

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

Nuance Communications, Inc.

Form 10-Q

May 12, 2008

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

Form 10-Q

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

*(State or other jurisdiction of
incorporation or organization)*

94-3156479

*(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 No

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 Accelerated filer Non-accelerated filer Smaller reporting
(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 No

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

NUANCE COMMUNICATIONS, INC.

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Table of Contents**Part I. Financial Information****Item 1. Financial Statements****NUANCE COMMUNICATIONS, INC.****CONSOLIDATED BALANCE SHEETS**

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

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

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

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

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

Basic and diluted earnings per share:

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

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

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

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

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

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

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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, and on November 26, 2007, the Company acquired Viecore, Inc. (Viecore), a consulting and systems integration firm (Note 3).

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

Reclassification

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

2. Summary of Significant Accounting Policies

Use of Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles, requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the reporting period. On an ongoing basis, the Company evaluates its estimates, assumptions and judgments, including those related to revenue recognition; allowance for doubtful accounts and returns; accounting for patent legal defense costs; the costs to complete the development of custom software applications; the valuation of goodwill, other intangible assets and tangible long-lived assets; accounting for

acquisitions; share-based payments; the obligation relating to pension and post-retirement benefit plans; interest rate swaps which are characterized as derivative instruments; income tax reserves and valuation allowances; and loss contingencies. The Company bases its estimates on historical experience and various other factors that are believed to be reasonable under the circumstances. Actual amounts could differ significantly from these estimates.

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NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Basis of Consolidation

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

Revenue Recognition

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

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

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

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

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

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

When the Company provides professional services considered essential to the functionality of the software, it recognizes revenue from the professional services as well as any related software licenses on a

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

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NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

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

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

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

Goodwill and Other Intangible Assets

The Company has significant long-lived tangible and intangible assets, including goodwill and intangible assets with indefinite lives, which are susceptible to valuation adjustments as a result of changes in various factors or conditions. The most significant long-lived tangible and other intangible assets are fixed assets, patents and core technology, completed technology, customer relationships and trademarks. All finite-lived intangible assets are amortized based upon patterns in which the economic benefits of such assets are expected to be utilized. The values of intangible assets, with the exception of goodwill and intangible assets with indefinite lives, were initially determined by a risk-adjusted, discounted cash flow approach. The Company assesses the potential impairment of identifiable

intangible assets and fixed assets whenever events or changes in circumstances indicate that the carrying values may not be recoverable. Factors it considers important, which could trigger an impairment of such assets, include but are not limited to the following:

significant underperformance relative to historical or projected future operating results;

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

significant negative industry or economic trends;

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NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

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

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

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

Capitalized Patent Defense Costs

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

Comprehensive loss

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

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NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

Net Income (Loss) Per Share

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

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

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

Accounting for Share-Based Payments

The Company accounts for share-based payments to employees, including grants of employee stock options, purchases under employee stock purchase plans, awards in the form of restricted shares (Restricted Stock) and awards in the form of units of stock purchase rights (Restricted Units) in accordance with SFAS 123 (revised 2004),

Share-Based Payment, (SFAS 123R). The Restricted Stock and Restricted Units are collectively referred to as Restricted Awards. SFAS 123R requires the recognition of the fair value of share-based payments as a charge against earnings. The Company recognizes share-based payment expense over the requisite service period. Based on the provisions of SFAS 123R the Company s share-based payment awards are accounted for as equity

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

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

Stock Options

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

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

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

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

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NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

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

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

Restricted Awards

The Company is authorized to issue equity incentive awards in the form of Restricted Awards, including Restricted Units and Restricted Stock, which are individually discussed below. Unvested Restricted Awards may not be sold, transferred or assigned. The fair value of the Restricted Awards is measured based upon the market price of the underlying common stock as of the date of grant, reduced by the purchase price of \$0.001 per share of the awards. The Restricted Awards generally are subject to vesting over a period of two to four years, and may have opportunities for

acceleration for achievement of defined goals. The Company also issued certain Restricted Awards with vesting solely dependent on the achievement of specified performance targets. The fair value of the Restricted Awards is amortized to expense over its applicable requisite service period using the straight-line method. In the event that the employees employment with the Company terminates, or in the case of awards with only performance goals, if those goals are not met, any unvested shares are forfeited and revert to the Company.

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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 six months ended March 31, 2008:

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

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

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

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

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

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

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NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

The Company has historically repurchased common stock upon its employees vesting in the Restricted Stock, and cancelled a portion of the employees vested Restricted Units. This has been done to satisfy the employees withholding tax liability as a result of the Restricted Awards having vested. In the six months ended March 31, 2008, the Company paid cash of \$14.7 million relating to 0.8 million shares of common stock that were cancelled or repurchased.

Assuming that one-third of all Restricted Awards outstanding as of March 31, 2008, such amount approximating the tax rate of the Company's employees, and based on the weighted average recognition period of 1.9 years, were purchased or cancelled, the Company would have an obligation to pay cash relating to approximately 0.9 million shares during the twelve month period ending March 31, 2009.

Employee Stock Purchase Plan

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

Income Taxes

Effective October 1, 2007, the Company adopted the provisions of FASB Interpretation (FIN) 48, Accounting for Uncertainty in Income Taxes—an Interpretation of FASB Statement No. 109. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements in accordance with SFAS 109, Accounting for Income Taxes. FIN 48 prescribes the recognition and measurement of a tax position taken or expected to be taken in a tax return. It also provides guidance