Nuance Communications, Inc.
Form 10-Q
August 11, 2008

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

Form 10-Q

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended June 30, 2008

or

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

Commission file number 0-27038

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

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

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

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

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

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

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

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

227,556,640 shares of the registrant s Common Stock, $0.001 par value, were outstanding as of July 31, 2008.

NUANCE COMMUNICATIONS, INC.

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Part I. Financial Information

Item 1. ***Financial Statements***

NUANCE COMMUNICATIONS, INC.

CONSOLIDATED BALANCE SHEETS

	June 30, 2008 (Unaudited)	September 30, 2007
	(In thousands, except share and per share amounts)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 265,753	$ 184,335
Marketable securities	56	2,628
Accounts receivable, less allowances of $18,859 and $22,074, respectively	172,883	174,646
Acquired unbilled accounts receivable	24,583	35,061
Inventories, net	7,941	8,013
Prepaid expenses and other current assets	22,183	16,489
Deferred tax assets	396	444
Total current assets	493,795	421,616
Land, building and equipment, net	43,328	37,618
Goodwill	1,565,672	1,249,642
Intangible assets, net	527,917	391,190
Other assets	74,931	72,721
Total assets	$ 2,705,643	$ 2,172,787
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term debt and obligations under capital leases	$ 6,972	$ 7,430
Contingent acquisition payment	49,784	
Accounts payable	39,893	55,659
Accrued expenses and other current liabilities	87,610	83,245
Current portion of accrued business combination costs	11,917	14,547
Deferred maintenance revenue	76,182	68,075
Unearned revenue and customer deposits	36,090	27,787
Total current liabilities	308,448	256,743
Long-term debt and obligations under capital leases, net of current portion	895,551	899,921
Accrued business combination costs, net of current portion	33,292	35,472

Deferred revenue, net of current portion	15,093	13,185
Deferred tax liability	30,280	26,038
Other liabilities	41,898	63,161
Total liabilities	1,324,562	1,294,520
Commitments and contingencies		
Stockholders equity:		
Series B preferred stock, $0.001 par value; 15,000,000 shares authorized; 3,562,238 shares issued and outstanding (liquidation preference $4,631)	4,631	4,631
Common stock, $0.001 par value; 560,000,000 shares authorized; 230,551,697 and 196,368,445 shares issued and 227,329,378 and 193,178,708 shares outstanding, respectively	228	196
Additional paid-in capital	1,623,984	1,078,020
Treasury stock, at cost (3,222,319 and 3,189,737 shares, respectively)	(16,070)	(15,418)
Accumulated other comprehensive income	25,458	14,979
Accumulated deficit	(257,150)	(204,141)
Total stockholders equity	1,381,081	878,267
Total liabilities and stockholders equity	$ 2,705,643	$ 2,172,787

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

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NUANCE COMMUNICATIONS, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	Nine Months Ended June 30, 2008	Nine Months Ended June 30, 2007
	(Unaudited) (In thousands, except per share amounts)			
Revenue:				
Product and licensing	$ 96,396	$ 74,868	$ 288,587	$ 220,931
Professional services, subscription and hosting	82,320	49,271	216,942	110,078
Maintenance and support	38,028	32,500	109,541	91,113
Total revenue	216,744	156,639	615,070	422,122
Costs and expenses:				
Cost of revenue:				
Cost of product and licensing	10,214	9,448	32,485	31,734
Cost of professional services, subscription and hosting	55,511	32,339	156,777	75,458
Cost of maintenance and support	7,912	6,973	24,266	20,512
Cost of revenue from amortization of intangible assets	5,248	3,367	17,995	9,209
Total cost of revenue	78,885	52,127	231,523	136,913
Gross margin	137,859	104,512	383,547	285,209
Operating expenses:				
Research and development	27,068	19,661	85,822	53,748
Sales and marketing	55,526	46,733	168,299	132,454
General and administrative	27,323	19,705	80,631	52,630
Amortization of intangible assets	14,386	6,347	40,040	16,613
Restructuring and other charges (credits), net	2,646	(54)	8,124	(54)
Total operating expenses	126,949	92,392	382,916	255,391
Income from operations	10,910	12,120	631	29,818
Other income (expense):				
Interest income	1,780	1,384	6,293	4,100
Interest expense	(12,655)	(9,119)	(42,580)	(24,301)
Other income (expense), net	(774)	364	(1,904)	(476)
Income (loss) before income taxes	(739)	4,749	(37,560)	9,141
Provision for income taxes	9,127	12,384	14,521	19,740
Net loss	$ (9,866)	$ (7,635)	$ (52,081)	$ (10,599)

Net loss per share:				
Basic and diluted	$ (0.05)	$ (0.04)	$ (0.25)	$ (0.06)
Weighted average common shares outstanding:				
Basic and diluted	213,683	180,356	204,843	173,786

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

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NUANCE COMMUNICATIONS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Nine Months Ended June 30, 2008	2007
	(Unaudited) (In thousands)	
Cash flows from operating activities		
Net loss	$ (52,081)	$ (10,599)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation of property and equipment	11,795	8,521
Amortization of intangible assets	58,035	25,822
Accounts receivable allowances	2,113	1,199
Share-based payments	53,447	33,079
Non-cash interest expense	3,962	3,025
Deferred tax provision	6,019	14,152
Other	717	542
Changes in operating assets and liabilities, net of effects from acquisitions:		
Accounts receivable	74,689	4,265
Inventories	238	(1,047)
Prepaid expenses and other assets	1,716	(2,999)
Accounts payable	(12,983)	9,449
Accrued expenses and other liabilities	(19,244)	791
Deferred maintenance revenue, unearned revenue and customer deposits	1,706	5,470
Net cash provided by operating activities	130,129	91,670
Cash flows from investing activities		
Capital expenditures for property and equipment	(13,884)	(8,987)
Payments for acquisitions, net of cash acquired	(354,572)	(96,308)
Proceeds from maturities of marketable securities	2,577	494
Payments for minority investment	(2,172)	
Payments for capitalized patent defense costs and licensing agreements	(6,279)	(3,400)
Change in restricted cash balances	279	709
Net cash used in investing activities	(374,051)	(107,492)
Cash flows from financing activities		
Payments of notes payable and capital leases	(6,000)	(4,922)
Deferred acquisition payments		(18,650)
Purchase of treasury stock	(652)	(1,833)
Repurchase of shares		(3,178)
Payments on other long-term liabilities	(8,793)	(8,431)
Proceeds from issuance of common stock, net of issuance costs	330,987	
Excess tax benefits from share-based payments	4,656	

Net proceeds from employee share-based payment activities	3,996	20,176
Proceeds from bank debt, net of issuance costs		87,658
Net cash provided by financing activities	324,194	70,820
Effects of exchange rate changes on cash and cash equivalents	1,146	699
Net increase in cash and cash equivalents	81,418	55,697
Cash and cash equivalents at beginning of period	184,335	112,334
Cash and cash equivalents at end of period	$ 265,753	$ 168,031

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

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NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Organization and Presentation

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

On November 2, 2007, the Company acquired Vocada, Inc. (Vocada), a provider of software and other products for managing critical medical test results. On November 26, 2007, the Company acquired Viecore, Inc. (Viecore), a consulting and systems integration firm. On May 20, 2008, the Company acquired eScription, Inc. (eScription), a provider of hosted or premises-based computer-aided medical transcription solutions. See Note 3 for additional information on these acquisitions.

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

Reclassification

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

2. Summary of Significant Accounting Policies

Use of Estimates

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

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Basis of Consolidation

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

Revenue Recognition

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

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

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

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

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

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

When the Company provides professional services considered essential to the functionality of the software, it recognizes revenue from the professional services as well as any related software licenses on a percentage-of-completion basis in accordance with SOP 81-1, Accounting for Performance of Construction Type and Certain Performance Type Contracts. In these circumstances, the Company separates license revenue from professional service revenue for income statement presentation by classifying the 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

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

in the period identified. Significant judgments and estimates are involved in determining the percent complete of each contract. Different assumptions could yield materially different results.

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

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

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

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

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

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

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

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

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NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

significant negative industry or economic trends;

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

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

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

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

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

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

Capitalized Patent Defense Costs

The Company monitors the anticipated outcome of legal actions, and if it determines that the success of the defense of a patent is probable, and so long as the Company believes that the future economic benefit of the patent will be increased, the Company capitalizes external legal costs incurred in the defense of these patents, up to the level of the expected increased future economic benefit. If changes in the anticipated outcome occur, the Company writes off any capitalized costs in the period the change is determined. Upon successful defense of the patent, the amounts previously capitalized are amortized over the remaining life of the patent. As of June 30, 2008 and September 30, 2007, capitalized patent defense costs totaled $6.5 million and $6.4, respectively.

Comprehensive loss

Comprehensive loss consists of net loss, current period foreign currency translation adjustments, changes in minimum pension liability and unrealized gains (losses) on cash flow hedge derivatives. For the purposes of comprehensive loss disclosures, the Company does not record tax provisions or benefits for the net changes in the

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NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2008	**2007**	**2008**	**2007**
Net loss	$ (9,866)	$ (7,635)	$ (52,081)	$ (10,599)
Other comprehensive income (loss):				
Foreign currency translation adjustment	2,103	1,705	11,345	3,661
Net unrealized (loss) gain on cash flow hedge derivatives	1,219	664	(868)	633
Net unrealized gains on investments			2	
Other comprehensive income	3,322	2,369	10,479	4,294
Total comprehensive loss	$ (6,544)	$ (5,266)	$ (41,602)	$ (6,305)

Net Income (Loss) Per Share

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

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

Diluted net income per share is computed using the more dilutive of (a) the two-class method, or (b) the if-converted method. The Company allocates net income first to preferred stockholders based on dividend rights and then to common and preferred stockholders based on ownership interests. The weighted-average number of common shares outstanding gives effect to all potentially dilutive common equivalent shares, including outstanding stock options using the treasury stock method, unvested restricted stock, shares held in escrow, contingently issuable shares under earnout agreements once earned, warrants, and the convertible debenture using the if-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 to 23.6 million shares and 25.6 million shares for the three month periods ended June 30, 2008 and 2007, respectively; and 24.2 million and 25.4 million shares for the nine month periods ended June 30, 2008 and 2007, respectively, have been excluded from the computation of diluted net loss per share because their inclusion would be anti-dilutive.

Accounting for Share-Based Payments

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

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	Nine Months Ended June 30, 2008	Nine Months Ended June 30, 2007
Cost of product and licensing	$ 2	$ 3	$ 16	$ 15
Cost of professional services, subscription and hosting	1,304	962	6,325	2,412
Cost of maintenance and support	218	249	1,125	716
Research and development	2,517	1,887	11,621	4,912
Sales and marketing	5,925	5,338	17,487	13,640
General and administrative	5,062	3,686	16,873	11,384
Total	$ 15,028	$ 12,125	$ 53,447	$ 33,079

Stock Options

The Company has several share-based compensation plans under which employees, officers and directors may be granted stock options to purchase the Company s common stock generally at fair market value. The Company s plans do not allow for options to be granted at below fair market value nor can they be re-priced at anytime. Options granted under plans adopted by the Company become exercisable over various periods, typically two to four years and have a maximum term of seven years. The Company has also assumed options and option plans in connection with certain of its acquisitions. These stock options are governed by the plans and agreements that they were originally issued under, but are now exercisable for shares of the Company s common stock. The table below summarizes activity relating to stock options for the nine months ended June 30, 2008:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value(1)
Outstanding at September 30, 2007	18,240,722	$ 6.48		
Issued in connection with the acquisition of eScription	2,846,118	$ 4.35		
Granted	231,000	$ 19.82		
Exercised	(5,099,407)	$ 3.15		
Forfeited	(737,916)	$ 11.17		
Expired	(33,465)	$ 4.63		

Outstanding at June 30, 2008	15,447,052	$	7.16	4.8 years	$	135.9 million
Exercisable at June 30, 2008	10,391,322	$	5.08	4.1 years	$	110.2 million
Exercisable at June 30, 2007	11,122,652	$	4.24	4.8 years	$	139.0 million

(1) The aggregate intrinsic value on this table was calculated based on the positive difference between the closing market value of the Company s common stock on June 30, 2008 ($15.67) and the purchase price of the underlying options.

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NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

As of June 30, 2008, the total unamortized fair value of stock options was $38.1 million with a weighted-average remaining recognition period of 2.1 years. A summary of weighted-average grant-date fair value, including the stock options assumed in respective periods, and the intrinsic value of stock options exercised is as follows:

	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	Nine Months Ended June 30, 2008	Nine Months Ended June 30, 2007
Weighted-average grant-date fair value per share	$ 16.38	$ 8.49	$ 15.85	$ 7.08
Total intrinsic value of stock options exercised (in millions)	$ 59.81	$ 15.59	$ 80.68	$ 46.03

The Company uses the Black-Scholes option pricing model to calculate the grant-date fair value of options. The fair value of the stock options granted during the three and nine month periods ended June 30, 2008 and 2007 were calculated using the following weighted-average assumptions:

	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	Nine Months Ended June 30, 2008	Nine Months Ended June 30, 2007
Dividend yield	0.0%	0.0%	0.0%	0.0%
Expected volatility	52.0%	46.3%	51.8%	49.2%
Average risk-free interest rate	2.5%	4.6%	2.7%	4.7%
Expected term (in years)	3.1	3.8	3.2	3.8

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

Restricted Awards

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

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NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Restricted Units are not included in issued and outstanding common stock until the shares are vested and released. The table below summarizes activity relating to Restricted Units for the nine months ended June 30, 2008:

	Number of Shares Underlying Restricted Units	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value(1)
Outstanding at September 30, 2007	6,808,800		
Issued in connection with the acquisition of eScription	806,044		
Granted	4,612,290		
Released	(2,639,344)		
Forfeited	(589,307)		
Outstanding at June 30, 2008	8,998,483	1.5 years	$ 141.0 million
Vested and expected to vest	7,877,171	1.5 years	$ 123.4 million

(1) The aggregate intrinsic value on this table was calculated based on the positive difference between the closing market value of the Company s common stock on June 30, 2008 ($15.67) and the purchase price of the underlying Restricted Units.

The purchase price for vested Restricted Units is $0.001 per share. As of June 30, 2008, unearned share-based payment expense related to unvested Restricted Units is $118.5 million, which will, based on expectations of future performance vesting criteria, where applicable, be recognized over a weighted-average period of 2.0 years. 39.3% of the Restricted Units outstanding as of June 30, 2008 is subject to performance vesting acceleration conditions. A summary of weighted-average grant-date fair value, including those assumed in respective periods, and intrinsic value of Restricted Units vested is as follows:

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2008	2007	2008	2007
Weighted-average grant-date fair value per share	$ 19.02	$ 15.99	$ 18.63	$ 13.93
Total intrinsic value of shares vested (in millions)	$ 8.08	$ 0.93	$ 49.03	$ 9.32

Restricted Stock is included in the issued and outstanding common stock in these financial statements at the date of grant. The table below summarizes activity relating to Restricted Stock for the nine months ended June 30, 2008:

	Number of Shares Underlying Restricted Stock	Weighted Average Grant Date Fair Value
Outstanding at September 30, 2007	1,195,902	$ 6.17
Granted	250,000	$ 15.89
Vested	(820,651)	$ 5.53
Outstanding at June 30, 2008	625,251	$ 10.90

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The purchase price for vested Restricted Stock is $0.001 per share. As of June 30, 2008, unearned share-based payment expense related to unvested Restricted Stock is $1.8 million, which will, based on expectations of future performance vesting criteria, when applicable, be recognized over a weighted-average period of 1.1 years. 60.0% of the Restricted Stock outstanding as of June 30, 2008 is subject to performance vesting acceleration conditions.
A summary of weighted-average grant-date fair value and intrinsic value of Restricted Stock vested is as follows:

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2008	2007	2008	2007
Weighted-average grant-date fair value per share	n/a	$ 11.35	$ 15.89	$ 8.75
Total intrinsic value of shares vested (in millions)	$ 9.34	$ 0.97	$ 16.85	$ 5.60

In order to satisfy its employees withholding tax liability as a result of the vesting of Restricted Stock, the Company has historically repurchased shares upon the employees vesting. Similarly, in order to satisfy its employees withholding tax liability as a result of the release of its employees Restricted Units, the Company has historically cancelled a portion of the common stock upon the release. In the nine months ended June 30, 2008, the Company paid cash of $16.9 million relating to 0.9 million shares of common stock that were repurchased or cancelled. Based on the Company s estimate of the Restricted Awards that will vest, or be released, in the twelve month period ending June 30, 2009, and further assuming that one-third of these Restricted Awards would be repurchased or cancelled to satisfy the employee s withholding tax liability (such amount approximating the tax rate of the Company s employees), the Company would have an obligation to pay cash relating to approximately 0.9 million shares during the twelve month period ending June 30, 2009.

Employee Stock Purchase Plan

The Company s 1995 Employee Stock Purchase Plan (the Plan), as amended and restated on April 21, 2008, authorizes the issuance of a maximum of 6,000,000 shares of common stock in semi-annual offerings to employees at a price equal to the lower of 85% of the closing price on the applicable offering commencement date or 85% of the closing price on the applicable offering termination date. Compensation expense related to the employee stock purchase plan was $1.1 million and $2.7 million for the three and nine months ended June 30, 2008, respectively, and was $0.5 million and $1.5 million for the three and nine months ended June 30, 2007, respectively.

Income Taxes

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

The liability for unrecognized tax benefits related to various federal, state, and foreign income tax matters was $2.5 million at October 1, 2007. At June 30, 2008, the liability for income taxes associated with uncertain tax positions was $2.7 million. Included in this amount is approximately $0.8 million of unrecognized tax benefits, which if recognized, would impact the effective tax rate. The difference between the total amount of unrecognized tax benefits and the amount that would impact the effective tax rate consists of items that would be offset through

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