Nuance Communications, Inc.
Form 10-Q/A
April 07, 2006

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q/A
(Amendment No. 1)

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

For the quarterly period ended December 31, 2005

or

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

Commission file number 0-27038

NUANCE COMMUNICATIONS, INC.

(Exact name of registrant as specified in its charter)

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

1 Wayside Road
Burlington, MA 01803
(Address of principal executive office)
Registrant s telephone number, including area code:
781-565-5000

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Securities Exchange Act of 1934).
Yes þ No o

Indicate by check mark whether the registrant is a large accelerated filer, and accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):
Large accelerated filer o Accelerated filer þ Non-accelerated filer 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

164,678,453 shares of the registrant s Common Stock, $0.001 par value, were outstanding as of January 31, 2006.

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EXPLANATORY NOTE

This Amendment No. 1 on Form 10-Q/A (the Amendment) to the Company s quarterly report on Form 10-Q for the fiscal quarter ended December 31, 2005 (the Form 10-Q) is being filed solely to expand the disclosure under the heading *Accounting for Stock-Based Compensation* in Footnote 2 to the Company s consolidated financial statements included in Item 1 of Part I of the Form 10-Q in response to a comment that the Company received from the staff of the Securities and Exchange Commission in a comment letter dated March 27, 2006. Specifically, such expanded disclosure sets forth additional information required pursuant to the provisions of SFAS No. 123 (revised 2004), Share-Based Payment.

Except for the expanded disclosure discussed above, the Company has not updated the disclosure in this Amendment to reflect any events subsequent to the date of the original filing of the Form 10-Q. The filing of this Amendment shall not be deemed an admission that the original filing, when made, included any untrue statement of a material fact or omitted to state a material fact necessary to make a statement not misleading.

PART I: FINANCIAL INFORMATION

Item 1. ***Financial Information***

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NUANCE COMMUNICATIONS, INC.
CONSOLIDATED BALANCE SHEETS
(In thousands, except per share amounts)

	December 31, 2005 (Unaudited)	September 30, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 67,503	$ 71,687
Marketable securities	3,711	24,127
Accounts receivable, less allowances of $13,777 and $13,578, respectively (Note 3)	77,174	69,540
Inventory	312	313
Prepaid expenses and other current assets	8,180	9,235
Total current assets	156,880	174,902
Property and equipment, net	15,419	14,333
Goodwill	458,201	458,313
Other intangible assets, net (Note 4)	87,882	92,350
Other assets (Note 11)	17,560	17,314
Total assets	$ 735,942	$ 757,212
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 15,348	$ 17,347
Accrued compensation	13,301	13,911
Accrued expenses (Note 5)	31,044	46,242
Accrued business combination costs (Note 8)	15,879	17,027
Deferred revenue	26,701	24,120
Notes payable (Note 7)	28,113	27,711
Deferred acquisition payment ART (Note 6)	2,894	16,414
Total current liabilities	133,280	162,772
Long-term deferred revenue	234	291
Long-term notes payable, net of current portion (Note 7)	24	35
Deferred tax liability	4,832	4,241
Deferred acquisition payment, net Phonetic (Note 6)	16,497	16,266
Accrued business combination costs, net of current portion (Note 8)	52,883	54,972
Other liabilities	4,064	3,970
Total liabilities	211,814	242,547
Commitments and contingencies (Notes 2, 6, 7, 10 and 11)		
Stockholders equity (Note 10):		
	4,631	4,631

Series B preferred stock, $0.001 par value; 40,000,000 shares authorized; 3,562,238 shares issued and outstanding (liquidation preference $4,631)		
Common stock, $0.001 par value; 280,000,000 shares authorized; 162,601,425 and 159,431,907 shares issued and 159,670,371 and 156,585,046 shares outstanding, respectively	163	160
Additional paid-in capital	705,761	699,427
Treasury stock, at cost (2,931,054 and 2,846,861 shares, respectively)	(11,994)	(11,432)
Deferred stock-based compensation (Note 2)		(8,782)
Accumulated other comprehensive loss	(2,303)	(2,100)
Accumulated deficit	(172,130)	(167,239)
Total stockholders equity	524,128	514,665
Total liabilities and stockholders equity	$ 735,942	$ 757,212

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

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NUANCE COMMUNICATIONS, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share data)
(Unaudited)

	Three Months Ended December 31,	
	2005	**2004**
Revenue:		
Product licenses	$ 53,183	$ 46,834
Maintenance	7,803	2,785
Professional services	14,566	10,959
Total revenue	75,552	60,578
Costs and Expenses:		
Cost of revenue:		
Cost of product licenses(1)	4,982	5,520
Cost of maintenance(1)	2,295	890
Cost of professional services(1)	10,385	8,737
Cost of revenue from amortization of intangible assets	2,475	2,825
Total cost of revenue	20,137	17,972
Gross Margin	55,415	42,606
Operating expenses:		
Research and development(1)	12,157	9,194
Sales and marketing(1)	28,333	18,762
General and administrative(1)	14,647	7,231
Amortization of other intangible assets	2,000	669
Restructuring and other charges, net		659
Total operating expenses	57,137	36,515
Income (loss) from operations	(1,722)	6,091
Other income (expense):		
Interest income	748	117
Interest expense	(1,016)	(90)
Other (expense) income, net	70	(917)
Income (loss) before income taxes	(1,920)	5,201
Provision for income taxes	2,300	2,060
Income (loss) before cumulative effect of accounting change	(4,220)	3,141
Cumulative effect of accounting change(1)	672	
Net income (loss)	$ (4,892)	$ 3,141
Basic and Diluted earnings per share:		

Income (loss) before cumulative effect of accounting change	$ (0.03)	$ 0.03
Cumulative effect of accounting change		
Net income (loss) per share	$ (0.03)	$ 0.03
Weighted average common shares outstanding:		
Basic	156,389	104,973
Diluted	156,389	112,430

(1) Effective October 1, 2005 the Company adopted SFAS 123(R) Share-Based Payment, and uses the modified prospective method to value its share-based payments. Accordingly, for the three months ended December 31, 2005, stock-based compensation was accounted for under SFAS 123R, while for the three months ended December 31, 2004, stock-based compensation was accounted for under APB 25, Accounting for Stock Issued to Employees. See Note 2 Summary of Significant Accounting Policies. The amounts in

these consolidated statements of operations include stock-based compensation as follows:

Cost of product licenses	$ 21	$ 4
Cost of maintenance	48	1
Cost of professional services	290	34
Research and development	852	84
Sales and marketing	1,111	211
General and administrative	1,419	364
Cumulative effect of accounting change	672	
	$ 4,413	$ 698

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

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NUANCE COMMUNICATIONS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Three Months Ended December 31,	
	2005	**2004**
Cash flows from operating activities		
Net income (loss)	$ (4,892)	$ 3,141
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation of property and equipment	1,698	1,021
Amortization of other intangible assets	4,475	3,494
Accounts receivable allowances	246	346
Stock-based compensation, including cumulative effect of accounting change	4,413	698
Foreign exchange gain (loss)	6	(891)
Non-cash interest expense	616	66
Deferred tax provision	1,464	1,076
Normalization of rent expense	306	
Changes in operating assets and liabilities, net of effects from acquisitions:		
Accounts receivable	(8,122)	(12,824)
Inventory	3	(436)
Prepaid expenses and other assets	748	68
Accounts payable	(1,932)	3,080
Accrued expenses (including restructuring and business combination costs)	(5,958)	3,992
Deferred revenue	2,610	2,772
Net cash provided by (used in) operating activities	(4,319)	5,603
Cash flows from investing activities		
Capital expenditures for property and equipment	(2,461)	(829)
Cash paid for acquisitions, including transaction costs	(14,179)	(6,694)
Maturities of marketable securities	20,435	19,494
Net cash provided by investing activities	3,795	11,971
Cash flows from financing activities		
Payment of note payable and deferred acquisition obligations	(13,520)	(227)
Purchase of treasury stock	(588)	(125)
Proceeds from issuance of common stock under employee stock-based compensation plans	10,732	203
Net cash used in financing activities	(3,376)	(149)
Effects of exchange rate changes on cash and cash equivalents	(284)	888
Net (decrease) increase in cash and cash equivalents	(4,184)	18,313
Cash and cash equivalents at beginning of period	71,687	22,963

Cash and cash equivalents at end of period	$ 67,503	$ 41,276

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

NUANCE COMMUNICATIONS, INC.

1. Organization and Presentation

Nuance Communications, Inc. (the Company or Nuance) was incorporated as Visioneer, Inc. in 1992. In 1999, the Company changed its name to ScanSoft, Inc., and in October 2005 the Company again changed its name to Nuance Communications, Inc. In November 2005, the Company changed its ticker symbol from SSFT to NUAN.

On September 15, 2005, the Company acquired Nuance Communications, Inc., a company based in Menlo Park, California. That acquired company is referred to as Former Nuance in these consolidated financial statements.

The accompanying consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States of America. In the opinion of management, these unaudited interim consolidated financial statements reflect all adjustments, consisting of normal recurring adjustments, necessary for a fair presentation of the financial position at December 31, 2005, the results of operations for the three month periods ended December 31, 2005 and 2004, and cash flows for the three month periods ended December 31, 2005 and 2004. Although the Company believes that the disclosures in these financial statements are adequate to make the information presented not misleading, certain information normally included in the footnotes prepared in accordance with generally accepted accounting principles in the United States of America has been omitted as permitted by the rules and regulations of the Securities and Exchange Commission. The accompanying financial statements should be read in conjunction with the audited financial statements and notes thereto included in the Company s Annual Report on Form 10-K/A for the fiscal year ended September 30, 2005 filed with the Securities and Exchange Commission on January 30, 2006. The results for the three month period ended December 31, 2005 are not necessarily indicative of the results that may be expected for the fiscal year ending September 30, 2006, or any future period.

Beginning in this quarter, the Company has begun to report maintenance revenue and the related cost of revenue separately. The amounts relating to these revenues and expenses have been reclassified from the previously reported aggregated amounts in the Company s Quarterly Report on Form 10-Q for the fiscal quarter ended December 31, 2004.

2. Summary of Significant Accounting Policies

Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with generally accepted accounting principles in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenue and expenses during the reporting periods. On an ongoing basis, the Company evaluates its estimates and judgments, including those related to revenue recognition, the costs to complete the development of custom software applications, valuation allowances, accounting for patent legal defense costs, the valuation of goodwill, other intangible assets and tangible long-lived assets, estimates used in accounting for acquisitions, assumptions used in valuing stock-based compensation instruments, evaluation of loss contingencies, assumptions relating to lease exit costs, and valuation allowances for deferred tax assets. Actual amounts could differ significantly from these estimates. The Company bases its estimates and judgments on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities and the amounts of revenue and expenses that are not readily apparent from other sources.

Basis of Consolidation

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

NUANCE COMMUNICATIONS, INC.

Revenue Recognition

The Company recognizes revenue in accordance with Statement of Position (SOP) 97-2, Software Revenue Recognition , as amended by SOP 98-9, Modification of SOP 97-2 with Respect to Certain Transactions , SOP 81-1, Accounting for Performance of Construction Type and Certain Performance Type Contracts , the Securities and Exchange Commission s Staff Accounting Bulletin 104, Revenue Recognition in Financial Statements (SAB 104), Emerging Issues Task Force (EITF) Issue 01-9, Accounting for Consideration Given by a Vendor (Including a Reseller of the Vendor s Products) and Statement of Financial Accounting Standards (SFAS) 48, Revenue Recognition when Right of Return Exists . In general the Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, collectibility is probable, and vendor specific objective evidence (VSOE) of fair value exists for any undelivered elements. The Company reduces revenue recognized for estimated future returns, price protection and rebates, and certain marketing funds at the time the related revenue is recorded.

Certain distributors and value-added resellers have been granted rights of return for as long as the distributors or resellers hold the inventory. The Company has not analyzed historical returns from distributor and resellers to form a basis in order to estimate the future sales returns by distributor and resellers. As a result, the Company recognizes revenue from sales to these distributors and resellers when the distributor and reseller has sold products through to retailers and end-users. Title and risk of loss pass to the distributor or reseller upon shipment, at which time the transaction is invoiced and payment is due. Based on reports from distributors and resellers of their inventory balances at the end of each period, the Company records an allowance against accounts receivable for the sales price of all inventories subject to return. This allowance is included in the allowance against accounts receivable amounts presented in the accompanying consolidated balance sheets.

The Company also makes an estimate of sales returns by retailers or end users directly or through its distributors or resellers based on historical returns experience. The Company has analyzed historical returns from retailers and end users which forms the basis of its estimate of future sales returns by retailers or end users. In accordance with SFAS 48, the provision for these estimated returns is recorded as a reduction of revenue at the time that the related revenue is recorded. If actual returns differ significantly from its estimates, such differences could have a material impact on the Company s results of operations for the period in which the actual returns become known.

Revenue from royalties on sales of the Company s products by original equipment manufacturers (OEMs) to third parties, where no services are included, is typically recognized upon delivery to the third party when such information is available, or when the Company is notified by the OEM that such royalties are due as a result of a sale, provided that all other revenue recognition criteria are met.

When the Company provides professional services considered essential to the functionality of the software, such as custom application development for a fixed fee, it recognizes revenue from the fees for such services and any related software licenses based on the percentage-of-completion method in accordance with SOP 81-1. The Company generally determines the percentage-of-completion by comparing the labor hours incurred to date to the estimated total labor hours required to complete the project. The Company considers labor hours to be the most reliable, available measure of progress on these projects. Adjustments to estimates to complete are made in the periods in which facts resulting in a change become known. When the estimate indicates that a loss will be incurred, such loss is recorded in the period identified. Significant judgments and estimates are involved in determining the percent complete of each contract. Different assumptions could yield materially different results.

When the Company provides services on a time and materials basis, it recognizes revenue as it performs the services based on actual time incurred.

Other professional services not considered essential to the functionality of the software are limited and primarily include training and feasibility studies, which are recognized as revenue when the related services are performed. When the Company provides software support and maintenance services, it recognizes the revenue ratably over the term of the related contracts, typically one year.

NUANCE COMMUNICATIONS, INC.

The Company may sell, under one contract or related contracts, software licenses, custom software applications and other services considered essential to the functionality of the software and a maintenance and support arrangement. The total contract value is attributed first to the maintenance and support arrangement based on VSOE of its fair value and additionally based upon stated renewal rates. The remainder of the total contract value is then attributed to the software license and related professional services, which are typically recognized as revenue using the percentage-of-completion method. The Company may sell, under one contract or related contracts, software licenses, a maintenance and support arrangement and professional services not considered essential to the functionality of the software. In those arrangements, the total contract value is attributed first to the undelivered elements of maintenance and support and professional services based on VSOE of their respective fair values. The remainder of the contract value is attributed to the software licenses, which are typically recognized as revenue upon delivery, provided all other revenue recognition criteria are met.

The Company follows the guidance of EITF 01-9, in determining whether consideration given to a customer should be recorded as an operating expense or a reduction of revenue recognized from that same customer. Consideration given to a customer is recorded as a reduction of revenue unless both of the following conditions are met:

- the Company receives an identifiable benefit in exchange for the consideration, and the identified benefit is sufficiently separable from the customer s purchase of the Company s products and services such that the Company could have purchased the products from a third party, and

- the Company can reasonably estimate the fair value of the benefit received.

Consideration, including that in the form of the Company s equity instruments (if applicable), is recorded as a reduction of revenue to the extent the Company has recorded cumulative revenue from the customer or reseller, which resulted in a $0.2 million and $0.1 million reduction in total revenue in the three month periods ended December 31, 2005 and 2004, respectively.

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

Long-lived Tangible and Intangible Assets and Goodwill

The Company has significant long-lived tangible and intangible assets, including goodwill, which are susceptible to valuation adjustments as a result of changes in various factors or conditions. The most significant long-lived tangible and other intangible assets are fixed assets, patents and core technology, completed technology, customer relationships and trademarks which are amortized using the straight-line method over their estimated useful lives, which the Company believes is the most rational method. The values of intangible assets, with the exception of goodwill, were initially determined by a risk-adjusted, discounted cash flow approach. The Company assesses the potential impairment of identifiable intangible assets and fixed assets whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors it considers important, which could trigger an impairment of such assets, include the following:

- significant underperformance relative to historical or projected future operating results;

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

- significant negative industry or economic trends;

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

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

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

Effective January 1, 2002, the Company adopted SFAS 142, Goodwill and Other Intangible Assets . SFAS 142 requires, among other things, the discontinuance of goodwill amortization. The standard also requires the Company to test goodwill for impairment on at least an annual basis. The Company uses July 1st as the date of the annual impairment test. The impairment test compares the fair value of the reporting unit to its carrying amount, including goodwill, to assess whether impairment is present. The Company has reviewed the provisions of SFAS 142 with respect to the criteria necessary to evaluate the number of reporting units that exist, based on its review the Company has determined that it operates in one reporting unit. Based on this assessment test, the Company has not had any goodwill impairment charges. The Company will assess the impairment of goodwill more often if indicators of impairment arise. The Company did evaluate the goodwill as of September 30, 2005, following its acquisition of Former Nuance, and again determined that no impairment existed at that time.

In accordance with SFAS 144, Accounting for the Impairment or Disposal of Long-Lived Assets , the Company periodically reviews long-lived assets for impairment whenever events or changes in business circumstances indicate that the carrying amount of the assets may not be fully recoverable or that the useful lives of those assets are no longer appropriate. Each impairment test is based on a comparison of the undiscounted cash flows to the recorded value for the asset. If impairment is indicated, the asset is written down to its estimated fair value based on a discounted cash flow analysis. No impairment charges were taken in the three months ended December 31, 2005 or in fiscal 2005.

Significant judgments and estimates are involved in determining the useful lives and amortization patterns of intangible assets, determining what reporting units exist and assessing when events or circumstances would require an interim impairment analysis of goodwill or other long-lived assets to be performed. Changes in the organization or the Company s management reporting structure, as well as other events and circumstances, including but not limited to technological advances, increased competition and changing economic or market conditions, could result in (a) shorter estimated useful lives, (b) additional reporting units, which may require alternative methods of estimating fair values or greater disaggregation or aggregation in our analysis by reporting unit, and/or (c) other changes in previous assumptions or estimates. In turn, this could have a significant impact on the consolidated financial statements through accelerated amortization and/or impairment charges (Note 4).

Legal Expenses Incurred to Defend Patents

The Company monitors the anticipated outcome of legal action, and if it determines that the success of the defense of a patent is probable, and so long as the Company believes that the future economic benefit of the patent will be increased, the Company then capitalizes external legal costs incurred in the defense of these patents, up to the level of the expected increased future economic benefit. If changes in the anticipated outcome occur, the Company writes off any capitalized costs in the period the change is determined. As of December 31, 2005 and September 30, 2005, capitalized patent defense costs totaled $2.8 million and $2.3 million, respectively. While the Company believes it will probably be successful in defending its patents, there can be no assurance of future success.

Comprehensive Income (loss)

Comprehensive income (loss) for the three month periods ended December 31, 2005 and 2004 consists of net income (loss), adjustments to shareholders equity for the foreign currency translation adjustment, and net unrealized gains (losses) on marketable securities. For the purposes of comprehensive income (loss) disclosures, the Company does not record tax provisions or benefits for the net changes in the foreign currency translation adjustment, as the Company intends to permanently reinvest undistributed earnings in its foreign subsidiaries. The components of comprehensive income (loss) are as follows (in thousands):

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NUANCE COMMUNICATIONS, INC.

	Three Months Ended December 31,	
	2005	**2004**
Net income (loss)	$ (4,892)	$ 3,141
Other comprehensive income:		
Foreign currency translation adjustment	226	1,129
Net unrealized gain (loss) on marketable securities	(24)	85
Other comprehensive income	202	1,214
Total comprehensive income (loss)	$ (4,690)	$ 4,355

Net Income (Loss) Per Share

The Company computes net income (loss) per share under the provisions of SFAS 128 Earnings per Share , and EITF 03-6 Participating Securities and Two Class Method under FASB Statement No. 128, Earnings per Share . Accordingly, basic net income (loss) per share is computed by dividing net income (loss) available to common stockholders by the weighted-average number of common shares outstanding for the period.

Diluted net income (loss) per share is computed by dividing net income (loss) available to common stockholders by the weighted-average number of common shares outstanding for the period plus potential dilutive common equivalent shares, which include, when dilutive, outstanding stock options, warrants, unvested shares of restricted stock using the treasury stock method and the convertible debenture using the as converted method. The computation of net income (loss) per share for the three month periods ended December 31, 2005 and 2004, respectively (in thousands, except per share data) follows:

	Three Months Ended December 31,	
	2005	**2004**
Basic:		
Net income (loss)	$ (4,892)	$ 3,141
Assumed distributions on 3,562 shares of participating convertible preferred stock		(146)
Net income (loss) applicable to common shareholders, basic	$ (4,892)	$ 2,995
Weighted average common shares, basic	156,389	104,973
Net income (loss) per share, basic	$ (0.03)	$ 0.03
Diluted:		
Net income (loss)	$ (4,892)	$ 3,141
Assumed distributions on 3,562 shares of participating convertible preferred stock		(137)
Net income (loss) applicable to common shareholders, diluted	$ (4,892)	$ 3,004
Weighted average common shares, basic	156,389	104,973
Effect of dilutive securities:		
Stock options		2,321
Convertible debentures, zero interest rate		4,587

Warrants		443
Unvested restricted stock		106
Weighted average common shares, diluted	156,389	112,430
Net income (loss) per share, diluted	$ (0.03)	$ 0.03

Potential weighted-average common shares, including stock options, unvested restricted stock, unvested stock purchase units, preferred shares, convertible debt and warrants for the three month periods ended December 31, 2005 and 2004 were 24.6 million and 12.2 million shares, respectively. These potential common shares were excluded from the calculation of diluted net loss per share as their inclusion would have been antidilutive for the period presented.

Accounting for Stock-Based Compensation

The Company adopted SFAS No. 123 (revised 2004), Share-Based Payment, (SFAS 123R) effective October 1, 2005. SFAS 123R requires the recognition of the fair value of stock-based compensation as a charge against earnings. The Company recognizes stock-based compensation expense over the requisite service period of the individual grantees, which generally equals the vesting period. The Company has several equity instruments that are required to be evaluated under SFAS 123R, including: stock option plans, an employee stock purchase plan, awards in the form of restricted shares (Restricted Stock) and

NUANCE COMMUNICATIONS, INC.

awards in the form of units of stock purchase rights (Restricted Units). The Restricted Stock and Restricted Units are collectively referred to as Restricted Awards . Based on the provisions of SFAS123R the Company s stock-based compensation is accounted for as equity instruments. Prior to October 1, 2005, the Company followed Accounting Principles Board (APB) Opinion 25, Accounting for Stock Issued to Employees, and related interpretations in accounting for stock-based compensation. The Company has elected the modified prospective transition method for adopting SFAS 123R. Under this method, the provisions of SFAS 123R apply to all awards granted or modified after the date of adoption, as well as to the future vesting of awards granted and not vested as of the date of adoption.

The Company s unearned stock-based compensation balance of $8.8 million as of September 30, 2005, which was accounted for under APB 25, was reclassified against additional paid-in-capital upon the adoption of SFAS 123R. The unearned stock-based compensation balance was composed of $4.8 million from the issuance of Restricted Awards and $4.0 million relating to the intrinsic value of stock options assumed in the Company s September 2005 acquisition of Former Nuance. The unrecognized expense of awards not yet vested at October 1, 2005 will be recognized in net income in the periods after that date, based on their fair value which was determined using the Black-Scholes valuation method, and the assumptions determined under the original provisions of SFAS 123, Accounting for Stock-Based Compensation, as disclosed in the Company s previous filings.

In connection with the adoption of SFAS 123R, the Company is required to amortize stock-based instruments with performance-related vesting terms over the period from the grant date to the sooner of the performance vesting condition (when that condition is expected to be met), and the stated cliff vesting date. The cumulative effect of the change in accounting principle from APB 25 to SFAS 123R relating to this change was $672,000, and is included in the accompanying consolidated statement of operations for the three month period ended December 31, 2005.

Under the provisions of SFAS 123R, the Company recorded $3.7 million of stock-based compensation, excluding the cumulative effect of the change in accounting, in the accompanying consolidated statement of operations for the three months ended December 31, 2005. No amounts relating to the stock-based compensation have been capitalized. The Company uses the Black-Scholes valuation model for estimating the fair value of the stock-based compensation granted after the adoption of SFAS 123R with the following weighted-average assumptions:

	Three Months Ended December 31, 2005	
	Stock Option Plans	**Stock Purchase Plan**
Dividend yield	none	None
Expected volatility	63%	50%
Average risk-free interest rate	4.5%	3.7%
Expected life	4.6 years	0.5 years

The dividend yield of zero is based on the fact that the Company has never paid cash dividends and has no present intention to pay cash dividends. Expected volatility is based on the combination of historical volatility of the Company s common stock over the period commensurate with the expected life of the options and the historical implied volatility from traded options with a term of 180 days or greater. The risk-free interest rate is derived from the average U.S. Treasury STRIPS rate during the period, which approximates the rate in effect at the time of grant, commensurate with the expected life of the instrument. The expected life calculation is based on the simplified method provided for under SEC Staff Accounting Bulletin No. 107, which averages the contractual term of the Company s options (7.0 years) with the vesting term (2.2 years). The fair value per share of the Restricted Awards is equal to the difference between the quoted market price of the Company s common stock on the date of grant, and the $0.001 par value per share.

Based on the above assumptions, the weighted-average fair values of the options granted under the Company s stock option plans, shares subject to purchase under the employee stock purchase plan, and Restricted Awards for the three months ended December 31, 2005 were $2.64, $1.52 and $5.84, respectively.

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Based on historical experience the Company has assumed an annualized forfeiture rate of 12% for its stock options, and a 5% forfeiture rate for its Restricted Awards. The Company will record additional expense if the actual forfeitures are lower than estimated and will record a recovery of prior expense if the actual forfeitures are higher than estimated.

SFAS 123R requires the presentation of pro forma information for the comparative period prior to the adoption as if the Company had accounted for all its employee stock options under the fair value method of the original SFAS 123. The following table illustrates the effect on net income (loss) and earnings per share if the Company had applied the fair value recognition provisions of SFAS 123R to stock-based employee compensation to the prior-year (in thousands, except per-share data):

		Three Months Ended December 31, 2004
Net income as reported	$	3,141
Add: employee stock-based compensation included in reported net income		698
Less: employee stock-based compensation under SFAS 123		(2,794)
Pro forma net income	$	1,045
Net income per basic and diluted share, as reported	$	0.03
Pro forma net income per basic and diluted share	$	0.01

During the three months ended December 31, 2004, the weighted-average fair values of the options granted under the Company s stock option plans, shares subject to purchase under the employee stock purchase plan, and Restricted Awards were $1.68, $1.22 and $3.99, respectively. The Company utilized the Black-Scholes valuation model for estimating the fair values with the following weighted-average assumptions:

	Three Months Ended December 31, 2004	
	Stock Option Plans	Stock Purchase Plan
Dividend yield	none	none
Expected volatility	55%	50%
Average risk-free interest rate	3.1%	1.8%
Expected life	3.5 years	0.5 years

The fair value per share of the Restricted Awards is equal to the difference between the quoted market price of the Company s common stock on the date of grant, and the $0.001 par value per share.

The following table summarizes activity under all stock option plans for the three months ended December 31, 2005 (dollars in thousands, except per-share data):

	Number	Weighted Average	Weighted Average Remaining Contractual	Aggregate

	of Shares	Exercise Price	Term	Intrinsic Value (1)
Outstanding as of September 30, 2005	27,114,849	$ 4.10		
Options granted	273,600	$ 5.50		
Options exercised	(3,017,673)	$ 3.56		
Options forfeited	(1,633,080)	$ 5.68		
Outstanding as of December 31, 2005	22,737,696	$ 4.08	6.2 years	$80.9 million
Exercisable as of December 31, 2005	14,802,834	$ 3.95	5.9 years	$54.6 million
Exercisable as of December 31, 2005 and expected to become exercisable	21,841,656	$ 4.06	6.1 years	$77.9 million

(1) The aggregate intrinsic value on this table was calculated based on the positive difference between the closing market value of the Company s common stock on December 31, 2005 ($7.63) and the exercise price of the underlying options.

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During the three-month period ended December 31, 2005, the total intrinsic value of stock options exercised was $9.1 million. The unamortized fair value of stock options as of December 31, 2005 was $18.7 million with a weighted average remaining recognition period of 1.2 years.

The table below summarizes activity relating to Restricted Units in the three months ended December 31, 2005:

	Number of Shares Underlying Restricted Units	Aggregate Intrinsic Value of Restricted Units (1)
Outstanding as of September 30, 2005	849,451	
Grants	94,884	
Vesting	(167,264)	
Forfeitures	(5,780)	
Outstanding as of December 31, 2005	771,291	$3.7 million
Expected to become exercisable	696,779	$3.4 million

(1) The aggregate intrinsic value on this table was calculated based on the positive difference between the closing market value of the Company s common stock on December 31, 2005 ($7.63) and the exercise price of the underlying Restricted Units.

The intrinsic value of the vested Restricted Units for the three month period ended December 31, 2005 was $1.1 million. The purchase price for vested Restricted Units is $0.001 per share. The weighted average contractual term of the Restricted Units, calculated based on the service-based term of each instrument, is 1.8 years, and when based on the specific terms of each Restricted Unit s vesting based on the Company s evaluation of the probability of performance based milestones being met, is 1.5 years.

The table below summarizes activity relating to Restricted Stock in the three months ended December 31, 2005:

	Number of Shares Underlying Restricted Stock	Weighted Average Grant Date Fair Value
Outstanding as of September 30, 2005	1,125,703	$4.60
Grants		
Vesting	(169,953)	$5.52
Forfeitures	(14,771)	$3.90
Outstanding as of December 31, 2005	940,979	$4.45

The weighted average contractual term of the Restricted Stock, calculated based on the service-based term of each instrument is 1.7 years, and when based on the specific terms of each Restricted Stock award s vesting based on the Company s evaluation of the probability of performance based milestones, is 1.2 years.

As of December 31, 2005, the unamortized fair value of all Restricted Awards was $4.6 million, and the weighted average remaining recognition period, calculated based on the service-based term of each Restricted Award, is 1.7 years, and when based on the specific terms of each Restricted Award s vesting based on the Company s evaluation of the probability of performance based milestones being met, is 1.3 years. 930,423, or 54%, of the Restricted Awards outstanding as of December 31, 2005 are subject to performance vesting acceleration conditions.

The Company has historically repurchased common stock upon its employees vesting in Restricted Awards, in order to allow the employees to cover their tax liability as a result of the Restricted Award(s) having vested. Assuming that the Company repurchased one-third of all vesting Restricted Awards outstanding as of December 31, 2005, such amount approximating a tax rate of its employees, and based on

a weighted average recognition period of approximately 1.5 years, the Company would repurchase approximately 0.4 million shares during the 12-month period ending December 31, 2006. In the three months ended December 31, 2005, the Company repurchased 84,193 shares of common stock at a cost of $0.6 million to cover employees tax obligations related to vesting of Restricted Awards.

Income Taxes

Deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities using enacted tax rates in effect in the years in which the differences are expected to reverse. A valuation allowance against deferred tax assets is recorded if, based on the weight of available evidence, it is more likely than not that some or all of the deferred tax assets will not be realized. The Company does not provide for U.S. income taxes on the undistributed earnings of its foreign subsidiaries, which the Company considers to be permanent investments.

The Company monitors the realization of its deferred tax assets based on changes in circumstances, for example, recurring periods of income for tax purposes following historical periods of cumulative losses or changes in tax laws or regulations. The Company s income tax provisions and its assessment of the realizability of its deferred tax assets involve significant judgments and estimates. If the Company continued to generate taxable income through profitable operations in future years it may be required to recognize these deferred tax assets through the reduction of the valuation allowance which would result in a material benefit to its results of operations in the period in which the benefit is determined, excluding the recognition of the portion of the valuation allowance which relates to net deferred tax assets acquired in a business combination and stock compensation.

The provision for income taxes for the three months ended December 31, 2005 reflects foreign income and withholding taxes, state income taxes and the impact relating to the increase in deferred tax valuation allowance that is derived from temporary differences that arise due to the amortization of goodwill for tax purposes for which the book amortization is indefinite. The provision for income taxes in the three months ended December 31, 2004 consists primarily of foreign taxes relating to international operations and United States alternative minimum taxes.

Recently Issued Accounting Standards

In May 2005, the Financial Accounting Standards Board (FASB) issued SFAS 154, Accounting Changes and Error Corrections , which replaces APB 20, Accounting Changes , and SFAS 3, Reporting Accounting Changes in Interim Financial Statements An Amendment of APB Opinion No. 28 . SFAS 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. It establishes retrospective application, or the latest practicable date, as the required method for reporting a change in accounting principle and the reporting of a correction of an error. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005 and is therefore required to be adopted by the Company in the first quarter of fiscal 2007. The Company is currently evaluating the effect that the adoption of SFAS 154 will have on its consolidated financial statements but does not expect it will have a material impact.

In November 2004, the FASB issued SFAS 151, Inventory Costs , an amendment of Accounting Research Bulletin (ARB) 43, Chapter 4, Inventory Pricing . SFAS 151 amends previous guidance regarding treatment of abnormal amounts of idle facility expense, freight, handling costs, and spoilage. This statement requires that those items be recognized as current period charges regardless of whether they meet the criterion of so abnormal specified in ARB 43. In addition, this Statement requires that allocation of fixed production overhead to the cost of the production be based on normal capacity of the production facilities. This pronouncement became effective for the Company beginning October 1, 2005. The adoption of SFAS 151 by the Company did not have a material impact on the Company s consolidated financial statements.

3. Accounts Receivable

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Accounts receivable consist of the following (in thousands):

	December 31, 2005	September 30, 2005
Accounts receivable	$ 70,758	$ 62,672
Unbilled accounts receivable	20,193	20,446
	90,951	83,118
Less allowances for doubtful accounts	(3,485)	(3,455)
Less reserves for distributor and reseller accounts receivable	(10,292)	(10,123)
	$ 77,174	$ 69,540

Unbilled accounts receivable primarily relate to revenue earned under royalty-based arrangements for which billing occurs in the month following receipt of the royalty report, revenue earned under percentage of completion contracts that have not yet been billed based on the terms of the specific arrangement and, based on the provisions of EITF 01-3, also includes future expected billings of consulting and maintenance contracts which have been assumed by the Company in connection with its accounting for acquisitions.

As discussed more fully in Note 2, Revenue Recognition , the Company invoices its distributor and reseller customers upon shipment of product to them, at which point title and risk of loss have passed to the distributor and reseller. At that point in time the Company also records an allowance against accounts receivable for the sales price of all inventories subject to return from distributors and resellers. In addition to this amount, the Company also makes an estimate of sales returns by retailers or end users directly or though its distributors or resellers based on historical returns experience. Each of these reserves is reflected as a reduction to the revenue, which is recorded upon the billing of these amounts, and are reflected in the amounts.

4. Other Intangible Assets

Other intangible assets consist of the following as of December 31, 2005 (dollars in thousands):

	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Weighted Average Remaining Life (Years)
Technology and patents	$ 67,832	$ 19,130	$ 48,702	6.0
Customer relationships	41,488	7,439	34,049	4.8
Tradenames and trademarks	8,089	3,388	4,701	6.7
Non-competition agreement	557	127	430	3.9
	$ 117,966	$ 30,084	$ 87,882	

Aggregate amortization expense was $4.5 million and $3.5 million ($2.5 million and $2.8 million included in cost of revenue) for the three months ended December 31, 2005 and 2004, respectively. Estimated amortization expense for each of the five succeeding years as of December 31, 2005 is as follows (in thousands):

	Cost of	Selling, General and

Year Ending September 30,	Revenue	Administrative	Total
2006 (January 1, 2006 to September 30, 2006)	$ 7,167	$ 6,475	$ 13,642
2007	9,528	8,422	17,950
2008	8,260	7,951	16,211
2009	6,469	6,947	13,416
2010	5,557	4,743	10,300
Thereafter	11,721	4,642	16,363
Total	$ 48,702	$ 39,180	$ 87,882

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5. Accrued Expenses

Accrued expenses consist of the following (in thousands):

	December 31, 2005	September 30, 2005
Accrued sales and marketing incentives	$ 3,452	$ 2,994
Accrued restructuring and other charges (Note 9)	4,530	5,805
Accrued professional fees	4,670	6,169
Accrued acquisition costs and liabilities	5,082	18,233
Accrued other	13,310	13,041
	$ 31,044	$ 46,242

6. Deferred and Contingent Acquisition Payments

In connection with the Company s acquisition of ART Advanced Recognition Technologies, Inc. (ART) in January 2005, a deferred payment of $16.4 million was payable in December 2005. The Company paid $13.5 million of this obligation in December 2005 and $0.9 million was paid in January 2006. The remaining $2.0 million represents proceeds withheld by the Company to satisfy claims against the former ART shareholders under the purchase agreement. The Company is currently negotiating a resolution of these claims with the former ART shareholders. If the Company s claims are agreed to, this amount will be reduced from the current liability and from goodwill in future periods.

In connection with the Company s acquisition of Phonetic Systems Ltd. (Phonetic) in February 2005, a deferred payment of $17.5 million is due to the former shareholders of Phonetic in February 2007. The present value of that payment is included as a long-term liability in the accompanying consolidated financial statements and is being accreted to the stated amount through the payment date.

Our acquisition of Brand & Groeber Communications GbR (B&G) has provisions through January 2007 that may require us to pay up to an additional 5.5 million euro based on the achievement of certain performance targets (approximately $6.5 million based on exchange rates at December 31, 2005). In connection with the Phonetic acquisition, we agreed to make contingent payments of up to an additional $35.0 million, if at all, for the achievement of certain performance targets.

7. Debt and Credit Facilities

Credit Facility

The Company maintains a Loan and Security Agreement with Silicon Valley Bank (the Bank) which was initiated on October 31, 2002, and which has been amended several times including most recently in December 2005. This agreement, as amended, is referred to as the Loan Agreement . In connection with the Company s acquisition of Former Nuance, it recorded a significant amount of goodwill, which caused the Company to temporarily no longer satisfy the tangible net worth covenant. Following the December 2005 amendment, the Company is in compliance with all terms of the Loan Agreement. The Loan Agreement expires on March 31, 2006. The revolving loan is for the lesser of $20.0 million or a borrowing base equal to either 80% or 70% of eligible accounts receivable, as defined; letters of credit may be drawn against the borrowing base. The Company must maintain unrestricted compensating cash balances with the Bank that are equal to or exceed the outstanding amount of loans under the Loan Agreement, including any amounts outstanding under letters of credit. Borrowings under the Loan Agreement are subject to interest at the Bank s prime rate plus up to 0.75% (collectively 7.25% at December 31, 2005), as defined in the Loan Agreement. As of December 31, 2005, no amount was outstanding under the Loan Agreement, and $5.9 million was committed for outstanding letters of credit. Borrowings under the Loan Agreement cannot exceed the borrowing base and must be repaid in the event they exceed the calculated borrowing base or upon expiration of the loan term. Borrowings under the Loan Agreement are collateralized by substantially all of the Company s personal property,

predominantly its accounts receivable, but not its intellectual property.

Convertible Debenture

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On January 30, 2003, the Company issued a $27.5 million three-year, zero-interest convertible subordinated debenture due January 2006 (the Note) to Philips in connection with the Philips acquisition. The Note is convertible into shares of the Company s common stock at $6.00 per share at any time until maturity at Philips option. In January 2006, Philips exercised their right to convert the Note, and the Company issued 4,587,333 shares of its common stock to Philips in full satisfaction of all amounts due under the terms of the Note.

8. Accrued Business Combination Costs

In connection with several of its acquisitions, the Company has assumed obligations relating to certain leased facilities that were abandoned by the acquired companies prior to the acquisition date, or have been or will be abandoned by the Company in connection with a restructuring plan implemented as a result of the acquisitions occurrence. Additionally, the Company has implemented restructuring plans to eliminate duplicate personnel or assets in connection with the business combinations. In accordance with EITF 95-3, Recognition of Liabilities in Connection with a Purchase Business Combination, costs such as these are recognized as liabilities assumed by the Company and accordingly are included in the allocation of the purchase price, generally resulting in an increase to the recorded amount of the goodwill.

Included in the Company s determination of the fair value of the obligations are assumptions relating to estimated sublease income. In addition, for those facilities that were abandoned by the acquired companies prior to the acquisition date, the gross payments have been discounted in calculating the fair value of the obligation as of the date of acquisition, which are being accreted through expected maturity. As of December 31, 2005, the total gross payments due from the Company to the landlords of the facilities is $101.0 million. This is reduced by $24.7 million of estimated sublease income and an $8.6 million present value discount. These obligations extend through February 2016.

In addition to the facilities accrual, the Company has an obligation relating to certain incentive compensation payments to former employees of the acquired companies whose positions have been eliminated in connection with the combination. These payments are expected to be made in fiscal 2006.

The components of accrued business combination costs are as follows (in thousands):

	Lease Exit Costs	Employee Related	Total
Balance at September 30, 2005	$ 69,863	$ 2,136	$ 71,999
Charged in interest expense	616		616
Cash payments, net of sublease receipts	(2,767)	(1,086)	(3,853)
Balance at December 31, 2005	$ 67,712	$ 1,050	$ 68,762

9. Restructuring and Other Charges

In the first quarter of fiscal 2005, a plan of restructuring relating to the elimination of ten employees was enacted. In June 2005, the Company initiated the process of consolidating certain operations into its new corporate headquarters facility in Burlington, Massachusetts. In addition, at various times during the third fiscal quarter, the Company committed to pursuing the closure and consolidation of certain other domestic and international facilities. As a result of these initiatives, the Company recorded restructuring charges in its third quarter of fiscal 2005 totaling approximately $2.1 million. In September 2005, in connection with the acquisition of Former Nuance, the Company committed to a plan of restructuring of certain of its personnel and facilities. Under this plan of restructuring, the Company accrued $2.5 million relating to the elimination of approximately 40 personnel, mainly in research and development and sales and marketing. Additionally, certain of its facilities were selected to be closed, resulting in an accrual of $2.0 million for future committed facility lease payments, net of assumed sublease income, and $0.2 million in property and equipment were written off. The restructuring charges taken in the fourth quarter of fiscal 2005 was related to only the Company s historic personnel and facilities. As noted above, costs to be incurred due to eliminating any personnel or facilities usage of Former Nuance were recorded as assumed liabilities on September 15, 2005 (Note

8).

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The following table sets forth the activity relating to the restructuring accruals in the three month period ended December 31, 2005 (in thousands):

	Lease Exit Costs	Employee Related	Total
Balance at September 30, 2005	$ 4,019	$ 1,786	$ 5,805
Cash payments, net of sublease receipts	(878)	(397)	(1,275)
Balance at December 31, 2005	$ 3,141	$ 1,389	$ 4,530

A significant portion of the remaining employee related accrual as of December 31, 2005 will be paid in fiscal 2006. The accrual as of December 31, 2005 for lease exit costs is composed of gross payments of $5.1 million, offset by estimated sublease payments of $1.7 million, and further reduced by $0.3 million of imputed interest to arrive at the net present value of the obligation. The gross value of the lease exit costs will be paid out approximately as follows: $1.3 million in fiscal 2006, $0.6 million per annum through fiscal 2009, and then $0.5 million per annum in fiscal 2010 through the middle of fiscal 2013.

10. Stockholders Equity

Preferred Stock

The Company is authorized to issue up to 40,000,000 shares of preferred stock, par value $0.001 per share. The Company has designated 100,000 shares as Series A Preferred Stock and 15,000,000 as Series B Preferred Stock. In connection with the acquisition of ScanSoft from Xerox Corporation (Xerox), the Company issued 3,562,238 shares of Series B Preferred Stock to Xerox. On March 19, 2004, the Company announced that Warburg Pincus, a global private equity firm, had agreed to purchase all outstanding shares of the Company s stock held by Xerox Corporation for approximately $80 million, including the 3,562,238 shares of Series B Preferred Stock. The Series B Preferred stock is convertible into shares of common stock on a one-for-one basis. The Series B Preferred Stock has a liquidation preference of $1.30 per share plus all declared but unpaid dividends. The holders of Series B Preferred Stock are entitled to non-cumulative dividends at the rate of $0.05 per annum per share, payable when, and if declared by the Board of Directors. To date no dividends have been declared by the Board of Directors. Holders of Series B Preferred Stock have no voting rights, except those rights provided under Delaware law. The undesignated shares of preferred stock will have rights, preferences, privileges and restrictions, including voting rights, dividend rights, conversion rights, redemption privileges and liquidation preferences, as shall be determined by the Board of Directors upon issuance of the preferred stock. The Company has reserved 3,562,238 shares of its common stock for issuance upon conversion of the Series B Preferred Stock.

Common Stock

On May 5, 2005, the Company entered into a Securities Purchase Agreement (the Securities Purchase Agreement) by and among the Company, Warburg Pincus Private Equity VIII, L.P. and certain of its affiliated entities (collectively Warburg Pincus) pursuant to which Warburg Pincus agreed to purchase and the Company agreed to sell 3,537,736 shares of its common stock and warrants to purchase 863,236 shares of its common stock for an aggregate purchase price of $15.1 million. The warrants have an exercise price of $5.00 per share and a term of four years. On May 9, 2005, the sale of the shares and the warrants pursuant to the Securities Purchase Agreement was completed. The Company also entered into a Stock Purchase Agreement (the Stock Purchase Agreement) by and among the Company and Warburg Pincus pursuant to which Warburg Pincus agreed to purchase and the Company agreed to sell 14,150,943 shares of the Company s common stock and warrants to purchase 3,177,570 shares of the Company s common stock for an aggregate purchase price of $60.0 million. The warrants have an exercise price of $5.00 per share and a term of four years. On September 15, 2005, the sale of the shares and the warrants pursuant to the Securities Purchase Agreement was completed. The net proceeds from these two fiscal 2005 financings was $73.9 million. In connection with the financings, the Company granted Warburg Pincus registration rights giving

Warburg Pincus the right to request that the Company use commercially reasonable efforts to register some or all of the shares of common stock issued to Warburg Pincus under both the Securities Purchase Agreement and Stock Purchase Agreement, including shares of common stock underlying the warrants. The Company has evaluated these warrants under EITF 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company s Own Stock and has

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determined that the warrants should be classified within the stockholders equity section of the accompanying consolidated balance sheet.

Common Stock Repurchases

As of December 31, 2005 and September 30, 2005 the Company had repurchased a total of 2,931,054 and 2,846,861 shares, respectively, under various repurchase programs. The Company intends to use the repurchased shares for its employee stock plans and for potential future acquisitions.

In the three months ended December 31, 2005, the Company repurchased 84,193 shares of common stock at a cost of $0.6 million to cover employees tax obligations related to vesting of Restricted Awards.

Common Stock Warrants

In fiscal 2005 the Company issued several warrants for the purchase of its common stock. Warrants were issued to Warburg Pincus as described above. Additionally, on November 15, 2004, in connection with the acquisition of Phonetic Systems Ltd. (Phonetic), the Company issued unvested warrants to purchase 750,000 shares of its common stock at an exercise price of $4.46 per share that will vest, if at all, upon the achievement of certain performance targets. The initial valuation of the warrants occurred upon closing of the Phonetic acquisition, February 1, 2005, and was treated as purchase consideration in accordance with EITF 97-8, Accounting for Contingent Consideration Issued in a Purchase Business Combination . Based on its review of EITF 00-19, the Company has determined that the warrants should be classified within the stockholders equity section of the accompanying consolidated balance sheet.

In March 1999 the Company issued Xerox Corporation (Xerox) a ten-year warrant with an exercise price for each share of common stock of $0.61. This warrant is exercisable for the purchase of 525,732 shares of the Company s common stock. On March 19, 2004, the Company announced that Warburg Pincus, a global private equity firm, had agreed to purchase all outstanding shares of the Company s stock held by Xerox, including this warrant, for approximately $80 million. In connection with this transaction, Warburg Pincus acquired new warrants to purchase 2.5 million additional shares of the Company s common stock from the Company for total consideration of $0.6 million. The warrants have a six year life and an exercise price of $4.94.

In connection with the March 31, 2003 acquisition of the certain intellectual property assets related to multimodal speech technology, the Company issued a warrant for the purchase of 78,000 shares of the Company s common stock at an exercise price of $8.10 per share. The warrant was immediately exercisable and was valued at $0.1 million based upon the Black-Scholes option pricing model with the following assumptions: expected volatility of 80%, a risk-free rate of 1.87%, an expected term of 2.5 years, no dividends and a stock price of $4.57 based on the Company s stock price at the time of issuance. This warrant expired, unexercised, on October 31, 2005.

In connection with the acquisition of SpeechWorks International, Inc. (SpeechWorks), the Company issued a warrant to its investment banker, expiring on August 11, 2009, for the purchase of 150,000 shares of the Company s common stock at an exercise price of $3.98 per share. The warrant became exercisable August 11, 2005, and was valued at its issuance at $0.2 million based upon the Black-Scholes option pricing model with the following assumptions: expected volatility of 60%, a risk-free interest rate of 4.03%, an expected term of 8 years, no dividends and a stock price of $3.92, based on the Company s stock price at the time of issuance.

In connection with the acquisition of SpeechWorks, the Company assumed outstanding warrants previously issued by SpeechWorks to America Online. These warrants allow for the purchase of up to 219,421 shares of the Company s common stock and were issued in connection with a long-term marketing arrangement. The warrant is currently exercisable at a price of $14.49 per share and expires on June 30, 2007. The value of the warrant was insignificant.

Based on its review of EITF 00-19, the Company has determined that each of the warrants should be classified within the stockholders equity section of the accompanying consolidated balance sheet.

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11. Commitments and Contingencies

Operating Leases

The Company has various operating leases for office space around the world. In connection with many of its acquisitions the Company assumed facility lease obligations. Among these assumed obligations are lease payments related to certain office locations that were vacated by certain of the acquired companies prior to the acquisition date (Note 8). Additionally, certain of the Company s lease obligations have been included in various restructuring charges, and are included in the Company s balance sheet as accrued expenses (Note 9). The following table outlines the Company s gross future minimum payments under all non-cancelable operating leases as of December 31, 2005 (in thousands):

Year Ending September 30,	Total Gross Commitment
2006 (January 1, 2006 to September 30, 2006)	$ 15,920
2007	17,874
2008	17,599
2009	17,999
2010	17,274
Thereafter	50,643
Total	$ 137,309

At December 31, 2005, the Company has sub-leased certain office space to third parties. Total sub-lease income under contractual terms of $14.1 million, or approximately $1.4 million annually, which has not been reflected in the above operating lease contractual obligations, will be received through February 2016.

In connection with certain of its acquisitions, the Company assumed certain financial guarantees that the acquired companies had committed to the landlords of certain facilities. These financial guarantees consist of standby letters of credit outstanding which are secured by certificates of deposit, representing the restricted cash requirements that collateralize the Company s lease obligations. These certificates of deposit total $11.8 million as of December 31, 2005, and are included in other assets. The majority of this amount relates to one of Former Nuance s leases of property that is not occupied and is included in the lease exit costs discussed in Note 8.

Litigation and Other Claims

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

From time to time, the Company receives information concerning possible infringement by third parties of the Company s intellectual property rights, whether developed, purchased or licensed by the Company. In response to any such circumstance, the Company has counsel investigate the matter thoroughly and the Company takes all appropriate action to defend its rights in these matters.

On May 18, 2005, Former Nuance received a copy of a complaint naming Former Nuance and the members of the board of directors as defendants in a lawsuit filed on May 13, 2005, in the Superior Court of the State of California, County of San Mateo, by Mr. Frank Capovilla, on behalf of himself and, purportedly, the holders of Former Nuance s common stock. The complaint alleges, among other things, that Former Nuance s board of directors breached their fiduciary duties to Former Nuance s stockholders respecting the merger agreement that was entered into with the Company. The complaint seeks to declare that the merger agreement was unenforceable. The complaint also seeks an

award of attorney s and expert s

NUANCE COMMUNICATIONS, INC.

fees. The Company believes the allegations of this lawsuit are without merit and is vigorously contesting the action.

On August 5, 2004, Compression Labs Inc. filed an action against the Company in the United States District Court for the Eastern District of Texas claiming patent infringement. Damages were sought in an unspecified amount. In the lawsuit, Compression Labs alleged that the Company was infringing United States Patent No. 4,698,672 entitled Coding System for Reducing Redundancy. This matter was settled in December 2005, and the claims against the Company were dismissed on or about January 11, 2006.

On July 15, 2003, Elliott Davis (Davis) filed an action against SpeechWorks in the United States District Court for the Western District for New York (Buffalo) claiming patent infringement. Damages are sought in an unspecified amount. In addition, on November 26, 2003, Davis filed an action against the Company in the United States District Court for the Western District for New York (Buffalo) also claiming patent infringement. Damages are sought in an unspecified amount. SpeechWorks filed an Answer and Counterclaim to Davis s Complaint in its case on August 25, 2003 and the Company filed an Answer and Counterclaim to Davis s Complaint in its case on December 22, 2003. The Company believes these claims have no merit, and it intends on defending the actions vigorously.

On November 27, 2002, AllVoice Computing plc (AllVoice) filed an action against the Company in the United States District Court for the Southern District of Texas claiming patent infringement. In the lawsuit, AllVoice alleges that the Company is infringing United States Patent No. 5,799,273 entitled Automated Proofreading Using Interface Linking Recognized Words to Their Audio Data While Text Is Being Changed (the 273 Patent). The 273 Patent generally discloses techniques for manipulating audio data associated with text generated by a speech recognition engine. Although the Company has several products in the speech recognition technology field, the Company believes that its products do not infringe the 273 Patent because, in addition to other defenses, they do not use the claimed techniques. Damages are sought in an unspecified amount. The Company filed an Answer on December 23, 2002. On January 4, 2005, the case was transferred to a new judge of the United States District Court for the Southern District of Texas for administrative reasons. The Company believes that it has meritorious defenses and it intends on defending itself vigorously.

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

The Company believes that the final outcome of the current litigation matters described above will not have a significant adverse effect on its financial position or results of operations. However, even if the

NUANCE COMMUNICATIONS, INC.

Company s defense is successful, the litigation could require significant management time and will be costly. Should the Company not prevail in these litigation matters, its operating results, financial position and cash flows could be adversely impacted.

Guarantees and Other

The Company currently includes indemnification provisions in the contracts it enters with its customers and business partners. Generally, these provisions require the Company to defend claims arising out of its products infringement of third-party intellectual property rights, breach of contractual obligations and/or unlawful or otherwise culpable conduct on its part. The indemnity obligations imposed by these provisions generally cover damages, costs and attorneys fees arising out of such claims. In most, but not all, cases, the Company s total liability under such provisions is limited to either the value of the contract or a specified, agreed upon, amount. In some cases its 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 the Company could be required to make under all the indemnification provisions in its contracts with customers and business partners is unlimited, it believes that the estimated fair value of these provisions is minimal due to the low frequency with which these provisions have been triggered.

The Company has entered into agreements to indemnify its directors and officers to the fullest extent authorized or permitted under applicable law. These agreements, among other things, provide for the indemnification of its directors and officers for expenses, judgments, fines, penalties and settlement amounts incurred by any such person in his or her capacity as a director or officer of the Company, whether or not such person is acting or serving in any such capacity at the time any liability or expense is incurred for which indemnification can be provided under the agreements. In accordance with the terms of the SpeechWorks merger agreement, the Company is required to indemnify the former members of the SpeechWorks board of directors, on similar terms as described above, for a period of six years from the acquisition date. In connection with this indemnification, the Company was required to purchase a director and officer insurance policy related to this obligation for a period of three years from the date of acquisition, this three year policy was purchased in 2003. In accordance with the terms of the Former Nuance merger agreement, the Company is required to indemnify the former members of the Former Nuance board of directors, on similar terms as described above, for a period of six years from the acquisition date. In connection with this indemnification, the Company has purchased a director and officer insurance policy related to this obligation covering the full period of six years.

12. Segment and Geographic Information and Significant Customers

The Company has reviewed the provisions of SFAS 131, Disclosures about Segments of an Enterprise and Related Information (SFAS 131) with respect to the criteria necessary to evaluate the number of operating segments that exist, based on its review the Company has determined that it operates in one segment. Revenue classification below is based on the country in which the sale originates. No single country outside of the United States had revenue greater than 10% of total revenue. Revenue in other countries predominately relates to sales to customers in Europe and Asia. Inter-company sales are insignificant as products sold in other countries are sourced within Europe or the United States. The following table presents total revenue information by geographic area (in thousands):

	Three Months Ended December 31,	
	2005	**2004**
United States of America	$ 49,916	$ 40,352
Foreign countries	25,636	20,226
Total	$ 75,552	$ 60,578

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The following table presents revenue information for principal product lines, which do not constitute separate segments (in thousands):

	Three Months Ended December 31,	
	2005	**2004**
Speech	$ 58,168	$ 41,576
Imaging	17,384	19,002
Total	$ 75,552	$ 60,578

Two distribution and fulfillment partners, Ingram Micro and Digital River, accounted for 9% and 6%, and 10% and 11% of the Company s consolidated revenue for the three months ended December 31, 2005 and 2004, respectively. No customer accounted for 10% or more of accounts receivable as of December 31, 2005 or September 30, 2005.

The following table summarizes the Company s long-lived assets, including intangible assets and goodwill, by geographic location (in thousands):

	December 31, 2005	**September 30, 2005**
United States of America	$ 516,661	$ 520,719
Foreign countries	62,401	69,704
Total	$ 579,062	$ 590,423

13. Pro Forma Results

The following table reflects unaudited pro forma results of operations of the Company assuming that the Rhetorical Systems, Ltd., ART Advanced Recognition Technologies, Inc., Phonetic Systems Ltd., and the Former Nuance acquisitions had occurred on October 1, 2004 (in thousands, except per share data):

	Three Months Ended December 31,	
	2005	**2004**
Revenue	$75,552	$79,663
Net (loss)	$ (4,892)	$ (8,456)
Net (loss) per basic and diluted share	$ (0.03)	$ (0.06)

The unaudited pro forma results of operations are not necessarily indicative of the actual results that would have occurred had the transactions actually taken place at the beginning of this period.

14. Related Parties

At September 30, 2005, a member of the Company s Board of Directors was a senior executive at Convergys Corporation. During the three month period ended December 31, 2005, the member of the Company s Board of Directors discontinued his affiliation with Convergys, and as a result, Convergys is no longer a related party. The Company and Convergys have entered into multiple non-exclusive agreements in which Convergys resells the Company s software. Revenues from Convergys during the three months ended December 31, 2005 and 2004 were not material.

A member of the Company s Board of Directors is also a partner at Wilson Sonsini Goodrich & Rosati, Professional Corporation, a law firm that provides services to the Company. In fiscal 2005, and in the three months ended December 31, 2005 the Company was billed $2.6 million and $0.6 million, respectively, by Wilson Sonsini

Goodrich & Rosati for professional services provided to the Company. As of December 31, 2005 and September 30, 2005 the Company had $0.9 million and $2.5 million, respectively, included in accounts payable and accrued expenses to Wilson Sonsini Goodrich & Rosati.

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15. Subsequent Events

Philips NoteConversion

On January 30, 2006, the Company issued 4,587,333 shares of common stock to Koninklijke Philips Electronics N.V. (Philips) in full satisfaction of all amounts due under a convertible debenture in the principal amount of $27.5 million (the Note). The Note was issued to Philips on January 30, 2003 as partial consideration for certain assets the Company acquired from Philips and was convertible into shares of the Company s common stock at a conversion price of $6.00 per share. The shares issued to Philips have historically been included in the Company s reported diluted earnings per share results, when appropriate.

Acquisition of Dictaphone Corporation and Debt Financing

On February 8, 2006, the Company announced it had entered into a definitive Agreement and Plan of Merger by and among the Company, Phoenix Merger Sub, Inc., a wholly-owned subsidiary of the Company (Merger Sub) and Dictaphone Corporation (Dictaphone), pursuant to which, among other things Merger Sub will merge with and into Dictaphone, and Dictaphone will continue as the surviving corporation. At the effective time of the merger, each share of common stock of Dictaphone will be converted into the right to receive the per share merger consideration, determined by dividing $357,000,000, (subject to adjustment as described below) (the Aggregate Merger Consideration) by the number of shares of Dictaphone common stock outstanding on a fully diluted basis on the closing date. The Aggregate Merger Consideration is subject to net cash and working capital adjustments at the closing. The acquisition is expected to be completed in the second quarter of fiscal 2006. The closing of the acquisition is subject to customary closing conditions, including regulatory approvals. The merger agreement may be terminated by either the Company or Dictaphone upon certain events occurring or not occurring, as defined in the merger agreement.

In connection with the execution of the merger agreement, the Company received a Commitment Letter dated as of February 8, 2006 from UBS Investment Bank, Credit Suisse, Citigroup and Bank of America. The Commitment Letter provides for a 7-year $355 million term facility and a 6-year $75 million revolving credit facility (the Facility). The Facility will be used to fund a portion of the Aggregate Merger Consideration and for other working capital purposes and will be secured by all of the assets of the Company and its domestic subsidiaries. The Facility will contain customary representations, warranties and covenants and the closing of, and funding under, the Facility is subject to the satisfaction of customary conditions.

16. Supplemental Cash Flow Information

The Company paid $0.6 million and $1.2 million for income taxes in the three month periods ended December 31, 2005 and 2004, respectively.

The Company paid $0.2 million and $0.1 million for interest expense in the three month periods ended December 31, 2005 and 2004, respectively.

NUANCE COMMUNICATIONS, INC.
PART II: OTHER INFORMATION

Item 6. ***Exhibits***

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

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this Amendment No. 1 to its Quarterly Report on Form 10-Q to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Burlington, Commonwealth of Massachusetts, on April 6, 2006.

Nuance Communications, Inc.

By: /s/ James R. Arnold, Jr.

James R. Arnold, Jr.

Chief Financial Officer

NUANCE COMMUNICATIONS, INC.
EXHIBIT INDEX

		Incorporated by Reference				
Exhibit Number	**Exhibit Description**	**Form**	**File No.**	**Exhibit**	**Filing Date**	**Filed Herewith**
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	Amended and Restated Bylaws of the Registrant.	10-K	0-27038	3.2	3/15/2004	
10.1	Eighth Loan Modification Agreement dated December 30, 2005 by and between Silicon Valley Bank and Nuance Communications, Inc.	10-Q	0-27038	10.1	2/9/2006	
10.2	Fiscal Year 2006 Performance Bonus Program.	10-Q	0-27038	10.2	2/9/2006	
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