document conversion and PDF products. We license our software to companies such as Brother, Canon, Dell, HP and Xerox, which bundle our solutions with multifunction devices, digital copiers, printers and scanners. We also license software development toolkits to independent software vendors who use our technology for production capture or desktop applications, including vendors such as Autodesk, Canon, EMC/Captiva, Filenet, Kofax, Microsoft, Sharp and Verity.

Growth Strategy

We focus on providing market-leading, value-added solutions for our customers and partners through a broad set of technologies, service offerings and channel capabilities. We intend to pursue growth through the following key elements of our strategy:

Extend Technology Leadership. Our solutions are recognized as among the best in their respective categories. We intend to leverage our global research and development organization and broad portfolio of technologies, applications and intellectual property to foster technological innovation and maintain customer preference for our solutions. We also intend to invest in our engineering resources and seek new technological advancements that further expand the addressable markets for our solutions.

Broaden Expertise in Vertical Markets. Businesses are increasingly turning to Nuance for comprehensive solutions rather than for a single technology product. We intend to broaden our expertise and capabilities to deliver targeted solutions for a range of industries including mobile device manufacturers, healthcare, telecommunications, financial services and government administration. We also intend to expand our global sales and professional services capabilities to help our customers and partners design, integrate and deploy innovative solutions.

Increase Subscription and Transaction Based Recurring Revenue. We intend to increase our subscription and transaction based offerings in our core industries. The expansion of our subscription or transaction based solutions will enable us to deliver applications that our customers use on a repeat basis, and pay for on a per use basis, providing us with the opportunity to enjoy the benefits of recurring revenue streams.

Expand Global Presence. We intend to further expand our international resources to better serve our global customers and partners and to leverage opportunities in emerging markets such as China, India, Latin America and Asia. We continue to add regional executives and sales employees in different geographic regions to better address demand for speech based solutions and services.

Pursue Strategic Acquisitions. We have selectively pursued strategic acquisitions to expand our technology, solutions and resources to complement our organic growth. We have proven experience in integrating businesses and technologies and in delivering enhanced value to our customers, partners, employees and shareholders. We intend to continue to pursue acquisitions that enhance our solutions, serve specific vertical markets and strengthen our technology portfolio.

Research and Development/Intellectual Property

In recent years, we have developed and acquired extensive technology assets, intellectual property and industry expertise in speech and imaging that provide us with a competitive advantage in markets where we compete. Our technologies are based on complex algorithms which require extensive amounts of linguistic and image data, acoustic models and recognition techniques. A significant investment in capital and time would be necessary to replicate our current capabilities.

We continue to invest in technologies to maintain our market-leading position and to develop new applications. Our technologies are covered by more than 540 issued patents and 490 patent applications. Our intellectual

Table of Contents

property, whether purchased or developed internally, is critical to our success and competitive position and, ultimately, to our market value. Our products and services build on a portfolio of patents, copyrights, trademarks, services marks, trade secrets, confidentiality provisions and licensing arrangements to establish and protect our intellectual property and proprietary rights.

International Operations

We have principal offices in a number of international locations including: Belgium, Canada, Germany, Hungary, India, Japan, Australia, and the United Kingdom. The responsibilities of our international operations include research and development, healthcare transcription and editing customer support, sales and marketing and administration. Additionally, we maintain smaller sales, services and support offices throughout the world to support our international customers and to expand international revenue opportunities.

Geographic revenue classification is based on the geographic areas in which our customers are located. For fiscal 2007, 2006 and 2005, 78%, 74% and 69% of revenue was generated in the United States and 22%, 26% and 31% of revenue was generated by our international operations, respectively.

Competition

The individual markets in which we compete are highly competitive and are subject to rapid technology changes. There are a number of companies that develop or may develop products that compete in our target markets; however, currently there is no one company that competes with us in all of our product areas. While we expect competition to continue to increase both from existing competitors and new market entrants, we believe that we will compete effectively based on many factors, including:

Technological Superiority. Our speech and imaging technologies, applications and solutions are often recognized as the most proficient products in their respective categories. Our speech technology has industry-leading recognition accuracy and provides a natural, speech-enabled interaction with systems, devices and applications. Our imaging technology is viewed as the most accurate in the industry, with rates as high as 99.8%. Technology publications, analyst research and independent benchmarks have indicated our products rank at or above performance levels of alternative solutions.

Broad Distribution Channels. Our extensive global network of resellers, comprising system integrators, independent software vendors, value-added resellers, hardware vendors, telecommunications carriers and distributors; our dedicated direct sales force; and our e-commerce website (www.nuance.com) enable us to address the needs of specific markets, such as financial, legal, healthcare and government, and introduce new products quickly and effectively.

International Appeal. The international reach of our products is due to the broad language coverage of our offerings, including our speech technology which provides recognition for up to 49 languages and dialects and natural sounding synthesized speech in 26 languages and supports a broad range of hardware platforms and operating systems. Our imaging technology supports more than 100 languages.

Specialized Professional Services. Our superior technology, when coupled with the high quality of our professional services, allows our customers and partners to place a high degree of confidence and trust in our ability to deliver results.

Within speech, we compete with AT&T, IBM, Microsoft, Telisma and other small providers. Within healthcare dictation and transcription, we compete with eScription, Philips Medical, Spheris and other smaller providers. Within

imaging, we compete directly with ABBYY, Adobe, eCopy, and I.R.I.S. 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 competitive with our solutions in some markets. 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.

Table of Contents

Some of our competitors or potential competitors in our markets, 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.

Employees

As of September 30, 2007, we had approximately 3,900 full time employees in total, including approximately 600 in sales and marketing, approximately 650 in professional services, approximately 700 in research and development, approximately 350 in general and administrative and approximately 1,600 that provide healthcare transcription and editing services. Approximately, fifty-five percent of our employees are based outside of the United States, the majority of whom are based in India. Our employees are not represented by any labor union and are not organized under a collective bargaining agreement, and we have never experienced a work stoppage. We believe that our relationships with our employees are generally good.

Company Information

Our website is located at www.nuance.com. This Annual Report on Form 10-K, our Quarterly Reports on Form 10-Q, our Current Reports on Form 8-K, and all amendments to these reports, as well as proxy statements and other information we file with or furnish to the Securities and Exchange Commission or the SEC, are accessible free of charge on our website. We make these documents available as soon as reasonably practicable after we file them with, or furnish them to, the SEC. Except as otherwise stated in these documents, the information contained on our website or available by hyperlink from our website is not incorporated by reference into this report or any other documents we file with or furnish to the SEC.

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 are expected to continue to fluctuate in the future. Given this fluctuation, we believe that quarter to quarter comparisons of 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 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 our inability 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;

Table of Contents

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;

delayed realization of synergies resulting from our acquisitions;

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 stockholders.

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, including our acquisitions of Dictaphone, Focus, BeVocal, VoiceSignal, Tegic, Commissure, Vocada and Viecore. We may continue to issue equity securities for future acquisitions, which would dilute existing stockholders, perhaps significantly depending on the terms of such acquisitions. 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.

Our ability to realize the anticipated benefits of our acquisitions will depend on successfully integrating the acquired businesses.

Our prior acquisitions required, and our recently completed acquisitions continue to require, substantial integration and management efforts and we expect our pending and future acquisitions to require similar efforts. Acquisitions of this nature involve a number of risks, including:

difficulty in transitioning and integrating the operations and personnel of the acquired businesses;

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 business units both in the United States and internationally;

impairment of relationships with partners and customers;

Table of Contents

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 business.

As a result of these and other risks, if we are unable to successfully integrate acquired businesses, we may not realize the 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.

Accounting treatment of our acquisitions could decrease our net income or expected revenue 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 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 an impairment analysis, at least annually, which may result in an impairment charge if the carrying value exceeds its implied fair value. As of September 30, 2007, we had identified intangible assets amounting to approximately \$391.2 million and goodwill of approximately \$1.2 billion. In addition, purchase accounting limits our ability to recognize certain revenue that otherwise would have been recognized by the acquired company as an independent business. The combined company may delay revenue recognition or recognize less revenue than we and the acquired company would have recognized as independent companies.

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

We have a significant amount of debt. As of September 30, 2007, we had a total of \$913.7 million of gross debt outstanding, including \$663.7 million in term loans due in March 2013 and \$250.0 million in convertible debentures which investors may require us to redeem in August 2014. We also have a \$75.0 million revolving credit line available to us through March 2012. As of September 30, 2007, there were \$17.3 million of letters of credit issued under the revolving credit line and there were no other outstanding borrowings under the revolving credit line. Our debt level could have important consequences, for example it could:

require us to use a large portion of our cash flow to pay principal and interest on debt, including the convertible debentures and the credit facility, which will reduce the availability of our cash flow to fund working capital, capital expenditures, acquisitions, 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.

Our ability to meet our payment and other obligations under our debt instruments depends on our ability to generate significant cash flow in the future. This, to some extent, is subject to general economic, financial, competitive, legislative and regulatory factors as well as other factors that are beyond our control. We cannot assure you that our business will generate cash flow from operations, or that additional capital will be available to us, in an amount sufficient to enable us to meet our payment obligations under the convertible debentures and our other debt and to fund other liquidity needs. If we are not able to generate sufficient cash flow to service our debt obligations, we may need to refinance or restructure our debt, including the convertible debentures, sell assets, reduce or delay capital investments, or seek to raise additional capital. If we are unable to implement one or more of these

Table of Contents

alternatives, we may not be able to meet our payment obligations under the convertible debentures and our other debt.

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 flows. While we have entered into an interest rate swap agreement limiting our exposure for a portion of our debt, the agreement does not offer complete protection from this risk.

Our debt agreements contain covenant restrictions that may limit our ability to operate our business.

The agreement governing our senior credit facility contains, and any of our other future debt agreements may contain, covenant restrictions that limit our ability to operate our business, including restrictions on our ability to:

- incur additional debt or issue guarantees;
- create liens;
- make certain investments;
- enter into transactions with our affiliates;
- sell certain assets;
- redeem capital stock or make other restricted payments;
- declare or pay dividends or make other distributions to stockholders; and
- merge or consolidate with any entity.

Our ability to comply with these covenants is dependent on our future performance, which will be subject to many factors, some of which are beyond our control, including prevailing economic conditions. As a result of these covenants, our ability to respond to changes in business and economic conditions and to obtain additional financing, if needed, may be significantly restricted, and we may be prevented from engaging in transactions that might otherwise be beneficial to us. In addition, our failure to comply with these covenants could result in a default under our debt, which could permit the holders to accelerate our obligation to repay the debt. If any of our debt is accelerated, we may not have sufficient funds available to repay the accelerated debt.

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

We reported net losses of approximately \$14.0 million, \$22.9 million and \$5.4 million for fiscal years 2007, 2006 and 2005, respectively. We had an accumulated deficit of approximately \$204.1 million at September 30, 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 transaction to raise 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.

Speech technologies may not achieve widespread acceptance, 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:

consumer and business demand for speech-enabled applications;

development by third-party vendors of applications using speech technologies; and

Table of Contents

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 speech, we compete with AT&T, IBM, Microsoft, and other smaller providers. Within healthcare dictation and transcription, we compete with eScription, Philips Medical, Spheris and other smaller providers. Within imaging, we compete directly with ABBYY, Adobe, eCopy, I.R.I.S. and NewSoft. 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 for our fiscal year ended September 30, 2006, 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 based outside the United States. Our results could be harmed by economic, political, regulatory and other risks associated with these international regions.

Because we operate worldwide, our business is subject to risks associated with doing business internationally. We anticipate that revenue from international operations will increase in the future. Reported international revenue,

Table of Contents

classified by the major geographic areas in which our customers are located, represented approximately \$130.4 million, \$100.2 million and \$71.5 million, representing 22%, 26%, and 31% of our total revenue, respectively, for fiscal 2007, 2006 and 2005, 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 than in the United States.

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. 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, 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 that 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 on an annual basis, as well as whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors that 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;

significant negative industry or economic trends;

Table of Contents

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 September 30, 2007, we had identified intangible assets amounting to approximately \$391.2 million and goodwill of approximately \$1.2 billion.

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

We are dependent on certain suppliers, including limited and sole source suppliers, to provide key components used in our healthcare-related 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.

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

If any of our key employees were to leave, 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 in the past. We cannot assure you that one or more key employees will not leave in the future. We intend to continue to hire additional highly qualified personnel, including software engineers and operational personnel, but 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 the Company. 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 that could have a material adverse affect on our business, results of operations and financial condition.

Table of Contents

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 our technologies 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 November 9, 2007, Autotext Technologies, a subsidiary of Acacia Research, filed an action against us in the United States District Court for the Northern District of Ohio. The complaint alleges that our T9 Predictive Text software infringes U.S. Patent No. 5,305,205 entitled Computer-assisted transcription apparatus. The patent generally relates to a predictive word processing system, where a list of word choices is presented when a user inputs just a few letters of a word. Damages are sought in an unspecified amount. Because the complaint was only filed recently, we have not yet been able to assess the merits of the claim or identify the defenses available to us.

On May 31, 2006, GTX Corporation 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 Corporation 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 filed an action against us in the United States District Court for the Southern District of Texas claiming patent infringement. In the lawsuit, AllVoice Computing plc 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. Such 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 AllVoice Computing plc's patent because, in addition to other defenses, we 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

Table of Contents

the Southern District of Texas entered summary judgment against AllVoice Computing plc and dismissed all claims against us on February 21, 2006. AllVoice Computing plc filed a notice of appeal from this judgment on April 26, 2006. On October 12, 2007, the U.S. Court of Appeals for the Federal Circuit reversed and remanded the summary judgment. 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 which 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 \$80.0 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 September 30, 2007, Warburg Pincus beneficially owned approximately 21% 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. As of September 30, 2007, Fidelity was our second largest stockholder, owning approximately 7.0% of our common stock. 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, and this may make it difficult for you to resell the common stock when you want or at prices you find attractive.

Our stock price historically has been, and may continue to be, volatile. Various factors contribute to the volatility of the 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. Sales of a substantial number of shares of our common stock by our two largest stockholders, or the perception that such sales could occur, could also contribute to the volatility of our stock price. 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.

Table of Contents

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

Future sales of our common stock in the public market could adversely affect the trading price of our common stock and our ability to raise funds in new stock offerings.

Future sales of substantial amounts of our common stock in the public market, or the perception that such sales could occur, could adversely affect prevailing trading prices of our common stock and could impair our ability to raise capital through future offerings of equity or equity-related securities. In connection with past acquisitions, we issued a substantial number of shares of our common stock as transaction consideration. We may continue to issue equity securities for future acquisitions, which would dilute existing stockholders, perhaps significantly depending on the terms of such acquisitions. In addition, in connection with the acquisitions of Viecore, Vocada and Commissure and the issuance of shares of our common stock in those transactions, we have agreed to register the shares of our common stock issued for resale. Approximately 7,300,000 shares of common stock have been issued in these acquisitions. No prediction can be made as to the effect, if any, that future sales of shares of common stock or the availability of shares of common stock for future sale, will have on the trading price of our common stock.

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 1B. *Unresolved Staff Comments*

None.

Table of Contents**Item 2. Properties**

Our corporate headquarters and administrative, sales, marketing, research and development and support functions occupy approximately 105,000 square feet of space that we lease in Burlington, Massachusetts. We also lease additional properties in the United States and a number of foreign countries. The following table summarizes our significant properties as of September 30, 2007:

Location	Sq. Ft. (approx.)	Lease Term	Primary Use
Burlington, Massachusetts (1)	105,000	March 2018	Corporate headquarters and administrative, sales, marketing, research and development and support functions.
Burlington, Massachusetts	29,000	March 2012	Administrative and support functions.
Menlo Park, California (2)	34,000	August 2009	Sales, marketing and support functions.
Aachen, Germany	20,000	March 2011	Research and development.
Budapest, Hungary	21,000	December 2009	Research and development.
Merelbeke, Belgium	25,000	April 2010	Administrative, sales, marketing, research and development and support functions.
Montreal, Quebec	55,000	December 2016	Sales, marketing, research and development, customer support and order fulfillment functions.
Pacific Shores, Redwood City, California (3)	141,000	July 2012	Fifty percent of this facility is unoccupied, the remainder has been sublet to third party tenants.
Melbourne, Florida (4)	130,000	Owned	Administrative, sales, marketing, customer support and order fulfillment functions. Small portion of the facility has been sublet to a third party.
New York, New York (5)	34,000	February 2016	Subleased to third-party tenants.

(1) During fiscal 2007 we amended this lease, committing to lease an additional 95,000 sq ft beginning in fiscal 2008. As a result of this amendment, the term of the lease was extended for a period of ten years from the date we occupy a majority of the additional space, currently anticipated to be in March 2008.

(2) This is a lease that was assumed as part of our acquisition of Former Nuance. 10,000 sq ft of this facility is unoccupied.

(3) The lease for this property was assumed as part of our acquisition of Former Nuance.

(4) This building was acquired as part of our acquisition of Dictaphone.

(5) The lease for this property was assumed as part of our SpeechWorks acquisition.

In addition to the properties referenced above, we also lease a number of small sales and marketing offices in the United States and internationally. As of September 30, 2007, we were productively utilizing substantially all of the space in our facilities, except for space identified above as unoccupied or that has been subleased to third parties.

Item 3. *Legal Proceedings*

Like many companies in the software industry, we have from time to time been notified of claims that we 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, we 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 us 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 us.

Table of Contents

On November 9, 2007, Autotext Technologies, a subsidiary of Acacia Research, filed an action against us in the United States District Court for the Northern District of Ohio. The complaint alleges that our T9 Predictive Text software infringes U.S. Patent No. 5,305,205 entitled Computer-assisted transcription apparatus. The patent generally relates to a predictive word processing system, where a list of word choices is presented when a user inputs just a few letters of a word. Damages are sought in an unspecified amount. Because the complaint was only filed recently, we have not yet been able to assess the merits of the claim or identify the defenses available to us.

On May 31, 2006, GTX Corporation, or 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 the claims have no merit and intend to defend the action vigorously.

On November 27, 2002, AllVoice Computing plc, or 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 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, or 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. On January 4, 2005, the case was transferred to a new judge of the United States District Court for the Southern District of Texas for administrative reasons. 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. On October 12, 2007, the U.S. Court of Appeals for the Federal Circuit reversed and remanded the summary judgment. We believe these claims have no merit and intend to defend the action vigorously.

In August 2001, the first of a number of complaints was filed in the United States District Court for the Southern District of New York, on behalf of a purported class of persons who purchased Former Nuance stock between April 12, 2000 and December 6, 2000. Those complaints have been consolidated into one action. The complaint generally alleges that various investment bank underwriters engaged in improper and undisclosed activities related to the allocation of shares in Former Nuance's initial public offering of securities. The complaint makes claims for violation of several provisions of the federal securities laws against those underwriters, and also against Former Nuance and some of the Former Nuance's directors and officers. Similar lawsuits, concerning more than 250 other companies' initial public offerings, were filed in 2001. In February 2003, the Court denied a motion to dismiss with respect to the claims against Former Nuance. In the third quarter of 2003, a proposed settlement in principle was reached among the plaintiffs, issuer defendants (including Former Nuance) and the issuers' insurance carriers. The settlement calls for the dismissal and release of claims against the issuer defendants, including Former Nuance, in exchange for a contingent payment to be paid, if necessary, by the issuer defendants' insurance carriers and an assignment of certain claims. The timing of the conclusion of the settlement remains unclear, and the settlement is subject to a number of conditions, including approval of the Court. The settlement is not expected to have any material impact upon us, as payments, if any, are expected to be made by insurance carriers, rather than by us. In July 2004, the underwriters filed a motion opposing approval by the court of the settlement among the plaintiffs, issuers and insurers. In March 2005, the court granted preliminary approval of the settlement, subject to the parties agreeing to modify the term of the settlement which limits each underwriter from seeking contribution against its issuer for damages it may be forced to pay in the action. On April 24, 2006, the court held a fairness hearing in connection with the motion for final approval of the settlement. The court has yet to issue a ruling on the motion for final approval. On December 5, 2006, the Court of Appeals for the Second Circuit reversed the Court's order certifying a class in several test cases that had been selected by the underwriter defendants and plaintiffs in the coordinated proceeding. The plaintiffs petitioned

the Second Circuit for rehearing of the Second Circuit's decision, however, on April 6, 2007, the Second Circuit denied the petition for rehearing. At a status conference on April 23, 2007, the district court suggested that the issuers settlement could not be approved in its present form, given the Second Circuit's ruling. On June 25, 2007 the district court issued an order terminating the settlement

Table of Contents

agreement. The plaintiffs are due to submit amended complaints and the issue of a new class definition for certification will be heard. In the meantime, the issuer defendants are working to reinstate the settlement agreement with the plaintiffs on substantially the same terms. In the event the settlement is not concluded, we intend to defend the litigation vigorously. We believe we have meritorious defenses to the claims against Former Nuance.

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

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

No matters were submitted to a vote of security holders in the fourth quarter of the fiscal year covered by this Annual Report on Form 10-K.

PART II**Item 5. *Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities*****Market Information**

Our common stock is traded on the NASDAQ Global Select Market under the symbol NUAN. The following table sets forth, for our fiscal quarters indicated, the high and low sales prices of our common stock, in each case as reported on the NASDAQ Global Select Market.

	Low	High
Fiscal 2006:		
First quarter	\$ 4.60	\$ 7.89
Second quarter	7.42	12.04
Third quarter	7.37	13.48
Fourth quarter	6.94	10.39
Fiscal 2007:		
First quarter	\$ 7.64	\$ 12.02
Second quarter	11.00	16.63
Third quarter	14.94	18.85
Fourth quarter	14.81	20.24

Holders

As of October 31, 2007, there were 931 stockholders of record of our common stock.

Dividend Policy

We have never declared or paid any cash dividends on our common stock. We currently expect to retain future earnings, if any, to finance the growth and development of our business and do not anticipate paying any cash dividends in the foreseeable future. The terms of our credit facility place restrictions on our ability to pay dividends

except for stock dividends.

Issuer Purchases of Equity Securities

We have not announced any currently effective authorization to repurchase shares of our common stock.

Table of Contents**Item 6. Selected Consolidated Financial Data**

On October 23, 2004, our Board of Directors approved a change in the Company's fiscal year end from December 31 to September 30, effective beginning September 30, 2004. All references in this Annual Report on Form 10-K to fiscal 2004 refer to the nine month period ended September 30, 2004. References to fiscal 2005, 2006 and 2007, refer to the twelve month periods ended September 30. References to fiscal 2003 and prior years refer to the twelve month periods ended December 31.

The following selected consolidated financial data is not necessarily indicative of the results of future operations and should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and our consolidated financial statements and related notes included elsewhere in this Annual Report on Form 10-K. The interim statement of operations for the nine months ended September 30, 2003 is unaudited and, in the opinion of management, reflects all adjustments, consisting of normal recurring adjustments, necessary for a fair statement of results of operations for the nine months ended September 30, 2003 (i.e. amounts in millions, except per share dollars and percentages):

	Year Ended			Nine Month Period Ended		Year Ended
	September 30, 2007(1),(2),(4)	September 30, 2006(3),(4),(5)	2005(6),(7)	September 30, 2004(8)	September 30, 2003(9)	December 31, 2003(9)
Operations:						
Total revenue	\$ 602.0	\$ 388.5	\$ 232.4	\$ 130.9	\$ 88.5	\$ 135.4
Gross margin	404.1	267.5	163.2	89.1	65.4	80.7
Income (loss) from operations	39.0	8.4	2.0	(8.0)	(7.0)	(6.5)
Income (loss) before income taxes	8.5	(7.1)	1.4	(8.0)	(6.4)	(5.8)
Provision for (benefit from) income taxes	22.5	15.1	6.8	1.3	0.5	(0.3)
Loss before cumulative effect of accounting change	(14.0)	(22.2)	(5.4)	(9.4)	(6.9)	(5.5)
Cumulative effect of accounting change(4)		(0.7)				
Net loss	\$ (14.0)	\$ (22.9)	\$ (5.4)	\$ (9.4)	\$ (6.9)	\$ (5.5)
Basic and Diluted Earnings Per Share Data:						
Loss before cumulative effect of accounting change	\$ (0.08)	\$ (0.13)	\$ (0.05)	\$ (0.09)	\$ (0.10)	\$ (0.10)

Edgar Filing: Nuance Communications, Inc. - Form 10-K

Net loss	\$ (0.08)	\$ (0.14)	\$ (0.05)	\$ (0.09)	\$ (0.10)	\$ (0.10)
Weighted average common shares outstanding:						
Basic and diluted	176.4	163.9	109.5	103.8	71.3	78.4
Financial Position:						
Cash, cash equivalents and short and long-term marketable securities	\$ 187.0	\$ 112.3	\$ 95.8	\$ 47.7	\$ 48.0	\$ 42.6
Total assets	2,172.8	1,235.1	757.2	392.7	376.3	401.9
Long-term debt, net of current portion(2)(5)	900.0	350.0		27.7	28.1	27.9
Total stockholders' equity	878.3	576.6	514.7	301.7	288.5	303.2

Table of Contents

	Year Ended			Nine Month Period Ended		Year Ended
	September 30,			September 30,		December 31,
	2007(1),(2),(4)	2006(3),(4),(5)	2005(6),(7)	2004(8)	2003(9)	2003(9)
Selected Data and Ratios:						
Working capital	\$ 164.9	\$ 51.3	\$ 12.1	\$ 27.9	\$ 36.4	\$ 44.3
Depreciation of property and equipment	12.1	8.4	5.0	29.9	1.5	2.4
Amortization of other intangible assets	37.7	30.1	13.1	10.4	8.9	12.8
Gross margin percentage	67.1%	68.8%	70.2%	68.1%	73.9%	72.9%

- (1) During fiscal 2007, we acquired all of the outstanding shares of Mobile Voice Control, Inc.; Bluestar Resources Limited, the parent of Focus Enterprises Limited and Focus India Private Limited; BeVocal, Inc.; Voice Signal Technologies, Inc.; Tegic Communications, Inc.; and Commissure Inc. See Note 3 of the Notes to our Consolidated Financial Statements.
- (2) During fiscal 2007, we entered into a \$90.0 million term loan and a \$225.0 million term loan, each of which is an expansion of our senior secured credit facility entered into in fiscal 2006. We also issued \$250.0 million principal amount of 2.75% senior convertible debentures. As of September 30, 2007, there were no borrowings outstanding under the \$75.0 million revolving credit line taken out in fiscal 2006. See Note 10 of the Notes to our Consolidated Financial Statements.
- (3) On March 31, 2006, we acquired all of the outstanding shares of Dictaphone Corporation. See Note 3 of the Notes to our Consolidated Financial Statements.
- (4) Nuance adopted the provision of SFAS 123(R), Share-Based Payment effective October 1, 2005, the beginning of fiscal 2006. As a result, the results of operations in fiscal 2007 and fiscal 2006 included incremental share-based payments over what would have been recorded had the company continued to account for share-based compensation under APB No. 25, Accounting for Stock Issued to Employees. See Note 16 of the Notes to our Consolidated Financial Statements.
- (5) During fiscal 2006, we entered into a new senior secured credit facility which consists of a \$355.0 million 7-year term loan and a \$75.0 million six-year revolving credit line to partially finance our acquisition of Dictaphone. As of September 30, 2006, there were no outstanding borrowings under the revolving credit line. See Note 10 of the Notes to our Consolidated Financial Statements.
- (6) During fiscal 2005, we acquired all of the outstanding shares of Rhetorical Systems, Ltd., ART Advanced Recognition Technologies, Inc., Phonetic Systems Ltd., MedRemote, Inc. and Nuance Communications, Inc. (Former Nuance). See Note 3 of the Notes to our Consolidated Financial Statements.
- (7) Income from operations for the year ended September 30, 2005 reflects \$7.2 million in restructuring charges, consisting of \$2.9 million related to the elimination of personnel and \$4.3 million related to the abandoned leased facilities, including the write-off of leasehold improvements. See Note 13 of the Notes to our

Consolidated Financial Statements.

- (8) During fiscal 2004, we acquired all of the outstanding shares of Telelogue, Inc. and Brand & Groeber Communications GbR.
- (9) During fiscal 2003, we acquired Royal Philips Electronic Speech Processing Telephony and Voice control business units, and related intellectual property. We also acquired all of the outstanding shares of SpeechWorks International, Inc. and LocusDialog, Inc.

Item 7. *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 the accompanying notes to the consolidated financial statements.

Table of Contents

Forward-Looking Statements

This annual report contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 that involve risks, uncertainties and assumptions that, if they never materialize or if they prove incorrect, could cause our consolidated results to differ materially from those expressed or implied by such 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 pending and 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 Annual Report on Form 10-K.

You should not place undue reliance on these forward-looking statements, which speak only as of the date of this Annual Report on Form 10-K. 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

Nuance Communications, Inc. is a leading provider of speech-based solutions for businesses and consumers worldwide. Our speech solutions are designed to transform the way people interact with information systems, mobile devices and services. We have designed our solutions to make the user experience more compelling, convenient, safe and satisfying, unlocking the full potential of these systems, devices and services.

The vast improvements in the power and features of information systems and mobile devices have increased their complexity and reduced their ease of use. Many of the systems, devices and services designed to make our lives easier are cumbersome to use, involving complex touch-tone menus in call centers, counterintuitive and inconsistent user interfaces on computers and mobile devices, inefficient manual processes for transcribing medical records and automobile dashboards overrun with buttons and dials. These complex interfaces often limit the ability of the average user to take full advantage of the functionality and convenience offered by these products and services. By using the spoken word, our speech solutions help people naturally obtain information, interact with mobile devices and access services such as navigation, online banking and medical transcription.

We provide speech solutions to several rapidly growing markets:

Enterprise Speech. We deliver a portfolio of speech-enabled customer care solutions that improve the quality and consistency of customer communications. Our solutions are used to automate a wide range of customer services and business processes in a variety of information and process-intensive vertical markets such as telecommunications, financial services, travel and entertainment, and government.

Mobility. Our mobile speech solutions add voice control capabilities to mobile devices and services, allowing people to use spoken words or commands to dial a mobile phone, enter destination information into an automotive navigation system, dictate a text message or have emails and screen information read aloud. Our mobile solutions are used by many of the world's leading mobile device and automotive manufacturers.

Table of Contents

Healthcare Dictation and Transcription. We provide comprehensive dictation and transcription solutions and services that improve the way patient data is captured, processed and used. Our healthcare dictation and transcription solutions automate the input and management of medical information and are used by many of the largest hospitals in the United States.

In addition to our speech offerings, we provide PDF and document solutions that reduce the time and cost associated with creating, using and sharing documents. Our solutions benefit from the widespread adoption of the PDF format and the increasing demand for networked solutions for managing electronic documents. Our solutions are used by millions of professionals and within large enterprises.

We leverage our global professional services organization and our extensive network of partners to design and deploy innovative speech and imaging solutions for businesses and organizations around the globe. We market and distribute our products indirectly through a global network of resellers, including system integrators, independent software vendors, value-added resellers, hardware vendors, telecommunications carriers and distributors, and directly through our dedicated sales force and through our e-commerce website.

We have built a world-class portfolio of speech solutions both through internal development and acquisitions. We continue to pursue opportunities to broaden our speech solutions and 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. Acquisitions completed in recent years include 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 is referred 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 December 29, 2006, we acquired Mobile Voice Control, Inc. to further accelerate our deployment of speech-enabled solutions in the wireless industry.

On March 26, 2007, we acquired Bluestar Resources Limited, the parent of Focus Enterprises Limited and Focus Infosys India Private Limited, a leading provider of healthcare transcription services, to compliment our Dictaphone iChart Web-based transcription solutions and expand our ability to deliver Web-based speech recognition solutions and provide scalable Internet delivery of automated transcription.

On April 24, 2007, we acquired BeVocal, Inc., a provider of hosted self-service customer case solutions to expand our product portfolio in the areas of mobile customer lifecycle management, mobile premium services and other mobile consumer products.

On August 24, 2007, we acquired Voice Signal Technologies, Inc. a global provider of speech technology for mobile devices to enhance our solutions and expertise addressing the accelerating demand for speech-enabled mobile devices and services that allow people to use spoken commands to simply and effectively navigate and retrieve information and to control and operate mobile phones.

Table of Contents

On August 24, 2007, we acquired Tegic Communications, Inc. a wholly owned subsidiary of AOL LLC and a developer of embedded software for mobile devices. The Tegic acquisition expands our presence in the mobile device industry and accelerates the delivery of a new mobile user interface that combines voice, text and touch to improve the user experience for consumers and mobile professionals.

On September 28, 2007, we acquired Commissure Inc. a provider of speech-enabled radiology workflow optimization and data analysis solutions to enhance the capabilities of our Dictaphone Healthcare solutions for the medical imaging industry, extend our domain expertise in the radiology market.

On November 2, 2007, we acquired Vocada, Inc., a provider of software and other products for managing critical medical test results. The Vocada acquisition allows us to broaden the capabilities of our Dictaphone Healthcare solutions for the medical imaging industry, enhance our domain expertise within diagnostic specialties (including radiology, laboratory tests, pathology and cardiology).

On November 26, 2007, we acquired Viacore, Inc., a consulting and systems integration firm. The Viacore acquisition expands our professional services capabilities and complements our existing partnerships, allowing us to deliver end-to-end speech solutions and system integration for speech-enabled customer care in key vertical markets including financial services, telecommunications, healthcare, utilities and government.

These acquisitions have had a material impact on our results of operations. Our results of operations for fiscal 2007 included the operations of Dictaphone for a full year and partial year results from our acquisitions of Mobile Voice Control, Focus, BeVocal, VoiceSignal, Tegic and Commissure. We refer to these transactions collectively as our 2007 acquisitions. Our results of operations during fiscal 2006 included the operations of Former Nuance for a full year and the operations of Dictaphone for six months. We refer to these transactions together as our 2006 acquisitions. Our fiscal 2005 results included only two weeks of the operations of Former Nuance and partial year results from our acquisitions of Phonetic as well as Rhetorical Systems, Inc., ART Advanced Recognition Technologies, Inc. and MedRemote, Inc. As you review our year over year results of operations described below, you will note that these acquisitions represent a significant factor in the increase in our revenue and expenses.

Table of Contents**RESULTS OF OPERATIONS**

The following table presents, as a percentage of total revenue, certain selected financial data for the years ended September 30, 2007, 2006 and 2005.

	Year Ended September 30, 2007	Year Ended September 30, 2006	Year Ended September 30, 2005
Revenue:			
Product and licensing	51.8%	60.7%	73.7%
Professional services, subscription and hosting	27.5	20.9	20.3
Maintenance and support	20.7	18.4	6.0
Total revenue	100.0	100.0	100.0
Costs and expenses:			
Cost of product and licensing	7.2	7.7	8.8
Cost of professional services, subscription and hosting	19.0	16.2	14.9
Cost of maintenance and support	4.5	4.0	2.1
Cost of revenue from amortization of intangible assets	2.2	3.3	3.9
Gross margin	67.1	68.8	70.3
Research and development	13.3	15.3	16.9
Sales and marketing	30.7	33.1	33.9
General and administrative	12.5	14.2	13.8
Amortization of other intangible assets	4.1	4.4	1.7
Restructuring and other charges (credits), net		(0.3)	3.1
Total operating expenses	60.6	66.7	69.4
Income from operations	6.5	2.1	0.9
Other income (expense), net	(5.1)	(3.9)	(0.3)
Income (loss) before income taxes	1.4	(1.8)	0.6
Provision for income taxes	3.7	3.9	2.9
Loss before cumulative effect of accounting changes	(2.3)	(5.7)	(2.3)
Cumulative effect of accounting change		0.2	
Net loss	(2.3)%	(5.9)%	(2.3)%

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):

	Fiscal 2007	Fiscal 2006	Fiscal 2005	% Change 2007 vs 2006	% Change 2006 vs 2005
United States	\$ 471.6	\$ 288.3	\$ 160.9	63.6%	79.1%
International	130.4	100.2	71.5	30.1	40.2
Total Revenue	\$ 602.0	\$ 388.5	\$ 232.4	55.0%	67.2%

Table of Contents***Fiscal 2007 Compared to Fiscal 2006***

In fiscal 2007 total revenue increased \$213.5 million primarily due to \$127.2 million of revenue related to our 2007 acquisitions and organic revenue growth of \$86.3 million, or 22%, from fiscal 2006, including a 19% increase in network revenue, a 27% increase in dictation revenue, a 36% increase in embedded revenue, and a 2% increase in imaging revenue.

Based on the location of the customers, the geographic split in fiscal 2007 was 78% of total revenue in the United States and 22% internationally as compared to 74% of total revenue in the United States and 26% internationally in fiscal 2006. The increase in proportion of revenue generated in the United States was primarily due to our 2007 acquisitions which have a higher proportion of their revenue derived from customers in the United States.

Fiscal 2006 Compared to Fiscal 2005

In fiscal 2006 total revenue increased \$156.1 million due to \$112.4 million of revenue related to our 2006 acquisitions and organic growth of \$43.7 million, or 19%, from fiscal 2005 including a 20% increase in network revenue, a 25% increase in dictation revenue, primarily as a result of the release of *Dragon NaturallySpeaking 9.0* in the fourth quarter of fiscal 2006, a 37% increase in embedded revenue and a 6% increase in imaging revenue.

Based on the location of the customers, the geographic split in fiscal 2006 was 74% of total revenue in the United States and 26% internationally as compared to 69% of total revenue in the United States and 31% internationally in fiscal 2005. The increase in proportion of revenue generated in the United States was primarily due to 2006 acquisitions which have a high proportion of their revenue derived from customers in the United States.

Product and Licensing Revenue

Product and licensing revenue primarily consists of sales and licenses of our 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):

	Fiscal 2007	Fiscal 2006	Fiscal 2005	% Change 2007 vs 2006	% Change 2006 vs 2005
Product and licensing revenue	\$ 311.8	\$ 235.8	\$ 171.2	32.2%	37.7%
As a percentage of total revenue	51.8%	60.7%	73.7%		

Fiscal 2007 Compared to Fiscal 2006

Product and licensing revenue in fiscal 2007 increased \$76.0 million compared to fiscal 2006 due to \$29.8 million of revenue attributable to our 2007 acquisitions and organic revenue growth of \$46.2 million, or 20%, from fiscal 2006. Due to a change in revenue mix, primarily relating to the accelerated growth of professional services, subscription and hosting revenue, product and licensing revenue decreased by 8.9 percentage points of total revenue as compared to fiscal 2006.

Speech related product and licensing revenue increased \$74.9 million, or 46%, from fiscal 2006. Excluding revenue related to our 2007 acquisitions, speech related product and licensing revenue grew \$45.1 million or 28% from fiscal 2006. Included in this organic growth, network revenue increased 14%, dictation revenue increased 26% and embedded revenue increased 49%. The growth in organic speech revenue resulted from increased sales of our legacy network products, sustained performance of our embedded products in automotive, handsets, and personal navigation devices as well as increased sales in dictation fueled by our fourth quarter 2006 release of *Dragon NaturallySpeaking 9.0*.

Table of Contents***Fiscal 2006 Compared to Fiscal 2005***

Product and licensing revenue in fiscal 2006 increased \$64.6 million as compared to fiscal 2005 due to \$39.8 million of revenue attributable to our 2006 acquisitions and organic revenue growth of \$24.8 million, up 15% from fiscal 2005. 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 decreased by 13.0 percentage points as compared to fiscal 2005.

Speech related product and licensing revenue increased \$59.4 million or 57% from fiscal 2006, growing to 70% of total product and licensing revenue in fiscal 2006 from 60% in fiscal 2005. Excluding revenue related to our 2006 acquisitions, speech related product and licensing revenue increased \$19.6 million, or 19%, from fiscal 2005. The growth in organic speech revenue resulted from increased sales of our legacy network products, embedded products in automotive and handsets, as well as increased sales in dictation fueled by our fourth quarter release of *Dragon NaturallySpeaking 9.0*. Product and licensing revenue from our imaging products increased \$5.2 million, or 8%.

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):

	Fiscal 2007	Fiscal 2006	Fiscal 2005	% Change 2007 vs 2006	% Change 2006 vs 2005
Professional services, subscription and hosting revenue	\$ 165.5	\$ 81.3	\$ 47.3	103.5%	71.9%
As a percentage of total revenue	27.5%	20.9%	20.3%		

Fiscal 2007 Compared to Fiscal 2006

Professional services, subscription and hosting revenue for fiscal 2007 increased \$84.2 million compared to fiscal 2006 due to \$58.5 million of revenue from our 2007 acquisitions and organic revenue growth of \$25.7 million, or 32% from fiscal 2006. The organic growth is due primarily to 22% growth in network professional services based on increasing demand for our core network consulting and transactional directory assistance services and a 34% growth in our Dictaphone iChart solution. Additionally, our healthcare professional services, largely based on our acquisition of Dictaphone in March 2006, provided revenue growth of 45% in the second half of fiscal 2007 relative to the second half of fiscal 2006. As a percentage of total revenue, professional services, subscription and hosting revenue increased 6.6% due to accelerated organic and acquisition related growth as compared to the growth of product and license revenue and maintenance and support revenue.

Fiscal 2006 Compared to Fiscal 2005

Professional services, subscription and hosting revenue for fiscal 2006 increased \$34.0 million as compared to fiscal 2005 due to \$22.1 million of revenue from our 2006 acquisitions and \$11.9 million from organic revenue growth as

compared to the fiscal 2005 base. Network services, excluding revenue attributable to fiscal 2006 acquisitions, provided \$9.0 million, or 25% growth, based on growth in core network consulting and training revenue.

Table of Contents**Maintenance and Support Revenue**

Maintenance and support revenue primarily consists of technical support and maintenance service for our 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):

	Fiscal 2007	Fiscal 2006	Fiscal 2005	% Change 2007 vs 2006	% Change 2006 vs 2005
Maintenance and support revenue	\$ 124.6	\$ 71.4	\$ 13.9	74.5%	413.7%
As a percentage of total revenue	20.7%	18.4%	6.0%		

Fiscal 2007 Compared to Fiscal 2006

Maintenance and support revenue for fiscal 2007 increased \$53.2 million as compared to fiscal 2006, with \$38.9 million of this increase due to our 2007 acquisitions, which have a significant customer base of maintenance and support contracts and organic revenue growth of \$14.4 million, or 20%, as compared to fiscal 2006. Organic revenue growth was principally in maintenance and support for network services. As a percentage of total revenue, maintenance and support revenue grew 2.3 percentage points in fiscal 2007 due primarily due to our 2007 acquisitions.

Fiscal 2006 Compared to Fiscal 2005

Maintenance and support revenue for fiscal 2006 increased \$57.5 million as compared to fiscal 2005. \$50.5 million of this increase is due to our 2006 acquisitions, which have a significant customer base of maintenance and support contracts from historic sales of products and \$7.0 million, or 50%, organic growth in fiscal 2006 compared to fiscal 2005, due to our continued strong renewal rates as well as from new sales in our network products. As a percentage of total revenue, maintenance and support revenue grew 12.4 percentage points in fiscal 2006 because of significant increase due to 2006 acquisitions.

COSTS AND EXPENSES**Cost of Product and Licensing Revenue**

Cost of product and licensing revenue primarily consists of material and fulfillment costs, manufacturing and operations costs, and third-party royalty expenses. 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):

	Fiscal 2007	Fiscal 2006	Fiscal 2005	% Change 2007 vs 2006	% Change 2006 vs 2005
--	------------------------	------------------------	------------------------	--	--

Cost of product and licensing revenue	\$ 43.2	\$ 29.7	\$ 20.4	45.5%	45.6%
As a percentage of product and licensing revenue	13.8%	12.6%	11.9%		

Fiscal 2007 Compared to Fiscal 2006

Cost of product and licensing revenue increased \$13.5 million for fiscal 2007 as compared to fiscal 2006 due in large part to our 2007 acquisitions and increased royalties and fulfillment of certain productivity products. As a percentage of revenue, cost of revenue and licensing revenue increased slightly due to the higher third-party hardware cost and royalties associated with products acquired through our 2007 acquisitions.

Table of Contents***Fiscal 2006 Compared to Fiscal 2005***

Cost of product and licensing revenue for fiscal 2006 increased \$9.3 million as compared to fiscal 2005 primarily due to costs relating to our 2006 acquisitions. As a percentage of product and licensing revenue, cost of product and licensing revenue increased slightly in fiscal 2006, largely due to our 2006 acquisitions products that have higher cost of goods sold relative to our other products. The added costs of goods sold for the acquired products are primarily due to third-party hardware that is included 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 and overhead, as well as the hardware and communications fees that support our subscription and hosted solutions. The following table shows cost of revenue, in absolute dollars and as a percentage of professional services, subscription and hosting revenue (dollars in millions):

	Fiscal 2007	Fiscal 2006	Fiscal 2005	% Change 2007 vs 2006	% Change 2006 vs 2005
Cost of professional services, subscription and hosting revenue	\$ 114.2	\$ 62.8	\$ 34.7	81.8%	81.0%
As a percentage of professional services, subscription and hosting revenue	69.0%	77.2%	73.4%		

Fiscal 2007 Compared to Fiscal 2006

Cost of professional services, subscription and hosting revenue increased \$51.4 million in fiscal 2007 as compared to fiscal 2006 due primarily to \$39.4 million of incremental cost related to our 2007 acquisitions. Cost of professional services, subscription and hosting revenue in our organic business increased \$12.1 million, or 19% as compared to the 2006 base, on 32% organic revenue growth. This significant improvement for the organic business was largely as a result of our ability to increase the utilization of existing resources in our healthcare and network professional service teams which drove an increase of 8.2 percentage points in gross margin for the professional services, subscription and hosting revenue.

Fiscal 2006 Compared to Fiscal 2005

Cost of professional services, subscription and hosting revenue increased \$28.1 million in fiscal 2006 as compared to fiscal 2005 primarily due to \$14.9 million of costs due to our 2006 acquisitions, which have professional services organizations to support their revenue including the Dictaphone subscription-based licensing and hosted application customer base. The 80.6% growth in costs supports the 71.9% growth in related revenue for fiscal 2006. Cost of professional services as a percentage of the revenue, excluding share-based payments which changed \$1.8 million, improved 2.9% as synergies were realized from the merging of the service teams from our 2006 acquisitions. These improvements were offset partially by increased expenses for the subscription and hosting services.

Table of Contents**Cost of Maintenance and Support Revenue**

Cost of maintenance and support revenue primarily consists of compensation for product support personnel and overhead. 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):

	Fiscal 2007	Fiscal 2006	Fiscal 2005	% Change 2007 vs 2006	% Change 2006 vs 2005
Cost of maintenance and support revenue	\$ 27.5	\$ 15.6	\$ 4.9	76.3%	218.4%
As a percentage of maintenance and support revenue	22.0%	21.9%	35.6%		

Fiscal 2007 Compared to Fiscal 2006

Cost of maintenance and support revenue increased \$11.9 million as compared to fiscal 2006 due to \$8.5 million related to our 2007 acquisitions and the cost of maintenance and support revenue for our organic business increased \$3.3 million, or 21% as compared to the 2006 base. Cost of maintenance and support revenue as a percentage of revenue stayed relatively flat at 22%, as maintenance and support revenue and associated costs grew approximately 76% from fiscal 2006.

Fiscal 2006 Compared to Fiscal 2005

Cost of maintenance and support revenue increased \$10.7 million compared to fiscal 2005. As a percentage of maintenance and support revenue, cost of revenue decreased 13.7 percentage points in fiscal 2006 to 21.9%. This decrease in percentage is primarily attributable to lower costs relative to the revenue in our speech business, including our healthcare maintenance and support business following our acquisition of Dictaphone and also in areas other than speech due to synergies we realized upon the combination of pre-existing and acquired product lines following our acquisition of Former Nuance.

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 (in millions):

	Fiscal 2007	Fiscal 2006	Fiscal 2005	% Change 2007 vs 2006	% Change 2006 vs 2005
--	------------------------	------------------------	------------------------	--	--

Cost of revenue from amortization of intangible assets	\$ 13.1	\$ 12.9	\$ 9.2	1.6%	40.2%
As a percentage of total revenue	2.2%	3.3%	3.9%		

Fiscal 2007 Compared to Fiscal 2006

Cost of revenue from amortization of intangible assets increased \$0.2 million in fiscal 2007 as compared to fiscal 2006. The increase was primarily attributable to \$3.1 million in amortization of intangible assets related to our 2007 acquisitions offset by a fiscal 2006 non-recurring charge of \$2.6 million to write down technology licensed from a third party to its net realizable value. As a percentage of revenue, cost of revenue from amortization of intangible assets declined from 3.3% to 2.2% largely because of a non-recurring charge in fiscal 2006 as well as the effect of amortization expense over a larger revenue base.

Table of Contents

Based on the amortizable intangible assets as of September 30, 2007, and assuming no impairment or reduction in expected lives, we expect cost of revenue from amortization of intangible assets for fiscal 2008 to be \$19.1 million.

Fiscal 2006 Compared to Fiscal 2005

Cost of revenue from amortization of intangible assets increased \$3.7 million in fiscal 2006 as compared to fiscal 2005. The increase was primarily attributable to the \$4.4 million in amortization of intangible assets relating to our 2006 acquisitions and \$0.4 million incremental expense resulting from amortization of the December 2006 settlement and license from z4 Technologies, Inc. In addition, during the fourth quarter of fiscal 2006, we determined that we would not make additional investments to support a technology licensed from a non-related third-party in 2003. As a result, we revised the cash flow estimates related to the purchased technology and recorded an additional \$2.6 million in cost of revenue to write down the purchased technology to its net realizable value. These increases were offset in part by the cessation of the amortization of technology and patents that was established in connection with our acquisitions consummated in 1999 and 2000 as they were fully amortized.

Research and Development Expense

Research and development expense primarily consists of salaries and benefits and overhead 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):

	Fiscal 2007	Fiscal 2006	Fiscal 2005	% Change 2007 vs 2006	% Change 2006 vs 2005
Research and development expense	\$ 80.0	\$ 59.4	\$ 39.2	34.7%	51.5%
As a percentage of total revenue	13.3%	15.3%	16.9%		

Fiscal 2007 Compared to Fiscal 2006

Research and development expense increased \$20.6 million in fiscal 2007 compared to fiscal 2006 due to an increase of \$8.6 million in compensation expense due to increased headcount largely associated with our 2007 acquisitions, an additional \$6.9 million for contract labor and professional services to support ongoing research and development projects and an additional \$2.6 million of increased shared-based payment expense. To date, we have not capitalized any internal development costs as the cost incurred after technological feasibility but before release of products has not been significant. The remaining increase relates to additional employee-related travel, entertainment and infrastructure expenses. While increasing in absolute dollars, research and development expense continued to decrease as a proportion of total revenue reflecting achievement of synergies following acquisitions and on-going efforts to increase productivity.

We believe that the development of new products and the enhancement of existing products are essential to our success. Accordingly, we plan to continue to invest in research and development activities at approximately the same percentage of revenue in fiscal 2008.

Fiscal 2006 Compared to Fiscal 2005

Research and development expense increased \$20.2 million in fiscal 2006 compared to fiscal 2005 due to a \$10.7 million increase in compensation related expense due to increased headcount largely resulting from our 2006 acquisitions and an increase of \$4.3 million relating to share-based payments. The remaining increase was attributable to an increase in other headcount related expenses, including travel and infrastructure related expenses as we continued to invest in our products. While continuing to increase in absolute dollars, research and development expense has decreased relative to our total revenue. This decrease in expense as a percentage of total revenue reflects synergies following previous acquisitions.

Table of Contents**Sales and Marketing Expense**

Sales and marketing expense includes salaries and benefits, commissions, advertising, direct mail, public relations, tradeshow 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):

	Fiscal 2007	Fiscal 2006	Fiscal 2005	% Change 2007 vs 2006	% Change 2006 vs 2005
Sales and marketing expense	\$ 184.9	\$ 128.4	\$ 78.8	44.0%	62.9%
As a percentage of total revenue	30.7%	33.1%	33.9%		

Fiscal 2007 Compared to Fiscal 2006

Sales and marketing expense increased \$56.5 million in fiscal 2007 as compared to fiscal 2006 due to an increase of \$35.0 million in salaries and other variable costs, such as commissions and travel expenses relating to increased headcount from our 2007 acquisitions and to support the organic business, an increase of \$13.0 million relating to share-based compensation, and an increase of \$4.2 million relating to marketing programs and channel program expenses. The remaining increase in expenses relates to employee-related travel, temporary and professional services, recruiting and other expenses associated with the support of the sales and marketing organization. While the expenses increased in absolute dollars, sales and marketing expenses continued to decrease as a percentage of total revenue due to synergies achieved from acquisitions and increased productivity of sales organization.

We expect sales and marketing expenses to increase in absolute dollars as we continue to pursue our strategic goals but remain relatively consistent as a percentage of revenue in fiscal 2008.

Fiscal 2006 Compared to Fiscal 2005

Sales and marketing expense increased \$49.6 million in fiscal 2006 as compared to fiscal 2005 due to a \$30.1 million increase in our 2006 acquisitions and continued investment in the sales force for our existing products, an increase of \$6.4 million relating to share-based payments and a \$7.8 million increase in marketing expenses primarily to support new product releases made during fiscal 2006 as well as marketing expenses associated with products acquired as part of our 2006 acquisitions. While the expense in absolute dollars increased, sales and marketing expense as a percentage of revenue decreased as we achieved higher sales volumes while controlling our cost structure.

General and Administrative Expense

General and administrative expense primarily consists of personnel costs, (including 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):

	Fiscal 2007	Fiscal 2006	Fiscal 2005	% Change 2007 vs 2006	% Change 2006 vs 2005
General and administrative expense	\$ 75.6	\$ 55.3	\$ 32.0	36.7%	72.8%
As a percentage of total revenue	12.6%	14.2%	13.8%		

Table of Contents***Fiscal 2007 Compared to Fiscal 2006***

General and administrative expense increased \$20.3 million in fiscal 2007 as compared to fiscal 2006 due to increased compensation associated with our 2007 acquisitions, an increase of \$8.4 million relating to share-based compensation, and a \$4.0 million increase in expenses relating to temporary employees and professional services to support our growing organization. While expenses increased in absolute dollars, the expenses have decreased as a percent of total revenue primarily as we have realized synergies from the integration of general and administrative organizations of acquired companies into our general and administrative organization.

We expect general and administrative expense to continue to increase in absolute dollars but decrease slightly as a percentage of revenue as we continue to achieve synergies of scale.

Fiscal 2006 Compared to Fiscal 2005

General and administrative expense increased \$23.3 million in fiscal 2006 compared to fiscal 2005. Our 2006 acquisitions contributed \$7.8 million of this increase, including \$3.0 million paid to Dictaphone staff for non-recurring activities necessary to transition knowledge and processes post-acquisition. General and administrative expense, excluding those related to our 2006 acquisitions, increased \$15.5 million due primarily to compensation for increased employees and external contractors in the finance, human resources, legal and other general and administrative functions. This increase in spending on staff and contractors was related to our need to comply with new regulations, such as the implementation of SFAS 123R in fiscal 2006. These new initiatives were partially offset by a reduction in overall costs for staffing and contractors needed to comply with the provisions of Sarbanes Oxley in fiscal 2006. While the expense increased in absolute dollars, general and administrative expense as a percentage of revenue decreased as we achieved higher sales volumes while controlling our cost structure.

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):

	Fiscal 2007	Fiscal 2006	Fiscal 2005	% Change 2007 vs 2006	% Change 2006 vs 2005
Amortization of other intangible assets	\$ 24.6	\$ 17.2	\$ 4.0	43.0%	330.0%
As a percentage of total revenue	4.1%	4.4%	1.7%		

Fiscal 2007 Compared to Fiscal 2006

Amortization of intangible assets increased \$7.4 million in fiscal 2007 as compared to fiscal 2006. The increase was primarily attributable to \$10.6 million in amortization of intangible assets related to our 2007 acquisitions. Customer relationships compose the majority of the intangible assets amortized to operating expense, and are amortized to expense based upon patterns in which the economic benefits are expected to be utilized. Based on these patterns, the amortization relating to certain of our acquisitions consummated in fiscal 2006 acquisitions and before, was less in fiscal 2007 than in fiscal 2006. This decrease partially offset the increase from our 2007 acquisitions.

Based on the amortizable intangible assets as of September 30, 2007, and assuming no impairment or reduction in expected lives, we expect cost of revenue from amortization of intangible assets for fiscal 2008 to be \$49.5 million.

Table of Contents***Fiscal 2006 Compared to Fiscal 2005***

Amortization of intangible assets increased \$13.2 million in fiscal 2006 as compared to fiscal 2005 largely attributable to the \$10.8 million of amortization of identifiable intangible assets related to our 2006 acquisitions and full year amortization relating to our fiscal 2005 acquisitions.

Restructuring and Other Charges (Credits), Net

During the second quarter of fiscal 2006, we recorded a \$1.3 million reduction to existing restructuring reserves as a result of the execution of a favorable sublease agreement relating to one of the facilities included in our 2005 restructuring plan. The amount was partially offset by other net adjustments of \$0.1 million associated with prior years restructuring programs.

In fiscal 2005, we incurred restructuring charges of \$7.2 million. The charges were related to the elimination of ten employees during the first quarter of 2006, a plan of restructuring relative to certain of our facilities in June 2005, and a September 2005 plan of restructuring to eliminate additional facilities and a reduction of approximately 40 employees in connection with our acquisition of Former Nuance. The facilities charges included \$0.2 million related to the write-down of leasehold improvements based on their net book value relative to the fair market value for their shortened lives. The reduction in personnel was primarily from the research and development and sales and marketing teams, and was based on the elimination of redundancies resulting from our acquisition of Former Nuance.

The following table sets forth the activity relating to the restructuring accruals in fiscal 2007, 2006 and 2005 (in millions):

	Personnel Related	Facilities Costs	Asset Impairment	Total
Balance at September 30, 2004	\$ 0.4	\$ 0.1	\$	\$ 0.5
Restructuring and other charges	2.9	4.1	0.2	7.2
Non-cash write-off			(0.2)	(0.2)
Cash payments	(1.5)	(0.2)		(1.7)
Balance at September 30, 2005	1.8	4.0		5.8
Restructuring and other charges (credits)		(1.2)		(1.2)
Cash payments	(1.4)	(2.3)		(3.7)
Balance at September 30, 2006	0.4	0.5		0.9
Restructuring and other charges (credits)	(0.1)			(0.1)
Cash payments		(0.5)		(0.5)
Balance at September 30, 2007	\$ 0.3	\$	\$	\$ 0.3

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):

	Fiscal 2007	Fiscal 2006	Fiscal 2005	% Change 2007 vs 2006	% Change 2006 vs 2005
Interest income	\$ 6.0	\$ 3.3	\$ 1.2	81.8%	175.0%
Interest expense	(36.5)	(17.6)	(1.6)	107.4	1,000.0
Other income (expense), net		(1.1)	(0.2)	(100.0)	450.0
Total other income (expense), net	\$ (30.5)	\$ (15.4)	\$ (0.6)		
As a percentage of total revenue	(5.1)%	(4.0)%	(0.3)%		

Table of Contents***Fiscal 2007 Compared to Fiscal 2006***

Interest income increased \$2.7 million in fiscal 2007, as compared to fiscal 2006, primarily due to higher cash and investment balances during fiscal 2007 as well as higher interest rates. Interest expense increased \$18.9 million during fiscal 2007, as compared to fiscal 2006, primarily due to (i) interest related to the credit facility we entered into on March 31, 2006 having been outstanding for a full 12 months; (ii) the April 2007 and August 2007 amendments to that facility that added \$90.0 million and \$225.0 million of debt, respectively; and (iii) the \$250.0 million convertible debentures that we issued in August 2007. Additionally, we have recorded \$4.6 million of non-cash interest expense mainly related to imputed interest in association with certain lease obligations included in our accrued business combination costs and accrued restructuring charges, the amortization of debt issuance costs associated with the credit facility we entered into on March 31, 2006 as well as to the accretion of the interest related to the note payable from our Phonetic acquisition in February 2005. 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 who have transactions denominated in currencies other than their functional currencies, as well as the translation of certain of our intercompany balances.

We expect interest expense to increase during fiscal 2008, relative to fiscal 2007, as we pay interest on the 2006 credit facility, as amended, as well as on the new convertible debentures, and as we amortize the debt issuance costs and debt discount for the full year as compared to the partial year during which these items were outstanding in fiscal 2007. We will continue to record interest expense as it relates to certain lease obligations included in our accrued restructuring and accrued business combination costs.

Fiscal 2006 Compared to Fiscal 2005

Interest income increased \$2.1 million in fiscal 2006, as compared to fiscal 2005, primarily due to higher cash and investment balances during fiscal 2006, as compared to the prior year, and to a lesser degree to greater yields on our cash and investments. Interest expense increased \$16.0 million during fiscal 2006, as compared to fiscal 2005, mainly due to \$12.2 million of interest expense paid quarterly on 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 (in thousands, except percentages):

	Fiscal 2007	Fiscal 2006	Fiscal 2005	% Change 2007 vs 2006	% Change 2006 vs 2005
Income tax provision (benefit)	\$ 22.5	\$ 15.1	\$ 6.8	49.0%	122.1%
Effective income tax rate	265.1%	(214.2)%	488.3%		

Fiscal 2007 Compared to Fiscal 2006 and Fiscal 2005

The variance from the federal statutory rate in all periods was due primarily to the increase in our valuation allowance with respect to certain deferred tax assets. Valuation allowances have been established for the U.S. net deferred tax asset, which we believe do not meet the more likely than not realization criteria established by SFAS 109, Accounting for Income Taxes. Due to a history of cumulative losses in the United States, a full valuation allowance has been recorded against the net deferred assets of our U.S. entities. At September 30, 2007, we had a valuation allowance for U.S. net deferred tax assets of approximately \$298.5 million. The U.S. net deferred tax assets is composed of tax assets primarily related to net operating loss carryforwards (resulting both from business combinations and from operations) and tax credits, offset by deferred tax liabilities primarily related to intangible assets. Certain of these intangible assets have indefinite lives, and the resulting deferred tax liability

Table of Contents

associated with these assets is not allowed as an offset to our deferred tax assets for purposes of determining the required amount of our valuation allowance.

Our utilization of deferred tax assets that were acquired in a business combination (primarily net operating loss carryforwards) will require the reversal of the deferred tax asset in accordance with the manner in which the deferred tax asset was originally recorded and will vary based upon the business combination whose deferred tax assets are being utilized. Our establishment of new deferred tax assets as a result of operating activities requires the establishment of valuation allowances based upon the SFAS 109 more likely than not realization criteria. The establishment of a valuation allowance relating to operating activities is recorded as an increase to tax expense.

Our tax provision also includes state and foreign tax expense, which is determined on either a legal entity or separate tax jurisdiction basis.

LIQUIDITY AND CAPITAL RESOURCES

Cash and cash equivalents totaled \$184.3 million as of September 30, 2007, an increase of \$72.0 million compared to \$112.3 million as of September 30, 2006. In addition, we had \$2.6 million of marketable securities as of September 30, 2007. We completed fiscal 2007 with working capital of \$164.9 million as compared to \$51.3 million at the end of fiscal 2006. As of September 30, 2007, total retained deficit was \$204.1 million. We do not expect our retained deficit to impact our future ability to operate given our strong cash and financial position. Our increase in cash and cash equivalents was composed of \$106.4 million provided by operating activities, partially offset by the net impact of cash provided by financing activities and cash used in investing activities.

Cash provided by operating activities

Cash provided by operating activities for fiscal 2007 was \$106.4 million, an increase of \$44.4 million, or 72%, from \$62.0 million provided by operating activities in fiscal 2006. The increase was primarily composed of changes relating to the net loss after adding back non-cash items such as depreciation and amortization and share-based compensation. In fiscal 2007 this amount was \$100.9 million compared to \$53.2 million in fiscal 2006, an increase of \$47.8 million, or 90%. This increase in fiscal 2007 was augmented by changes in working capital accounts of \$5.5 million, which was composed primarily of a \$24.1 million increase in accounts payable and accrued expenses, offset by a \$14.2 million increase in accounts receivable. The increase in accounts receivable represents a 13% increase as compared to the September 30, 2006 balance of \$110.8 million, while the accounts payable and accrued expenses represent a 30% increase to the September 30, 2006 balance of \$80.4 million. Each of the accounts receivable and the accounts payable and accrued expenses grew in support of our business which grew considerably in fiscal 2007, with revenue increasing 55% as compared to fiscal 2006.

Cash provided by operating activities for fiscal 2006 was \$62.0 million, an increase of \$45.8 million, or 283%, from \$16.2 million provided by operating activities in fiscal 2005. The increase was primarily composed of changes relating to the net loss after adding back non-cash items such as depreciation and amortization and share-based compensation. In fiscal 2006 this amount was \$53.2 million compared to \$21.8 million in fiscal 2005, an increase of \$31.4 million, or 144%. This increase in the comparable annual periods was offset by net changes to working capital accounts of \$14.4 million.

Beginning in fiscal 2006, SFAS 123R requires the benefits of tax deductions in excess of the tax-affected compensation that would have been recognized as if we had always accounted for our share-based compensation activity under SFAS 123R to be reported as a cash flow from financing activities, rather than as a cash flow from operating activities, as was prescribed under accounting rules applicable through fiscal 2005. Under SFAS 123R, these excess tax benefits from share-based compensation activity generated in 2007 and 2006, are reported as a cash

flow from financing activities with an offsetting cash flow used in operating activities. The benefits of tax deductions in excess of the tax-affected compensation could fluctuate significantly from period to period based on the number of share-based compensation exercised, sold or vested, the tax benefit realized and the tax-affected compensation recognized.

Table of Contents**Cash used in investing activities**

Cash used in investing activities for fiscal 2007 was \$577.7 million, an increase of \$207.5 million, or 56%, as compared to \$370.2 million for fiscal 2006. The increase in cash used in investing was primarily driven by a \$171.5 million increase in cash paid relating to our acquisitions. In fiscal 2007 we paid, net of cash assumed and including cash paid and held in escrow, \$564.3 million relating to certain of our acquisitions, as compared to \$392.8 million in fiscal 2006. Our purchases of property and equipment and fees paid to defend our intellectual property each increased in fiscal 2007 relative to fiscal 2006, collectively using \$20.2 million in fiscal 2007 as compared to \$12.6 million in fiscal 2006, using an additional \$7.5 million in cash. In fiscal 2007 we generated \$28.6 million less cash from maturities of marketable securities and removal of encumbrances against certain restricted cash balances, as we generated \$6.7 million and \$35.3 million during fiscal 2007 and 2006, respectively. The decrease in cash provided from marketable securities and restricted cash was the result of most of our investments and restricted cash having been converted to cash and cash equivalents during fiscal 2006.

Cash used in investing activities for fiscal 2006 was \$370.2 million, an increase of \$325.6 million, or 730%, as compared to \$44.6 million for fiscal 2005. The increase in cash used in investing was primarily driven by an increase of \$331.5 million in cash paid for our acquisitions, of which the majority of the fiscal 2006 payments related to our acquisition of Dictaphone on March 31, 2006, and \$8.3 million of the increase related to incremental purchases of property and equipment and fees paid to defend our intellectual property. The increase in cash used in investing activities was partially offset by an incremental \$11.1 million cash generated from removal of encumbrances on restricted cash and \$3.1 million of incremental maturities of marketable securities.

Cash provided by financing activities

Cash provided by financing activities for fiscal 2007 was \$541.5 million, an increase of \$192.8 million, or 55%, as compared to \$348.7 million in fiscal 2006. The increase in cash provided by financing activities is primarily related to \$205.4 million of incremental net borrowings from our Expanded 2006 Credit Facility and 2.75% Convertible Senior Debentures. This increase in cash generated was partially offset by \$4.5 million additional payments of notes and payables and capital leases, \$4.2 million in additional deferred acquisition payments, \$3.2 million for repurchase of shares originally issued to the former shareholders of Mobile Voice Control, Inc., incremental \$1.1 million purchases of additional treasury stock and \$2.3 million less cash generated for proceeds from issuance of common stock under employee share-based compensation plans.

Cash provided by financing activities for fiscal 2006 was \$348.7 million, an increase of \$272.3 million compared to \$76.5 million in fiscal 2005. The increase in cash provided by financing activities was primarily driven by \$346.0 million net proceeds from the new credit facility we entered into in March 2006. Additionally, the proceeds from the issuance of common stock under employee based compensation plans increased \$24.6 million, or 397%. These increases were partially offset by \$73.9 million in net proceeds from the issuance of common stock under private placements that occurred in fiscal 2005 and deferred acquisition payments of \$14.4 million made in fiscal 2006 related to our acquisition of ART.

Credit Facilities and Debt***2.75% Convertible Senior Debentures***

On August 13, 2007, Nuance issued \$250 million of 2.75% convertible senior debentures due in 2027 (the 2027 Debentures) in a private placement to Citigroup Global Markets Inc. and Goldman, Sachs & Co. (the Initial Purchasers). Total proceeds, net of debt discount of \$7.5 million and deferred debt issuance costs of \$1.1 million, to us were \$241.4 million. The 2027 Debentures bear an interest rate of 2.75% per annum, payable semi-annually in arrears

beginning on February 15, 2008, and mature on August 15, 2027 subject to the right of the holders of the 2027 Debentures to require us to redeem the 2007 Debentures on August 15, 2014, 2017 and 2022. The related debt discount and debt issuance costs are being amortized to interest expense using the effective interest rate method through August 2014. As of September 30, 2007, the ending unamortized deferred financing fees were \$1.1 million and are included in other assets in our accompanying balance sheet. The 2027 Debentures are general senior unsecured obligations, ranking equally in right of payment to all of our existing and future unsecured, unsubordinated indebtedness and senior in right of payment to any indebtedness that is contractually subordinated to the 2027

Table of Contents

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

Expanded 2006 Credit Facility

We have entered into a credit facility which consists of a \$75 million revolving credit line including letters of credit, a \$355 million term loan entered into on March 31, 2006, a \$90 million term loan entered into on April 5, 2007 and a \$225 million term loan entered into on August 24, 2007 (the Expanded 2006 Credit Facility). The term loans are due March 2013 and the revolving credit line is due March 2012. As of September 30, 2007, \$663.7 million remained outstanding under the term loans and there were \$17.4 million of letters of credit issued under the revolving credit line. There were no other outstanding borrowings under the revolving credit line.

The Expanded 2006 Credit Facility contains covenants, including, among other things, covenants that restrict the ability of us and our subsidiaries to incur certain additional indebtedness, create or permit liens on assets, enter into sale-leaseback transactions, make loans or investments, sell assets, make certain acquisitions, pay dividends, or repurchase stock. The agreement also contains events of default, including failure to make payments of principal or interest, failure to observe covenants, breaches of representations and warranties, defaults under certain other material indebtedness, failure to satisfy material judgments, a change of control and certain insolvency events. As of September 30, 2007, we were in compliance with the covenants under the Expanded 2006 Credit Facility.

Borrowings under the Expanded 2006 Credit Facility bear interest at a rate equal to the applicable margin plus, at our option, either (a) the base rate (which is the higher of the corporate base rate of UBS AG, Stamford Branch, or the federal funds rate plus 0.50% per annum) or (b) LIBOR (equal to (i) the British Bankers' Association Interest Settlement Rates for deposits in U.S. dollars divided by (ii) one minus the statutory reserves applicable to such borrowing). The applicable margin for term loan borrowings under the Expanded 2006 Credit Facility ranges from 0.75% to 1.50% per annum with respect to base rate borrowings and from 1.75% to 2.50% per annum with respect to LIBOR-based borrowings, depending on our leverage ratio. The applicable margin for revolving loan borrowings,

under the Expanded 2006 Credit Facility ranges from 0.50% to 1.25% per annum with respect to base rate borrowings and from 1.50% to 2.25% per annum with respect to LIBOR-based borrowings, depending upon our leverage ratio. As of September 30, 2007, our applicable margin for term loan was 0.75% for base rate borrowings and 2.00% for LIBOR-based borrowings. We are required to pay a commitment fee for unutilized commitments

Table of Contents

under the revolving credit facility at a rate ranging from 0.375% to 0.50% per annum, based upon our leverage ratio. As of September 30, 2007, the commitment fee rate was 0.375% and the interest rate was 7.13%.

We capitalized debt issuance costs related to the Expanded 2006 Credit Facility and are amortizing the costs to interest expense using the effective interest rate method through March 2012 for costs associated with the revolving credit facility and through March 2013 for costs associated with the term loan. As of September 30, 2007, the ending unamortized deferred financing fees were \$12.3 million and are included in other assets in our accompanying balance sheet.

The credit facility is subject to repayment in four equal quarterly installments of 1% per annum (\$6.7 million per year, not including interest, which is also payable quarterly), and an annual excess cash flow sweep, as defined in the Expanded 2006 Credit Facility, which is first payable beginning in the first quarter of fiscal 2008, based on the excess cash flow generated in fiscal 2007. Any term loan 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 annual aggregate principal amount of the term loans repaid would be as follows (in millions):

Year Ending September 30,	Amount
2008	\$ 6.7
2009	6.7
2010	6.7
2011	6.7
2012	6.7
Thereafter	630.2
Total	\$ 663.7

Our obligations under the Expanded 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 Expanded 2006 Credit Facility and the guarantees thereof are secured by first priority liens and security interests in the following: 100% of the capital stock of substantially all of our domestic subsidiaries and 65% of the outstanding voting equity interests and 100% of the non-voting equity interests of first-tier foreign subsidiaries, all material tangible and intangible assets of us and the guarantors, and any present and future intercompany debt. The Expanded 2006 Credit Facility also contains provisions for mandatory prepayments of outstanding term loans upon receipt of the following, and subject to certain exceptions: 100% of net cash proceeds from asset sales, 100% of net cash proceeds from issuance or incurrence of debt, and 100% of extraordinary receipts. We may voluntarily prepay borrowings under the Expanded 2006 Credit Facility without premium or penalty other than breakage costs, as defined with respect to LIBOR-based loans.

As noted above, beginning in the first quarter of fiscal 2008, we may be required to annually repay a portion of the outstanding principal under the Expanded 2006 Credit Facility in accordance with the excess cash flow sweep provision, as defined in the Expanded 2006 Credit Facility. There is no payment in the first fiscal quarter of fiscal 2008 under the excess cash flow sweep provision of the Expanded 2006 Credit Facility.

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 and the contingent payments

for acquisitions, if any are realized, 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 terms that may be less favorable.

Table of Contents**Off-Balance Sheet Arrangements, Contractual Obligations, Contingent Liabilities and Commitments****Contractual Obligations**

The following table outlines our contractual payment obligations as of September 30, 2007 (in millions):

Contractual Obligations	Total	Payments Due by Year			
		Fiscal 2008	Fiscal 2009 and 2010	Fiscal 2011 and 2012	Thereafter
Expanded 2006 Credit Facility	\$ 663.7	\$ 6.7	\$ 13.4	\$ 13.4	\$ 630.2
2.75% Convertible Senior Debentures(1)	250.0				250.0
Interest payable under 2006 Expanded Credit Facility(2)	261.9	48.5	96.1	94.1	23.2
Interest payable under 2.75% Convertible Senior Debentures(3)	48.2	6.8	13.8	13.8	13.8
Lease obligations and other liabilities					
Capital leases and other liabilities	1.1	0.7	0.4		
Operating leases	92.8	11.2	22.2	17.8	41.6
Other lease obligations associated with the closing of duplicate facilities related to restructurings and acquisitions(4)	5.9	2.0	2.3	1.2	0.4
Pension, minimum funding requirement(5)	7.0	1.8	3.5	1.7	
Purchase commitments(6)	4.2	4.2			
Other long-term liabilities assumed(7)	76.5	12.8	26.8	26.8	10.1
Total contractual cash obligations	\$ 1,411.3	\$ 94.7	\$ 178.5	\$ 168.8	\$ 969.3

(1) Holders of the 2.75% Senior Convertible Debentures have the right to require us to repurchase the debentures on August 15, 2014, 2017 and 2022.

(2) Interest is due and payable monthly under the credit facility, and principal is paid on a quarterly basis. The amounts included as interest payable in this table are based on the terms of the Expanded 2006 Credit Facility.

(3) Interest is due and payable semi-annually under the 2.75% convertible senior debentures.

(4) Obligations include contractual lease commitments related to a facility that was part of a 2005 restructuring plan. As of September 30, 2007, total gross lease obligations are \$3.4 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 September 30, 2007, we have subleased two of the facilities to unrelated third parties with total sublease income of \$4.2 million through fiscal 2013.

- (5) Our U.K. pension plan has a minimum funding requirement of £859,900 (\$1.8 million based on the exchange rate at September 30, 2007) for each of the next 4 years, through fiscal 2011.
- (6) These amounts include non-cancelable purchase commitments for inventory in the normal course of business to fulfill customers' orders currently scheduled in our backlog.
- (7) 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 \$76.5 million. As of September 30, 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 \$20.0 million, which ranges from \$2.7 million to \$3.1 million on an annualized basis through 2016.

On November 2, 2007, we completed our acquisition of Vocada, Inc., a developer of software applications to complement certain of our healthcare solutions. The announced estimated aggregate consideration for this

Table of Contents

acquisition is approximately 0.9 million shares of our common stock, and a contingent payment of up to an additional \$21.0 million in cash or shares of our common stock, at our election, based on the acquired business achieving certain performance targets through 2010.

On November 26, 2007, we completed our acquisition of Viacore, Inc. The Viacore acquisition will expand our professional services capabilities. The announced estimated aggregate consideration for this acquisition will be approximately 5.0 million shares of our common stock, and a payment of approximately \$9.5 million in cash, including 0.6 million shares of stock to be placed into escrow, in connection with certain standard representations and warranties. The cash requirements of this acquisition were funded out of our cash and cash equivalents as of September 30, 2007.

Contingent Liabilities and Commitments

In connection with our acquisition of Phonetic, we agreed to make contingent earnout payments of up to \$35.0 million upon the achievement of certain established financial and performance targets through December 31, 2007, in accordance with the purchase agreement. We have notified the former shareholders of Phonetic that the performance targets for the scheduled payments for calendar 2005 and 2006, totaling \$24.0 million, were not achieved. The former shareholders of Phonetic have objected to this determination. We are currently in discussions with the former shareholders of Phonetic in regards to this matter. We have not recorded any obligation as of September 30, 2007.

In connection with our acquisition of Mobile Voice Control, we agreed to make contingent earnout payments payable in our common stock of up to 1.7 million shares upon the achievement of certain performance targets through December 31, 2008, in accordance with the purchase agreement. We have not recorded any obligation relative to these performance measures as of September 30, 2007.

In connection with our acquisition of BeVocal, we agreed to make contingent earnout payments of up to \$65.1 million, including amounts payable to an investment banker, upon the achievement of certain performance targets through December 31, 2007, in accordance with the purchase agreement. We have accrued \$44.2 million of this amount as of September 30, 2007. Of the amount estimated to be paid, \$41.3 million of the contingent earnout consideration is payable in cash, and \$2.9 million may be paid in the form of our common stock, or cash, at our option. These contingent earnout liabilities are payable in October 2008.

In connection with our acquisition of Commissure, we agreed to make contingent earnout payments of up to \$8.0 million upon the achievement of certain performance targets through 2010, in accordance with the merger agreement. If the targets are achieved, the contingent earnout payment may be made in cash or shares of our common stock, at our election. We have not recorded any obligation relative to these performance measures as of September 30, 2007.

In connection with our acquisition of Vocada, we agreed to make contingent earnout payments of up to an additional \$21,000,000 upon the achievement of certain performance targets through 2010, in accordance with the terms of the merger agreement. If the targets are achieved, the contingent earnout payment will be made in cash or shares of our common stock, at our election. We have not recorded any obligation relative to these performance measures as of September 30, 2007.

In connection with our acquisition of Viacore, we agreed to use our commercially reasonable efforts to file a registration statement with the Securities and Exchange Commission following the closing of the acquisition to register the shares of the common stock issued to the former Viacore stockholders. The cash paid in the acquisition may increase by up to \$15,375,000, and the shares issued in the acquisition may decrease by up to 350,032 shares, based on the volume weighted average price of our common stock on the effective date of the registration statement,

as more fully set forth in the merger agreement.

Pension and Post-Retirement Benefit Plans

We assumed defined benefit pension plans as part of the acquisition of Dictaphone Corporation on March 31, 2006, which provide certain retirement and death benefits for former Dictaphone employees located in the United Kingdom and Canada. These plans require periodic cash contributions. The Canadian plan is fully funded and

Table of Contents

expected to remain fully funded during fiscal 2008, without additional funding by us. In fiscal 2007, total cash funding for the UK pension plan was \$1.7 million. For the UK pension plan, we have a minimum funding requirement of £859,900 (approximately \$1.8 million based on the exchange rate at September 30, 2007) for each of the next four years, through fiscal 2011.

We have also assumed a post-retirement health care and life insurance benefit plan in connection with the acquisition of Dictaphone. The plan, which is closed to new participants, provides certain post-retirement health care and life insurance benefits and consists of a fixed subsidy for qualifying employees in the United States and Canada. The plan is non-funded and cash contributions are made each year to cover claim costs incurred in that year. Total cash paid during fiscal 2007 for the post-retirement health care and life insurance benefit plan was not material.

Off-Balance Sheet Arrangements

Through September 30, 2007, we have not entered into any off-balance sheet arrangements or material transactions with unconsolidated entities or other persons.

CRITICAL ACCOUNTING POLICIES, JUDGMENTS AND 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, Nuance 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; 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. Nuance management bases its estimates on historical experience and various other factors that are believed to be reasonable under the circumstances. Actual results could differ from these estimates.

Nuance believes the following critical accounting policies most significantly affect the portrayal of its financial condition and results of operations and require its most difficult and subjective judgments.

Revenue Recognition. Nuance recognizes product and licensing revenue in accordance with Statement of Position, or SOP, 97-2, Software Revenue Recognition, and SOP 98-9, Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transactions, and related authoritative literature. The application of SOP 97-2 requires judgment, including whether a software arrangement includes multiple elements, and if so, whether vendor-specific objective evidence, or VSOE, of fair value exists for those elements. Nuance's software arrangements generally include software and post contract support which includes telephone support and the right to receive unspecified upgrades/enhancements on a when-and-if-available basis, typically for one to three years. Changes to the elements in a software arrangement, the ability to identify VSOE for those elements and the fair value of the respective elements could materially impact the amount of earned and unearned revenue. Judgment is also required to assess whether future releases of certain software represent new products or upgrades and enhancements to existing products. In accordance with SOP 97-2, revenue is recognized when (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred, (iii) the fee is fixed or determinable and (iv) collectibility is probable.

Non-software revenue is recognized in accordance with, the Securities and Exchange Commission's Staff Accounting Bulletin, or SAB, 104, Revenue Recognition in Financial Statements. Under SAB 104, Nuance recognizes revenue when (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred or services have been rendered,

(iii) the fees are fixed or determinable and (iv) collectibility is reasonably assured.

Professional services revenue is recognized in accordance with SOP 81-1, Accounting for Performance of Construction Type and Certain Performance Type Contracts on the percentage-of-completion method. Nuance generally determines the percentage-of-completion by comparing the labor hours incurred to date to the estimated

Table of Contents

total labor hours required to complete the project. Nuance considers labor hours to be the most reliable, available measure of progress on these projects. Adjustments to estimates to complete are made in the periods in which facts resulting in a change become known. When the estimate indicates that a loss will be incurred, such loss is recorded in the period identified. Significant judgments and estimates are involved in determining the percent complete of each contract. Different assumptions could yield materially different results.

Nuance makes estimate of sales returns based on historical experience. In accordance with Statement of Financial Accounting Standards, or 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. Nuance also makes estimates and reduces revenue recognized for price protection and rebates, and certain marketing allowances at the time the related revenue is recorded. If actual results differ significantly from Nuance's estimates, such differences could have a material impact on Nuance's results of operations for the period in which the actual results become known.

Nuance's revenue recognition policies require management to make significant estimates. Management analyzes various factors, including a review of specific transactions, historical experience, creditworthiness of customers and current market and economic conditions. Changes in judgments based upon these factors could impact the timing and amount of revenue and cost recognized and thus affects Nuance's results of operations and financial condition.

Capitalized Patent Defense Costs. Nuance monitors the anticipated outcome of legal actions, and if Nuance determines that the success of the defense of a patent is probable, and so long as Nuance believes that the future economic benefit of the patent will be increased, Nuance then 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, Nuance writes off any capitalized costs in the period the change is determined. As of September 30, 2007 and 2006, capitalized patent defense costs totaled \$6.4 million. Additional costs had been capitalized in fiscal 2007 relating to our historic litigation with VoiceSignal, upon the consummation of our acquisition of VoiceSignal we reclassified \$6.9 million of previously capitalized patent defense costs, of which the majority were recorded into goodwill as a component of the purchase price of VoiceSignal.

Research and Development Costs. Nuance accounts for the internal costs relating to research and development activities in accordance with SFAS 2, Accounting for Research and Development Costs, and SFAS 86, Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed. Research and development costs incurred for new software products and enhancements to existing products, other than certain software development costs that qualify for capitalization, are expensed as incurred. Software development costs incurred subsequent to the establishment of technological feasibility, but prior to the general release of the product, are capitalized and amortized to cost of revenue over the estimated useful life of the related products. Judgment is required in determining when technological feasibility of a product is established. Nuance has determined that technological feasibility for its software products is reached shortly before the products are released to manufacturing. Costs incurred after technological feasibility is established have not been material, and accordingly, Nuance has expensed the internal costs relating to research and development when incurred.

Licensed Technology. The cost of technology which we have licensed to be sold, leased, or otherwise marketed by us is capitalized and amortized to cost of revenue over the estimated useful life of the related products. At each balance sheet date, Nuance evaluates these assets for impairment by comparing the unamortized cost to the net realizable value. Amortization expense was \$0.5 million, \$5.1 million and \$2.1 million for fiscal 2007, 2006 and 2005, respectively. Included in the fiscal 2006 amortization expense was an additional \$2.6 million of expense representing an impairment determined to exist in order to value the licensed technology at its net realizable value. See Note 8 of the Notes to our Consolidated Financial Statements. The net unamortized licensed technology included in other intangible assets at September 30, 2007 and 2006 were \$2.4 million and \$1.6 million, respectively.

Valuation of Long-lived Tangible and Intangible Assets and Goodwill. Nuance 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 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

Table of Contents

economic benefits of customer relationships are expected to be utilized. The values of intangible assets, with the exception of goodwill, were initially determined by a risk-adjusted, discounted cash flow approach. Nuance 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 and at least annually. Factors Nuance 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 Nuance's overall business;
- significant negative industry or economic trends;
- significant decline in Nuance's stock price for a sustained period; and
- a decline in Nuance's market capitalization below net book value.

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

In accordance with SFAS 142, *Goodwill and Other Intangible Assets*, Nuance tests goodwill and intangible assets with indefinite lives 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. Nuance 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, Nuance has determined that it operates in one reporting unit. Based on this assessment, Nuance 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*, Nuance 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 carrying 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 in fiscal 2007, 2006 or 2005, based on the review of long-lived assets under SFAS 144.

Significant judgments and estimates are involved in determining the useful lives of Nuance's 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 Nuance's organization or its 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 Nuance's analysis by reporting unit, and/or (c) other changes in previous assumptions or estimates. In turn, this could have a significant impact on Nuance's consolidated financial statements through accelerated amortization and/or impairment charges.

Accounting for Acquisitions. We have completed a number of significant business and other asset acquisitions over the preceding five years which have resulted in significant goodwill and other intangible asset balances. Our future business strategy contemplates that we may continue to pursue additional acquisitions in the future. Our accounting

for acquisitions involves significant judgments and estimates primarily, but not limited to: the fair value of certain forms of consideration, the fair value of acquired intangible assets, which involve projections of future revenue and cash flows, the fair value of other acquired assets and assumed liabilities, including potential contingencies, and the useful lives and, as applicable, the reporting unit, of the assets. Our financial position or results of operations may be materially impacted by changes in our initial assumptions and estimates relating to prior or future acquisitions. Additionally, under SFAS 142, we determine the fair value of the reporting unit, for purposes of the first step in our annual goodwill impairment test, based on our market value. If prior or future acquisitions are not accretive to our results of operations as expected, our market value declines dramatically, or we determine we have more than one

Table of Contents

reporting unit, we may be required to complete the second step which requires significant judgments and estimates and which may result in material impairment charges in the period in which they are determined.

Accounting for Long-Term Facility Obligations. We have historically acquired companies which have previously established restructuring charges relating to lease exit costs, and we have recorded restructuring charges of our own that include lease exit costs. We follow the provisions of EITF 95-3 Recognition of Liabilities in Connection with a Purchase Business Combination or SFAS 146 Accounting for Costs Associated with Exit or Disposal Activities as applicable. In accounting for these obligations, we are required to make assumptions relating to the time period over which the facility will remain vacant, sublease terms, sublease rates and discount rates. We base our estimates and assumptions on the best information available at the time of the obligation having arisen. These estimates are reviewed and revised as facts and circumstances dictate; changes in these estimates could have a material effect on the amount accrued on the balance sheet.

Accounting for Share-Based Payments. We account for share-based payments in accordance with SFAS 123R, Share-Based Payment. Under the fair value recognition provisions of this statement, share-based compensation cost is measured at the grant date based on the value of the award and is recognized as expense over the requisite service period which is generally the vesting period. Determining the fair value of share-based awards at the grant date requires judgment, including estimating expected dividends, share price volatility and the amount of share-based awards that are expected to be forfeited. If actual results differ significantly from these estimates, share-based compensation expense and our results of operations could be materially impacted.

Pension and Post-Retirement Benefit Plans. We have defined benefit pension plans that were assumed as part of the acquisition of Dictaphone Corporation, which provide certain retirement and death benefits for former Dictaphone employees located in the United Kingdom and Canada. Nuance also assumed a post-retirement health care and life insurance benefit plan, which is frozen relative to new enrollment, and 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. We use several actuarial and other factors which attempt to estimate the ultimate expense, liability and assets values related to our pension and post-retirement benefit plans. These factors include assumptions about discount rates, expected return on plan assets and the rate of future compensation increases. In addition, subjective assumptions, such as withdrawal and mortality rates, are also utilized. The assumptions may differ materially from actual results due to the changing market and economic condition or other factors, and depending on their magnitude, could have a significant impact on the amount we recorded. Pension and post-retirement benefit plan assumptions are included in Note 18 of Notes to our Consolidated Financial Statements.

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. Nuance does not provide for U.S. income taxes on the undistributed earnings of its foreign subsidiaries, which Nuance 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.

Nuance 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 Nuance will generate sufficient future taxable income to realize these deferred tax assets after consideration of all available evidence. Nuance 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 Nuance believes do not meet the more likely than not criteria established by SFAS 109. If Nuance is subsequently able to utilize all or a portion of the

deferred tax assets for which a valuation allowance has been established, then Nuance may be required to recognize these deferred tax assets through the reduction of the valuation allowance which would result in a material benefit to its results of operations in the period in which the benefit is determined, excluding the recognition of the portion of the valuation allowance which relates to net deferred tax assets acquired in a business combination and created as a result of share-based payments. The recognition of the portion of the valuation allowance which relates to net deferred tax assets resulting from share-based payments will be recorded as additional paid-in-capital. The recognition of the

Table of Contents

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.

Loss Contingencies. We are subject to legal proceedings, lawsuits and other claims relating to labor, service and other matters arising in the ordinary course of business, as discussed in Note 17 of Notes to our Consolidated Financial Statements. Quarterly, we review the status of each significant matter and assess our potential financial exposure. If the potential loss from any claim or legal proceeding is considered probable and the amount can be reasonably estimated, we accrue a liability for the estimated loss. Significant judgment is required in both the determination of probability and the determination as to whether an exposure is reasonably estimable. Because of uncertainties related to these matters, accruals are based only on the best information available at the time. As additional information becomes available, we reassess the potential liability related to our pending claims and litigation and may revise our estimates. Such revisions in the estimates of the potential liabilities could have a material impact on our results of operations and financial position.

RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

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. We are evaluating the impact, if any, that SFAS 159 may have on our consolidated financial statements.

In September 2006, the FASB issued SFAS 157, *Fair Value Measurements*. SFAS 157 establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007. We have not yet determined the effect, if any, that the application of SFAS 157 will 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 SFAS 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 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 currently evaluating the effect that the adoption of FIN 48 will have on our consolidated financial statements.

Item 7A. *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 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.

Table of Contents

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, and Hungarian Forint.

Assuming a 10% appreciation or depreciation in foreign currency exchange rates from the quoted foreign currency exchange rates at September 30, 2007, the impact to our revenue, operating results or cash flows could be adversely affected.

Occasionally, we have entered into forward exchange contracts to hedge against foreign currency fluctuations. These foreign currency exchange contracts are entered into as economic hedges, but are not designated as hedges for accounting purposes as defined under SFAS 133. The notional contract amount of these outstanding foreign currency exchange contracts was not material at September 30, 2007 and a hypothetical change of 10% in exchange rates would not have a material impact on the financial results. During the fiscal year ended 2007 and 2006, the Company recorded foreign exchange gains of \$0.8 million and a loss of \$0.2 million, respectively.

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 Expanded 2006 Credit Facility.

At September 30, 2007, we held approximately \$184.3 million of cash and cash equivalents primarily consisting of cash and money-market funds and \$2.6 million of short-term marketable securities. 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 September 30, 2007, our total outstanding debt balance exposed to variable interest rates was \$663.7 million. To partially offset this variable interest rate exposure, Nuance 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 \$563.7 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 \$5.6 million per annum.

Item 8. *Financial Statements and Supplementary Data*

Nuance Communications, Inc. Consolidated Financial Statements

Table of Contents

NUANCE COMMUNICATIONS, INC.
INDEX TO FINANCIAL STATEMENTS

	Page
<u>Reports of Independent Registered Public Accounting Firm</u>	51
<u>Consolidated Balance Sheets</u>	54
<u>Consolidated Statements of Operations</u>	55
<u>Consolidated Statements of Stockholders' Equity and Comprehensive Loss</u>	56
<u>Consolidated Statements of Cash Flows</u>	57
<u>Notes to Consolidated Financial Statements</u>	58

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders
Nuance Communications, Inc.
Burlington, Massachusetts

We have audited the accompanying consolidated balance sheets of Nuance Communications, Inc. (the Company) as of September 30, 2007 and 2006, and the related consolidated statements of operations, stockholders' equity and comprehensive loss, and cash flows for each of the three years in the period ended September 30, 2007. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Nuance Communications, Inc. at September 30, 2007 and 2006, and the results of its operations and its cash flows for each of the three years in the period ended September 30, 2007, in conformity with U.S. generally accepted accounting principles.

As described in note 18 of the Notes to Consolidated Financial Statements, Nuance Communications, Inc. adopted Statement of Financial Accounting Standards No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—An Amendment of FASB Statements No. 87, 88, 106, and 132(R), effective September 30, 2007.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Nuance Communications, Inc.'s internal control over financial reporting as of September 30, 2007, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO Criteria), and our report dated November 29, 2007 expressed an unqualified opinion thereon.

/s/ BDO SEIDMAN, LLP
BDO Seidman, LLP

Boston, Massachusetts
November 29, 2007

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders
Nuance Communications, Inc.
Burlington, Massachusetts

We have audited Nuance Communication Inc.'s internal control over financial reporting as of September 30, 2007, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Nuance Communication Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Item 9A, Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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

As indicated in the accompanying Item 9A, Management's Report on Internal Control over Financial Reporting, management's assessment of and conclusion on the effectiveness of internal control over financial reporting did not include the internal controls of Mobile Voice Control, Inc., which the Company acquired on December 29, 2006, BlueStar Resources Limited, which the Company acquired on March 26, 2007, BeVocal, Inc., which the Company acquired on April 24, 2007, Tegic Communications, Inc., and Voice Signal Technologies, Inc., which the Company acquired on August 24, 2007, and Commissure Inc., which the Company acquired on September 28, 2007, (collectively the 2007 Acquisitions), all of which are included in the consolidated balance sheets of Nuance Communications, Inc. as of September 30, 2007, and the related consolidated statements of operations, stockholders equity and comprehensive loss, and cash flows for the year then ended. Management did not assess the effectiveness of internal control over financial reporting of the 2007 Acquisitions because of the timing of the acquisitions which were completed during the year ended September 30, 2007. The internal control over financial reporting excluded

from management's assessment for the 2007 Acquisitions constituted 4.5% of total assets as of September 30, 2007, and 6.2% of total revenues for the year then ended. Our audit of internal control over financial reporting of Nuance Communications, Inc. also did not include an evaluation of the internal control over financial reporting of the 2007 Acquisitions.

In our opinion, Nuance Communications, Inc. maintained, in all material respects, effective internal control over financial reporting as of September 30, 2007, based on the COSO criteria.

Table of Contents

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Nuance Communications, Inc. as of September 30, 2007 and 2006, and the related consolidated statements of operations, stockholders' equity and comprehensive loss, and cash flows for each of the three years in the period ended September 30, 2007 and our report dated November 29, 2007 expressed an unqualified opinion thereon.

/s/ BDO SEIDMAN, LLP
BDO Seidman, LLP

Boston, Massachusetts
November 29, 2007

Table of Contents**NUANCE COMMUNICATIONS, INC.****CONSOLIDATED BALANCE SHEETS**

	September 30, 2007	September 30, 2006
	(In thousands, except share and per share amounts)	
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 184,335	\$ 112,334
Marketable securities	2,628	
Accounts receivable, less allowances of \$22,074 and \$20,207, respectively	174,646	110,778
Acquired unbilled accounts receivable	35,061	19,748
Inventories, net	8,013	6,795
Prepaid expenses and other current assets	16,489	13,245
Deferred tax assets	444	421
 Total current assets	 421,616	 263,321
 Land, building and equipment, net	 37,618	 30,700
Goodwill	1,249,642	699,333
Other intangible assets, net	391,190	220,040
Other assets	72,721	21,680
 Total assets	 \$ 2,172,787	 \$ 1,235,074
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term debt and obligations under capital leases	\$ 7,430	\$ 3,953
Accounts payable	55,659	27,768
Accrued expenses	83,245	52,674
Current portion of accrued business combination costs	14,547	14,810
Deferred maintenance revenue	68,075	63,269
Unearned revenue and customer deposits	27,787	30,320
Deferred acquisition payments, net		19,254
 Total current liabilities	 256,743	 212,048
 Long-term debt and obligations under capital leases, net of current portion	 899,921	 349,990
Accrued business combination costs, net of current portion	35,472	45,255
Deferred revenue, net of current portion	13,185	9,800
Deferred tax liability	26,038	19,926
Other liabilities	63,161	21,459
 Total liabilities	 1,294,520	 658,478

Commitments and contingencies

Stockholders' equity:

Series B preferred stock, \$0.001 par value; 15,000,000 shares authorized; 3,562,238 shares issued and outstanding (liquidation preference \$4,631)	4,631	4,631
Common stock, \$0.001 par value; 560,000,000 and 280,000,000 shares authorized, respectively; 196,368,445 and 173,182,430 shares issued and 193,178,708 and 170,152,247 shares outstanding, respectively	196	174
Additional paid-in capital	1,078,020	773,120
Treasury stock, at cost (3,189,737 and 3,030,183 shares, respectively)	(15,418)	(12,859)
Accumulated other comprehensive income	14,979	1,656
Accumulated deficit	(204,141)	(190,126)
 Total stockholders' equity	 878,267	 576,596
 Total liabilities and stockholders' equity	 \$ 2,172,787	 \$ 1,235,074

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

Table of Contents**NUANCE COMMUNICATIONS, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS**

	Year Ended September 30,		
	2007	2006	2005
	(In thousands, except per share amounts)		
Revenue:			
Product and licensing	\$ 311,847	\$ 235,825	\$ 171,200
Professional services, subscription and hosting	165,520	81,320	47,308
Maintenance and support	124,629	71,365	13,880
Total revenue	601,996	388,510	232,388
Costs and Expenses:			
Cost of revenue:			
Cost of product and licensing	43,162	29,733	20,378
Cost of professional services, subscription and hosting	114,228	62,752	34,737
Cost of maintenance and support	27,461	15,647	4,938
Cost of revenue from amortization of intangible assets	13,090	12,911	9,150
Total cost of revenue	197,941	121,043	69,203
Gross margin	404,055	267,467	163,185
Operating expenses:			
Research and development	80,024	59,403	39,190
Sales and marketing	184,948	128,412	78,797
General and administrative	75,564	55,343	31,959
Amortization of other intangible assets	24,596	17,172	3,984
Restructuring and other charges (credits), net	(54)	(1,233)	7,223
Total operating expenses	365,078	259,097	161,153
Income from operations	38,977	8,370	2,032
Other income (expense):			
Interest income	5,991	3,305	1,244
Interest expense	(36,501)	(17,614)	(1,644)
Other (expense) income, net	20	(1,132)	(237)
Income (loss) before income taxes	8,487	(7,071)	1,395
Provision for income taxes	22,502	15,144	6,812
Loss before cumulative effect of accounting change	(14,015)	(22,215)	(5,417)
Cumulative effect of accounting change		672	
Net loss	\$ (14,015)	\$ (22,887)	\$ (5,417)

Basic and diluted earnings per share:

Loss before cumulative effect of accounting change	\$ (0.08)	\$ (0.13)	\$ (0.05)
Cumulative effect of accounting change		(0.01)	
Net loss per share	\$ (0.08)	\$ (0.14)	\$ (0.05)

Weighted average common shares outstanding:

Basic and diluted	176,424	163,873	109,540
-------------------	---------	---------	---------

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

Table of Contents

NUANCE COMMUNICATIONS, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY AND COMPREHENSIVE LOSS

Preferred Stock		Common Stock		Additional Paid-In	Treasury Stock		Deferred	Accumulated Other Comprehensive Income	Accumulated
Shares	Amount	Shares	Amount	Capital	Shares	Amount	Compensation	(loss)	Deficit
(In thousands, except share amounts)									
562,238	\$ 4,631	108,604,686	\$ 109	\$ 476,206	2,771,507	\$ (11,071)	\$ (5,465)	\$ (843)	\$ (161,822)
		2,040,339	2	6,085					
				370					
		30,753,696	31	140,778			(4,218)		
		17,688,679	18	73,893					
		344,507		2,095			(2,095)		
							2,996		
					75,354	(361)			(5,417)
								98	
								(1,355)	

Edgar Filing: Nuance Communications, Inc. - Form 10-K

,562,238	4,631	159,431,907	160	699,427	2,846,861	(11,432)	(8,782)	(2,100)	(167,239)
		8,002,211	8	31,163					
		1,194,958	1						
		(43,680)		(392)	183,322	(1,427)			
		9,700		59					
		4,587,334	5	27,519					
				13,757			8,782		
				1,726					
				(139)					(22,887)
								42	
								(570)	
								4,284	
,562,238	4,631	173,182,430	174	773,120	3,030,183	(12,859)		1,656	(190,126)
		6,383,051	6	30,654					

958,124 1

(164,300) (2,220) 159,554 (2,559)
48,135

4,172

14,794,848 15 227,337

1,400,091
(261,422) (3,178)

75,623

(14,015)

(355)

9,628

4,050

,562,238 \$ 4,631 196,368,445 \$ 196 \$ 1,078,020 3,189,737 \$ (15,418) \$ \$ 14,979 \$ (204,141)

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

Table of Contents**NUANCE COMMUNICATIONS, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS**

	Year Ended September 30,		
	2007	2006	2005
	(In thousands)		
Cash flows from operating activities			
Net loss	\$ (14,015)	\$ (22,887)	\$ (5,417)
Adjustments to reconcile net loss to net cash provided by operating activities:			
Depreciation of property and equipment	12,148	8,366	5,019
Amortization of other intangible assets	37,685	30,083	13,134
Accounts receivable allowances	2,449	1,407	1,516
Non-cash portion of restructuring charges		1,233	212
Share-based payments, including cumulative effect of accounting change	48,135	22,539	2,996
Non-cash interest expense	4,169	3,862	1,006
Deferred tax provision	14,068	8,811	2,962
Excess tax benefits from share-based payments	(4,172)	(1,726)	
Normalization of rent expense	465	1,485	357
Changes in operating assets and liabilities, net of effects from acquisitions:			
Accounts receivable	(14,217)	16,599	(19,832)
Inventories	(624)	(1,781)	646
Prepaid expenses and other assets	(4,413)	(1,019)	1,219
Accounts payable	10,736	7,534	6,687
Accrued expenses and other liabilities	13,405	(1,337)	2,845
Deferred maintenance revenue, unearned revenue and customer deposits	603	(11,186)	2,848
Net cash provided by operating activities	106,422	61,983	16,198
Cash flows from investing activities			
Capital expenditures for property and equipment	(12,656)	(8,447)	(4,598)
Proceeds from sale of property and equipment			214
Payments for acquisitions, net of cash acquired	(528,495)	(392,826)	(61,287)
Payments for escrow on acquisitions	(35,800)		
Proceeds from maturities of marketable securities	5,714	24,159	21,089
Payments for capitalized patent defense costs	(7,501)	(4,189)	
Decrease in restricted cash	1,023	11,131	
Net cash used in investing activities	(577,715)	(370,172)	(44,582)
Cash flows from financing activities			
Payments of note payable and capital leases	(6,768)	(2,234)	(463)
Deferred acquisition payments	(18,650)	(14,433)	

Edgar Filing: Nuance Communications, Inc. - Form 10-K

Proceeds from credit facility and convertible debentures, net of discount and issuance costs	551,447	346,032	
Payments associated with licensing agreements			(2,800)
Purchase of treasury stock	(2,559)	(1,427)	(361)
Repurchase of shares	(3,178)		
Payments on other long-term liabilities	(11,419)	(11,573)	
Proceeds from issuance of common stock and common stock warrants, net of issuance costs		(139)	73,911
Excess tax benefits from share-based payments	4,172	1,726	
Net proceeds from issuance of common stock under employee share-based payment plans	28,441	30,780	6,190
Net cash provided by financing activities	541,486	348,732	76,477
Effects of exchange rate changes on cash and cash equivalents	1,808	104	631
Net increase in cash and cash equivalents	72,001	40,647	48,724
Cash and cash equivalents at beginning of period	112,334	71,687	22,963
Cash and cash equivalents at end of period	\$ 184,335	\$ 112,334	\$ 71,687

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

Table of Contents

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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.

During fiscal 2007, 2006 and 2005, the Company acquired the following businesses:

September 28, 2007 Commissure Inc. (Commissure);

August 24, 2007 Voice Signal Technologies, Inc. (VoiceSignal);

August 24, 2007 Tegic Communications, Inc. (Tegic);

April 24, 2007 BeVocal, Inc. (BeVocal);

March 26, 2007 Bluestar Resources Limited, the parent of Focus Enterprises Limited and Focus India Private Limited (collectively Focus);

December 29, 2006 Mobile Voice Control, Inc. (MVC);

March 31, 2006 Dictaphone Corporation (Dictaphone);

September 15, 2005 Nuance Communications, Inc. (Former Nuance);

May 12, 2005 MedRemote, Inc. (MedRemote);

February 1, 2005 Phonetic Systems Ltd. (Phonetic);

January 21, 2005 ART Advanced Recognition Technologies, Inc. (ART); and,

December 6, 2004 Rhetorical Systems, Ltd. (Rhetorical).

The results of operations from the acquired businesses have been included in the Company's consolidated financial statements since the acquisition dates. See Note 3 for additional disclosure related to each of these acquisitions.

Reclassification: Certain amounts presented in the 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

Table of Contents

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

factors that are believed to be reasonable under the circumstances. Actual amounts could differ significantly from these estimates.

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

Revenue Recognition: The Company recognizes revenue from the sale of software products and licensing in accordance with Statement of Position (SOP) 97-2, Software Revenue Recognition, and SOP 98-9, Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transactions, and related authoritative literature. In select situations, we sell or license intellectual property in conjunction with, or in place of, embedding our intellectual property in software. In accordance with SOP 97-2, revenue is recognized when (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred, (iii) the fee is fixed or determinable and (iv) collectibility is probable.

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

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

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

For revenue arrangements with multiple elements outside of the scope of SOP 97-2, the Company accounts for the arrangements in accordance with Emerging Issues Task Force (EITF) Issue 00-21, Revenue Arrangements with Multiple Elements, and allocates an arrangement's fees into separate units of accounting based on fair value.

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

When the Company provides professional services considered essential to the functionality of the software, it recognizes revenue from the professional services as well as any related software licenses on a percentage-of-completion basis in accordance with SOP 81-1, Accounting for Performance of Construction Type and Certain Performance Type Contracts on the percentage-of-completion method. In these circumstances, the Company separates license revenue from professional service revenue for income statement purpose by classifying the vendor-specific objective evidence of the fair value of professional service revenue as professional service revenue and the residual portion as license revenue. The Company generally determines the percentage-of-completion by

comparing the labor hours incurred to date to the estimated total labor hours required to complete the project. The Company considers labor hours to be the most reliable, available measure of progress on these projects. Adjustments to estimates to complete are made in the periods in which facts resulting in a change become known. When the estimate indicates that a loss will be incurred, such loss is recorded in the period identified. Significant judgments and estimates are involved in determining the percent complete of each contract. Different assumptions could yield materially different results.

Table of Contents

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

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

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

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

Cash and Cash Equivalents: Cash and cash equivalents consists of cash on hand, including money market funds and commercial paper with original maturities of 90 days or less.

Marketable Securities: The Company accounts for its marketable equity securities in accordance with SFAS 115 Accounting for Certain Investments in Debt and Equity Securities. Investments are classified as available-for-sale and are recorded on the balance sheet at fair value with unrealized gains or losses reported as a separate component of accumulated other comprehensive income, net of tax. Realized gains and losses on sales of short-term and long-term investments have not been material. The Company had \$2.6 million in marketable securities as of September 30, 2007, and had no marketable securities as of September 30, 2006.

Allowance against Accounts Receivable: The Company maintains an allowance for doubtful accounts for the estimated probable losses on uncollectible accounts receivable. The allowance is based upon the credit worthiness of its customers, its historical experience, the age of the receivable and current market and economic conditions. Receivables are written off against these reserves in the period they are determined to be uncollectible. For sell-through arrangements with certain distributors or resellers for whom the Company does not have history to estimate returns, the Company maintains an allowance against accounts receivable for all product subject to return

Table of Contents

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

at the sales price. The allowance is recorded as a reduction in revenue and based upon the ending product balance held by these distributors or resellers at the end of each period and receivables are written off against these reserves in the period the product is returned. The Company reverses the allowance to revenue when the products are sold through to retailers and end-users. The Company also maintains an allowance for sales returns from customers for which it has the ability to estimate returns based on historical experience. The returns allowance is recorded as a reduction in revenue and accounts receivable at the time that the related revenue is recorded and the receivables are written off against the allowance in the period the return is received.

Inventories: Inventories are stated at the lower of cost, computed using the first-in, first-out method, or market. The Company regularly reviews inventory quantities on hand and records a provision for excess and/or obsolete inventory primarily based on future purchase commitments with its suppliers, and the estimated utility of its inventory as well as other factors including technological changes and new product development.

Land, Building and Equipment: Land, building and equipment are stated at cost. Building and equipment are depreciated over their estimated useful lives. Leasehold improvements are depreciated over the shorter of the lease term or the estimated useful life. Computer software developed or obtained for internal use is accounted for under SOP 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use, and is depreciated over the estimated useful life of the software, generally five years or less. Depreciation is computed using the straight-line method. Significant improvements are capitalized and repairs and maintenance costs are expensed as incurred. The cost and related accumulated depreciation of sold or retired assets are removed from the accounts and any gain or loss is included in operations.

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, 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;

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

Table of Contents

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 in fiscal 2007, 2006 or 2005, 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.

Research and Development Costs: Internal costs relating to research and development costs incurred for new software products and enhancements to existing products, other than certain software development costs that qualify for capitalization, are expensed as incurred. Software development costs incurred subsequent to the establishment of technological feasibility, but prior to the general release of the product, are capitalized and amortized to cost of revenue over the estimated useful life of the related products. The Company has determined that technological feasibility for its software products is reached shortly before the products are released to manufacturing. Costs incurred after technological feasibility is established have not been material, and accordingly, the Company has expensed the internal costs relating to research and development when incurred.

Licensed Technology: The cost of technology which we have licensed to be sold, leased, or otherwise marketed by us is capitalized and amortized to cost of revenue over the estimated useful life of the related products. At each balance sheet date, the Company evaluates these assets for impairment by comparing the unamortized cost to the net realizable value. Amortization expense was \$0.5 million, \$5.1 million and \$2.1 million for fiscal 2007, 2006 and 2005, respectively. Included in the fiscal 2006 amortization expense was an additional \$2.6 million of expense representing an impairment determined to exist in order to value the licensed technology at its net realizable value. The net unamortized licensed technology included in other intangible assets at September 30, 2007 and 2006 were \$2.4 million and \$1.6 million, respectively.

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 September 30, 2007 and 2006, capitalized patent defense costs totaled \$6.4 million. Additional costs had been capitalized in fiscal 2007 relating to the Company's historic litigation with VoiceSignal, upon the consummation of its acquisition of VoiceSignal the Company reclassified \$6.9 million of previously capitalized

Table of Contents

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

patent defense costs, of which the majority was recorded into goodwill as a component of the purchase price of VoiceSignal.

Advertising Costs: Advertising costs are expensed as incurred and are classified as sales and marketing expenses. Cooperative advertising programs reimburse customers for marketing activities for certain of the Company's products, subject to defined criteria. Cooperative advertising obligations are accrued and the costs expensed at the same time the related revenue is recognized. Cooperative advertising expenses are recorded as expense to the extent that an advertising benefit separate from the revenue transaction can be identified and the cash paid does not exceed the fair value of that advertising benefit received. Any excess of cash paid over the fair value of the advertising benefit received is recorded as a reduction in revenue. The Company incurred advertising costs of \$19.2 million, \$16.4 million and \$11.4 million for fiscal 2007, 2006 and 2005, 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 23, Accounting for Income Taxes - Special Areas.

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

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

Comprehensive Loss: Total comprehensive loss, net of taxes, was approximately \$4.7 million, \$19.1 million and \$6.7 million for fiscal 2007, 2006, and 2005, respectively. Comprehensive loss consists of net loss, current period foreign currency translation adjustments, unrealized gains (losses) on cash flow hedge derivatives, unrealized gains (losses) on marketable securities, and a cumulative adjustment for transition to SFAS 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements 87, 88, 106 and 132(R). For the purposes of comprehensive loss disclosures, the Company does not record tax provisions or benefits for the net changes in the foreign currency translation adjustment, as the Company intends to reinvest undistributed earnings in its foreign subsidiaries permanently.

Table of Contents**NUANCE COMMUNICATIONS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The components of accumulated other comprehensive loss, reflected in the Consolidated Statements of Stockholders Equity and Comprehensive Loss, consisted of the following (in thousands):

	2007	2006	2005
Unrealized losses on cash flow hedge derivatives	\$ (925)	\$ (570)	\$
Unrealized losses on marketable securities			(42)
Cumulative foreign currency translation adjustments	11,854	2,226	(2,058)
Cumulative adjustment for transition to SFAS 158	4,050		
	\$ 14,979	\$ 1,656	\$ (2,100)

Concentration of Risk: Financial instruments that potentially subject the Company to significant concentrations of credit risk principally consist of cash, cash equivalents, and trade accounts receivable. The Company places its cash and cash equivalents with financial institutions with high credit ratings. The Company performs credit evaluations of its customers' financial condition and does not require collateral, since management does not anticipate nonperformance of payment. The Company also maintains reserves for potential credit losses and such losses have been within management's expectations. At September 30, 2007 and 2006, no customer represented greater than 10% of the Company's net accounts receivable balance. No customer composed more than 10% of revenue for fiscal 2007 and 2006 and one customer composed of 11% of revenue for fiscal 2005.

Fair Value of Financial Instruments: Financial instruments include cash equivalents, marketable securities, accounts receivable, long-term debt and cash flow hedge derivative instruments and are carried in the financial statements at amounts that approximate their fair value.

Foreign Currency Translation: The Company transacts business in various foreign currencies. In general, the functional currency of a foreign operation is the local country's currency. Non-functional currency monetary balances are remeasured into the functional currency of the subsidiary with any related gain or loss recorded in other income (expense), net, in the accompanying consolidated statements of operations. Assets and liabilities of operations outside the United States, for which the functional currency is the local currency, are translated into United States dollars using period-end exchange rates. Revenue and expenses are translated at the average exchange rates in effect during each fiscal month during the year. The effects of foreign currency translation adjustments are included as a component of accumulated other comprehensive income (loss) in the accompanying consolidated balance sheets.

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 (loss) to the income statement, in the related revenue or expense caption, as appropriate. Any ineffective portion of the derivatives designated as cash flow hedges is recognized in current earnings. See Note 11.

Accounting for Long-Term Facility Obligations: The Company has historically acquired companies who have previously established restructuring charges relating to lease exit costs, and has recorded restructuring charges of its own that include lease exit costs. The Company follows the provisions of EITF 95-3 Recognition of

Table of Contents

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Liabilities in Connection with a Purchase Business Combination or SFAS 146 Accounting for Costs Associated with Exit or Disposal Activities, as applicable. In accounting for these obligations, the Company is required to make assumptions relating to the time period over which the facility will remain vacant, sublease terms, sublease rates and discount rates. The Company bases its estimates and assumptions on the best information available at the time of the obligation having arisen. These estimates are reviewed and revised as facts and circumstances dictate. Changes in these estimates could have a material effect on the amount accrued on the balance sheet.

Accounting for Share-Based Payments: Effective October 1, 2005, the Company adopted SFAS 123 (revised 2004), Share-Based Payment, (SFAS 123R). Under the fair value recognition provisions of this statement, share-based compensation cost is measured at the grant date based on the value of the award and is recognized as expense over the requisite service period which is generally the vesting period. Determining the fair value of share-based awards at the grant date requires judgment, including estimating expected dividends, share price volatility and the amount of share-based awards that are expected to be forfeited. If actual results differ significantly from these estimates, share-based compensation expense and our results of operations could be materially impacted. Prior to the adoption of SFAS 123R, the Company applied APB 25, Accounting for Stock Issued to Employees, to account for its share-based payments. See Note 16 for additional information related to share-based payments.

SFAS 123R requires the presentation of pro forma information for the comparative periods prior to the adoption, as if the Company had accounted for all its employee share-based payments under the fair value method of the original SFAS 123. No amounts relating to the share-based payments have been capitalized. The following table illustrates the pro forma effect on net income (loss) and earnings per share in fiscal 2005 (in thousands, except per share data):

Net loss, as reported	\$ (5,417)
Add: employee stock-based compensation included in reported net income	2,996
Less: employee stock-based compensation under SFAS 123	(9,056)
Net loss, pro forma	\$ (11,477)
Net loss per share:	
Basic and diluted, as reported	\$ (0.05)
Basic and diluted, pro forma	\$ (0.10)

In fiscal 2005, the fair value of the stock options granted under the original SFAS 123 was estimated on the dates of grant using the Black-Scholes model with the following weighted-average assumptions: dividend yield of 0.0%, expected volatility of 54.1%, average risk-free interest rate of 3.9% and expected term of 3.6 years, as estimated by the Company based on historical exercise behavior.

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, shares held in escrow, 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 23.0 million for

Table of Contents

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

fiscal 2007, 19.3 million for fiscal 2006 and 13.3 million for fiscal 2005, have been excluded from the computation of diluted net loss per share because their inclusion would be anti-dilutive.

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 September 2006, the FASB issued SFAS 157, Fair Value Measurements. SFAS 157 establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007. The Company has not yet determined the effect, if any, that the application of SFAS 157 will 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 SFAS 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 July 2006, the FASB issued Interpretation No. 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 the Company's 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 Commissure

On September 28, 2007, the Company acquired all of the outstanding capital stock of Commissure, a medical imaging software company that provides speech-enabled radiology workflow optimization and data analysis solutions for total purchase consideration of approximately \$25.6 million including \$2.3 million in transaction costs and 1.2 million shares of the Company's common stock valued at \$19.49 per share. In connection with the Company's acquisition of Commissure, the purchase and sale agreement required 0.2 million shares of the Company's common stock, valued at \$3.4 million, to be placed into escrow for 15 months from the date of acquisition, in connection with certain standard

representations and warranties. The Company cannot make a determination, beyond a reasonable doubt, that the escrow will become payable to the former shareholders of Commissure, and accordingly has not included the escrow as a component of the purchase price. Upon satisfaction of the contingency, the escrowed amount will be recorded as additional purchase price and allocated to goodwill.

Table of Contents**NUANCE COMMUNICATIONS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

In addition, the Plan of Merger includes a contingent earnout payment of up to an additional \$8.0 million, at the election of the Company in cash or shares of the Company's common stock, to be paid, if at all, over a three year period based on the business achieving certain performance targets in the fiscal years ended September 30, 2008, 2009 and 2010. The merger was a non-taxable event. The results of operations of the acquired business have been included in the consolidated financial statements of the Company since the date of acquisition. The Company is currently finalizing the valuation of the assets acquired and liabilities assumed; therefore the fair values set forth below are subject to adjustment as additional information is obtained. A summary of the preliminary purchase price allocation for the acquisition of Commissure is as follows (in thousands):

Total purchase consideration:		
Common stock issued		\$ 23,293
Transaction costs		2,319
Total purchase consideration		\$ 25,612
Allocation of the purchase consideration:		
Current assets		\$ 3,830
Property and equipment		45
Identifiable intangible assets		5,650
Goodwill		19,140
Total assets acquired		28,665
Total liabilities assumed		(3,053)
Net assets acquired		\$ 25,612

Current assets acquired from Commissure primarily relate to cash, accounts receivable, prepaid expenses, and acquired unbilled accounts receivable. Current liabilities assumed primarily relate to accounts payable, accrued expenses, and deferred revenue.

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

	Amount	Weighted Average Life (In years)
Customer relationships	\$ 3,000	7.0
Core and completed technology	2,010	4.8

Non-compete agreements	590	4.0
Trademarks	50	2.0
Total	\$ 5,650	

Acquisition of VoiceSignal

On August 24, 2007, the Company acquired all of the outstanding capital stock of VoiceSignal, a software company that provides speech technology for cell phones and other mobile devices. The purchase consideration consisted of cash of \$174.5 million, 5.84 million shares of the Company's common stock valued at \$15.57 per share and transaction costs of \$16.8 million. In connection with the Company's acquisition of VoiceSignal, the purchase and sale agreement required \$30.0 million in cash to be placed into escrow for 12 months from the date

Table of Contents**NUANCE COMMUNICATIONS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

of acquisition, in connection with certain standard representations and warranties. The Company cannot make a determination, beyond a reasonable doubt, that the escrow will become payable to the former shareholders of VoiceSignal, accordingly has not included the escrow as a component of the purchase price. The \$30.0 million paid and held in escrow is included in Other Assets in the accompanying consolidated balance sheet at September 30, 2007. The acquisition was a taxable event. The results of operations of the acquired business have been included in the consolidated financial statements of the Company since the date of acquisition. The Company is currently finalizing the valuation of the assets acquired and liabilities assumed; therefore the fair values set forth below are subject to adjustment as additional information is obtained. A summary of the preliminary purchase price allocation for the acquisition of VoiceSignal is as follows (in thousands):

Total purchase consideration:	
Cash	\$ 174,490
Common stock issued	90,851
Transaction costs	16,776
 Total purchase consideration	 \$ 282,117
 Allocation of the purchase consideration:	
Cash	\$ 10,874
Accounts receivable, including acquired unbilled accounts receivable	15,707
Property and equipment	913
Other assets	1,247
Identifiable intangible assets	71,700
Goodwill	196,054
 Total assets acquired	 296,495
 Accounts payable and accrued expenses	 (13,906)
Long-term liabilities	(472)
 Total liabilities assumed	 (14,378)
 Net assets acquired	 \$ 282,117

The Company assumed stock options for the purchase of 155,710 shares of the Company's common stock in connection with its acquisition of VoiceSignal. These stock options are governed by the original equity compensation plan and agreements that they were issued under (the VoiceSignal Stock Option Plan), but are now exercisable for, or will vest into, shares of the Company's common stock. All assumed options were unvested as of the date of acquisition, and the vesting of these shares has been, and will be, reflected as compensation expense as disclosed in Note 16, Accounting for Share-Based Payments.

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

	Amount	Weighted Average Life (In years)
Customer relationships	\$ 60,700	7.0
Core and completed technology	11,000	6.0
Total	\$ 71,700	

Table of Contents

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Acquisition of Tegic

On August 24, 2007, the Company acquired all of the outstanding capital stock of Tegic, a developer of embedded software for mobile devices. The purchase consideration consisted of cash of \$265.0 million and transaction costs of \$3.3 million. The results of operations of the acquired business have been included in the consolidated financial statements of the Company since the date of acquisition. The acquisition was a taxable event. The Company is currently finalizing the valuation of the assets acquired including certain acquired customer contracts with minimum purchase commitments and liabilities assumed; therefore the fair values set forth below are subject to adjustment as additional information is obtained. A summary of the preliminary purchase price allocation for the acquisition of Tegic is as follows (in thousands):

Total purchase consideration:	
Cash	\$ 265,000
Transaction costs	3,320
 Total purchase consideration	 \$ 268,320
Allocation of the purchase consideration:	
Accounts receivable, including acquired unbilled accounts receivable	\$ 34,873
Property and equipment	242
Other assets	306
Identifiable intangible assets	60,100
Goodwill	176,043
 Total assets acquired	 271,564
Accounts payable and accrued expenses	(1,931)
Deferred revenue	(1,313)
 Total liabilities assumed	 (3,244)
 Net assets acquired	 \$ 268,320

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

Amount	Weighted Average Life (In years)
--------	---

Edgar Filing: Nuance Communications, Inc. - Form 10-K

Customer relationships	\$ 42,100	5.4
Core and completed technology	16,400	9.6
Trademarks	1,600	10.0
Total	\$ 60,100	

Table of Contents

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Acquisition of BeVocal

On April 24, 2007, the Company acquired all of the outstanding capital stock of BeVocal, a provider of on-demand self-service customer care solutions that address the unique business requirements of the mobile communications market and its customers. The purchase price was \$182.7 million, which consists of 7.0 million shares of common stock valued at \$104.4 million, cash payment of \$34.1 million including transaction costs and contingent consideration related to earnout provisions in the acquisition agreement (the Earnout) of \$44.2 million payable to shareholders and optionholders. Management has assessed probability under SFAS 141 and determined that the payment of a portion of the Earnout is determinable beyond a reasonable doubt. Accordingly, included in this estimated purchase price is the current estimate of Earnout that will be payable of which \$41.3 million is payable in cash and \$2.9 million is payable in the form of the Company's common stock, or cash, at the Company's option. If the entire Earnout were to be achieved, the maximum Earnout payable is \$65.1 million, including fees payable to an investment bank. The Earnout is payable in October 2008, and is included in other liabilities in the Company's accompanying balance sheet as of September 30, 2007. In connection with the Company's acquisition of BeVocal, the purchase and sale agreement required 1.2 million shares of the Company's common stock, to be placed into escrow for 15 months from the date of acquisition, in connection with certain standard representations and warranties. The Company cannot make a determination, beyond a reasonable doubt, that the escrow will become payable to the former shareholders of BeVocal, and accordingly has not included the escrow as a component of the purchase price. Upon satisfaction of the contingency, the escrowed amount will be recorded as additional purchase price and allocated to goodwill. The Merger was a non-taxable event. The results of operations of the acquired business have been included in the consolidated financial statements of the Company since the date of acquisition. The Company is currently finalizing the valuation of the assets acquired and liabilities assumed; therefore the fair value set forth below are subject to adjustment as additional information is obtained. A summary of the preliminary purchase price allocation for the acquisition of BeVocal is as follows (in thousands):

Total purchase consideration:	
Common stock issued	\$ 104,405
Cash	30,000
Contingent consideration	44,212
Transaction costs	4,058
Total purchase consideration	\$ 182,675
Allocation of the purchase consideration:	
Cash	\$ 9,266
Accounts receivable and acquired unbilled accounts receivable	11,868
Property and equipment	3,139
Other current and long-term assets	7,933
Identifiable intangible assets	41,200
Goodwill	121,240