

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

Nuance Communications, Inc.
Form 10-Q
February 09, 2010

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

Form 10-Q

(Mark One)

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended December 31, 2009
- 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 No.)*

1 Wayside Road
Burlington, Massachusetts
(Address of principal executive offices)

01803
(Zip Code)

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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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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 company
(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). Yes No

The number of shares of the Registrant's Common Stock, outstanding as of January 31, 2010, was 283,960,393.

NUANCE COMMUNICATIONS, INC.

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NUANCE COMMUNICATIONS, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

| | Three Months Ended December 31, | |
|--------------------------------------|---|-------------|
| | 2009 | 2008 |
| | (Unaudited) | |
| | (In thousands, except per share amounts) | |
| Revenue: | | |
| Product and licensing | \$ 113,227 | \$ 85,575 |
| Professional services and hosting | 103,695 | 90,192 |
| Maintenance and support | 46,055 | 41,067 |
| Total revenue | 262,977 | 216,834 |
| Cost of revenue: | | |
| Product and licensing | 12,591 | 8,757 |
| Professional services and hosting | 61,996 | 58,482 |
| Maintenance and support | 7,990 | 7,043 |
| Amortization of intangible assets | 11,018 | 8,018 |
| Total cost of revenue | 93,595 | 82,300 |
| Gross profit | 169,382 | 134,534 |
| Operating expenses: | | |
| Research and development | 36,950 | 30,550 |
| Sales and marketing | 65,562 | 60,474 |
| General and administrative | 27,451 | 25,589 |
| Amortization of intangible assets | 22,126 | 17,348 |
| Acquisition-related costs, net | 12,805 | 5,903 |
| Restructuring and other charges, net | 615 | 2,098 |
| Total operating expenses | 165,509 | 141,962 |
| Income (loss) from operations | 3,873 | (7,428) |
| Other income (expense): | | |
| Interest income | 436 | 1,420 |
| Interest expense | (10,237) | (14,926) |
| Other income, net | 1,990 | 6,227 |
| Loss before income taxes | (3,938) | (14,707) |
| Provision for income taxes | 340 | 11,611 |
| Net loss | \$ (4,278) | \$ (26,318) |

Net loss per share:

| | | |
|-------------------|-----------|-----------|
| Basic and diluted | \$ (0.02) | \$ (0.11) |
|-------------------|-----------|-----------|

Weighted average common shares outstanding:

| | | |
|-------------------|---------|---------|
| Basic and diluted | 279,068 | 236,237 |
|-------------------|---------|---------|

See accompanying notes. Financial statements as of September, 30, 2009 and for the three months ended December 31, 2008 have been adjusted for the retrospective application of FASB ASC 470-20 (see Notes 2 and 12).

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NUANCE COMMUNICATIONS, INC.
CONSOLIDATED BALANCE SHEETS

| | December 31, 2009 | September 30, 2009 |
|---|---|-------------------------------|
| | (Unaudited) | |
| | (In thousands, except per share amounts) | |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 426,902 | \$ 527,038 |
| Accounts receivable, less allowances for doubtful accounts of \$7,168 and \$6,833 | 215,293 | 199,548 |
| Acquired unbilled accounts receivable | 10,125 | 9,171 |
| Inventories, net | 7,946 | 8,525 |
| Prepaid expenses and other current assets | 58,122 | 51,545 |
| | | |
| Total current assets | 718,388 | 795,827 |
| Land, building and equipment, net | 53,094 | 53,468 |
| Goodwill | 2,019,685 | 1,891,003 |
| Intangible assets, net | 723,730 | 706,805 |
| Other assets | 69,457 | 52,361 |
| | | |
| Total assets | \$ 3,584,354 | \$ 3,499,464 |

LIABILITIES AND STOCKHOLDERS EQUITY

| | | |
|---|-----------|-----------|
| Current liabilities: | | |
| Current portion of long-term debt and capital leases | \$ 7,985 | \$ 6,862 |
| Contingent and deferred acquisition payments | 10,838 | 91,431 |
| Accounts payable | 70,578 | 59,574 |
| Accrued expenses and other current liabilities | 176,992 | 104,819 |
| Accrued business combination costs | 10,375 | 12,144 |
| Deferred maintenance revenue | 87,735 | 84,607 |
| Unearned revenue and customer deposits | 54,919 | 59,788 |
| | | |
| Total current liabilities | 419,422 | 419,225 |
| Long-term portion of debt and capital leases | 849,291 | 848,898 |
| Long-term portion of accrued business combination costs | 22,062 | 24,904 |
| Deferred revenue, net of current portion | 45,872 | 33,904 |
| Deferred tax liability | 55,865 | 56,346 |
| Other liabilities | 70,192 | 73,186 |
| | | |
| Total liabilities | 1,462,704 | 1,456,463 |

Commitments and contingencies (Notes 2, 5 and 18)

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| | | |
|--|------------------|------------------|
| Stockholders' equity: | | |
| Series B preferred stock, \$0.001 par value; 15,000 shares authorized; 3,562 shares issued and outstanding (liquidation preference \$4,631) | 4,631 | 4,631 |
| Common stock, \$0.001 par value; 560,000 shares authorized; 287,211 and 280,647 shares issued and 283,472 and 276,935 shares outstanding | 287 | 281 |
| Additional paid-in capital | 2,392,352 | 2,308,992 |
| Treasury stock, at cost (3,739 and 3,712 shares) | (16,601) | (16,214) |
| Accumulated other comprehensive income | 7,515 | 7,567 |
| Accumulated deficit | (266,534) | (262,256) |
| Total stockholders' equity | 2,121,650 | 2,043,001 |
| Total liabilities and stockholders' equity | \$ 3,584,354 | \$ 3,499,464 |

See accompanying notes. Financial statements as of September 30, 2009 and for the three months ended December 31, 2008 have been adjusted for the retrospective application of FASB ASC 470-20 (see Notes 2 and 12).

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NUANCE COMMUNICATIONS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

| | Three Months Ended | |
|--|---------------------------|-------------|
| | December 31, | |
| | 2009 | 2008 |
| | (Unaudited) | |
| | (In thousands) | |
| Cash flows from operating activities: | | |
| Net loss | \$ (4,278) | \$ (26,318) |
| Adjustments to reconcile net loss to net cash provided by operating activities: | | |
| Depreciation of property and equipment | 5,086 | 4,570 |
| Amortization of intangible assets | 33,144 | 25,366 |
| Non-cash interest expense | 3,279 | 3,159 |
| Bad debt provision | 771 | 1,627 |
| Stock-based compensation | 20,066 | 16,987 |
| Gain on foreign currency forward contracts | | (8,049) |
| Deferred tax provision | (311) | 6,420 |
| Other | (80) | (25) |
| Changes in operating assets and liabilities, net of effects from acquisitions: | | |
| Accounts receivable | (6,267) | 22,735 |
| Inventories | 574 | (766) |
| Prepaid expenses and other assets | (99) | (4,698) |
| Accounts payable | (3,709) | 21,883 |
| Accrued expenses and other liabilities | 7,403 | 10,878 |
| Deferred revenue | 9,473 | 6,993 |
| Net cash provided by operating activities | 65,052 | 80,762 |
| Cash flows from investing activities: | | |
| Capital expenditures | (2,756) | (8,608) |
| Payments for acquisitions, net of cash acquired | (141,721) | (37,353) |
| Proceeds from maturities of marketable securities | | 56 |
| Payments for equity investment | (14,970) | (159) |
| Payments for capitalized patent costs and licensing agreements | | (50,000) |
| Net cash used in investing activities | (159,447) | (96,064) |
| Cash flows from financing activities: | | |
| Payments of debt and capital leases | (1,740) | (1,766) |
| Purchases of treasury stock | (387) | (66) |
| Payments of other long-term liabilities | (2,256) | (2,369) |
| Proceeds from issuance of common stock from employee stock options and purchase plan | 5,181 | 737 |
| Cash used to net share settle employee equity awards | (7,229) | (2,652) |

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| | | |
|---|------------|------------|
| Net cash used in financing activities | (6,431) | (6,116) |
| Effects of exchange rate changes on cash and cash equivalents | 690 | (763) |
| Net decrease in cash and cash equivalents | (100,136) | (22,181) |
| Cash and cash equivalents at beginning of period | 527,038 | 261,540 |
| Cash and cash equivalents at end of period | \$ 426,902 | \$ 239,359 |

See accompanying notes. Financial statements as of September 30, 2009 and for the three months ended December 31, 2008 have been adjusted for the retrospective application of FASB ASC 470-20 (see Notes 2 and 12).

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NUANCE COMMUNICATIONS, INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

1. Organization and Presentation

The consolidated financial statements include the accounts of Nuance Communications, Inc. (Nuance , we , or the Company) and our wholly-owned subsidiaries. We prepared these unaudited interim consolidated financial statements in accordance with U.S. generally accepted accounting principles (GAAP) for interim periods. In our opinion, these financial statements reflect all adjustments, consisting of normal recurring adjustments, necessary for a fair presentation of our financial position for the periods disclosed. Intercompany transactions have been eliminated.

On December 30, 2009, we acquired SpinVox Limited (SpinVox), a UK-based privately-held company engaged in the business of providing voice to text services. Refer to Note 4 for additional information.

Although we believe 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 GAAP has been omitted. Accordingly, these financial statements should be read in conjunction with the audited financial statements and the notes thereto included in our Annual Report on Form 10-K for the fiscal year ended September 30, 2009. Interim results are not necessarily indicative of the results that may be expected for a full year.

We reclassified certain acquisition-related costs included within operating expenses for the three-month period ended December 31, 2008 to conform to our revised statement of operations presentation for such costs as disclosed in Note 2 below. Such reclassifications did not affect total revenues, gross profit, income (loss) from operations, net income (loss), or cash flow from operations.

We evaluated subsequent events through the date and time our unaudited consolidated financial statements were filed with the Securities and Exchange Commission (SEC) on February 9, 2010.

2. Summary of Significant Accounting Policies

We have made no material changes to the significant accounting policies disclosed in our Annual Report on Form 10-K for the fiscal year ended September 30, 2009, other than as outlined below.

In June 2009, the Financial Accounting Standards Board (FASB) issued Accounting Standards Codification (ASC) 105-10, *Generally Accepted Accounting Principles* (formerly referred to as Statement of Financial Accounting Standards (SFAS) No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles*). This standard establishes the Codification as the sole source of authoritative accounting principles recognized by the FASB to be applied by non-governmental entities in the preparation of financial statements in conformity with GAAP. Rules and interpretive releases of the SEC under authority of federal securities laws remain sources of authoritative GAAP for SEC registrants. The Codification was effective for financial statements issued for interim and annual periods ending after September 15, 2009. We have included references to the Codification, where appropriate, in our Annual Report on Form 10-K for the fiscal year ended September 30, 2009 and in these unaudited interim consolidated financial statements.

Adoption of new accounting standards

During the first quarter of fiscal 2010, we adopted the guidance in ASC 805, *Business Combinations* (formerly referred to as SFAS No. 141 (revised), *Business Combinations* (SFAS 141R)) and related Staff Positions effective October 1, 2009. ASC 805 supersedes the previous accounting guidance related to business combinations, including the measurement of acquirer shares issued in consideration for a business combination, the recognition of and subsequent accounting for contingent consideration, the recognition of acquired in-process research and development, the accounting for acquisition-related restructurings, the treatment of acquisition-related transaction costs and the recognition of changes in

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NUANCE COMMUNICATIONS, INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

the acquirer's income tax valuation allowance. The guidance is applied prospectively from the date of acquisition with minor exception related to income tax contingencies from companies acquired prior to the adoption date. As a result of our adoption of the new guidance, we expensed \$2.2 million in acquisition-related transaction costs which were capitalized as of September 30, 2009, as well as \$4.5 million of transaction costs incurred during the first quarter of fiscal 2010. These costs were recorded as expense within the acquisition-related costs, net line in the consolidated statement of operations.

During the first quarter of fiscal 2010, we adopted the remaining provisions of ASC 820 (formerly referred to as SFAS No. 157, *Fair Value Measurements*) related to non-financial assets and non-financial liabilities, except for certain items that are recognized or disclosed at fair value in the financial statements on a recurring basis, as well as the provisions of ASC 350-30-25-5 [formerly referred to as Emerging Issues Task Force (EITF) Issue No. 08-7, *Accounting for Defensive Intangible Assets*] as they apply to defensive intangible assets. ASC 820-10-15-1A deferred our adoption of the remaining provisions of ASC 820 to the first quarter of fiscal 2010. The adoption of these standards did not have a material impact on our consolidated financial statements; however, the effect of these standards could be material in future periods to the extent they impact the manner in which we assess fair value of our non-financial assets and liabilities and depending on the extent to which we acquire defensive intangible assets.

During the first quarter of fiscal 2010, we adopted the guidance in ASC 350-30-65-1 (formerly referred to as FASB Staff Position (FSP) FAS 142-3, *Determination of the Useful Life of Intangible Assets*). This guidance amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under ASC 350 (formerly known as SFAS No. 142, *Goodwill and Intangible Assets*). The adoption of this guidance had no material impact on our financial statements.

During the first quarter of fiscal 2010, we adopted the guidance in ASC 815-40-15 (formerly referred to as EITF Issue No. 07-5, *Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock*). ASC 815-40-15 provides guidance in assessing whether derivative instruments meet the criteria in paragraph 11(a) of SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, now referred to as ASC 815, for being considered indexed to an entity's own common stock. We have completed our evaluation of the impact of ASC 815-40-15 and have determined the impact is immaterial based on the nature of our derivative and hedging activities.

During the first quarter of fiscal 2010, we adopted the provisions in FASB ASC 470-20 as they relate to our convertible debt instruments that may be settled in cash upon conversion (formerly referred to as FSP APB 14-1, *Accounting for Convertible Debt Instruments that May be Settled in Cash upon Conversion (Including Partial Cash Settlement)*) effective October 1, 2009. The guidance requires us to separately account for the liability (debt) and equity (conversion option) components of our convertible debt instruments that require or permit settlement in cash upon conversion in a manner that reflects our nonconvertible debt borrowing rate at the time of issuance. The equity components of our convertible debt instruments are recorded to stockholders equity with an offsetting debt discount. The debt discount created is amortized to interest expense in our consolidated statement of operations using the effective interest method over the expected term of the convertible debt. The provisions herein discussed have been applied retrospectively to all financial information presented. Refer to information below and in Note 12 for further information.

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

The following table illustrates the retrospective effect of adopting ASC 470-20 to the consolidated statement of operations for the three months ended December 31, 2008 (in thousands):

| | As Originally Reported | As Adjusted for Retrospective Application |
|----------------------------------|-----------------------------------|--|
| Interest expense | \$ 13,158 | \$ 14,926 |
| Loss before income taxes | (12,939) | (14,707) |
| Net loss | (24,550) | (26,318) |
| Basic and diluted loss per share | \$ (0.10) | \$ (0.11) |

The following table illustrates the retrospective effect of adopting ASC 470-20 to the consolidated balance sheet as of September 30, 2009 (in thousands):

| | As Originally Reported | As Adjusted for Retrospective Application |
|---|-----------------------------------|--|
| Other assets(a) | \$ 52,511 | \$ 52,361 |
| Long-term portion of debt and capital leases(b) | 888,611 | 848,898 |
| Additional paid-in-capital(c) | 2,254,511 | 2,308,992 |
| Accumulated deficit | \$ (247,338) | \$ (262,256) |

- (a) Other assets have been adjusted for the portion of the debt issuance costs attributable to the 2.75% Convertible Senior Notes that must be retrospectively allocated to the equity component of the debt instrument through additional paid-in-capital as of the date of the notes issuance.
- (b) Long-term portion of debt and capital leases has been adjusted to reflect retrospective recognition of the debt discount created by bifurcating the equity component of the convertible notes from the liability component.
- (c) Additional paid-in-capital has been adjusted to reflect recording, retrospectively, the equity component of the convertible notes, as well as the equity component allocation of the debt issuance costs attributable to the 2.75% Convertible Senior Notes.

Acquisition-Related Costs, net

Acquisition-related costs include those costs related to business and other acquisitions, including potential acquisitions. These costs consist of transition and integration costs, including retention payments, transitional employee costs and earn-out payments treated as compensation expense, as well as the costs of integration-related

services provided by third-parties; professional service fees, including direct third-party costs of the transaction and post-acquisition legal and other professional service fees associated with disputes and regulatory matters related to acquired entities; and adjustments to acquisition-related items that are required to be marked to fair value each reporting period, such as contingent consideration, and other items related to acquisitions for which the measurement period has ended. Previous to our adoption of ASC 805 in fiscal 2010, certain acquisition-related costs and adjustments now recorded as operating expenses in our consolidated statements of operations were included as a part of the consideration transferred and capitalized as a part of the accounting for our business acquisitions pursuant to previous accounting rules, primarily direct transaction

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

costs. In addition, there were no items under the legacy business combination accounting guidance that were required to be re-measured to fair value on a recurring basis.

| | Three Months Ended December 31, | |
|----------------------------------|--|-------------|
| | 2009 | 2008 |
| Transition and integration costs | \$ 3,453 | \$ 1,327 |
| Professional service fees | 9,298 | 4,516 |
| Acquisition-related adjustments | 54 | 60 |
| Total | \$ 12,805 | \$ 5,903 |

Accounting for Collaboration Agreements

On October 9, 2009, we entered into a five-year agreement with a third party to accelerate the development of new speech technologies. All intellectual property derived from the collaboration will be jointly-owned by the two parties and Nuance will have the sole rights to commercialize the intellectual property during the term of the agreement. All sales related thereto will be recorded as revenue by the selling party. In consideration for the services from the third party in the collaboration efforts, as well as the joint ownership rights over intellectual property developed under the arrangement and the exclusive right to commercialize such developed intellectual property for the term of the arrangement, we will pay \$80.0 million in five equal payments of \$16.0 million on August 15th of each year, payable in cash or our common stock, at our option. These upfront payments will be recorded as a prepaid asset and expensed ratably over each annual period, commensurate with the pattern in which we expect the third party to perform its services and convey our rights under the arrangement. On October 14, 2009, we made our first payment under the arrangement consisting of 1,047,120 shares of our common stock valued at \$16.0 million.

On January 13, 2010, we amended the collaboration agreement to extend certain provisions thereof for eighteen months following the termination of the agreement. In consideration for the extension, we agreed to pay an additional \$12.0 million to the third-party in five equal payments of \$2.4 million on August 15th of each year over the five-year agreement term, payable in cash or our common stock, at our option, with the exception of the first of these additional payments, which we expect to make during the second quarter of fiscal 2010. These upfront payments will be recorded as a prepaid asset when made and expensed ratably over the eighteen-month extension period.

Recently Issued Accounting Standards

In September 2009, the Emerging Issues Task Force (EITF) ratified EITF Issue No. 08-1, *Revenue Arrangements with Multiple Deliverables*, which has since been codified in the FASB Accounting Standards Codification (the Codification or ASC) as Accounting Standards Update (ASU) No. 2009-13 (ASU 2009-13), supersedes EITF Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*, now referred to as ASC 605-25-50-1. ASU 2009-13 eliminates the residual method of accounting for non-software arrangements, as well as the associated requirements for establishing vendor objective evidence of fair value. The residual method is replaced in ASU 2009-13 by the

estimated selling price method whereby revenue in a multiple-element arrangement is allocated to each element based on its estimated selling price. Estimating selling price is established through a hierarchy starting with vendor-specific objective evidence of fair value, followed by third-party evidence, and lastly by any reasonable, objective estimate of the selling price were the element to be sold on a standalone basis. Estimates of selling price must consider both entity-specific factors and market conditions. ASU 2009-13 is applied prospectively to all revenue transactions entered into, or materially modified, after June 15, 2010. Early adoption is permitted if adopted as of the beginning of an entity's fiscal year and no prior interim period financial statements from that fiscal year have already been issued or the entity retrospectively applies the provisions of this ASU to its previously-issued current fiscal

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

year interim financial statements. We currently do not expect that the adoption of ASU 2009-13 will have a material impact on our consolidated financial statements.

In September 2009, the EITF ratified EITF Issue No. 09-3, *Applicability of AICPA Statement of Position 97-2 to Certain Arrangements That Include Software Elements*, which has since been codified in the Codification as ASU No. 2009-14 (ASU 2009-14). ASU 2009-14 applies to multiple-element arrangements that contain both software and hardware elements, and amends the scope of AICPA Statement of Position (SOP) No. 97-2, *Software Revenue Recognition*, now referred to as ASC 985-605, to exclude tangible products containing software and non-software components that together function to deliver the product s essential functionality from the scope of ASC 985-605. ASU 2009-14 is applied prospectively to all revenue transactions entered into, or materially modified, after June 15, 2010. Early adoption is permitted only when ASU 2009-13 is also early adopted as of the same period. We are continuing to evaluate the potential impact of this ASU on our consolidated financial statements.

3. Comprehensive Loss

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

| | Three Months Ended December 31, | |
|--|--|-------------|
| | 2009 | 2008 |
| Net loss | \$ (4,278) | \$ (26,318) |
| Other comprehensive income (loss): | | |
| Foreign currency translation gains (losses), net | (864) | 11,790 |
| Unrealized gains on cash flow hedge derivatives, net | 811 | 4,219 |
| Net comprehensive income (loss) adjustments | (53) | 16,009 |
| Other comprehensive loss | \$ (4,331) | \$ (10,309) |

4. Business Acquisitions***Acquisition of SpinVox***

On December 30, 2009 we acquired all of the outstanding capital stock of SpinVox Limited (SpinVox), a UK-based privately-held company engaged in the business of providing voice to text services. The acquisition was a non-taxable event and the goodwill resulting from this acquisition is not expected to be deductible for tax purposes. The revenues and expenses of SpinVox for the one day, December 31, 2009, of the reporting period during which SpinVox was a part of Nuance were excluded from our consolidated results for the three months ended December 31, 2009 as such amounts for that one day were immaterial.

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

A summary of the preliminary allocation of the purchase consideration is as follows (in thousands):

| | |
|---|----------------|
| Total purchase consideration: | |
| Cash | \$ 67,500 |
| Common stock(a) | 36,352 |
| Total purchase consideration | \$ 103,852 |
| Allocation of the purchase consideration: | |
| Cash | \$ 4,061 |
| Accounts receivable(b) | 13,715 |
| Other assets | 2,836 |
| Property and equipment | 1,902 |
| Identifiable intangible assets | 45,300 |
| Goodwill | 110,105 |
| Total assets acquired | 177,919 |
| Current liabilities | (73,015) |
| Deferred revenue | (1,052) |
| Total liabilities assumed | (74,067) |
| Net assets acquired | \$ 103,852 |

(a) Approximately 2.3 million shares of our common stock valued at \$15.81 per share based on the closing price of our common stock on the acquisition date were issued at closing.

(b) Accounts receivable have been recorded at their estimated fair value, which consists of the gross accounts receivable assumed of \$14.4 million, reduced by fair value reserve of \$0.7 million, which represents the portion of SpinVox's contractually owed accounts receivable we do not expect to be able to collect.

The following are the identifiable intangible assets acquired and their respective weighted average useful lives, as determined based on a preliminary valuation (table in thousands, except for years):

| | Amount | Weighted Average Life (In years) |
|-------------------------------|---------------|---|
| Customer relationships | \$ 28,000 | 14.0 |
| Core and completed technology | 16,300 | 4.3 |

| | | |
|------------|-----------|-----|
| Trade name | 1,000 | 1.5 |
| Total | \$ 45,300 | |

Pro Forma Results

The following table shows unaudited pro forma results of operations as if we had acquired SpinVox on October 1, 2008 (table in thousands, except per share data):

| | Three Months Ended December 31, | |
|--------------------|--|-------------|
| | 2009 | 2008 |
| Revenue | \$ 274,953 | \$ 217,946 |
| Net loss | \$ (35,840) | \$ (55,072) |
| Net loss per share | \$ (0.13) | \$ (0.23) |

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NUANCE COMMUNICATIONS, INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. Contingent Acquisition Payments

Earn-out Payments

In connection with our acquisition of SNAPin Software, Inc. (SNAPin) we agreed to make a contingent earn-out payment of up to \$45.0 million in cash to be paid, if at all, based on the business achieving certain performance targets that are measurable from the acquisition date to December 31, 2009. Additionally, we would be required to issue earn-out consideration to SNAPin option holders. This option earn-out consideration, if earned, is payable at our sole discretion, in cash, stock or additional options to purchase common stock. The total value of this option earn-out consideration may aggregate up to \$2.5 million, which will be recorded as compensation expense over the service period, if earned. These earn-out payments, if any, would be payable upon the final measurement of the performance targets. Through December 31, 2009, we have recorded approximately \$10.1 million related to contingent earn-out provisions as additional purchase price.

In connection with our acquisition of Multi-Vision Communications, Inc., we agreed to make contingent earn-out payments of up to \$15.0 million, payable in stock, or cash, solely at our discretion, relating to earn-out provisions described in the share purchase agreement. Two-thirds of the earn-out is conditioned on performance targets and continued employment; accordingly, up to \$10.0 million of any earn-out payments that become payable will be recorded as compensation expense, and up to \$5.0 million, the portion of the prospective earn-out attributable solely to performance targets, will be recorded as additional purchase price and allocated to goodwill. Through December 31, 2009, we have not recorded any obligation or related compensation expense relative to these measures.

In connection with our acquisition of Vocada, Inc. (Vocada), we agreed to make contingent earn-out payments of up to \$21.0 million upon the achievement of certain financial targets measured over defined periods through December 31, 2010. Payments, if any, may be made in the form of cash or shares of our common stock, at our sole discretion. We have notified the former shareholders of Vocada that the financial targets for certain periods were not achieved. The former shareholders of Vocada have requested additional information regarding this determination. We are currently in discussions with the former shareholders of Vocada regarding this matter. Through December 31, 2009, we have not recorded any obligation relative to these matters.

In connection with the acquisition of Commissure, Inc. (Commissure), we agreed to make contingent earn-out payments of up to \$8.0 million upon the achievement of certain financial targets for the fiscal years 2008, 2009 and 2010. Payments, if any, may be made in the form of cash or shares of our common stock, solely at our discretion. We have notified the former shareholders of Commissure that the financial targets for the fiscal year ended September 30, 2008 were not achieved and the related contingent earn-out payment was not earned. We are continuing to evaluate the financial targets related to the fiscal year ended September 30, 2009. Through December 31, 2009, we have not recorded any obligation relative to the Commissure transaction earn-out provisions.

During fiscal 2008, we amended the earn-out provisions set forth in the merger agreement related to the acquisition of Mobile Voice Control, Inc. (MVC) such that the former shareholders of MVC were eligible to earn the remaining calendar 2007 earn-out amount, consisting of 188,962 shares, if certain conditions were met at December 31, 2008. As of December 31, 2008, we determined that the full 188,962 shares had been earned. The total value of the shares was \$3.0 million, of which \$1.0 million was recorded to goodwill as incremental purchase price during fiscal 2008, and the

remaining \$2.0 million was amortized as compensation expense from May 2008 to December 2008. In November 2008, a second amendment to the merger agreement was signed pursuant to which the earn-out period for the calendar 2008 earn-out was extended, such that 377,964 and 755,929 shares could now be earned based on the achievement of calendar 2008 and 2009 targets, respectively. The stock payments, if any, that are made based on the provisions of this second amendment will be recorded to goodwill, as incremental purchase price. We notified the former shareholders of MVC that the

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financial targets for calendar 2008 were not achieved and the 377,964 shares were not earned. We are continuing to evaluate the financial targets for calendar year 2009. Through December 31, 2009, we have not recorded any obligation relative to the second amendment.

In connection with our acquisition of Phonetic Systems Ltd. (*Phonetic*) in February 2005, a deferred payment of \$17.5 million was due and paid to the former shareholders of Phonetic on February 1, 2007. We also agreed to make contingent earn-out payments of \$35.0 million upon achievement of certain established financial and performance targets, in accordance with the merger agreement. In December 2009, we paid \$11.3 million to the former shareholders of Phonetic in final settlement of the contingent earn-out provisions; recording the amount paid as additional purchase price related to the Phonetic acquisition.

Escrow and Holdback Arrangements

In connection with certain of our acquisitions, we have placed either cash or shares of our common stock in escrow to satisfy any claims we may have. If no claims are made, the escrowed amounts will be released to the former shareholders of the acquired companies. Historically, under the previous accounting guidance of SFAS No. 141, *Business Combinations* (SFAS 141), we could not make a determination, beyond a reasonable doubt, whether the escrow would become payable to the former shareholders of these companies until the escrow period had expired. Accordingly, these amounts were treated as contingent purchase price until it was determined that the escrow was payable, at which time the escrowed amounts would be recorded as additional purchase price and allocated to goodwill. Under the revised accounting guidance of ASC 805, escrow payments are generally considered part of the initial purchase consideration and accounted for as goodwill.

The following table summarizes the terms of the escrow arrangements that were entered into under the guidance of SFAS 141 that were not released as of December 31, 2009 (table in thousands):

| | Initially Scheduled Escrow | | Share Payment Number of Shares |
|---------------|---------------------------------------|---------------------|---|
| | Release Date | Cash Payment | |
| eScription(a) | May 20, 2009 | \$ n/a | 103 |
| X-Solutions | December 10, 2010 | 1,050 | n/a |
| eCopy | December 30, 2010 | 7,800 | n/a |
| Total | | \$ 8,850 | 103 |

Discussion of amounts held in escrow following their initially scheduled release date:

- (a) We filed a claim against the escrow related to the breach of certain representations and warranties made in the merger agreement. 1.0 million shares held in escrow were released during fiscal 2009. The remaining

103,000 shares held in escrow at December 31, 2009 were released to the former shareholders of eScription in February 2010.

Table of Contents**NUANCE COMMUNICATIONS, INC.****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****6. Goodwill and Intangible Assets**

The changes in the carrying amount of goodwill for the three months ended December 31, 2009, are as follows (in thousands):

| | |
|--|--------------|
| Balance as of September 30, 2009 | \$ 1,891,003 |
| Goodwill acquired | 110,105 |
| Escrow amounts released | |
| Purchase accounting adjustments | 19,036 |
| Effect of foreign currency translation | (459) |
| Balance as of December 31, 2009 | \$ 2,019,685 |

Purchase accounting adjustments recorded during the three months ended December 31, 2009 consisted primarily of the following increases: the \$11.3 million Phonetic earn-out payment discussed in Note 5 above and a net \$12.6 million adjustment to goodwill primarily related to a revised estimate of the fair value of the intangible assets relating to our fourth quarter fiscal 2009 acquisition. These increases were partially offset by a \$2.8 million reduction to the SNAPin earn-out estimate and a \$1.9 million reduction to the Philips Speech Recognition Systems GMBH (PSRS) purchase price based on a final working capital adjustment agreed between us and the former shareholder of PSRS in November 2009.

Intangible assets consist of the following as of December 31, 2009 (table in thousands, except for years):

| | December 31, 2009 | | | Weighted Average Remaining Life (Years) |
|-----------------------------------|--------------------------------------|-------------------------------------|------------------------------------|--|
| | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount | |
| | | \$ | \$ | |
| Customer relationships | 582,030 | (175,877) | 406,153 | 7.5 |
| Technology and patents | 349,861 | (94,689) | 255,172 | 6.4 |
| Tradenames, trademarks, and other | 39,022 | (6,685) | 32,337 | 4.8 |
| Non-competition agreements | 5,410 | (3,142) | 2,268 | 2.1 |
| Subtotal | 976,323 | (280,393) | 695,930 | 7.0 |
| Tradename, indefinite life | 27,800 | | 27,800 | n/a |
| Total | \$ 1,004,123 | \$ (280,393) | \$ 723,730 | |

In June 2009, we entered into a joint marketing and selling agreement with a third party and paid \$7.0 million, consisting of \$2.0 million in cash and \$5.0 million in common stock, in consideration of that arrangement. We have capitalized the \$7.0 million payment as an intangible asset, included in the tradenames, trademarks, and other grouping above, and assigned a useful life of 3 years, commensurate with the legal term of the rights in the arrangement. In addition to the \$7.0 million paid in June, we also issued 879,567 shares of our common stock, valued at \$13.0 million, in December 2009 as an additional payment, upon the third party meeting certain performance criteria under the agreement by October 31, 2009. The additional \$13.0 million was capitalized and classified in the same manner as the initial \$7.0 million payment.

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NUANCE COMMUNICATIONS, INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Estimated amortization expense for each of the five succeeding years, is as follows (in thousands):

| Year Ending September 30, | Cost of Revenue | Operating Expenses | Total |
|--|--------------------|-----------------------|------------|
| 2010 (January 1, 2010 to September 30, 2010) | \$ 36,594 | \$ 65,567 | \$ 102,161 |
| 2011 | 47,536 | 80,259 | 127,795 |
| 2012 | 42,454 | 69,608 | 112,062 |
| 2013 | 35,276 | 55,333 | 90,609 |
| 2014 | 28,659 | 49,001 | 77,660 |
| Thereafter | 64,654 | 120,989 | 185,643 |
| Total | \$ 255,173 | \$ 440,757 | \$ 695,930 |

7. Financial Instruments and Hedging Activities*Interest Rate Swap Agreements*

To manage the interest rate exposure on our variable-rate borrowings, we use interest rate swaps to convert specific variable-rate debt into fixed-rate debt. As of December 31, 2009, we have two outstanding interest rate swaps designated as cash flow hedges with an aggregate notional amount of \$200 million. The interest rates on these swaps are 2.7% and 2.1%, plus the applicable margin for the Credit Facility, and they expire in October 2010 and November 2010, respectively. As of December 31, 2009 and September 30, 2009, the aggregate cumulative unrealized losses related to these swaps, were \$3.3 million and \$4.0 million, respectively and were included in accumulated other comprehensive income in the accompanying balance sheets.

Forward Currency Contracts Designated as Cash Flow Hedges

On October 1, 2009, we entered into foreign currency contracts to hedge exposure on the variability of cash flows in Canadian dollars with a total notional amount of CAD\$8.7 million. These contracts are designated as cash flow hedges. At December 31, 2009, these contracts had an aggregate remaining, unsettled notional amount of CAD\$5.3 million. The contracts settle each month from January 13, 2010 through July 13, 2010. As of December 31, 2009, the aggregate cumulative unrealized gains related to these contracts were \$0.2 million and were included in accumulated other comprehensive income in the accompanying balance sheets.

Other Derivative Activities

During the three months ended December 31, 2008, we entered into foreign currency forward contracts to offset foreign currency exposure on the deferred acquisition payment of 44.3 million related to our acquisition of PSRS, resulting in a net gain during that period of \$8.0 million included in other income (expense). The foreign currency contracts matured and were settled on October 22, 2009. The gain for the period from September 30, 2009 to settlement on October 22, 2009 was \$1.6 million, but was offset in other income (expense), net by the loss resulting

from the corresponding change in the associated deferred acquisition payment liability.

In June 2009, we acquired certain intangible assets and issued 1,809,353 shares of our common stock, valued at \$25.0 million, as part of the total consideration. We also issued an additional 315,790 shares of our common stock, valued at \$4.5 million, in June 2009 as a prepayment for professional services. These shares issued are subject to security price guarantees which are accounted for as derivatives, and are being accounted for separately from their host agreements due to the determination that such instruments would not be

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considered equity instruments if freestanding. The security price guarantees require a payment from either us to the third party, or from the third party to us based upon the difference between the price of our common stock on the issue date and an average price of our common stock approximately six months following the issue date. Changes in fair value of these security price guarantees are reported in earnings each period as non-operating income (expense) within other income (expense), net. The security price guarantee expired relative to 1,719,299 shares in December 2009, resulting in a \$2.1 million receivable from the third party as settlement of the guarantee. The cash payment by the third-party was remitted in January 2010; therefore, a receivable of \$2.1 million was recorded at December 31, 2009.

In October and December 2009, we issued 1,047,120 and 879,567 shares of our common stock in payment to a third party, valued at \$16.0 million and \$13.0 million, respectively. The \$16.0 million payment was our first payment in consideration for the research and development services of the third party in connection with the five-year joint research collaboration arrangement discussed in Note 2 above, while the \$13.0 million payment was final payment in respect of the joint marketing and selling agreement with the same third party discussed in Note 6 above. These shares are subject to security price guarantees of the same nature as those described above.

For the three months ended December 31, 2009, increases in fair value of \$2.1 million related to the settled and unsettled security price guarantees are reported in earnings as non-operating income within other income (expense), net.

The following table provides a quantitative summary of the fair value of our hedged and non-hedged derivative instruments as of December 31, 2009 and September 30, 2009 (table in thousands):

| Description | Balance Sheet Classification | Fair Value | |
|--|---|----------------------|-----------------------|
| | | December 31, 2009 | September 30, 2009 |
| Derivatives Not Designated as Hedges: | | | |
| Foreign currency contracts | Prepaid expenses and other current assets | \$ | \$ 8,682 |
| Security price guarantees | Prepaid expenses and other current assets | 2,239 | 2,299 |
| Net asset (liability) value of non-hedged derivative instruments | | \$ 2,239 | \$ 10,981 |
| Derivatives Designated as Hedges: | | | |
| Foreign currency contracts | Prepaid expenses and other current assets | \$ 153 | \$ |
| Interest rate swaps | Accrued expenses and other current liabilities(a) | (3,325) | (3,982) |
| | | \$ (3,172) | \$ (3,982) |

Net asset (liability) value of hedged
derivative instruments

- (a) The fair value of the interest rate swaps was classified in other long-term liabilities as of September 30, 2009 as the settlement date for the swaps was greater than twelve months from the balance sheet date.

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The following tables summarize the activity of derivative instruments for fiscal 2010 and 2009 (tables in thousands):

Derivatives Designated as Hedges for the Three Months Ended December 31,

| | Amount of Gain (Loss) | | Location and Amount of Gain (Loss) Reclassified from Accumulated OCI into Income (Effective Portion) | |
|----------------------------|-----------------------|------------|---|------|
| | Recognized in OCI | | 2009 | 2008 |
| | 2009 | 2008 | | |
| Foreign currency contracts | \$ 153 | \$ | N/A | \$ |
| Interest rate swaps | \$ 657 | \$ (4,218) | N/A | \$ |

Derivatives Not Designated as Hedges for the Three Months Ended December 31,

| | Location of Gain (Loss) Recognized in Income | Amount of Gain (Loss) Recognized in Income | |
|----------------------------|---|---|----------|
| | | 2009 | 2008 |
| Foreign currency contracts | Other income (expense), net | \$ 1,614 | \$ 8,049 |
| Security price guarantees | Other income (expense), net | \$ 2,072 | \$ |

Other Financial Instruments

Financial instruments, including cash equivalents, accounts receivable, and derivative instruments, are carried in the consolidated financial statements at amounts that approximate their fair value. Refer to Note 12 for discussion of fair value of our long-term debt.

8. Fair Value Measures

Fair value is defined as the price that would be received for an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date. Valuation techniques must maximize the use of observable inputs and minimize the use of unobservable inputs. When determining the fair value measurements for assets and liabilities required to be recorded at fair value, we consider the principal or most advantageous market in which we would transact and consider assumptions that market participants would use when pricing the asset or liability, such as inherent risk, transfer restrictions, and risk of nonperformance.

ASC 820 (formerly referred to as SFAS No. 157, *Fair Value Measurements*) establishes a value hierarchy based on three levels of inputs, of which the first two are considered observable and the third is considered unobservable:

Level 1. Quoted prices for identical assets or liabilities in active markets which we can access.

Level 2. Observable inputs other than those described as Level 1.

Level 3. Unobservable inputs.

Assets and liabilities measured at fair value on a recurring basis at December 31, 2009 consisted of (table in thousands):

| | Level 1 | December 31, 2009 | | Total |
|--|-------------------|--------------------------|----------------|-------------------|
| | | Level 2 | Level 3 | |
| Assets: | | | | |
| Money market funds(a) | \$ 348,052 | \$ | \$ | \$ 348,052 |
| US government agency securities(a) | 10,001 | | | 10,001 |
| Foreign currency exchange contracts(c) | | 153 | | 153 |
| Security price guarantees(d) | | 2,239 | | 2,239 |
| Total assets at fair value | \$ 358,053 | \$ 2,392 | \$ | \$ 360,445 |
| Liabilities: | | | | |
| Interest rate swaps(b) | \$ | \$ 3,325 | \$ | \$ 3,325 |
| Total liabilities at fair value | \$ | \$ 3,325 | \$ | \$ 3,325 |

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- (a) Money market funds and US government agency securities, included in cash and cash equivalents in the accompanying balance sheet, are valued at quoted market prices in active markets.
- (b) The fair values of the interest rate swaps are estimated using discounted cash flow analyses that factor in observable market inputs such as LIBOR based yield curves, forward rates, and credit spreads.
- (c) The fair value of our foreign currency exchange contracts is the intrinsic value of the contracts based on observable inputs for similar derivative instruments in active markets or quoted prices for identical or similar instruments in markets that are not active or are directly or indirectly observable.
- (d) The fair values of the security price guarantees are determined using a modified Black-Scholes model, derived from observable inputs such as US treasury interest rates, our common stock price, and the volatility of our common stock. The valuation model values both the put and call components of the guarantees simultaneously, with the net value of those components representing the fair value of each instrument.

Items Measured at Fair Value on a Nonrecurring Basis

Our cost-method investments are carried at historical cost in our consolidated financial statements and measured at fair value on a nonrecurring basis when indicators of impairment are identified and such indicators appear to be other than temporary. These assets' carrying values are adjusted to fair value when they are deemed to be other-than-temporarily impaired, with any impairment charges being recorded in other income (expense), net. At September 30, 2009, we had one cost-method investment of \$1.1 million in a non-public company. In October 2009, we entered into an additional cost-method investment in a non-public company for \$15.0 million. As of December 31, 2009 and September 30, 2009, the aggregate carrying amount of our cost-method investments was \$16.1 million and \$1.1 million, respectively. We did not record any impairment charges for these cost-method investments during the three months ended December 31, 2009.

9. Accrued Expenses and Other Current Liabilities

Accrued expenses consisted of the following (in thousands):

| | December 31, 2009 | September 30, 2009 |
|-------------------------------------|------------------------------|-------------------------------|
| Compensation | \$ 65,516 | \$ 52,600 |
| Sales and marketing incentives | 40,010 | 4,413 |
| Cost of revenue related liabilities | 16,436 | 7,585 |
| Acquisition costs and liabilities | 13,329 | 8,522 |
| Professional fees | 13,321 | 8,945 |
| Sales and other taxes payable | 7,235 | 5,913 |
| Income taxes payable | 5,446 | 7,185 |
| Deferred tax liability | 1,633 | 1,614 |

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| | | |
|-------|------------|------------|
| Other | 14,066 | 8,042 |
| Total | \$ 176,992 | \$ 104,819 |

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NUANCE COMMUNICATIONS, INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

10. Accrued Business Combination Costs

The activity for the three months ended December 31, 2009, relating to all facilities and personnel recorded in accrued business combination costs, is as follows (in thousands):

| | Facilities | Personnel | Total |
|---|-------------------|------------------|--------------|
| Balance at September 30, 2009 | \$ 34,551 | \$ 2,497 | \$ 37,048 |
| Charged to goodwill | (15) | (898) | (913) |
| Charged to restructuring and other charges, net | (559) | | (559) |
| Charged to interest expense | 344 | | 344 |
| Cash payments, net of sublease receipts | (2,557) | (926) | (3,483) |
| Balance at December 31, 2009 | \$ 31,764 | \$ 673 | \$ 32,437 |

| | December 31, 2009 | September 30, 2009 |
|--------------|------------------------------|-------------------------------|
| Reported as: | | |
| Current | \$ 10,375 | \$ 12,144 |
| Long-term | 22,062 | 24,904 |
| Total | \$ 32,437 | \$ 37,048 |

11. Restructuring and Other Charges, net

The following table sets forth the three months ending December 31, 2009 accrual activity relating to restructuring and other charges (in thousands):

| | Personnel | Facilities | Other | Total |
|--|------------------|-------------------|--------------|--------------|
| Balance at September 30, 2009 | \$ 607 | \$ 310 | \$ 28 | 945 |
| Restructuring and other charges (credits), net | 1,174 | | | 1,174 |
| Cash payments | (739) | (44) | | (783) |
| Balance at December 31, 2009 | \$ 1,042 | \$ 266 | \$ 28 | \$ 1,336 |

During the three months ended December 31, 2009, we eliminated approximately 40 personnel across multiple functions within our company and recorded a charge of \$1.2 million.

12. Credit Facilities and Debt

At December 31, 2009 and September 30, 2009, we had the following borrowing obligations (in thousands):

| | December 31, 2009 | September 30, 2009 |
|--|------------------------------|-------------------------------|
| 2.75% Convertible Debentures, net of unamortized discount of \$42.8 million and \$44.9 million, respectively | \$ 207,182 | \$ 205,064 |
| Credit Facility | 648,588 | 650,263 |
| Obligations under capital leases | 1,232 | 307 |
| Other | 274 | 126 |
| Total long-term debt | 857,276 | 855,760 |
| Less: current portion | 7,985 | 6,862 |
| Non-current portion of long-term debt | \$ 849,291 | \$ 848,898 |

The estimated fair value of our long-term debt approximated \$882.6 million at December 31, 2009 and \$893.2 million at September 30, 2009. These fair value amounts represent the value at which our lenders could

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NUANCE COMMUNICATIONS, INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

trade our debt within the financial markets, and do not represent the settlement value of these long-term debt liabilities to us at each reporting date. The fair value of these long-term debt issues will continue to fluctuate each period based on fluctuations in market interest rates, and these fluctuations may have little to no correlation to our outstanding debt balances. The decrease in fair value from September 30, 2009 to December 31, 2009 is not considered material and solely attributable to normal fluctuations within the debt markets. The term loan portion of our Credit Facility is traded and the fair values are based upon traded prices as of the reporting dates. The fair values of the 2.75% Convertible Debentures at each respective reporting date were estimated using the averages of the December 31, 2009 and September 30, 2009 bid and ask trading quotes. We had no outstanding balance on the revolving credit line portion of our Credit Facility. Our capital lease obligations and other debt are not traded and the fair values of these instruments are assumed to approximate their carrying values as of December 31, 2009 and September 30, 2009.

2.75% Convertible Debentures

On August 13, 2007, we issued \$250 million of 2.75% convertible senior debentures due in August 2027. As of December 31, 2009, 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 maturity.

Adoption of ASC 470-20

As discussed in Note 2 above, on October 1, 2009, we adopted ASC 470-20, which has been applied retrospectively to all periods presented in our consolidated financial statements herein. ASC 470-20 is applicable to our 2.75% Convertible Debentures as we have the right to deliver cash in lieu of shares of our common stock, or a combination of cash and shares of common stock, upon conversion for each of these issuances.

We recognized total interest expense of approximately \$10.2 million during the quarter ended December 31, 2009 and \$14.9 million during the quarter ended December 31, 2008 related to the contractual interest coupon on all our outstanding long-term debt, amortization of debt issuance costs, and amortization of the discount on the liability component of our 2.75% Convertible Debentures. The effective interest rate on the liability component of our 2.75% Convertible Debentures, including both the cash and non-cash interest components, was approximately 7% during the quarters ended December 31, 2009 and 2008. We are amortizing the discount on the liability component of our 2.75% Convertible Debentures through August 2014, which is the first put date available to the holders of the notes.

The carrying amount of the equity component, principal amount of the liability component, unamortized debt discount related to the liability component and net carrying amount of the liability component of our debt subject to ASC 470-20 as of December 31, 2009 and September 30, 2009 were as follows (in thousands):

| | December 31, 2009 | September 30, 2009 |
|--|----------------------|-----------------------|
| Carrying amount of equity component (conversion options) | \$ 54,695 | \$ 54,965 |

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| | | | | |
|---|----|----------|----|----------|
| Principal amount of liability component | \$ | 250,000 | \$ | 250,000 |
| Unamortized discount related to liability component | | (42,818) | | (44,936) |
| Net carrying amount of liability component | \$ | 207,182 | \$ | 205,064 |

Credit Facility

We have a credit facility which consists of a \$75 million revolving credit line, reduced by outstanding 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 (collectively the Credit Facility). The term loans are due March 2013 and the revolving credit line is due March 2012. As of December 31, 2009, there were \$16.2 million of letters of credit issued under the revolving credit line and

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there were no other outstanding borrowings under the revolving credit line. As of December 31, 2009, we are in compliance with the covenants under the Credit Facility.

As of December 31, 2009, based on our leverage ratio, the applicable margin for our term loan was 1.00% for base rate borrowings and 2.00% for LIBOR-based borrowings. This results in an effective interest rate of 2.24%. No payments under the excess cash flow sweep provision were due in the first quarter of fiscal 2010 as no excess cash flow, as defined, was generated in fiscal 2009. At the current time, we are unable to predict the amount of the outstanding principal, if any, that we may be required to repay in future fiscal years pursuant to the excess cash flow sweep provisions. If only the minimum required repayments are made, the annual aggregate principal amount of the term loans repaid would be as follows (table in thousands):

| Year Ending September 30, | Amount |
|--|---------------|
| 2010 (January 1, 2010 to September 30, 2010) | \$ 5,025 |
| 2011 | 6,700 |
| 2012 | 6,700 |
| 2013 (maturity) | 630,163 |
| Total | \$ 648,588 |

13. Net Income (Loss) Per Share

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 24.4 million shares and 35.8 million shares for the three months ended December 31, 2009 and December 31, 2008, respectively, have been excluded from the computation of diluted net loss per share because their inclusion would be anti-dilutive.

14. Stockholders Equity

In October and December 2009, we issued 1,047,120 and 879,567 shares of our common stock in payment to a third party, valued at \$16.0 million and \$13.0 million, respectively, based on the price of our common stock at closing on the respective issuance dates. The \$16.0 million payment was our first payment in connection with the five-year intellectual property collaboration arrangement discussed in Note 2 above, while the \$13.0 million payment was final payment in respect of the joint marketing and selling agreement with the same third party discussed in Note 6 above.

In December 2009, we issued 2.3 million shares of our common stock, valued at \$36.4 million, as partial consideration for the acquisition of SpinVox Limited discussed in Note 4 above.

On November 15, 2004, in connection with our acquisition of Phonetic, we issued unvested warrants to purchase 750,000 shares of our common stock that were to vest, if at all, upon the achievement of certain performance targets. In December 2009, as disclosed in Note 5, we paid \$11.3 million in cash to the former shareholders of Phonetic in final settlement of the contingent earn-out provisions related to that acquisition. The 750,000 warrants did not vest and

were cancelled as a result of the final settlement. None of the 750,000 warrants remain outstanding at December 31, 2009.

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NUANCE COMMUNICATIONS, INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

15. Stock-Based Compensation

We recognize stock-based compensation expense over the requisite service period. Our share-based awards are accounted for as equity instruments. The amounts included in the consolidated statements of operations relating to stock-based compensation are as follows (dollars in thousands):

| | Three Months Ended December 31, | |
|---|--|------------------|
| | 2009 | 2008 |
| Cost of product and licensing | \$ 9 | \$ 2 |
| Cost of professional services and hosting | 2,648 | 1,780 |
| Cost of maintenance and support | 215 | 150 |
| Research and development | 2,030 | 2,690 |
| Selling and marketing | 8,519 | 7,331 |
| General and administrative | 6,645 | 5,034 |
| | \$ 20,066 | \$ 16,987 |

Stock Options

The table below summarizes activity relating to stock options for the three months ended December 31, 2009:

| | Number of Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term | Aggregate Intrinsic Value(1) |
|-----------------------------------|-----------------------------|--|--|---|
| Outstanding at September 30, 2009 | 13,553,866 | \$ 7.48 | | |
| Granted | 1,150,000 | \$ 13.78 | | |
| Exercised | (1,095,244) | \$ 4.73 | | |
| Forfeited | (130,239) | \$ 11.43 | | |
| Expired | (6,331) | \$ 17.19 | | |
| Outstanding at December 31, 2009 | 13,472,052 | \$ 8.19 | 4.0 years | \$ 100.7 million |
| Exercisable at December 31, 2009 | 9,774,756 | \$ 6.51 | 3.1 years | \$ 89.3 million |
| Exercisable at December 31, 2008 | 11,246,958 | \$ 5.45 | 3.9 years | \$ 59.9 million |

- (1) The aggregate intrinsic value on this table was calculated based on the positive difference, if any, between the closing market value of our common stock on December 31, 2009 (\$15.53) and the exercise price of the underlying options.

As of December 31, 2009, the total unamortized fair value of stock options was \$20.2 million with a weighted average remaining recognition period of 1.4 years. A summary of weighted-average grant-date fair value and intrinsic value of stock options exercised is as follows:

| | Three Months Ended December 31, | |
|--|--|-------------|
| | 2009 | 2008 |
| Weighted-average grant-date fair value per share | \$ 5.90 | \$ 13.78 |
| Total intrinsic value of stock options exercised (in millions) | \$ 11.2 | \$ 2.2 |

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NUANCE COMMUNICATIONS, INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

We use the Black-Scholes option pricing model to calculate the grant-date fair value of an award. The fair value of the stock options granted and unvested options assumed from acquisitions were calculated using the following weighted-average assumptions:

| | Three Months Ended December 31, | |
|---------------------------------|--|-------------|
| | 2009 | 2008 |
| Dividend yield | 0.0% | 0.0% |
| Expected volatility | 51.0% | 58.1% |
| Average risk-free interest rate | 2.4% | 3.1% |
| Expected term (in years) | 4.2 | 6.2 |

Restricted Units

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 three months ending December 31, 2009:

| | Number of Shares Underlying Restricted Units Contingent Awards | Number of Shares Underlying Restricted Units Time-Based Awards |
|---|---|---|
| Outstanding at September 30, 2009 | 2,840,673 | 8,755,330 |
| Granted | 472,000 | 1,157,781 |
| Earned/released | (683,749) | (1,031,166) |
| Forfeited | (417,066) | (262,784) |
| Outstanding at December 31, 2009 | 2,211,858 | 8,619,161 |
| Weighted average remaining contractual term of outstanding Restricted Units | 1.2 years | 1.2 years |
| Aggregate intrinsic value of outstanding Restricted Units(1) | \$ 34.3 million | \$ 133.8 million |
| Restricted Units vested and expected to vest | 1,951,098 | 7,441,532 |
| Weighted average remaining contractual term of Restricted Units vested and expected to vest | 1.1 years | 1.2 years |
| Aggregate intrinsic value of Restricted Units vested and expected to vest(1) | \$ 30.3 million | \$ 115.6 million |

(1) The aggregate intrinsic value on this table was calculated based on the positive difference between the closing market value of our common stock on December 31, 2009 (\$15.53) and the exercise price of the underlying

Restricted Units.

The purchase price for vested Restricted Units is \$0.001 per share. As of December 31, 2009, unearned stock-based compensation expense related to all unvested Restricted Units is \$109.3 million, which will, based on expectations of future performance vesting criteria, where applicable, be recognized over a weighted-average period of 1.6 years.

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NUANCE COMMUNICATIONS, INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

A summary of weighted-average grant-date fair value, including those assumed in respective periods, and intrinsic value of all Restricted Units vested is as follows:

| | Three Months Ended December 31, | |
|--|--|-------------|
| | 2009 | 2008 |
| Weighted-average grant-date fair value per share | \$ 14.58 | \$ 9.59 |
| Total intrinsic value of shares vested (in millions) | \$ 25.3 | \$ 13.6 |

16. Pensions

The components of net periodic benefit cost of the pension plans for the three months ended December 31, 2009 were as follows (in thousands):

| | Three Months Ended December 31, | |
|--|--|-------------|
| | 2009 | 2008 |
| Interest cost | \$ 318 | \$ 279 |
| Expected return on plan assets | (269) | (252) |
| Amortization of unrecognized gain (loss) | 26 | 11 |
| Net periodic pension cost | \$ 75 | \$ 38 |

17. Income Taxes

The effective income tax rate was (8.6)% and (78.9)% for the three months ended December 31, 2009 and 2008, respectively. Included in the tax provision for the three months ended December 31, 2009 was foreign income tax provision, as well as a \$1.5 million tax benefit resulting from the favorable settlement of a state tax penalty related to the eScription acquisition. No tax benefit has been recognized for the U.S. losses, as the realization of such tax benefit is not more likely than not.

At December 31, 2009 and September 30, 2009, the liability for income taxes associated with uncertain tax positions was \$12.3 million and \$12.1 million, respectively. The increase is attributable to accrued interest. We do not expect a significant change in the amount of unrecognized tax benefits within the next 12 months.

18. Commitments and Contingencies*Operating Leases*

The following table outlines our gross future minimum payments under all non-cancelable operating leases as of December 31, 2009 (in thousands):

| Year Ending September 30, | Operating Leases | Leases Under Restructuring | Other Contractual Obligations Assumed | Total |
|--|-----------------------------|---|--|-------------------|
| 2010 (January 1, 2010 to September 30, 2010) | \$ 15,204 | \$ 3,078 | \$ 10,147 | \$ 28,429 |
| 2011 | 19,037 | 2,632 | 13,929 | 35,598 |
| 2012 | 17,145 | 1,341 | 12,284 | 30,770 |
| 2013 | 15,371 | 408 | 2,323 | 18,102 |
| 2014 | 12,705 | | 2,326 | 15,031 |
| Thereafter | 39,225 | | 3,294 | 42,519 |
| Total | \$ 118,687 | \$ 7,459 | \$ 44,303 | \$ 170,449 |

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NUANCE COMMUNICATIONS, INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

At December 31, 2009, we have subleased certain office space that is included in the above table to third parties. Total sublease income under contractual terms is \$16.7 million and ranges from approximately \$1.5 million to \$4.1 million on an annual basis through February 2016.

Litigation and Other Claims

Like many companies in the software industry, we have, from time to time, been notified of claims that we may be infringing, or contributing to the infringement of, the intellectual property rights of others. These claims have been referred to counsel, and they are in various stages of evaluation and negotiation. If it appears necessary or desirable, 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.

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 stock of former Nuance Communications, Inc. (Former Nuance), which we acquired in September 2005, between April 12, 2000 and December 6, 2000. Those complaints have been consolidated into one action. The complaint generally alleges that various investment bank underwriters engaged in improper and undisclosed activities related to the allocation of shares in Former Nuance s initial public offering of securities. The complaint makes claims for violation of several provisions of the federal securities laws against those underwriters, and also against Former Nuance and some of Former Nuance s directors and officers. Similar lawsuits, concerning more than 250 other companies initial public offerings, were filed in 2001. In February 2003, the Court denied a motion to dismiss with respect to the claims against Former Nuance. In the third quarter of 2003, a proposed settlement in principle was reached among the plaintiffs, the issuer defendants (including Former Nuance) and the issuers insurance carriers. The settlement called for the dismissal and release of claims against the issuer defendants, including Former Nuance, in exchange for a contingent payment to be paid, if necessary, by the issuer defendants insurance carriers and an assignment of certain claims. The settlement was not expected to have any material impact, as payments, if any, were expected to be made by insurance carriers, rather than by us. 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 agreement. The plaintiffs in the case then filed amended master allegations and amended complaints. On March 26, 2008, the Court largely denied the defendant s motion to dismiss the amended complaints. On April 2, 2009, the plaintiffs filed a motion for preliminary approval of a new proposed settlement between plaintiffs, the underwriter defendants, the issuer defendants and the insurers for the issuer defendants. Under the settlement, which remains subject to Court approval, the insurers would pay the full amount of the settlement attributable to Former Nuance, and Former Nuance would not bear any financial liability. The Court issued an order granting preliminary approval of the settlement, dated June 9, 2009, and a hearing on final approval of the settlement was held on September 10, 2009. On October 5, 2009, the court issued an opinion granting plaintiffs motion for final approval of the settlement, approval of the plan of distribution of the settlement fund and certification of the settlement classes. On October 20, 2009, a

petition for permission to appeal the court's October 5, 2009 certification of the settlement classes was filed in the United States Court of Appeals for the Second Circuit. No scheduling order has been issued by the Second Circuit Court of Appeals related to this petition. In the absence of any finalized settlement of the nature described above, we continue to believe we would have meritorious defenses to the litigation, which we would

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NUANCE COMMUNICATIONS, INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

defend vigorously. Therefore, due to the inherent uncertainties of litigation, we are unable to determine the ultimate outcome or potential range of loss, if any.

Vianix LLC has filed three legal actions against us, consisting of two breach of contract actions and a copyright infringement claim. It is too early for us to reach a conclusion as to the ultimate outcome or proposed settlement of these actions or to estimate the potential loss that could result from a settlement or adverse judgment against us in these matters. However, we believe that we have substantial defenses against these claims, and intend to defend them vigorously.

We do not believe that the final outcome of the above litigation matters will have a material 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 will be costly. Should we not prevail, our operating results, financial position and cash flows could be adversely impacted.

Guarantees and Other

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

We indemnify our directors and officers to the fullest extent permitted by law. These agreements, among other things, indemnify directors and officers for expenses, judgments, fines, penalties and settlement amounts incurred by such persons in their capacity as a director or officer of the company, regardless of whether the individual is serving in any such capacity at the time the liability or expense is incurred. Additionally, in connection with certain acquisitions we have agreed to indemnify the former officers and members of the boards of directors of those companies, on similar terms as described above, for a period of six years from the acquisition date. In certain cases we purchase director and officer insurance policies related to these obligations, which fully cover the six year periods. To the extent that we do not purchase a director and officer insurance policy for the full period of any contractual indemnification, we would be required to pay for costs incurred, if any, as described above.

At December 31, 2009, we have \$3.2 million of non-cancelable purchase commitments for inventory to fulfill customers' orders currently scheduled in our backlog.

19. Segment and Geographic Information and Significant Customers

We follow the provisions of ASC 280 (formerly referred to as SFAS No. 131, *Disclosures About Segments of an Enterprise and Related Information*), which establishes standards for reporting information about operating segments. ASC 280 also established standards for disclosures about products, services and geographic areas. Operating segments

are defined as components of an enterprise for which separate financial information is available and evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance. Our chief operating decision maker (CODM) is the Chief Executive Officer of the Company.

We have several customer-facing market groups that oversee the core markets where we conduct business. Beginning in fiscal 2009, these groups were referred to as Mobile-Enterprise, Healthcare-Dictation, and

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

Imaging. Each of these market groups has a president who has direct responsibility and oversight related to go-to-market strategies and plans, product management and product marketing activities. These groups do not directly manage centralized or shared resources or the allocation decisions regarding the activities related to these functions, which include sales and sales operations, certain research and development initiatives, business development and all general and administrative activities. Our CODM directly oversees each of the presidents, as well as each of the functions that provide the shared and centralized activities noted above. To manage the business, allocate resources and assess performance, the CODM primarily reviews revenue data by market group, while reviewing gross margins, operating margins, and other measures of income or loss on a consolidated basis. Thus, we have determined that we operate in one segment.

The following table presents revenue information for our three core markets (in thousands):

| | Three Months Ended December 31, | |
|----------------------|--|-------------|
| | 2009 | 2008 |
| Mobile-Enterprise | \$ 125,038 | \$ 99,834 |
| Healthcare-Dictation | 119,946 | 99,968 |
| Imaging | 17,993 | 17,032 |
| Total Revenue | \$ 262,977 | \$ 216,834 |

No country outside of the United States provided greater than 10% of our total revenue. Revenue, classified by the major geographic areas in which our customers are located, was as follows (table in thousands):

| | Three Months Ended December 31, | |
|---------------|--|-------------|
| | 2009 | 2008 |
| United States | \$ 186,499 | \$ 167,432 |
| International | 76,478 | 49,402 |
| Total Revenue | \$ 262,977 | \$ 216,834 |

No country outside of the United States held greater than 10% of our long-lived or total assets. Our long-lived assets, including intangible assets and goodwill, were located as follows (table in thousands):

| December 31, 2009 | September 30, 2009 |
|------------------------------|-------------------------------|
|------------------------------|-------------------------------|

| | | | | |
|---------------|----|-----------|----|-----------|
| United States | \$ | 2,399,495 | \$ | 2,395,773 |
| International | | 466,471 | | 307,864 |
| Total | \$ | 2,865,966 | \$ | 2,703,637 |

20. Related Parties

A member of our Board of Directors is also a partner at Wilson Sonsini Goodrich & Rosati, Professional Corporation, a law firm that provides professional services to us. These services may from time-to-time include contingent fee arrangements. For the three months ended December 31, 2009 and 2008, we paid \$0.9 million and \$0.2 million, respectively, to Wilson Sonsini Goodrich & Rosati for professional services. As of December 31, 2009 and September 30, 2009, we had \$1.8 million and \$1.7 million, respectively, included in accounts payable and accrued expenses to Wilson Sonsini Goodrich & Rosati.

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

The following Management's Discussion and Analysis is intended to help the reader understand the results of operations and financial condition of our business. Management's Discussion and Analysis is provided as a supplement to, and should be read in conjunction with, our consolidated financial statements and the accompanying notes to the consolidated financial statements.

FORWARD-LOOKING STATEMENTS

This Quarterly Report contains forward-looking statements, including predictions regarding:

our future revenue, cost of revenue, research and development expenses, selling, general and administrative expenses, amortization of intangible assets and gross margin;

our strategy relating to our core markets;

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 of Part II and elsewhere in this Quarterly Report.

You should not place undue reliance on these forward-looking statements, which speak only as of the date of this Quarterly Report. 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, imaging and keypad solutions for businesses, organizations and consumers around the world. Our technologies, applications and services make the user experience more compelling by transforming the way people interact with devices and systems, and how they create, share and use documents. Our solutions are used every day by millions of people and thousands of businesses for tasks and services such as requesting information from a phone-based self-service solution, dictating medical records, searching the mobile Web by voice, entering a destination into a navigation system, or working with PDF documents. Our solutions help make these interactions, tasks and experiences more productive, compelling and efficient.

Our technologies address our three core markets:

Mobile-Enterprise. We deliver a portfolio of solutions that improve the experience of customer communications, mobile interactions and personal productivity. Combining our expertise in enterprise and mobile solutions allows us to help consumers, businesses and manufacturers more effectively utilize mobile devices for accessing an array of content, services and capabilities. Our enterprise solutions help 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, utilities, travel and entertainment, and government. Our mobile solutions add voice control and texting capabilities to mobile devices and services, allowing people to more easily dial a mobile phone, enter destination

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information into an automotive navigation system, dictate a text message or have emails and screen information read aloud.

Healthcare-Dictation. Our healthcare solutions comprise a portfolio of speech-driven clinical documentation and communication solutions that help healthcare provider organizations reduce operating costs, increase reimbursement, and enhance patient care and safety. Our solutions automate the input and management of medical information and are used by many of the largest hospitals in the United States. We offer a variety of different solutions and deployment options to address the specific requirements of different healthcare provider organizations. Our Dragon NaturallySpeaking family of products help people and businesses increase productivity by using speech to create documents, streamline repetitive and complex tasks, input data, complete forms and automate manual transcription processes. Our Dragon Medical solution is a desktop application that provides front-end speech recognition that allows smaller groups of physicians and clinicians to create and navigate medical records.

Imaging. Our PDF and document imaging solutions 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 network of partners to design and deploy innovative solutions for businesses and organizations around the globe. We market and distribute our products through a global network of resellers, including system integrators, independent software vendors, value-added resellers, hardware vendors, telecommunications carriers and distributors, and also sell directly through a dedicated sales force and through our e-commerce website.

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 our solutions can transform the way people use the Internet, telecommunications systems, electronic medical records, wireless and mobile networks and related corporate infrastructure to conduct business.

We have built a world-class portfolio of intellectual property, technologies, applications and solutions through both internal development and acquisitions. We expect to continue to pursue opportunities to broaden these assets and expand our customer base through acquisitions. In evaluating the financial condition and operating performance of our business, management focuses on revenue, earnings, gross margins, operating margins and cash flow from operations. A summary of these key financial metrics for the three months ended December 31, 2009, as compared to the three months ended December 31, 2008, is as follows:

Total revenue increased by \$46.1 million to \$263.0 million;

Net loss decreased by \$22.0 million to \$4.3 million;

Gross margins increased by 2.4 percentage points to 64.4%;

Operating margins improved to 1.5% from (3.4)%; and

Cash provided by operating activities for the three months ended December 31, 2009 was \$65.1 million, a decrease of \$15.7 million from the same period in the prior fiscal year.

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CRITICAL ACCOUNTING POLICIES

Generally accepted accounting principles in the United States (GAAP) require us to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenue and expenses during the reporting periods. On an ongoing basis, we evaluate our estimates, 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 business combinations, share-based payments, valuation of derivative instruments; accounting for income taxes and related valuation allowances and loss contingencies. Our management bases its estimates on historical experience, market participant fair value considerations and various other factors that are believed to be reasonable under the circumstances. Actual results could differ from these estimates.

Information about those accounting policies we deem to be critical to our financial reporting may be found in our Annual Report on Form 10-K for the fiscal year ended September 30, 2009. There have been no significant changes or additions to our critical accounting policies from those disclosed in our annual report other than those changes in our policies for accounting for business combinations resulting from our adoption of ASC 805 [formerly referred to as Statement of Financial Accounting Standards (SFAS) No. 141(Revised), *Business Combinations* (SFAS 141R)], as described in Note 2 to the unaudited consolidated financial statements included in Item 1 of Part I of this Quarterly Report on Form 10-Q.

RECENTLY ISSUED ACCOUNTING STANDARDS

Refer to Note 2 to the unaudited consolidated financial statements included in Item 1 of Part I of this Quarterly Report on Form 10-Q.

Table of Contents**RESULTS OF OPERATIONS**

The following table presents, as a percentage of total revenue, certain selected financial data for the three months ended December 31, 2009 and 2008 (as adjusted for the retrospective application of FASB ASC 470-20).

| | Three Months Ended December 31, | |
|--|--|-------------|
| | 2009 | 2008 |
| Revenue: | | |
| Product and licensing | 43.1% | 39.5% |
| Professional services and hosting | 39.4 | 41.5 |
| Maintenance and support | 17.5 | 19.0 |
| Total revenue | 100.0 | 100.0 |
| Cost of revenue: | | |
| Cost of product and licensing | 4.8 | 4.0 |
| Cost of professional services and hosting | 23.6 | 27.0 |
| Cost of maintenance and support | 3.0 | 3.3 |
| Cost of revenue from amortization of intangible assets | 4.2 | 3.7 |
| Gross profit | 64.4 | 62.0 |
| Operating expenses: | | |
| Research and development | 14.1 | 14.0 |
| Sales and marketing | 24.9 | 27.9 |
| General and administrative | 10.4 | 11.8 |
| Amortization of intangible assets | 8.4 | 8.0 |
| Acquisition-related costs, net | 4.9 | 2.7 |
| Restructuring and other charges, net | 0.2 | 1.0 |
| Total operating expenses | 62.9 | 65.4 |
| Income (loss) from operations | 1.5 | (3.4) |
| Other expenses | (3.0) | (3.4) |
| Loss before income taxes | (1.5) | (6.8) |
| Provision for income taxes | 0.1 | 5.3 |
| Net loss | (1.6)% | (12.1)% |

Total Revenue

The following tables show total revenue from our three core market groups and revenue by geographic location, based on the location of our customers, in dollars and percentage change (dollars in millions):

| | Three Months Ended December 31, | | Dollar Change | Percent Change |
|----------------------|--|-------------|--------------------------|---------------------------|
| | 2009 | 2008 | | |
| Mobile-Enterprise | \$ 125.1 | \$ 99.8 | \$ 25.3 | 25.4% |
| Healthcare-Dictation | 119.9 | 100.0 | 19.9 | 19.9% |
| Imaging | 18.0 | 17.0 | 1.0 | 5.9% |
| Total Revenue | \$ 263.0 | \$ 216.8 | \$ 46.2 | 21.3% |

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| | Three Months Ended December 31, | | Dollar Change | Percent Change |
|---------------|--|-------------|--------------------------|---------------------------|
| | 2009 | 2008 | | |
| United States | \$ 186.5 | \$ 167.4 | \$ 19.1 | 11.4% |
| International | 76.5 | 49.4 | 27.1 | 54.9% |
| Total Revenue | \$ 263.0 | \$ 216.8 | \$ 46.2 | 21.3% |

The increase in total revenue was driven by a combination of organic growth and contributions from fiscal 2009 acquisitions. Mobile-Enterprise revenue increased \$25.3 million, primarily driven by growth in sales of our predictive text products, as well as continued growth in our Nuance Mobile Care solutions. Healthcare-Dictation revenue increased \$19.9 million, primarily driven by growth in revenues from our iChart and eScripture services and SpeechMagic solutions. Imaging revenue increased \$1.0 million, primarily driven by contributions from our third and fourth quarter fiscal 2009 acquisitions.

Product and Licensing Revenue

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

| | Three Months Ended December 31, | | Dollar Change | Percent Change |
|----------------------------------|--|-------------|--------------------------|---------------------------|
| | 2009 | 2008 | | |
| Product and licensing revenue | \$ 113.2 | \$ 85.6 | \$ 27.6 | 32.2% |
| As a percentage of total revenue | 43.1% | 39.5% | | |

The increase in product and licensing revenue for the three months ended December 31, 2009, as compared to the three months ended December 31, 2008, consisted of an \$18.4 million increase in Mobile-Enterprise revenue primarily due to contributions from increased sales of our predictive text products and organic growth of our core speech recognition solutions. Healthcare-Dictation product and licensing revenue increased by \$8.7 million primarily due to increased revenue contribution from our SpeechMagic solutions. The growth in our product and licensing revenue streams outpaced the relative growth of our other revenue types, resulting in a 3.6 percentage point increase as a percent of total revenue.

Professional Services and Hosting Revenue

Professional services revenue primarily consists of consulting, implementation and training services for speech customers. Hosting revenue primarily relates to delivering hosted transcription and dictation services over a specified term, as well as self-service, on-demand offerings to carriers and enterprises. The following table shows professional services and hosting revenue, in dollars and as a percentage of total revenue (dollars in millions):

| | Three Months Ended December 31, | | Dollar | Percent |
|---|--|-------------|---------------|----------------|
| | 2009 | 2008 | Change | Change |
| Professional services and hosting revenue | \$ 103.7 | \$ 90.2 | \$ 13.5 | 15.0% |
| As a percentage of total revenue | 39.4% | 41.5% | | |

The increase in professional services and hosting revenue for the three months ended December 31, 2009, as compared to the three months ended December 31, 2008, consisted of a \$9.3 million increase in Healthcare-Dictation revenue, including contributions from growth of our iChart and eScription services. During the three months ended December 31, 2009, we continued to increase the number of transcription lines processed as compared to the corresponding period in the prior year. Additionally, there was a \$4.0 million increase in Mobile-Enterprise revenue, primarily due to continued growth in our

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Nuance Mobile Care and other Mobile-Enterprise on-demand and professional services solutions. Our professional services and hosting hours backlog, including those related to contracts that are cancelable by our customers, continued to increase during the three months ended December 31, 2009, with the increase in hosting hours backlog largely driven by our acquisition of SpinVox. As a percentage of total revenue, professional services and hosting revenue decreased 2.1 percentage points as compared to the corresponding period in the prior year, primarily due to the accelerated growth in the fiscal first quarter in product and licensing revenue relative to professional services and hosting revenue.

Maintenance and Support Revenue

Maintenance and support revenue primarily consists of technical support and maintenance services. The following table shows maintenance and support revenue, in dollars and as a percentage of total revenue (dollars in millions):

| | Three Months Ended December 31, | | Dollar | Percent |
|----------------------------------|--|-------------|---------------|----------------|
| | 2009 | 2008 | Change | Change |
| Maintenance and support revenue | \$ 46.1 | \$ 41.1 | \$ 5.1 | 12.4% |
| As a percentage of total revenue | 17.5% | 19.0% | | |

The increase in maintenance and support revenue for the three months ended December 31, 2009, as compared to the three months ended December 31, 2008, consisted primarily of a \$2.9 million increase in Mobile-Enterprise maintenance and support revenue, driven by continued organic growth, and a \$1.9 million increase related to the expansion of our current installed base of Healthcare-Dictation solutions.

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 dollars and as a percentage of product and licensing revenue (dollars in millions):

| | Three Months Ended December 31, | | Dollar | Percent |
|--|--|-------------|---------------|----------------|
| | 2009 | 2008 | Change | Change |
| Cost of product and licensing revenue | \$ 12.6 | \$ 8.8 | \$ 3.8 | 43.2% |
| As a percentage of product and licensing revenue | 11.1% | 10.3% | | |

The increase in cost of product and licensing revenue for the three months ended December 31, 2009 as compared to the three months ended December 31, 2008, was primarily due to a \$2.3 million increase in Healthcare-Dictation costs, a \$0.9 million increase in Mobile-Enterprise costs and a \$0.7 million increase in Imaging costs as a result of growth in our product and licensing revenue.

Cost of Professional Services and Hosting Revenue

Cost of professional services and hosting revenue primarily consists of compensation for consulting personnel, outside consultants and overhead, as well as the hardware and communications fees that support

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our hosted, on-demand solutions. The following table shows cost of professional services and hosting revenue, in dollars and as a percentage of professional services and hosting revenue (dollars in millions):

| | Three Months Ended December 31, | | Dollar | Percent |
|--|--|-------------|---------------|----------------|
| | 2009 | 2008 | Change | Change |
| Cost of professional services and hosting revenue | \$ 62.0 | \$ 58.5 | \$ 3.5 | 6.0% |
| As a percentage of professional services and hosting revenue | 59.8% | 64.9% | | |

The increase in cost of professional services and hosting revenue for the three months ended December 31, 2009, as compared to the three months ended December 31, 2008, was primarily due to a \$3.4 million increase in Mobile-Enterprise costs related to our acquisition of SNAPin. As a percentage of revenue, cost of professional services and hosting revenue decreased due to faster growth in our higher margin hosted, on-demand solutions.

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 dollars and as a percentage of maintenance and support revenue (dollars in millions):

| | Three Months Ended December 31, | | Dollar | Percent |
|--|--|-------------|---------------|----------------|
| | 2009 | 2008 | Change | Change |
| Cost of maintenance and support revenue | \$ 8.0 | \$ 7.0 | \$ 1.0 | 14.3% |
| As a percentage of maintenance and support revenue | 17.3% | 17.2% | | |

The increase in cost of maintenance and support revenue for the three months ended December 31, 2009 as compared to the three months ended December 31, 2008, was primarily due to a \$0.5 million increase in Mobile-Enterprise costs as a result of our growth, and a \$0.5 million increase in our current installed based of Imaging and Healthcare-Dictation solutions.

Research and Development Expense

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

Three Months

| | Ended December 31, 2009 | 2008 | Dollar Change | Percent Change |
|--|--|-------------|--------------------------|---------------------------|
| Total research and development expense | \$ 37.0 | \$ 30.6 | \$ 6.4 | 20.9% |
| As a percentage of total revenue | 14.1% | 14.1% | | |

The increase in research and development expense for the three months ended December 31, 2009, as compared to the three months ended December 31, 2008, was largely attributable to the \$4.0 million in research and development expense recorded for the three months ended December 31, 2009 for services from a third party related to the joint research collaboration agreement discussed in Note 2 to the unaudited consolidated financial statements, as well as a \$2.5 million increase in compensation expense from additional headcount and fees from professional services resulting from our acquisitions during the third and fourth quarters of fiscal 2009.

Table of Contents**Sales and Marketing Expense**

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

| | Three Months Ended December 31, | | Dollar | Percent |
|-----------------------------------|--|-------------|---------------|----------------|
| | 2009 | 2008 | Change | Change |
| Total sales and marketing expense | \$ 65.6 | \$ 60.5 | \$ 5.1 | 8.4% |
| As a percentage of total revenue | 24.9% | 27.9% | | |

The increase in sales and marketing expense for the three months ended December 31, 2009, as compared to the three months ended December 31, 2008, was primarily attributable to a \$5.3 million increase in compensation and other variable costs, such as commissions and travel expenses. The increase in compensation and other variable costs was attributable to the additional headcount from our acquisitions during the third and fourth quarters of fiscal 2009. This increase was partially offset by a \$0.6 million decrease in marketing and channel programs. Sales and marketing expense, as a percentage of total revenue, decreased as a result of increased cost efficiencies of our sales and marketing expenditures.

General and Administrative Expense

General and administrative expense primarily consists of personnel costs 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 dollars and as a percentage of total revenue (dollars in millions):

| | Three Months Ended December 31, | | Dollar | Percent |
|--|--|-------------|---------------|----------------|
| | 2009 | 2008 | Change | Change |
| Total general and administrative expense | \$ 27.5 | \$ 25.6 | \$ 1.9 | 7.4% |
| As a percentage of total revenue | 10.4% | 11.8% | | |

The increase in general and administrative expense for the three months ended December 31, 2009, as compared to the three months ended December 31, 2008, was primarily attributable to increased legal costs of \$3.1 million associated with ongoing litigation and a \$2.0 million decrease in bad debt expense resulting from improved collection and bankruptcy recovery.

Amortization of Intangible Assets

Amortization of acquired patents and core and completed technology are included in cost of revenue and the amortization of acquired customer and contractual relationships, non-compete agreements, acquired tradenames and trademarks, and other intangibles are included in operating expenses. Customer relationships are amortized on an accelerated basis based upon the pattern in which the economic benefits of the customer

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relationships are being realized. Other identifiable intangible assets are amortized on a straight-line basis over their estimated useful lives. Amortization expense was recorded as follows (dollars in millions):

| | Three Months Ended December 31, | | Dollar Change | Percent Change |
|----------------------------------|--|-------------|--------------------------|---------------------------|
| | 2009 | 2008 | | |
| Cost of Revenue | \$ 11.0 | \$ 8.0 | \$ 3.0 | 37.5% |
| Operating Expenses | 22.1 | 17.3 | 4.8 | 27.7% |
| Total Amortization expense | \$ 33.1 | \$ 25.3 | \$ 7.8 | 30.8% |
| As a percentage of total revenue | 12.6% | 11.7% | | |

The increase in amortization of intangible assets for the three months ended December 31, 2009, as compared to the three months ended December 31, 2008, was primarily attributable to the amortization of acquired intangible assets from our business acquisitions during the third and fourth quarters of fiscal 2009. Amortization expense for the three months ended December 31, 2009 also increased over the corresponding period in 2008 due to our acquisition and licensing of certain technology from other third-parties during fiscal 2009.

Acquisition-Related Costs, Net

Acquisition-related costs include those costs related to business and other acquisitions, including potential acquisitions. These costs consist of transition and integration costs, including retention payments, transitional employee costs and earn-out payments treated as compensation expense, as well as the costs of integration-related services provided by third-parties; professional service fees, including direct third-party costs of the transaction and post-acquisition legal and other professional service fees associated with disputes and regulatory matters related to acquired entities; and adjustments to acquisition-related items that are required to be marked to fair value each reporting period, such as contingent consideration, and other items related to acquisitions for which the measurement period has ended. Acquisition-related costs were recorded as follows (dollars in millions):

| | Three Months Ended December 31, | | Dollar Change | Percent Change |
|--------------------------------------|--|-------------|--------------------------|---------------------------|
| | 2009 | 2008 | | |
| Transition and integration costs | \$ 3.4 | \$ 1.3 | \$ 2.1 | 161.5% |
| Professional service fees | 9.3 | 4.5 | 4.8 | 106.7% |
| Acquisition-related adjustments | 0.1 | 0.1 | 0.0 | 0.0% |
| Total Acquisition-related costs, net | \$ 12.8 | \$ 5.9 | \$ 7.1 | 120.3% |
| As a percentage of total revenue | 4.9% | 2.7% | | |

The increase in acquisition-related costs, net for the three months ended December 31, 2009, as compared to the three months ended December 31, 2008, was primarily a result of our adoption on October 1, 2009 of the new accounting guidance relative to business combinations in FASB ASC 805. We recognized approximately \$6.7 million in transaction costs, included within professional service fees above, during the three months ended December 31, 2009 that would have been capitalized in periods prior to our adoption of ASC 805, including approximately \$2.2 million that had been capitalized as of September 30, 2009 related to costs incurred in prior periods that was required to be expensed upon our adoption of ASC 805. The remainder of the increase was primarily attributable to transition costs for acquired employees from our acquisitions during the third and fourth quarters of fiscal 2009.

Restructuring and Other Charges, Net

For the three months ended December 31, 2009, we recorded net restructuring and other charges of \$0.6 million, which consisted of \$1.2 million related to the elimination of approximately 40 personnel across

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multiple functions within our company, partially offset by \$0.6 million in reversals of previously recorded facilities abandonment charges as a result of entering into a definitive sub-lease agreement for one of our leased properties.

For the three months ended December 31, 2008, we recorded restructuring and other charges of \$2.1 million, of which \$2.0 million related to the elimination of approximately 80 personnel across multiple functions within our company and the remaining amount related to adjustments to fiscal 2008 restructuring programs based on actual payments.

The following table sets forth the activity relating to the restructuring accruals for the three months ended December 31, 2009 (dollars in millions):

| | Personnel | Facilities | Total |
|---------------------------------|------------------|-------------------|--------------|
| Balance at September 30, 2009 | \$ 0.6 | \$ 0.3 | \$ 0.9 |
| Restructuring and other charges | 1.2 | | 1.2 |
| Cash payments | (0.8) | | (0.8) |
| Balance at December 31, 2009 | \$ 1.0 | \$ 0.3 | \$ 1.3 |

Other Income (Expense), Net

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

| | Three Months Ended | | Dollar Change | Percent Change |
|-----------------------------------|-------------------------------|-------------|--------------------------|---------------------------|
| | December 31, 2009 | 2008 | | |
| Interest income | \$ 0.4 | \$ 1.4 | \$ (1.0) | (71.4)% |
| Interest expense | (10.2) | (14.9) | (4.7) | (31.5)% |
| Other income, net | 2.0 | 6.3 | (4.3) | (68.3)% |
| Total other income (expense), net | \$ (7.8) | \$ (7.2) | \$ 0.6 | 8.3% |
| As a percentage of total revenue | (3.0)% | (3.4)% | | |

The change in other income, net for the three months ended December 31, 2009, as compared to the same period in fiscal 2008, was primarily driven by the change in gain recognized on foreign currency forward contracts. During the three months ended December 31, 2008, we entered into foreign currency forward contracts to manage exposure on our Euro-denominated deferred acquisition payment obligation of 44.3 million related to our acquisition of PSRS. The deferred acquisition payment was paid on October 22, 2009. These foreign currency contracts were not designated as hedges and changes in fair value of these contracts were reported in net earnings as other income. For the three months ended December 31, 2008, we recorded a net \$8.0 million gain as other income related to these contracts and the related Euro-denominated obligation. There was no corresponding gain during the three months ended December 31, 2009. However, this decrease was partially offset by gains on other derivative instruments of

\$2.2 million. Interest income was lower during the three months ended December 31, 2009 due to markedly lower prevailing market interest rates. Interest expense was similarly lower during the three months ended December 31, 2009 due to the lower prevailing average interest rates during the quarter related to our variable-interest rate borrowings.

Table of Contents**Provision for Income Taxes**

The following table shows the provision for income taxes and the effective income tax rate (in thousands of dollars, except percentages):

| | Three Months Ended | | Dollar Change | Percent Change |
|---------------------------|-------------------------------|-------------|--------------------------|---------------------------|
| | December 31, 2009 | 2008 | | |
| Income tax provision | \$ 0.3 | \$ 11.6 | \$ (11.3) | (97)% |
| Effective income tax rate | (8.6)% | (78.9)% | | |

Our effective income tax rate was (8.6)% and (78.9)% for the three months ended December 31, 2009 and 2008, respectively. The change in the effective tax rate primarily relates to an \$8.0 million tax provision charge resulting from an asset purchase election made in connection with the eScripture acquisition during the three months ended December 31, 2008, as well as a \$1.5 million tax benefit from the favorable settlement of the state tax penalty for the three months ended December 31, 2009. No tax benefit has been recognized for the U.S. losses, as the realization of such tax benefit is not more likely than not.

LIQUIDITY AND CAPITAL RESOURCES

Cash and cash equivalents totaled \$426.9 million as of December 31, 2009, a decrease of \$100.1 million as compared to \$527.0 million as of September 30, 2009. Our working capital was \$299.0 million as of December 31, 2009 as compared to \$376.6 million as of September 30, 2009. As of December 31, 2009, our total accumulated deficit was \$266.5 million. We do not expect our accumulated deficit to impact our future ability to operate the business given our strong cash and operating cash flow positions, and believe our current cash and cash equivalents on-hand are sufficient to meet our operating needs for at least the next twelve months.

Cash Provided by Operating Activities

Cash provided by operating activities for the three months ended December 31, 2009 was \$65.1 million, a decrease of \$15.7 million, or 19%, as compared to cash provided by operating activities of \$80.8 million for the three months ended December 31, 2008. The decrease was primarily driven by the following factors:

An increase in cash resulting from a decrease in net loss, exclusive of non-cash adjustment items, of approximately \$33.9 million mainly attributable to improvement in our operating margins, as well as the decrease in cash interest expense on our variable rate debt attributable to lower variable interest rates during the three months ended December 31, 2009;

A decrease in cash of \$29.0 million from accounts receivable primarily attributable to the timing of cash collections;

A decrease in cash from accounts payable and accrued expenses of \$29.1 million primarily attributable to the timing of cash payments under our normal operating cycles; and

An increase in cash of \$4.6 million from prepaid expenses and other assets attributable to individually insignificant fluctuations in prepaid expenses related to our normal operations.

Cash Used in Investing Activities

Cash used in investing activities for the three months ended December 31, 2009 was \$159.4 million, an increase of \$63.3 million, or 66%, as compared to cash used in investing activities of \$96.1 million for the three months ended December 31, 2008. The net increase was primarily driven by the following factors:

An increase in cash payments related to acquisitions of \$104.4 million, primarily driven by the cash paid during the quarter for the SpinVox acquisition, the PSRS deferred acquisition payment, and the settlement of the Phonetic earn-out;

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A decrease of \$50.0 million in cash payments to acquire a speech-related patent portfolio and a royalty-free paid-up perpetual license to speech-related source code;

An increase in cash payments related to equity investments of \$14.8 million primarily related to a cost method investment in a non-public company during the first quarter of 2010; and

A decrease of \$5.9 million in capital expenditures.

Cash Used in Financing Activities

Cash used in financing activities for the three months ended December 31, 2009 was \$6.4 million, a decrease of \$0.3 million, or 5%, as compared to cash used in financing activities of \$6.1 million for the three months ended December 31, 2008.

2.75% Convertible Debentures

On August 13, 2007, we issued \$250 million of 2.75% convertible senior debentures due in August 2027. As of December 31, 2009, 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 maturity.

Credit Facility

As of December 31, 2009, \$648.6 million remained outstanding under our term loan. There were \$16.2 million of letters of credit issued under the revolving credit line and there were no other outstanding borrowings under the revolving credit line. As of December 31, 2009, we are in compliance with the covenants under the Credit Facility.

As of December 31, 2009, based on our leverage ratio, the applicable margin for our term loan was 1.00% for base rate borrowings and 2.00% for LIBOR-based borrowings. This results in an effective interest rate of 2.24%. No payments under the excess cash flow sweep provision were due in the first quarter of fiscal 2010 as no excess cash flow, as defined, was generated in fiscal 2009. At the current time, we are unable to predict the amount of the outstanding principal, if any, that we may be required to repay in future fiscal years pursuant to the excess cash flow sweep provisions. If only the minimum required repayments are made, the annual aggregate principal amount of the term loans repaid would be as follows (table in thousands):

| Year Ending September 30, | Amount |
|--|---------------|
| 2010 (January 1, 2010 to September 30, 2010) | \$ 5,025 |
| 2011 | 6,700 |
| 2012 | 6,700 |
| 2013 (maturity) | 630,163 |
| Total | \$ 648,588 |

Equity

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In October and December 2009, we issued 1,047,120 and 879,567 shares of our common stock in payment to a third party, valued at \$16.0 million and \$13.0 million, respectively. The \$16.0 million payment was our first payment in consideration for the research and development services of the third party in connection with the five-year joint research collaboration arrangement discussed in Note 2 to the unaudited consolidated financial statements, while the \$13.0 million payment was final payment in respect of the joint marketing and selling agreement with the same third party discussed in Note 6 to the unaudited consolidated financial statements.

In December 2009, we issued 2.3 million shares of our common stock, valued at \$36.4 million, as partial consideration for the acquisition of SpinVox Limited discussed in Note 4 to the unaudited consolidated financial statements.

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

Off-Balance Sheet Arrangements, Contractual Obligations***Contractual Obligations***

The following table summarizes our outstanding contractual obligations as of December 31, 2009 (in millions):

| Contractual Obligations | Total | Payments Due by Period | | | | |
|--|------------|------------------------|-------------|----------------------|----------------------|------------|
| | | Remaining Fiscal 2010 | Fiscal 2011 | Fiscal 2012 and 2013 | Fiscal 2014 and 2015 | Thereafter |
| 2.75% Convertible Senior Debentures(1) | \$ 250.0 | \$ | \$ | \$ | \$ 250.0 | \$ |
| Credit Facility(2) | 648.6 | 5.0 | 6.7 | 636.9 | | |
| Interest on Credit Facility(2) | 46.6 | 10.9 | 14.4 | 21.3 | | |
| Interest on 2.75% Convertible Senior Debentures(3) | 34.5 | 6.9 | 6.9 | 13.8 | 6.9 | |
| Lease obligations and other liabilities: | | | | | | |
| Operating leases | 118.6 | 15.2 | 19.0 | 32.5 | 25.1 | 26.8 |
| Other lease obligations associated with the closing of duplicate facilities related to restructurings and acquisitions | 7.4 | 3.1 | 2.6 | 1.7 | | |
| Pension, minimum funding requirement | 6.5 | 1.0 | 1.4 | 2.7 | 1.4 | |
| Collaboration agreement(4) | 64.0 | 16.0 | 16.0 | 32.0 | | |
| Purchase commitments | 3.2 | 3.2 | | | | |
| Other liabilities assumed(5) | 44.3 | 10.1 | 13.9 | 14.6 | 4.7 | 1.0 |
| Total contractual cash obligations | \$ 1,223.7 | \$ 71.4 | \$ 80.9 | \$ 755.5 | \$ 288.1 | \$ 27.8 |

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

(2) Interest is due and payable monthly, and principal is paid on a quarterly basis. The amounts included as interest payable in this table are based on the effective interest rate as of December 31, 2009 excluding the effect of our interest rate swaps.

- (3) These figures represent coupon interest only, payable by us in cash, semi-annually.
- (4) Payments under the collaboration agreement are payable in cash or our common stock at our option. Refer to Note 2 to the unaudited consolidated financial statements for further information.
- (5) Obligations include assumed long-term liabilities related to restructuring programs initiated by the predecessor entities prior to our acquisition of SpeechWorks International, Inc. in August 2003, and our acquisition of the former Nuance Communications, Inc. in September 2005. These restructuring programs relate to the closing of two facilities with lease terms set to expire in 2016 and 2012. Total contractual obligations under these two leases are \$44.3 million. As of December 31, 2009, we have sub-leased a portion of the office space related to these

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two facilities to unrelated third parties. Total sublease income under the remaining contractual terms is expected to be \$13.9 million, which ranges from \$1.5 million to \$3.3 million on an annualized basis through 2016.

Contingent Liabilities and Commitments

In connection with our acquisition of SNAPin, we agreed to make a contingent earn-out payment of up to \$45.0 million in cash to be paid, if at all, based on the business achieving certain performance targets that are measurable from the acquisition date to December 31, 2009. Additionally, we would be required to issue earn-out consideration to SNAPin option holders. This option earn-out consideration, if earned, is payable at our sole discretion, in cash, stock or additional options to purchase common stock. The total value of this option earn-out consideration may aggregate up to \$2.5 million, which will be recorded as compensation expense over the service period, if earned. These earn-out payments, if any, would be payable upon the final measurement of the performance targets. As of December 31, 2009, we have recorded approximately \$10.1 million related to contingent earn-out provisions as additional purchase price.

In connection with our acquisition of Multi-Vision Communications, Inc., we agreed to make contingent earn-out payments of up to \$15.0 million, payable in stock, or cash, solely at our discretion, relating to earn-out provisions described in the share purchase agreement. Two-thirds of the earn-out is conditioned on performance targets and continued employment; accordingly, up to \$10.0 million of any earn-out payments that become payable will be recorded as compensation expense, and up to \$5.0 million, the portion of the prospective earn-out attributable solely to performance targets, will be recorded as additional purchase price and allocated to goodwill. As of December 31, 2009, we have not recorded any obligation or related compensation expense relative to these measures.

In connection with our acquisition of Vocada, Inc., we agreed to make contingent earn-out payments of up to \$21.0 million upon the achievement of certain financial targets measured over defined periods through December 31, 2010. Payments, if any, may be made in the form of cash or shares of our common stock, at our sole discretion. We have notified the former shareholders of Vocada that the financial targets for certain periods were not achieved. The former shareholders of Vocada have requested additional information regarding this determination. We are currently in discussions with the former shareholders of Vocada regarding this matter. As of December 31, 2009, we have not recorded any obligation relative to these matters.

In connection with the acquisition of Commissure, Inc., we agreed to make contingent earn-out payments of up to \$8.0 million upon the achievement of certain financial targets for the fiscal years 2008, 2009 and 2010. Payments, if any, may be made in the form of cash or shares of our common stock, solely at our discretion. We have notified the former shareholders of Commissure that the financial targets for the fiscal year ended September 30, 2008 were not achieved and the related contingent earn-out payment was not earned. We are continuing to evaluate the financial targets related to the fiscal year ended September 30, 2009. Through December 31, 2009, we have not recorded any obligation relative to the Commissure transaction earn-out provisions.

In connection with our acquisition of Phonetic Systems Ltd. (*Phonetic*) in February 2005, a deferred payment of \$17.5 million was due and paid to the former shareholders of Phonetic on February 1, 2007. We also agreed to make contingent earn-out payments of \$35.0 million upon achievement of certain established financial and performance targets, in accordance with the merger agreement. In December 2009, we paid \$11.3 million to the former shareholders of Phonetic in final settlement of the contingent earn-out provisions; recording the amount paid as additional purchase price related to the Phonetic acquisition.

Financial Instruments and Hedging Activities

We use financial instruments to manage our interest rate and foreign exchange risk. We follow Statement of Financial Accounting Standards (SFAS) No. 133, *Accounting for Derivative Instruments and Hedging Activities*, amended by SFAS No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*, now referred to as Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 815 (ASC 815), for certain designated forward contracts and interest rate swaps.

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To manage the interest rate exposure on our variable-rate borrowings, we use interest rate swaps to convert specific variable-rate debt into fixed-rate debt. As of December 31, 2009, we have two outstanding interest rate swaps designated as cash flow hedges with an aggregate notional amount of \$200 million. The interest rates on these swaps are 2.7% and 2.1%, plus the applicable margin for the Credit Facility, and they expire in October 2010 and November 2010, respectively. As of December 31, 2009 and September 30, 2009, the aggregate cumulative unrealized losses related to these swaps, and a previous swap that matured on March 31, 2009, were \$3.3 million and \$4.0 million, respectively and were included in accumulated other comprehensive income (loss) in the accompanying balance sheets.

On October 1, 2009, we entered into foreign currency contracts to hedge exposure on the variability of cash flows in Canadian dollars with a total notional amount of CAD\$8.7 million. These contracts are designated as cash flow hedges. At December 31, 2009, these contracts had an aggregate remaining, unsettled notional amount of CAD\$5.3 million. The contracts settle each month from November 12, 2009 through July 13, 2010. As of December 31, 2009, the aggregate cumulative unrealized gains related to these contracts were \$0.2 million and were included in accumulated other comprehensive income in the accompanying balance sheets.

In June 2009, we acquired certain intangible assets and issued 1,809,353 shares of our common stock, valued at \$25.0 million, as part of the total consideration. We also issued an additional 315,790 shares of our common stock, valued at \$4.5 million, in June 2009 as a prepayment for professional services. These shares issued are subject to security price guarantees which are accounted for as derivatives, and are being accounted for separately from their host agreements due to the determination that such instruments would not be considered equity instruments if freestanding. The security price guarantees require a payment from either us to the third party, or from the third party to us based upon the difference between the price of our common stock on the issue date and an average price of our common stock approximately six months following the issue date. Changes in fair value of these security price guarantees are reported in earnings each period as non-operating income (expense) within other income (expense), net. These security price guarantees expired relative to 1,719,299 shares in December 2009, resulting in a \$2.1 million receivable from the third-party as settlement of the guarantee. The cash payment by the third-party was remitted in January 2010; therefore, a receivable of \$2.1 million was recorded at December 31, 2009.

In October and December 2009, we issued 1,047,120 and 879,567 shares of our common stock in payment to a third party, valued at \$16.0 million and \$13.0 million, respectively. The \$16.0 million payment was our first payment in consideration for the research and development services of the third party in connection with the five-year joint research collaboration arrangement discussed in Note 2 to the unaudited consolidated financial statements, while the \$13.0 million payment was final payment in respect of the joint marketing and selling agreement with the same third party discussed in Note 6 to the unaudited consolidated financial statements. These shares are subject to security price guarantees of the same nature as those described above.

For the three months ended December 31, 2009, increases in fair value of \$2.1 million related to the settled and unsettled security price guarantees are reported in earnings as non-operating income within other income (expense), net.

Off-Balance Sheet Arrangements

Through December 31, 2009, we have not entered into any off-balance sheet arrangements or material transactions with unconsolidated entities or other persons.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Our exposure to market risk has not changed materially from that disclosed in our Annual Report on Form 10-K for the fiscal year ended September 30, 2009.

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Item 4. *Controls and Procedures*

Evaluation of Disclosure Controls and Procedures

Our management is responsible for establishing and maintaining a system of disclosure controls and procedures (as defined in Rule 13a-15 under the Securities Exchange Act of 1934 (the Exchange Act)) designed to ensure that information we are required to disclose in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Exchange Act is accumulated and communicated to the issuer's management, including its principal executive officer or officers and principal financial officer or officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

We have evaluated the effectiveness of the design and operation of our disclosure controls and procedures under the supervision of, and with the participation of, management, including the Chief Executive Officer and Chief Financial Officer, as of the end of the period covered by this report. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are effective to meet the requirements of Rule 13a-15 under the Exchange Act.

Changes in internal control over financial reporting

There were no changes to our internal controls over financial reporting identified in connection with the evaluation required by paragraph (d) of Exchange Act Rules 13a-15 or 15d-15 that occurred during the fiscal quarter covered by this Quarterly Report on Form 10-Q that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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Part II. Other Information

Item 1. *Legal Proceedings*

This information is included in Note 18, Commitments and Contingencies, in the accompanying notes to consolidated financial statements and is incorporated herein by reference from Item 1 of Part I.

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 intellectual property portfolio;

concentration of operations with one manufacturing partner and our inability to control expenses related to the manufacturing, packaging and shipping of our boxed software products;

customers delaying their purchasing decisions in anticipation of new versions of our products;

customers delaying, canceling or limiting their purchases as a result of the threat or results of terrorism;

introduction of new products by us or our competitors;

seasonality in purchasing patterns of our customers;

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

returns and allowance charges in excess of accrued amounts;

timing of significant marketing and sales promotions;

impairment charges against goodwill and intangible assets;

delayed realization of synergies resulting from our acquisitions;

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

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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. 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 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;

potential difficulties in completing projects associated with in-process research and development;

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;

assumption of unknown material liabilities of acquired companies;

accurate projection of revenue plans of the acquired entity in the due diligence process;

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.

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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, for transactions which closed prior to October 1, 2009, 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 tradenames 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 December 31, 2009, we had identified intangible assets of approximately \$723.7 million, net of accumulated amortization, and goodwill of approximately \$2.0 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.

Changes in the accounting method for business combinations may have an adverse impact on our reported or future financial results.

For the years ended September 30, 2009 and prior, in accordance with Statement of Financial Accounting Standard (SFAS) 141 *Business Combinations*, (SFAS 141), all acquisition-related costs, such as attorney s fees and accountant fees, as well as contingent consideration to the seller, which was recorded when it is beyond a reasonable doubt that the amount is payable, were capitalized as part of the purchase price.

In December 2007, the Financial Accounting Standards Board (FASB) issued SFAS No. 141 (revised 2007), *Business Combinations*, (SFAS 141R), now referred to as FASB Accounting Standards Codification 805 (ASC 805), which requires an acquirer to do the following: expense acquisition-related costs as incurred; reflect such payments as a reduction of cash flow from operations; record contingent consideration at fair value at the acquisition date with subsequent changes in fair value to be recognized in the income statement and cash flow from operations. ASC 805 applies to business combinations for which the acquisition date is on or after October 1, 2009. ASC 805 could have a material impact on our results of operations and our financial position due to our acquisition strategy.

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 December 31, 2009, we had a total of \$900.1 million of gross debt outstanding, including \$648.6 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 December 31, 2009, there were \$16.2 million of letters of credit issued under the revolving credit line but 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.

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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 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 interest rate swap agreements limiting our exposure for a portion of our debt, the agreements do 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 agreements, 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 \$4.3 million for the first quarter of fiscal 2010 and \$26.3 million for the first quarter of fiscal 2009. 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 and maintain 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.

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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 the 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

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 slower 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, Microsoft, Google, and other smaller providers. Within healthcare dictation and transcription, we compete with Spheris, Medquist and other smaller providers. Within imaging, we compete directly with ABBYY, Adobe, 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, Microsoft and Google, 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, Microsoft and Google, 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.

The SEC, as directed by Section 404 of the Sarbanes-Oxley Act of 2002, adopted rules requiring public companies to include a report of management on internal control over financial reporting in their annual reports on Form 10-K that contains an assessment by management of the effectiveness of our internal control

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over financial reporting. In addition, our independent registered public accounting firm must attest to and report on the effectiveness of our internal control over financial reporting. 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 statements in an accurate and timely manner, could subject us to regulatory actions, civil or criminal penalties, shareholder litigation, or loss of customer confidence, which could result in an adverse reaction in the financial marketplace due to a loss of investor confidence in the reliability of our financial statements, which ultimately could negatively impact our stock price.

A significant portion of our revenue is derived, and a significant portion of our research and development activities 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 could increase in the future. 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 and we have a large number of employees in India that provide transcription services. A significant portion of the development and manufacturing of our speech products are conducted in Belgium and Canada, and a significant portion of our imaging research and development is conducted in Hungary. We also have significant research and development resources in Aachen, Germany, and Vienna, Austria. 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. 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 and costs projected to increase, we are exposed to changes in foreign currencies including the

Euro, British Pound, Canadian Dollar, Japanese Yen, 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.

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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 benefits 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;

significant decline in our stock price for a sustained period;

changes in our organization or management reporting structure could result in additional reporting units, which may require alternative methods of estimating fair values or greater disaggregation or aggregation in our analysis by reporting unit; 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.

Our sales to government clients subject us to risks, including early termination, audits, investigations, sanctions and penalties.

We derive a portion of our revenues from contracts with the United States government, as well as various state and local governments, and their respective agencies. Government contracts are generally subject to audits and investigations which could identify violations of these agreements. Government contract violations could result in a range of consequences including, but not limited to, contract price adjustments, civil and criminal penalties, contract termination, forfeiture of profit and/or suspension of payment, and suspension or debarment from future government contracts. We could also suffer serious harm to our reputation if we were found to have violated the terms of our government contracts.

We recently conducted an analysis of our compliance with the terms and conditions of certain contracts with the U.S. General Services Administration (GSA). Based upon our analysis, we voluntarily notified GSA of non-compliance with the terms of two contracts. The final resolution of this matter may adversely impact our financial position.

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.

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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. 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.

Adverse changes in general economic or political conditions in any of the major countries in which we do business could adversely affect our operating results.

As our business has grown, we have become increasingly subject to the risks arising from adverse changes in domestic and global economic and political conditions. For example, the direction and relative strength of the U.S. and global economies have recently been increasingly uncertain due to softness in housing markets, extreme volatility in security prices, severely diminished liquidity and credit availability, rating downgrades of certain investments and declining valuations of others and continuing geopolitical uncertainties. If economic growth in the United States and other countries in which we do business is slowed, customers may delay or reduce technology purchases and may be unable to obtain credit to finance the purchase of our products. This could result in reduced sales of our products, longer sales cycles, slower adoption of new technologies and increased price competition. Any of these events would likely harm our business, results of operations and financial condition. Political instability in any of the major countries in which we do business would also likely harm our business, results of operations and financial condition.

Current uncertainty in the global financial markets and the global economy may negatively affect our financial results.

Current uncertainty in the global financial markets and economy may negatively affect our financial results. These macroeconomic developments could negatively affect our business, operating results or financial condition in a number of ways which, in turn, could adversely affect our stock price. A prolonged period of economic decline could have a material adverse effect on our results of operations and financial condition and exacerbate some of the other

risk factors described herein. Our customers may defer purchases of our products, licenses, and services in response to tighter credit and negative financial news or reduce their demand for them. Our customers may also not be able to obtain adequate access to credit, which could affect their ability to make timely payments to us or ultimately cause the customer to file for protection from creditors under applicable insolvency or bankruptcy laws. If our customers are not able to make timely payments to us, our accounts receivable could increase.

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Our investment portfolio, which includes short-term debt securities, is generally subject to credit, liquidity, counterparty, market and interest rate risks that may be exacerbated by the recent global financial crisis. If the banking system or the fixed income, credit or equity markets deteriorate or remain volatile, our investment portfolio may be impacted and the values and liquidity of our investments could be adversely affected.

In addition, our operating results and financial condition could be negatively affected if, as a result of economic conditions, either:

the demand for, and prices of, our products, licenses, or services are reduced as a result of actions by our competitors or otherwise; or

our financial counterparties or other contractual counterparties are unable to, or do not, meet their contractual commitments to us.

Security and privacy breaches in our systems may damage client relations and inhibit our growth.

The uninterrupted operation of our hosted solutions and the confidentiality and security of third-party information is critical to our business. Any failures in our security and privacy measures could have a material adverse effect on our financial position and results of operations. If we are unable to protect, or our clients perceive that we are unable to protect, the security and privacy of our electronic information, our growth could be materially adversely affected. A security or privacy breach may:

cause our clients to lose confidence in our solutions;

harm our reputation;

expose us to liability; and

increase our expenses from potential remediation costs.

While we believe we use proven applications designed for data security and integrity to process electronic transactions, there can be no assurance that our use of these applications will be sufficient to address changing market conditions or the security and privacy concerns of existing and potential clients.

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.

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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.

We may incur substantial costs enforcing or acquiring intellectual property rights and defending against third-party claims as a result of litigation or other proceedings.

In connection with the enforcement of our own intellectual property rights, the acquisition of third-party intellectual property rights, or disputes relating to the validity or alleged infringement of third-party intellectual property rights, including patent rights, we have been, are currently, and may in the future be, subject to claims, negotiations or complex, protracted litigation. Intellectual property disputes and litigation are typically very costly and can be disruptive to our business operations by diverting the attention and energy of management and key technical personnel. Although we have successfully defended or resolved past litigation and disputes, we may not prevail in any ongoing or future litigation and disputes. In addition, we may incur significant costs in acquiring the necessary third party intellectual property rights for use in our products. Third party intellectual property disputes could subject us to significant liabilities, require us to enter into royalty and licensing arrangements on unfavorable terms, prevent us from manufacturing or licensing certain of our products, cause severe disruptions to our operations or the markets in which we compete, or require us to satisfy indemnification commitments with our customers including contractual provisions under various license arrangements. Any of these could seriously harm our business.

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 largest stockholder may enable it to influence matters requiring stockholder approval.

As of December 31, 2009, Warburg Pincus beneficially owned approximately 25% of our outstanding common stock, including warrants exercisable for up to 10,062,422 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. Because of its large holdings of our capital stock relative to other stockholders, this stockholder has a strong influence over matters

requiring approval by our stockholders.

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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 largest stockholder, 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.

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. For example, we issued, and registered for resale, approximately 2.3 million shares of our common stock in connection with our December 2009 acquisition of SpinVox. 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;

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limiting the ability of stockholders to call special meetings of stockholders;
requiring all stockholder actions to be taken at meetings of our stockholders; and
establishing advance notice requirements for nominations of directors and for stockholder proposals.

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

On October 14, 2009, we issued 1,047,120 shares of our common stock to International Business Machines Corporation (IBM) as consideration for services to be provided under a collaboration agreement. The shares were issued in reliance upon an exemption from the registration requirements of the Securities Act of 1933, as amended, provided by Section 4(2) thereof because the issuance did not involve a public offering.

On December 18, 2009, we issued 879,567 shares of our common stock to IBM as consideration for the achievement of certain milestones in accordance with a joint marketing and selling agreement. The shares were issued in reliance upon an exemption from the registration requirements of the Securities Act of 1933, as amended, provided by Section 4(2) thereof because the issuance did not involve a public offering.

Item 3. *Defaults Upon Senior Securities*

None.

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

None.

Item 5. *Other Information*

None.

Item 6. *Exhibits*

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

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this Quarterly Report on Form 10-Q to be signed on its behalf by the undersigned, thereunto duly authorized, in the Town of Burlington, Commonwealth of Massachusetts, on February 9, 2010.

Nuance Communications, Inc.

By: /s/ Thomas L. Beaudoin

Thomas L. Beaudoin
Executive Vice President and Chief Financial Officer

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Table of Contents**EXHIBIT INDEX**

| Exhibit Number | Exhibit Description | Incorporated by Reference | | | Filed Herewith |
|-----------------------|--|----------------------------------|-----------------|----------------------------|-----------------------|
| | | Form | File No. | Exhibit Filing Date | |
| 2.1 | Agreement for the acquisition of the entire issued share capital of SpinVox Limited, the substitution of Foxtrot Acquisition Limited as the issuer of a debt instrument issued by SpinVox Limited, and the release and cancellation of such debt instrument in consideration of shares in Foxtrot Acquisition Limited dated December 29, 2009. | 8-K | 0-27038 | 2.1 1/5/2010 | |
| 2.2 | Agreement for the acquisition of shares in Foxtrot Acquisition Limited and the payment of certain sums to the Mezzanine Lenders and other parties dated December 29, 2009. | 8-K | 0-27038 | 2.2 1/5/2010 | |
| 3.1 | Amended and Restated Certificate of Incorporation of the Registrant. | 10-Q | 0-27038 | 3.2 5/11/2001 | |
| 3.2 | Certificate of Amendment of the Amended and Restated Certificate of Incorporation of the Registrant. | 10-Q | 0-27038 | 3.1 8/9/2004 | |
| 3.3 | Certificate of Ownership and Merger. | 8-K | 0-27038 | 3.1 10/19/2005 | |
| 3.4 | Certificate of Amendment of the Amended and Restated Certificate of Incorporation of the Registrant. | S-8 | 333-142182 | 3.3 4/18/2007 | |
| 3.5 | Amended and Restated Bylaws of the Registrant. | 10-K | 0-27038 | 3.2 3/15/2004 | |
| 31.1 | Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) or 15d-14(a). | | | | X |
| 31.2 | Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) or 15d-14(a). | | | | X |
| 32.1 | Certification Pursuant to 18 U.S.C. Section 1350. | | | | X |