Nuance Communications, Inc.
Form 10-Q
May 11, 2009

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q

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

For the quarterly period ended March 31, 2009

or

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

Commission file number 0-27038

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

Delaware	**94-3156479**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*

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

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

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

Indicate by check mark whether the registrant 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). o Yes þ No

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

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

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

264,008,627 shares of the registrant s Common Stock, $0.001 par value, were outstanding as of April 30, 2009.

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Part I. Financial Information

Item 1. ***Financial Statements***

NUANCE COMMUNICATIONS, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS

	Three Months Ended March 31,		Six Months Ended March 31,	
	2009	2008	2009	2008
	(Unaudited) (In thousands, except per share amounts)			
Revenue:				
Product and licensing	$ 87,025	$ 94,254	$ 172,600	$ 192,190
Professional services, subscription and hosting	103,004	72,203	193,196	134,623
Maintenance and support	39,116	36,845	80,183	71,513
Total revenue	229,145	203,302	445,979	398,326
Cost of revenue:				
Product and licensing	9,051	10,686	17,808	22,271
Professional services, subscription and hosting	62,781	56,443	121,263	101,267
Maintenance and support	7,137	8,908	14,180	16,353
Amortization of intangible assets	9,409	7,759	17,427	12,746
Total cost of revenue	88,378	83,796	170,678	152,637
Gross profit	140,767	119,506	275,301	245,689
Operating expenses:				
Research and development	27,766	30,908	58,779	58,753
Sales and marketing	50,369	56,766	111,615	112,773
General and administrative	27,902	28,074	58,159	53,309
Amortization of intangible assets	19,034	14,155	36,382	25,654
Restructuring and other charges, net	250	3,326	2,348	5,478
Total operating expenses	125,321	133,229	267,283	255,967
Income (loss) from operations	15,446	(13,723)	8,018	(10,278)
Other income (expense):				
Interest income	1,049	2,859	2,469	4,513
Interest expense	(9,977)	(14,640)	(23,135)	(29,925)
Other income (expense), net	(449)	(518)	5,778	(1,131)
Income (loss) before income taxes	6,069	(26,022)	(6,870)	(36,821)
Provision (benefit) for income taxes	(998)	769	10,613	5,394
Net income (loss)	$ 7,067	$ (26,791)	$ (17,483)	$ (42,215)
Net income (loss) per share:				
Basic	$ 0.03	$ (0.13)	$ (0.07)	$ (0.21)

Diluted	$ 0.03	$ (0.13)	$ (0.07)	$ (0.21)
Weighted average common shares outstanding:				
Basic	250,656	206,348	243,283	200,280
Diluted	269,187	206,348	243,283	200,280

See accompanying notes.

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NUANCE COMMUNICATIONS, INC.
CONSOLIDATED BALANCE SHEETS

	March 31, 2009 (Unaudited)	September 30, 2008
	(In thousands, except per share amounts)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 420,982	$ 261,540
Marketable securities		56
Accounts receivable, less allowance for doubtful accounts of $8,508 and $6,925	174,460	203,542
Acquired unbilled accounts receivable	7,719	14,457
Inventories, net	8,503	7,152
Prepaid expenses and other current assets	33,235	26,833
Deferred tax assets	1,718	1,703
Total current assets	646,617	515,283
Land, building and equipment, net	51,898	46,485
Goodwill	1,794,861	1,655,773
Intangible assets, net	647,874	585,023
Other assets	40,206	43,635
Total assets	$ 3,181,456	$ 2,846,199
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term debt and capital leases	$ 6,902	$ 7,006
Contingent and deferred acquisition payments	58,511	113,074
Accounts payable	57,038	31,517
Accrued expenses and other current liabilities	92,167	102,099
Accrued business combination costs	10,031	9,166
Deferred maintenance revenue	82,404	80,521
Unearned revenue and customer deposits	65,196	38,381
Total current liabilities	372,249	381,764
Long-term portion of debt and capital leases	891,271	894,184
Long-term portion of accrued business combination costs	27,495	32,012
Long-term deferred revenue	20,985	18,134
Deferred tax liability	37,956	46,745
Other long-term liabilities	57,488	48,452
Total liabilities	1,407,444	1,421,291
Commitments and contingencies (Notes 4, 5, 6 and 19)		

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; 265,127 and 232,592 shares issued and 261,890 and 229,370 shares outstanding	265	232
Additional paid-in capital	2,055,457	1,658,512
Treasury stock, at cost (3,237 and 3,222 shares)	(16,214)	(16,070)
Accumulated other comprehensive income (loss)	(17,508)	12,739
Accumulated deficit	(252,619)	(235,136)
Total stockholders equity	1,774,012	1,424,908
Total liabilities and stockholders equity	$ 3,181,456	$ 2,846,199

See accompanying notes.

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NUANCE COMMUNICATIONS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Six Months Ended March 31,	
	2009	2008
	(Unaudited) (In thousands)	
Cash flows from operating activities:		
Net loss	$ (17,483)	$ (42,215)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation of property and equipment	9,124	7,898
Amortization of intangible assets	53,809	38,400
Bad debt provision	1,897	1,426
Share-based payments	35,002	38,419
Unrealized gain on foreign currency forward contracts	(8,049)	
Deferred tax provision	1,612	1,730
Other	2,777	2,627
Changes in operating assets and liabilities, net of effects from acquisitions:		
Accounts receivable	33,782	43,642
Inventories	(1,461)	554
Prepaid expenses and other assets	(8,299)	6,666
Accounts payable	25,499	(3,735)
Accrued expenses and other liabilities	(2,832)	(15,921)
Deferred maintenance revenue, unearned revenue and customer deposits	5,187	2,512
Net cash provided by operating activities	130,565	82,003
Cash flows from investing activities:		
Capital expenditures	(12,657)	(7,004)
Payments for acquisitions, net of cash acquired	(61,712)	(22,078)
Proceeds from maturities of marketable securities	56	2,575
Payments for equity investment	(159)	(2,172)
Payments for purchase or license of technology and capitalized patent defense costs	(62,886)	(4,006)
Change in restricted cash balances		219
Net cash used in investing activities	(137,358)	(32,466)
Cash flows from financing activities:		
Payments of debt and capital leases	(3,521)	(4,243)
Purchases of treasury stock	(144)	(652)
Excess tax benefits from share-based payments		1,288
Payments of other long-term liabilities	(4,775)	(6,032)
Proceeds from issuance of common stock, net of issuance costs	175,111	131,118
Proceeds from issuance of common stock from employee stock options and purchase plan	7,069	11,804
Cash used to net share settle employee equity awards	(5,000)	(14,015)

Net cash provided by financing activities	168,740	119,268
Effects of exchange rate changes on cash and cash equivalents	(2,505)	1,042
Net increase in cash and cash equivalents	159,442	169,847
Cash and cash equivalents at beginning of period	261,540	184,335
Cash and cash equivalents at end of period	$ 420,982	$ 354,182

See accompanying notes.

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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 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.

Certain amounts presented in prior periods consolidated financial statements have been reclassified to conform to the current periods presentation. Proceeds from employee stock options and purchase plans and cash used to net-share settle employee equity awards are now presented as two separate line items in the Statement of Cash Flows, whereas previously they were presented within net proceeds from issuance of common stock under employee share-based payment plans.

We acquired SNAPin Software, Inc. (SNAPin), a developer of self service software for mobile devices on October 1, 2008. 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, 2008. Interim results are not necessarily indicative of the results that may be expected for a full year.

2. Accounting Changes

We 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, 2008, other than our adoption of Financial Accounting Standards Board (FASB) Statement No. 161 (SFAS 161), *Disclosures about Derivative Instruments and Hedging Activities, an Amendment of FASB Statement No. 133* and SFAS 157, *Fair Value Measurements* and related FASB staff positions. We have provided more information about our application of SFAS 161 in Note 7 and SFAS 157 in Note 8.

Recently Issued Accounting Standards

In April 2009, the FASB issued FASB Staff Position (FSP) 141R-1, *Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies*. This FSP requires that assets acquired and liabilities assumed in a business combination that arise from contingencies be recognized at fair value if fair value can be reasonably estimated. This FSP is effective for the fiscal years beginning after December 15, 2008.

In April 2009, the FASB issued FSP 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly.* FSP 157-4 provides guidance on how to determine the fair value of assets and liabilities under SFAS 157 in the current economic environment and reemphasizes that the objective of a fair value measurement remains an exit price. If we were to conclude that there has been a significant decrease in the volume and level of activity of the asset or liability in relation to *normal* market activities, quoted market values may not be representative of fair value and we may conclude that a change in valuation technique or the use of multiple valuation techniques may be appropriate. FSP 157-4 is effective for interim and annual periods ending after June 15, 2009. We believe FSP 157-4 will not have a material impact on our financial statements.

In June 2008, the Emerging Issues Task Force ratified EITF 07-5, *Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity s Own Stock*. It provides guidance in assessing whether these instruments are indexed to our own stock, and therefore whether to account for the instruments under SFAS 133, *Accounting For Derivative Instruments and Hedging Activities* and/or EITF 00-19, *Accounting For Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company s Own Stock*. EITF 07-5 is effective for fiscal years beginning after December 15, 2008. We are evaluating the potential impact of EITF 07-5.

In May 2008, the FASB issued FSP 14-1, *Accounting for Convertible Debt Instruments that May be Settled in Cash upon Conversion*. FSP 14-1 requires us to separately account for the liability (debt) and equity (conversion option) components of the instrument in a manner that reflects our nonconvertible debt borrowing rate. FSP 14-1 will significantly affect the accounting for convertible debt instruments that require or permit settlement in cash and/or shares at the issuer s option. FSP 14-1 is effective for

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NUANCE COMMUNICATIONS, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

fiscal years beginning after December 15, 2008 and may not be adopted early. FSP 14-1 must be applied retrospectively to all periods presented. We are evaluating the potential impact of FSP 14-1.

In April 2008, the FASB issued FSP 142-3, *Determination of the Useful Life of Intangible Assets*. It 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 SFAS 142. FSP 142-3 is effective for fiscal years beginning after December 15, 2008 and may not be adopted early. We are evaluating the potential impact of FSP 142-3.

In February 2008, the FASB issued FSP 157-2, *Effective Date of FASB Statement No. 157*. FSP 157-2 delays the effective date of SFAS 157 for nonfinancial assets and nonfinancial liabilities, except for certain items that are recognized or disclosed at fair value in the financial statements on a recurring basis. This FSP will be effective in the first quarter of fiscal 2010. We believe FSP 157-2 will not have a material impact on our financial statements.

In December 2007, the FASB issued SFAS 141R, *Business Combinations*. SFAS 141R changes the accounting for business combinations including the measurement of acquirer shares issued in consideration for a business combination, the recognition of contingent consideration, the accounting for pre-acquisition gain and loss contingencies, the recognition of capitalized in-process research and development, the accounting for acquisition-related restructuring cost accruals, the treatment of acquisition related transaction costs and the recognition of changes in the acquirer s income tax valuation allowance. SFAS 141R is effective for fiscal years beginning after December 15, 2008 and may not be adopted early.

3. Comprehensive Loss

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

	Three Months Ended March 31,		Six Months Ended March 31,	
	2009	**2008**	**2009**	**2008**
Net income (loss)	$ 7,067	$ (26,791)	$ (17,483)	$ (42,215)
Other comprehensive income (loss):				
Foreign currency translation adjustment	(14,229)	5,757	(26,018)	9,242
Net unrealized (loss) gain on cash flow hedge derivatives	(10)	(1,396)	(4,229)	(2,087)
Net unrealized gains on investments				2
Other comprehensive income (loss)	(14,239)	4,361	(30,247)	7,157
Total comprehensive loss	$ (7,172)	$ (22,430)	$ (47,730)	$ (35,058)

4. Business Acquisitions

Acquisition of SNAPin

On October 1, 2008, we acquired all of the outstanding capital stock of SNAPin, a developer of self service software for mobile devices, to expand our Mobile-Enterprise offerings. The results of operations of SNAPin have been included in our financial statements since the date of acquisition. The assets acquired and liabilities assumed must be recorded at the date of acquisition at their respective estimated fair values, with any excess of the purchase price over the estimated fair values of the net assets acquired recorded as goodwill. We are finalizing the valuation of the assets acquired and liabilities assumed and therefore the fair values set forth below are subject to adjustment as additional information is obtained. A summary of the preliminary purchase price allocation is as follows (table in thousands):

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NUANCE COMMUNICATIONS, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Total purchase consideration:	
Common stock(a)	$ 150,638
Stock options and restricted stock units assumed	11,523
Transaction costs	2,876
Total purchase consideration	$ 165,037
Allocation of the purchase consideration:	
Current assets	$ 6,084
Other assets	2,971
Deferred tax asset(c)	2,327
Identifiable intangible assets	60,900
Goodwill	124,422
Total assets acquired	196,704
Current liabilities	(2,190)
Deferred tax liability(c)	(2,327)
Deferred revenue(b)	(27,150)
Total liabilities assumed	(31,667)
Net assets acquired	$ 165,037

(a) Approximately 9.5 million shares of our common stock were issued and valued at $15.81 per share. Additionally, 1.1 million shares of our common stock, valued at $17.5 million, have been placed in escrow and have been excluded from purchase consideration until the satisfaction of the escrow contingencies. See additional discussion in Note 5.

(b) We assumed significant legal performance obligations related to acquired customer contracts. We estimate the fair market value of the obligations in accordance with the provision of EITF 01-03, *Accounting in a Business Combination for Deferred Revenue of Acquiree*. The fair value of the legal performance obligations remaining to be delivered on these customer contracts was approximately $52.8 million and the remaining cash to be collected on these contracts was approximately $25.6 million at the date of acquisition.

(c) We recorded a deferred tax liability as a result of purchase accounting associated with SNAPin. This results in an increase of the net deferred tax asset and a reduction of the corresponding valuation allowance in the consolidated group. Therefore, there is no impact on goodwill related to the deferred tax liability.

We assumed vested and unvested stock options that were converted into options to purchase 1,258,708 shares of our common stock and restricted stock units that were converted into 299,446 shares of our common stock. The fair value of the assumed vested stock options and restricted stock units as of the date of acquisition are included in the purchase price above. The fair value of the assumed vested stock options is calculated under the Black-Scholes option pricing model, with the following weighted-average assumptions: dividend yield of 0.0%; expected volatility of 55.5%; average risk-free interest rate of 2.8%; and an expected term of 4.8 years. Assumed unvested stock options and restricted stock units as of the date of acquisition will be recorded as shared-based compensation expense over the requisite service period as disclosed in Note 16.

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

	Amount	**Weighted Average Life (In years)**
Customer relationships	$ 21,200	10.8
Core and completed technology	39,000	10.0
Non-compete agreements	700	4.0
Total	$ 60,900	

The following table shows unaudited pro forma results of operations as if we had acquired SNAPin and our other significant acquisitions on October 1, 2007 (PSRS, eScription, Inc., and Viecore, Inc.) (table in thousands, except per share data):

	Three Months Ended March 31,		**Six Months Ended March 31,**	
	2009	**2008**	**2009**	**2008**
Revenue	$229,145	$225,715	$445,979	$452,421
Net income (loss)	7,067	(35,831)	(17,483)	(63,424)
Net income (loss) per share basic	$ 0.03	$ (0.16)	$ (0.07)	$ (0.29)
Net income (loss) per share diluted	$ 0.03	$ (0.16)	$ (0.07)	$ (0.29)

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NUANCE COMMUNICATIONS, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. Deferred and Contingent Acquisition Payments

Earnout Payments

In connection with our acquisition of Phonetic Systems Ltd. we agreed to pay up to $35.0 million of additional consideration if certain financial and performance targets were met. We have notified the former shareholders of Phonetic that these targets were not achieved. Accordingly, we have not recorded any obligations relative to these measures. The former shareholders of Phonetic have objected to this determination and have filed for arbitration.

During fiscal 2008, we amended the earnout 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 earnout 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 earnout period for the calendar 2008 earnout was extended, such that 377,964 and 755,929 shares may 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. As of March 31, 2009, we have not recorded any obligation relative to the second amendment.

In connection with the acquisition of Commissure, Inc. we agreed to make contingent earnout payments of up to $8.0 million upon the achievement of certain financial targets for the fiscal years ended September 30, 2008, 2009 and 2010. Any payments may be made in the form of cash or shares of our common stock, at our sole discretion. As of March 31, 2009, we have not recorded any obligation relative to these measures.

In connection with our acquisition of Vocada, Inc. we agreed to make contingent earnout payments of up to $21.0 million upon the achievement of certain financial targets measured over defined periods through December 31, 2010. Any payments may be made in the form of cash or shares of our common stock at our sole discretion. As of March 31, 2009, we have not recorded any obligation relative to these measures.

In connection with our acquisition of Multi-Vision Communications, Inc. we agreed to make contingent earnout payments of up to $15.0 million upon the achievement of certain financial targets for the period from August 1, 2008 to July 31, 2009. $10.0 million of the earnout is further conditioned on the continued employment of certain Multi-Vision employees. Accordingly, up to $10.0 million of any earnout payments will be recorded as compensation expense, and up to $5.0 million will be recorded as additional purchase price and allocated to goodwill. Any payments may be made in the form of cash or shares of our common stock, at our sole discretion. As of March 31, 2009, we have not recorded any obligation or related compensation expense relative to these measures.

In connection with our acquisition of SNAPin, we agreed to make a contingent earnout 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 earnout consideration to SNAPin option holders. This option earnout 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 earnout consideration may aggregate up to $2.5 million which will be recorded as compensation expense over the service period, if earned. These earnout payments, if any, would be payable upon the final measurement of the performance targets. As of March 31, 2009, we have not recorded any obligation or related compensation expense relative to these measures.

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NUANCE COMMUNICATIONS, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Escrow Arrangements

The following escrow arrangements have not been released as of March 31, 2009 (table in thousands):

	Scheduled Escrow Release Date	Cash Payment	Shares to be Issued
Focus(a)	March 26, 2008	5,800	n/a
BeVocal(b)	July 24, 2008	n/a	1,225
eScription(c)	May 20, 2009	n/a	1,124
SNAPin	October 1, 2009	n/a	1,107
Total		$ 5,800	3,456

The following amounts are being held in escrow after their initially scheduled release date:

(a) We filed a claim against the Focus Infomatics, Inc. escrow related to the breach of certain representations and warranties made in the share purchase agreement. We determined that the entire escrow will be paid to either satisfy liabilities indemnified under the agreement or paid to the former shareholders. Accordingly, an amount equal to the escrow was recorded as additional purchase price during fiscal 2008. The amount deposited in escrow will remain in escrow until the claims are finalized.

(b) We filed a claim against the BeVocal, Inc. escrow related to the breach of certain representations and warranties made in the merger agreement. We expect the entire amount to