Nuance Communications, Inc.
Form 10-Q
February 09, 2007

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 December 31, 2006

or

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

Commission file number 0-27038

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

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

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

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, 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 þ Accelerated filer o 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

172,555,084 shares of the registrant s Common Stock, $0.001 par value, were outstanding as of January 31, 2007.

NUANCE COMMUNICATIONS, INC.

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Part I. Financial Information

Item 1. ***Financial Statements***

NUANCE COMMUNICATIONS, INC.

CONSOLIDATED BALANCE SHEETS

	December 31, 2006 (Unaudited)	September 30, 2006
	(In thousands, except share and per share amounts)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 129,723	$ 112,334
Accounts receivable, less allowances of $19,877 and $20,207, respectively	125,202	110,778
Acquired unbilled accounts receivable	13,603	19,748
Inventories, net	8,060	6,795
Prepaid expenses and other current assets	14,621	13,245
Deferred tax assets	429	421
Total current assets	291,638	263,321
Land, building and equipment, net	30,888	30,700
Goodwill	705,393	699,333
Other intangible assets, net	217,189	220,040
Other long-term assets	23,672	21,680
Total assets	$ 1,268,780	$ 1,235,074
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term debt and obligations under capital leases	$ 3,974	$ 3,953
Accounts payable	34,505	27,768
Accrued expenses	55,907	52,674
Current portion of accrued business combination costs	13,651	14,810
Deferred maintenance revenue	62,781	63,269
Unearned revenue and customer deposits	36,047	30,320
Deferred acquisition payments, net	17,423	19,254
Total current liabilities	224,288	212,048
Long-term debt and obligations under capital leases, net of current portion	349,087	349,990

Accrued business combination costs, net of current portion	42,905	45,255
Deferred maintenance revenue, net of current portion	10,849	9,800
Deferred tax liability	20,948	19,926
Other liabilities	22,499	21,459
Total liabilities	670,576	658,478
Commitments and contingencies		
Stockholders equity:		
Series B preferred stock, $0.001 par value; 40,000,000 shares authorized; 3,562,238 shares issued and outstanding (liquidation preference $4,631)	4,631	4,631
Common stock, $0.001 par value; 280,000,000 shares authorized; 175,381,623 and 173,182,430 shares issued and 172,348,961 and 170,152,247 shares outstanding, respectively	176	174
Additional paid-in capital	794,911	773,120
Treasury stock, at cost (3,032,662 and 3,030,183 shares, respectively)	(12,886)	(12,859)
Accumulated other comprehensive income	2,733	1,656
Accumulated deficit	(191,361)	(190,126)
Total stockholders equity	598,204	576,596
Total liabilities and stockholders equity	$ 1,268,780	$ 1,235,074

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

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NUANCE COMMUNICATIONS, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

	Three Months Ended December 31, 2006	Three Months Ended December 31, 2005
	(Unaudited) (In thousands, except per share amounts)	
Revenue:		
Product and licensing	$ 75,740	$ 53,183
Professional services, subscription and hosting	27,965	14,566
Maintenance and support	29,716	7,803
Total revenue	133,421	75,552
Costs and Expenses:		
Cost of revenue:		
Cost of product and licensing	10,211	4,982
Cost of professional services, subscription and hosting	20,553	10,792
Cost of maintenance and support	6,979	1,888
Cost of revenue from amortization of intangible assets	2,886	2,475
Total cost of revenue	40,629	20,137
Gross Margin	92,792	55,415
Operating expenses:		
Research and development	16,512	12,157
Sales and marketing	43,861	28,333
General and administrative	15,385	14,647
Amortization of other intangible assets	5,150	2,000
Total operating expenses	80,908	57,137
Income (loss) from operations	11,884	(1,722)
Other income (expense):		
Interest income	1,405	748
Interest expense	(7,688)	(1,016)
Other (expense) income, net	(517)	70
Income (loss) before income taxes	5,084	(1,920)
Provision for income taxes	6,319	2,300
Loss before cumulative effect of accounting change	(1,235)	(4,220)

Cumulative effect of accounting change				672
Net loss	$	(1,235)	$	(4,892)
Basic and diluted earnings per share:				
Loss before cumulative effect of accounting change	$	(0.01)	$	(0.03)
Cumulative effect of accounting change				
Net loss per share	$	(0.01)	$	(0.03)
Weighted average common shares outstanding:				
Basic and diluted		169,505		156,389

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

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NUANCE COMMUNICATIONS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Three Months Ended December 31, 2006	Three Months Ended December 31, 2005
	(Unaudited) (In thousands, except share amounts)	
Cash flows from operating activities		
Net loss	$ (1,235)	$ (4,892)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation of property and equipment	2,612	1,698
Amortization of other intangible assets	8,036	4,475
Accounts receivable allowances	230	246
Share-based payments, including cumulative effect of accounting change	8,590	4,413
Non-cash interest expense	1,154	616
Deferred tax provision	4,436	1,464
Excess tax benefits from share-based payments	(658)	
Normalization of rent expense	417	306
Changes in operating assets and liabilities, net of effects from acquisitions:		
Accounts receivable	(8,671)	(8,122)
Inventories	(1,310)	3
Prepaid expenses and other assets	(1,207)	1,294
Accounts payable	6,577	(1,932)
Accrued expenses and other liabilities	(186)	(3,263)
Deferred maintenance revenue, unearned revenue and customer deposits	7,357	2,610
Net cash provided by (used in) operating activities	26,142	(1,084)
Cash flows from investing activities		
Capital expenditures for property and equipment	(2,788)	(2,461)
Payments for acquisitions, net of cash acquired	(3,808)	(14,179)
Proceeds from maturities of marketable securities		20,435
Payments for capitalized patent defense costs	(1,685)	(546)
Increase in restricted cash	(72)	
Net cash provided by (used in) investing activities	(8,353)	3,249
Cash flows from financing activities		
Payments of note payable, capital leases and deferred acquisition payments	(2,066)	(13,520)
Purchase of treasury stock	(26)	(588)
Excess tax benefits from share-based payments	658	

Payments on other long-term liabilities		(2,755)		(2,689)
Net proceeds from issuance of common stock under employee share-based payment plans		4,231		10,732
Net cash provided by (used in) financing activities		42		(6,065)
Effects of exchange rate changes on cash and cash equivalents		(442)		(284)
Net increase (decrease) in cash and cash equivalents		17,389		(4,184)
Cash and cash equivalents at beginning of period		112,334		71,687
Cash and cash equivalents at end of period	$	129,723	$	67,503
Supplemental disclosure of cash flow information:				
Cash paid for income taxes	$	1,067	$	640
Cash paid for interest	$	6,769	$	200
Non cash investing and financing activities:				
Issuance of 784,266 shares of common stock in connection with the acquisition of Mobile Voice Control, Inc.	$		$	
Issuance of 75,623 shares of common stock as a result of cashless exercise of warrant	$		$	

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

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NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Organization and Presentation

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

On December 29, 2006, the Company acquired Mobile Voice Control, Inc. (MVC), a provider of speech-enabled mobile search and messaging services headquartered in Mason, Ohio (Note 3).

The accompanying unaudited interim consolidated financial statements of the Company have been prepared in accordance with U.S. generally accepted accounting principles. In the opinion of management, these unaudited interim consolidated financial statements reflect all adjustments, consisting of normal recurring adjustments, necessary for a fair presentation of the financial position of the Company at December 31, 2006, the results of operations for the three month periods ended December 31, 2006 and 2005, and cash flows for the three month periods ended December 31, 2006 and 2005. Although the Company believes that the disclosures in these financial statements are adequate to make the information presented not misleading, certain information normally included in the footnotes prepared in accordance with U.S. generally accepted accounting principles has been omitted as permitted by the rules and regulations of the Securities and Exchange Commission. The accompanying financial statements should be read in conjunction with the audited financial statements and notes thereto included in the Company s Annual Report on Form 10-K/A for the fiscal year ended September 30, 2006 filed with the Securities and Exchange Commission on December 15, 2006. The results for the three month period ended December 31, 2006 are not necessarily indicative of the results that may be expected for the fiscal year ending September 30, 2007, or any future period.

Reclassification

Certain amounts presented in prior periods consolidated financial statements have been reclassified to conform to the current quarter s presentation.

2. Summary of Significant Accounting Policies

Use of Estimates

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

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.

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NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Revenue Recognition

The Company recognizes software revenue in accordance with Statement of Position (SOP) 97-2, Software Revenue Recognition, as amended by SOP 98-9 and all related interpretations. Non-software revenue is recognized in accordance with, the Securities and Exchange Commission s Staff Accounting Bulletin (SAB) 104, Revenue Recognition in Financial Statements, and SOP 81-1, Accounting for Performance of Construction Type and Certain Performance Type Contracts. For revenue arrangements with multiple elements outside of the scope of SOP 97-2, the Company accounts for the arrangements in accordance with Emerging Issues Task Force (EITF) Issue 00-21, Revenue Arrangements with Multiple Elements, and allocates an arrangement s fees into separate units accounting based on their relative fair value. In select situations, we sell or license intellectual property in conjunction with, or in place of, embedding our intellectual property in software. 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. When contracts contain substantive customer acceptance provisions, revenue and related costs are deferred until such acceptance is obtained. The Company reduces revenue recognized for estimated future returns, price protection and rebates, and certain marketing allowances at the time the related revenue is recorded.

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

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

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

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

When the Company provides maintenance and support services, it recognizes the revenue ratably over the term of the related contracts, typically one to three years. When maintenance and support contracts renew automatically, the

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

Professional services are generally not considered essential to the functionality of the software and are recognized as revenue when the related services are performed. Professional services revenue is generally recognized 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

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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.

The Company may sell, under one contract or related contracts, software licenses, professional services, and/or a maintenance and support arrangement. The total contract value is attributed first to the undelivered elements based on VSOE of their fair value. VSOE is established by the price charged when that element is sold separately. The remainder of the contract value is attributed to the delivered elements, typically software licenses, which are typically recognized as revenue upon delivery, provided 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 services as well as any related software licenses on a percentage-of-completion basis.

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

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

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

Goodwill and Other Intangible Assets

The Company has significant long-lived tangible and intangible assets, including goodwill and intangible assets with indefinite lives, which are susceptible to valuation adjustments as a result of changes in various factors or conditions. The most significant long-lived tangible and other intangible assets are fixed assets, patents and core technology, completed technology, customer relationships and trademarks. All finite-lived intangible assets are amortized based upon patterns in which the economic benefits of such assets are expected to be utilized. The values of intangible assets, with the exception of goodwill and intangible assets with indefinite lives, were initially determined by a risk-adjusted, discounted cash flow approach. The Company assesses the potential impairment of identifiable intangible assets and fixed assets whenever events or changes in circumstances indicate that the carrying values may not be recoverable. Factors it considers important, which could trigger an impairment of such assets, include 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

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

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

In accordance with SFAS 144, Accounting for the Impairment or Disposal of Long-Lived Assets, the Company periodically reviews long-lived assets for impairment whenever events or changes in business circumstances indicate that the carrying amount of the assets may not be fully recoverable or that the useful lives of those assets are no longer appropriate. Each impairment test is based on a comparison of the undiscounted cash flows to the recorded value for the asset. If impairment is indicated, the asset is written down to its estimated fair value based on a discounted cash flow analysis. No impairment charges were taken during the three month periods ended December 31, 2006 and 2005. The Company may make business decisions in the future which may result in the impairment of intangible assets.

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

Capitalized Patent Defense Costs

The Company monitors the anticipated outcome of legal actions, and if it determines that the success of the defense of a patent is probable, and so long as the Company believes that the future economic benefit of the patent will be increased, the Company capitalizes external legal costs incurred in the defense of these patents, up to the level of the expected increased future economic benefit. If changes in the anticipated outcome occur, the Company writes off any capitalized costs in the period the change is determined. As of December 31, 2006 and September 30, 2006, capitalized patent defense costs totaled $8.1 million and $6.4 million, respectively.

Comprehensive Income (Loss)

Comprehensive income (loss) consists of net income (loss) and other comprehensive income (loss), which includes current period foreign currency translation adjustments, unrealized gains (losses) related to derivatives reported as cash flow hedges, and 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 reinvest undistributed earnings in its foreign subsidiaries permanently.

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

	Three Months Ended December 31,	
	2006	**2005**
Net loss	$ (1,235)	$ (4,892)
Other comprehensive income (loss):		
Foreign currency translation adjustment	873	226
Net unrealized gains on cash flow hedge derivatives	204	
Net unrealized losses on marketable securities		(24)
Other comprehensive income	1,077	202
Total comprehensive loss	$ (158)	$ (4,690)

Net Income (Loss) Per Share

The Company computes net income (loss) per share under the provisions of SFAS 128, Earnings per Share, and EITF 03-06, 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 during 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 the dilutive effect of common equivalent shares, which include outstanding stock options, warrants, unvested shares of restricted stock using the treasury stock method and the convertible debenture using the as converted method. Common equivalent shares are excluded from the computation of diluted net income (loss) per share if their effect is anti-dilutive. Potentially dilutive common equivalent shares aggregating 23.5 million shares and 24.6 million shares for the three month periods ended December 31, 2006 and 2005, have been excluded from the computation of diluted net income (loss) per share because their inclusion would be anti-dilutive.

Accounting for Share-Based Payments

The Company adopted SFAS No. 123 (revised 2004), Share-Based Payment, (SFAS 123R) effective October 1, 2005. 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 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. SFAS 123R requires the recognition of the fair value of share-based payments as a charge against earnings. The Company recognizes share-based payment expense over the requisite service period of the individual grantees, which generally equals the vesting period. Based on the provisions of

SFAS 123R the Company s share-based payments awards are accounted for as equity instruments. 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 date upon which the performance vesting condition will be met (when that condition is expected to be met), or the time-based vesting dates. The cumulative effect of the change in accounting as a result of the adoption of SFAS 123R in

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NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

the fiscal 2006 period was $0.7 million. The amounts included in the consolidated statements of operations relating to share-based payments are as follows (dollars in thousands):

	Three Months Ended December 31, 2006	Three Months Ended December 31, 2005
Cost of product and licensing	$ 5	$ 21
Cost of professional services, subscription and hosting	544	290
Cost of maintenance and support	188	48
Research and development	1,207	852
Sales and marketing	3,449	1,111
General and administrative	3,197	1,419
Cumulative effect of accounting change		672
	$ 8,590	$ 4,413

Stock Options

The Company has several share-based payment plans under which employees, officers, directors and consultants may be granted stock options to purchase the Company s common stock generally at the fair market value on the date of grant. Plans do not allow for options to be granted at below fair market value nor can they be re-priced at anytime. Options granted under original plans of the Company become exercisable over various periods, typically two to four years and have a maximum term of 7 years. The Company also assumed an option plan in connection with its acquisition of Nuance Communications, Inc. (Former Nuance) on September 15, 2005. These stock options are governed by the original agreement (the Former Nuance Stock Option Plan) that they were issued under, but are now exercisable for shares of the Company. No further stock options may be issued under the Former Nuance Stock Option Plan. All stock options have been granted with exercise prices equal to or greater than the fair market value of the Company s common stock on the date of grant. The table below summarizes activity relating to stock options for the three months ended December 31, 2006:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value(1)
Outstanding at September 30, 2006	20,654,083	$ 4.80		
Granted	799,700	$ 9.91		

Exercised	(1,110,724)	$	4.22			
Forfeited	(238,120)	$	7.00			
Expired	(4,910)	$	5.10			
Outstanding at December 31, 2006	20,100,029	$	5.01	5.5 years	$	129.7 million
Exercisable at December 31, 2006	12,718,079	$	4.01	5.1 years	$	94.8 million

(1) The aggregate intrinsic value on this table was calculated based on the positive difference between the closing market value of the Company s common stock on December 31, 2006 ($11.46) and the exercise price of the underlying options. Stock options to purchase 14,802,834 shares of common stock were exercisable as of December 31, 2005.

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NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

As of December 31, 2006, the total unamortized fair value of stock options was $24.0 million with a weighted average remaining recognition period of 2.3 years. During the three month periods ended December 31, 2006 and 2005, the following activity occurred under the Company s plans:

	2006	2005
Weighted-average grant-date fair value per share	$ 4.55	$ 3.02
Total intrinsic value of stock options exercised	$ 7.3 million	$ 9.1 million

The fair value of the stock options granted during the three month periods ended December 31, 2006 and 2005 were estimated on the dates of grant using the Black-Scholes model with the following weighted-average assumptions:

	2006	2005
Dividend yield	0.0%	0.0%
Expected volatility	54.8%	63.0%
Average risk-free interest rate	4.7%	4.5%
Expected term (in years)	3.8	4.6

The dividend yield of zero is based on the fact that the Company has never paid cash dividends and has no present intention to pay cash dividends. Expected volatility is based on the historical volatility of the Company s common stock over the period commensurate with the expected life of the options and the historical implied volatility from traded options with a term of 180 days or greater. The risk-free interest rate is derived from the average U.S. Treasury STRIPS rate during the period, which approximates the rate in effect at the time of grant, commensurate with the expected life of the instrument. Upon the adoption of SFAS 123R, the Company used 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). Beginning in the fourth quarter of fiscal 2006 the Company estimated the expected life based on the historical exercise behavior.

Restricted Awards

The Company is authorized to issue equity incentive awards in the form of Restricted Awards. Unvested Restricted Awards may not be sold, transferred or assigned. The fair value of the Restricted Awards is measured based upon the market price of the underlying common stock as of the date of grant, reduced by the purchase price of $0.001 per share of the awards. The Restricted Awards generally are subject to vesting over a period of two to four years, and may have opportunities for acceleration for achievement of defined goals. Beginning in fiscal 2006, the Company began to issue certain Restricted Awards with vesting solely dependent on the achievement of specified performance targets. The fair value of the Restricted Awards is amortized to expense over its applicable vesting period using the straight-line method. In the event that the employees employment with the Company terminates, or in the case of awards with only performance goals those goals are not met, any unvested shares are forfeited and revert to the Company.

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NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Restricted Units are not included in issued and outstanding common stock until the shares are vested, at which point they are included as issued and outstanding. The table below summarizes activity relating to Restricted Units for the three months ended December 31, 2006:

	Number of Shares Underlying Restricted Units	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value(1)
Outstanding at September 30, 2006	2,750,054		
Granted	1,098,105		
Vested	(259,795)		
Forfeited	(75,296)		
Outstanding at December 31, 2006	3,513,068	1.3 years	$ 40.3 million
Expected to become exercisable	3,219,812	1.3 years	$ 36.9 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, 2006 ($11.46) and the exercise price of the underlying Restricted Units.

The purchase price for vested Restricted Units is $0.001 per share. As of December 31, 2006, unearned share-based payments expense related to unvested Restricted Units is $20.3 million, which will, based on expectations of future performance vesting criteria, where applicable, be recognized over a weighted-average period of 1.3 years. 48.3% of the Restricted Units outstanding as of December 31, 2006 are subject to performance vesting acceleration conditions. During the three month periods ended December 31, 2006 and 2005 the following activity occurred related to Restricted Units:

	2006	2005
Weighted-average grant-date fair value per share	$ 10.12	$ 5.84
Total intrinsic value of shares vested	$ 2.6 million	$ 1.1 million

Restricted Stock is included in the issued and outstanding common stock in these financial statements at date of grant. The table below summarizes activity relating to Restricted Stock for the three months ended December 31, 2006:

	Number of Shares Underlying Restricted Stock		Weighted Average Grant Date Fair Value
Nonvested balance at September 30, 2006	1,547,341	$	5.93
Granted	14,555	$	8.24
Nonvested balance at December 31, 2006	1,561,896	$	5.96

The purchase price for vested Restricted Stock is $0.001 per share. As of December 31, 2006, unearned share-based payments expense related to unvested Restricted Stock is $5.6 million, which will, based on expectations of future performance vesting criteria, when applicable, be recognized over a weighted-average period of 1.2 years. 84.8% of the Restricted Stock outstanding as of December 31, 2006 are subject to performance vesting acceleration conditions. During the three month periods ended December 31, 2006 and 2005 the following activity occurred related to Restricted Stock:

	2006		2005	
Weighted-average grant-date fair value per share	$	8.24	$	N/A
Total fair value of shares vested	$		$	1.1 million

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NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 Awards having vested. Assuming that the Company repurchased one-third of all vesting Restricted Awards outstanding as of December 31, 2006, such amount approximating a tax rate of its employees, and based on the weighted average recognition period of 1.3 years, the Company would repurchase approximately 2.1 million shares during the twelve month period ending December 31, 2007. During the three months ended December 31, 2006, the Company repurchased 45,770 shares of common stock at a cost of $0.5 million to cover employees tax obligations related to vesting of Restricted Awards.

Income Taxes

Deferred tax assets and liabilities are determined based on differences 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. The Company does not provide for U.S. income taxes on the undistributed earnings of its foreign subsidiaries, which the Company considers to be indefinitely reinvested outside of the U.S. in accordance with Accounting Principles Board (APB) Opinion No. 23, Accounting for Income Taxes Special Areas.

The Company makes judgments regarding the realizability of its deferred tax assets. In accordance with SFAS 109, Accounting for Income Taxes, the carrying value of the net deferred tax assets is based on the belief that it is more likely than not that the Company will generate sufficient future taxable income to realize these deferred tax assets after consideration of all available evidence. The Company regularly reviews its deferred tax assets for recoverability considering historical profitability, projected future taxable income, and the expected timing of the reversals of existing temporary differences and tax planning strategies.

Valuation allowances have been established for U.S. deferred tax assets, which the Company believes do not meet the more likely than not criteria established by SFAS 109. If the Company is subsequently able to utilize all or a portion of the deferred tax assets for which a valuation allowance has been established, then the Company 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 created as a result of share-based payments. The recognition of the portion of the valuation allowance which relates to net deferred tax assets resulting from share-based payments will be recorded as additional paid-in-capital; the recognition of the portion of the valuation allowance which relates to net deferred tax assets acquired in a business combination will reduce goodwill, other intangible assets, and to the extent remaining, the provision for income taxes.

Financial Instruments and Hedging Activities

The Company follows the requirements of SFAS 133, Accounting for Derivative Instruments and Hedging Activities, which establishes accounting and reporting standards for derivative instruments. To achieve hedge accounting, the criteria specified in SFAS 133, must be met, including (i) ensuring at the inception of the hedge that formal documentation exists for both the hedging relationship and the entity s risk management objective and strategy for undertaking the hedge and (ii) at the inception of the hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value attributed to the hedged risk during the period that the hedge is designated. Further, an assessment of effectiveness is required whenever financial statements or earnings are reported. Absent meeting these criteria, changes in fair value are recognized currently in other expense, net of tax, in the income statement. Once the underlying forecasted transaction is realized, the gain or loss from the derivative designated as a hedge of the transaction is reclassified from accumulated other comprehensive income to the income statement, in the related revenue or expense caption, as appropriate. Any ineffective portion of the derivatives designated as cash flow hedges is recognized in current earnings. As of December 31, 2006, there was a $100 million interest rate swap (the Swap) outstanding. The Swap

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

was entered into in conjunction with a term loan on March 31, 2006. The Swap was designated as a cash flow hedge, and changes in the fair value of this cash flow hedge derivative are recorded in stockholders equity as a component of accumulated other comprehensive income (loss). At December 31, 2006 and September 30, 2006, the fair value of the Swap was $0.4 million and $0.6 million, respectively, which were included in other liabilities.

Recently Issued Accounting Standards

In December 2006, the FASB issued EITF 00-19-2, Accounting for Registration Payment Arrangements. EITF 00-19-2 specifies that the contingent obligation to make future payments or otherwise transfer consideration under a registration payment arrangement, whether issued as a separate agreement or included as a provision of a financial instrument or other agreement, should be separately recognized and measured in accordance with FASB Statement No. 5, *Accounting for Contingencies*. For registration payment arrangements and financial instruments subject to those arrangements that were entered into prior to the issuance of EITF 00-19-2, this guidance shall be effective for financial statements issued for fiscal years beginning after December 15, 2006. The Company is evaluating the impact, if any, that EITF 00-19-2 may have on its consolidated financial statements.

In September 2006, the FASB issued SFAS 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements 87, 88, 106 and 132(R). SFAS 158 requires an employer to recognize the over-funded or under-funded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. SFAS 158 also requires the measurement of defined benefit plan assets and obligations as of the date of the employer s fiscal year-end statement of financial position (with limited exceptions). Under SFAS 158, the Company will be required to recognize the funded status of its defined benefit postretirement plan and to provide the required disclosures commencing as of September 30, 2007. The requirement to measure plan assets and benefit obligations as of the date of the employer s fiscal year-end is effective for the Company s fiscal year ended September 30, 2009. The Company is currently evaluating the impact that SFAS 158 will have on its consolidated financial statements.

In July 2006, the FASB issued Interpretation 48, Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company s financial statements in accordance with SFAS 109, Accounting for Income Taxes. FIN 48 prescribes the recognition and measurement of a tax position taken or expected to be taken in a tax return. It also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for its fiscal year beginning October 1, 2007. The Company is currently evaluating the effect that the adoption of FIN 48 will have on its consolidated financial statements.

In March 2006, the FASB issued EITF 06-03, How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That is, Gross versus Net Presentation). EITF 06-03 clarifies how a company discloses its recording of taxes collected that are imposed on revenue-producing activities. EITF 06-03 is effective for the first interim reporting period beginning after December 15, 2006, and thus the Company is required to adopt this standard as of January 1, 2007, in the second quarter of its fiscal year 2007. The Company is evaluating the impact, if any, that EITF 06-03 may have on its consolidated financial statements.

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. Acquisition of Mobile Voice Control, Inc.

On December 29, 2006, the Company acquired all of the outstanding capital stock of Mobile Voice Control, Inc. (MVC), a provider of speech-enabled mobile search and messaging services, for $12.8 million. The purchase price consists of $4.5 million in cash including transaction costs, and 784,266 shares of the Company s common stock valued at $8.3 million. The acquisition has been accounted for under the purchase method of accounting. The following table summarizes the preliminary allocation of the purchase price (in thousands):

Total purchase consideration:	
Common stock issued	$ 8,300
Cash	4,104
Transaction costs	386
Total purchase consideration	$ 12,790
Allocation of the purchase consideration:	
Current and non current assets	$ 79
Identifiable intangible assets	5,100
Goodwill	7,776
Total assets acquired	12,955
Total liabilities assumed	(165)
Net assets acquired	$ 12,790

Under the agreement, the Company agreed to make maximum additional payments of $18.0 million in contingent purchase price upon achievement of certain established financial targets through December 31, 2008. Additional payments, if any, related to this contingency will be accounted for as additional goodwill.

Customer relationships are amortized based upon patterns in which the economic benefits of customer relationships are expected to be utilized. 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 (dollars in thousands):

	Amount	Weighted Average Life (In years)
Customer relationships	$ 3,600	5.9
Patents	1,300	4.0

Non-competes	200	3.0
Total	$ 5,100	

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

4. Accounts Receivable

Accounts receivable, excluding acquired unbilled accounts receivable, consisted of the following (in thousands):

	December 31, 2006	September 30, 2006
Accounts receivable	$ 132,333	$ 118,580
Unbilled accounts receivable	12,746	12,405
	145,079	130,985
Less allowance for doubtful accounts	(4,390)	(4,106)
Less reserve for distribution and reseller accounts receivable	(8,393)	(9,797)
Less allowance for sales returns	(7,094)	(6,304)
	$ 125,202	$ 110,778

Unbilled accounts receivable primarily relate to product revenue earned under royalty-based arrangements for which billing occurs in the month following receipt of the royalty report, and for professional services revenue earned under percentage of completion contracts that have not yet been billed based on the terms of the specific arrangement.

5. Inventories, net

Inventories, net of allowances, consisted of the following (in thousands):

	December 31, 2006	September 30, 2006
Components and parts	$ 2,334	$ 2,311
Inventory at customers	4,621	3,173
Finished products	1,105	1,311
	$ 8,060	$ 6,795

Inventory at customers reflects equipment related to in-process installations of solutions of Dictaphone contracts with customers. These contracts have not been recorded to revenue as of December 31, 2006, and therefore the inventory is on the balance sheet until such time as the contract is recorded to revenue and the inventory will be expensed to cost of sales.

6. Goodwill and Other Intangible Assets

The changes in the carrying amount of goodwill during the three months ended December 31, 2006, are as follows (in thousands):

Balance as of September 30, 2006	$ 699,333
Goodwill acquired MVC acquisition	7,776
Purchase accounting adjustments	(3,207)
Effect of foreign currency translation	1,491
Balance as of December 31, 2006	$ 705,393

Goodwill adjustments during the three months ended December 31, 2006 included $2.7 million relating to the utilization of acquired deferred tax assets and $0.5 million of purchase accounting adjustments related to previous acquisitions.

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Other intangible assets consist of the following (dollars in thousands):

	At December 31, 2006			
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Weighted Average Remaining Life (Years)
Customer relationships	$ 151,417	$ 25,693	$ 125,724	8.6
Technology and patents	92,192	33,481	58,711	5.7
Tradenames and trademarks, subject to Amortization	6,951	2,526	4,425	5.7
Non-competition agreement	779	250	529	3.0
Subtotal	251,339	61,950	189,389	
Tradename, indefinite life	27,800		27,800	n/a
Total	$ 279,139	$ 61,950	$ 217,189	

	At September 30, 2006			
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Weighted Average Remaining Life (Years)
Customer relationships	$ 147,814	$ 20,721	$ 127,093	8.7
Technology and patents	91,033	30,897	60,136	6.0
Tradenames and trademarks, subject to amortization	8,750	4,092	4,658	5.9
Non-competition agreement	588	235	353	3.3
Subtotal	248,185	55,945	192,240	
Tradename, indefinite life	27,800		27,800	n/a
Total	$ 275,985	$ 55,945	$ 220,040	

Amortization expense for other intangible assets with finite lives was $8.0 million and $4.5 million for the three months ended December 31, 2006 and 2005, respectively. Estimated amortization expense for each of the five succeeding years is as follows (in thousands):

Year Ending September 30,	Cost of Revenue	Other Operating Expenses	Total
2007 (January 1, 2007 to September 30, 2007)	$ 8,497	$ 15,782	$ 24,279
2008	11,093	19,601	30,694
2009	10,076	17,737	27,813
2010	9,291	15,469	24,760
2011	8,629	14,263	22,892
2012	6,548	13,273	19,821
Thereafter	4,577	34,553	39,130
Total	$ 58,711	$ 130,678	$ 189,389

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NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

7. Accrued Expenses

Accrued expenses consist of the following (in thousands):

	December 31, 2006	September 30, 2006
Accrued compensation	$ 20,974	$ 21,310
Accrued sales and marketing incentives	4,604	4,454
Accrued restructuring and other charges	619	904
Accrued professional fees	6,051	3,823
Accrued acquisition costs and liabilities	556	747
Income taxes payable	4,871	3,857
Accrued other	18,232	17,579
	$ 55,907	$ 52,674

8. Deferred and Contingent Acquisition Payments

In connection with the Company s acquisition of Phonetic Systems Ltd. (Phonetic) in February 2005, a deferred payment of $17.5 million was due and paid to the former shareholders of Phonetic on February 1, 2007. The present value of that payment is included in current liabilities in the accompanying consolidated financial statements as of December 31, 2006 and has been accreted to the stated amount through the payment date. Under the agreement, the Company also agreed to make maximum additional payments of $35.0 million in contingent purchase price upon achievement of certain established financial targets through December 31, 2007. On June 1, 2006, the Company notified the former shareholders of Phonetic that the performance targets for the first scheduled payment of up to $12.0 million were not achieved. The former shareholders of Phonetic have objected to this determination. The Company and the former shareholders of Phonetic are in the early stages of discussing this matter. Additional payments, if any, related to this contingency will be accounted for as additional goodwill.

In connection with the Company s acquisition of Brand & Groeber Communications GbR (B&G) in September 2004, the Company agreed to make maximum additional payments of up to 5.5 million upon achievement of certain established financial targets through December 31, 2006. From the date of acquisition through December 31, 2006, a total of 0.4 million was paid based on the attainment of certain performance targets and has been accounted for as additional goodwill.

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NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

9. Pension and Other Postretirement Benefit Plans

In connection with the acquisition of Dictaphone on March 31, 2006, the Company assumed the assets and obligations related to its defined benefit pension plans, which provide certain retirement and death benefits for former Dictaphone employees located in the United Kingdom and Canada. The Company also assumed a post-retirement health care and life insurance benefit plan which provides certain post-retirement health care and life insurance benefits, as well as a fixed subsidy for qualified former employees in the United States and Canada. The components of net periodic benefit cost of the benefit plans were as follows (in thousands):

	Pension Benefits	Other Benefits
Service cost	$ 68	$ 26
Interest cost	294	19
Amortization of net (gain) loss		
Expected return on plan assets	(300)	
Amortization of prior service cost		
Net period benefit cost	$ 62	$ 45

10. Credit Facilities and Debt

On March 31, 2006 the Company entered into a new senior secured credit facility (the 2006 Credit Facility). The 2006 Credit Facility consists of a $355.0 million 7-year term loan which matures on March 31, 2013 and a $75.0 million revolving credit line which matures on March 31, 2012. The available revolving credit line capacity is reduced, as necessary, to account for certain letters of credit outstanding. As of December 31, 2006, there were $17.2 million of letters of credit issued under the revolving credit line and there were no other outstanding borrowings under the revolving credit line.

Borrowings under the 2006 Credit Facility bear interest at a rate equal to the applicable margin plus, at the Company s option, either (a) a base rate (which is the higher of the corporate base rate of UBS AG, Stamford Branch, or the federal funds rate plus 0.50% per annum) or (b) a LIBOR rate determined by reference to the British Bankers Association Interest Settlement Rates for deposits in U.S. dollars. The applicable margin for borrowings under the 2006 Credit Facility ranges from 0.50% to 1.00% per annum with respect to base rate borrowings and from 1.50% to 2.00% per annum with respect to LIBOR-based borrowings, depending upon the Company s leverage ratio. As of December 31, 2006, the Company s applicable margin is 1.00% for base rate borrowings and 2.00% for LIBOR-based borrowings. The Company is required to pay a commitment fee for unutilized commitments under the revolving credit facility at a rate ranging from 0.375% to 0.50% per annum, based upon our leverage ratio. As of December 31, 2006, the commitment fee rate is 0.50%.

The Company capitalized approximately $9.0 million in debt issuance costs related to the opening of the 2006 Credit Facility. The costs associated with the revolving credit facility are being amortized as interest expense over six years, through March 2012, while the costs associated with the term loan are being amortized as interest expense over seven years, through March 2013, which are the maturity dates of the revolving line and term facility, respectively under the 2006 Credit Facility. The effective interest method is used to calculate the amortization of the debt issuance costs for both the revolving credit facility and the term loan. These debt issuance costs, net of accumulated amortization of $1.0 million, are included in other assets in the consolidated balance sheet as of December 31, 2006.

The $355.0 million term loan is subject to repayment consisting of a baseline amortization of 1% per annum ($3.55 million per year, due in four equal quarterly installments), and an annual excess cash flow sweep, as defined in the 2006 Credit Facility, which will be first payable beginning in the first quarter of fiscal 2008, based on the excess cash flow generated in fiscal 2007. As of December 31, 2006, we have repaid $2.7 million of principal under

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

the term loan agreement. Any borrowings not paid through the baseline repayment, the excess cash flow sweep, or any other mandatory or optional payments that the Company may make, will be repaid upon maturity. If only the baseline repayments are made, the aggregate annual maturities of the term loan would be as follows (in thousands):

Year Ending September 30,	Amount
2007 (January 1, 2007 to September 30, 2007)	$ 2,663
2008	3,550
2009	3,550
2010	3,550
2011	3,550
2012	3,550
Thereafter	331,925
Total	$ 352,338

The Company s obligations under the 2006 Credit Facility are unconditionally guaranteed by, subject to certain exceptions, each of its existing and future direct and indirect wholly-owned domestic subsidiaries. The 2006 Credit Facility and the guarantees thereof are secured by first priority liens and security interests in the following: 100% of the capital stock of substantially all of the Company s domestic subsidiaries and 65% of the outstanding voting equity interests and 100% of the non-voting equity interests of first-tier foreign subsidiaries, material tangible and intangible assets, and present and future intercompany debt. The 2006 Credit Facility also contains provisions for mandatory prepayments of outstanding term loans, subject to certain exceptions, with: 100% of net cash proceeds of asset sales, 100% of net cash proceeds of issuance or incurrence of debt, and 100% of extraordinary receipts. The Company may voluntarily prepay the 2006 Credit Facility without premium or penalty other than customary breakage costs with respect to LIBOR-based loans.

The 2006 Credit Facility contains a number of covenants that, among other things, restrict, subject to certain exceptions, the ability of the Company and its subsidiaries to: incur additional indebtedness, create liens on assets, enter into certain sale and lease-back transactions, make investments, make certain acquisitions, sell assets, engage in mergers or consolidations, pay dividends and distributions or repurchase the Company s capital stock, engage in certain transactions with affiliates, change the business conducted by the Company and its subsidiaries, amend certain charter documents and material agreements governing subordinated indebtedness, prepay other indebtedness, enter into agreements that restrict dividends from subsidiaries and enter into certain derivatives transactions. The 2006 Credit Facility is governed by financial covenants that include, but are not limited to, maximum total leverage and minimum interest coverage ratios, as well as to a maximum capital expenditures limitation. The 2006 Credit Facility also contains certain customary affirmative covenants and events of default. As of December 31, 2006, the Company was in compliance with the covenants under the 2006 Credit Facility.

11. Accrued Business Combination Costs

In connection with the acquisitions of SpeechWorks International, Inc. in August 2003 and Former Nuance in September 2005, the Company has assumed obligations relating to certain leased facilities expiring in 2016 and 2012, respectively, and that were abandoned by the acquired companies prior to the acquisition date. The fair value of the obligations, net of estimated sublease income, 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. The net payments have been discounted in calculating the fair value of the obligation as of the date of acquisition, and the discount is being accreted through expected maturity. Cash payments net of sublease receipts are presented as cash used in financing activities on the consolidated statements of cash flows. As of December 31, 2006, the total gross payments due from the Company to the landlords of the facilities is $85.8 million. This is reduced by $21.1 million of sublease income and a $6.0 million present value discount.

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The gross value of the lease exit costs will be paid out approximately as follows: $9.3 million in the remaining months of fiscal 2007, $12.8 million in fiscal 2008, $13.2 million in fiscal 2009, $13.6 million in fiscal 2010, $14.2 million in fiscal 2011, and $22.8 million in total from fiscal 2012 through fiscal 2016. These gross payment obligations are included in the commitments disclosed in Note 14.

Additionally, the Company has implemented restructuring plans to eliminate duplicate facilities, 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. As of December 31, 2006, total gross payments due from the Company to the landlords of the facilities is $3.0 million. This is reduced by $1.0 million of sublease income. The gross value of the lease exit costs will be paid through fiscal 2009. These gross payment obligations are included in the commitments disclosed in Note 14.

Current activity charged against the accrued business combination costs for the three months ended December 31, 2006 was as follows (in thousands):

	Facilities	Personnel	Total
Balance at September 30, 2006	$ 59,221	$ 844	$ 60,065
Charged to goodwill	(96)	(615)	(711)
Charged to interest expense	501		501
Cash payments, net of sublease receipts	(3,070)	(229)	(3,299)
Balance at December 31, 2006	$ 56,556	$	$ 56,556

12. Restructuring and Other Charges

Current activity charged against the restructuring accrual for the three months ended December 31, 2006 was as follows (in thousands):

	Facilities	Personnel	Total
Balance at September 30, 2006	$ 530	$ 374	$ 904
Cash payments and foreign exchange	(285)		(285)
Balance at December 31, 2006	$ 245	$ 374	$ 619

The remaining personnel-related accrual as of December 31, 2006 is primarily composed of amounts due under a restructuring charge taken in the fourth quarter of fiscal 2005 which is expected to be paid during fiscal 2007.

13. 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 shares 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,

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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. The warrants provide the holder with the option to exercise the warrants on a net, or cashless, basis. 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 determined that the warrants should be classified within the stockholders equity section of the accompanying consolidated balance sheet.

On December 29, 2006, the Company issued 784,266 shares of its common stock in connection with the acquisition of MVC. See Note 3 for further disclosure relating to the issuance.

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, 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 warrants provide the holder with the option to exercise the warrants on a net, or cashless, basis. 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.

In March 1999 the Company issued Xerox a ten-year warrant with an exercise price for each warrant share 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 Corporation, 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. The warrants provide the holder with the option to

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

exercise the warrants on a net, or cashless, basis. The Company received this payment of $0.6 million during the quarter ended June 30, 2004.

In connection with the acquisition of SpeechWorks in 2003, the Company issued a warrant to its investment banker, expiring on August 11, 2011, for the purchase of 150,000 shares of the Company s common stock at an exercise price of $3.98 per share. The warrant provides the holder with the option to exercise the warrants on a net, or cashless, basis. The warrant became exercisable on 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. During the three months ended December 31, 2006, the warrant was exercised to purchase 125,620 shares of the Company s common stock. The holder of the warrant elected a cashless exercise resulting in a net issuance of 75,623 shares of the Company s common stock. As of December 31, 2006, a warrant to purchase 24,380 shares of the Company s common stock remains outstanding.

Also 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 provides the holder with the option to exercise the warrants on a net, or cashless, basis. The warrant expires on June 30, 2007 and the value of the warrant was insignificant.

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

14. 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 11). Additionally, certain of the Company s lease obligations have been included in various restructuring charges (Note 11 and Note 12). The following table outlines the Company s gross future minimum payments under all non-cancelable operating leases as of December 31, 2006 (in thousands):

Year Ending September 30,	Operating Leases	Leases Under Restructuring	Other Contractual Obligations Assumed	Total
2007 (January 1, 2007 to September 30, 2007)	$ 4,851	$ 1,395	$ 9,278	$ 15,524
2008	7,785	1,558	12,780	22,123
2009	7,553	1,432	13,202	22,187

2010	6,494	518	13,639	20,651
2011	5,740	535	14,172	20,447
2012	4,802	552	12,661	18,015
Thereafter	14,708	328	10,093	25,129
Total	$ 51,933	$ 6,318	$ 85,825	$ 144,076

At December 31, 2006, the Company has subleased certain office space that is included in the above table to third parties. Total sub-lease income under contractual terms is $25.3 million, which ranges from approximately $1.4 million to $3.8 million on an annual basis through February 2016.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 are secured by the 2006 Credit Facility or are secured by certificates of deposit. The total financial guarantees were $17.8 million, of which $0.6 million and $0.8 million were secured by certificates of deposit which were classified as restricted cash in other assets as of December 31, 2006 and September 30, 2006, respectively.

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.

On November 8, 2006, VoiceSignal Technologies, Inc. filed an action against the Company and eleven of its resellers in the United States District Court for the Western District of Pennsylvania claiming patent infringement. VoiceSignal is seeking damages and injunctive relief. In the lawsuit, VoiceSignal alleges that the Company is infringing United States Patent No. 5,855,000 which is related to improving correction in a dictation application based on a two input analysis. The Company believes the claims have no merit, and intends to defend the action vigorously.

On May 31, 2006 GTX Corporation (GTX), 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, GTX alleged that the Company was infringing United States Patent No. 7,016,536 entitled Method and Apparatus for Automatic Cleaning and Enhancing of Scanned Documents. The Company believes the claims have no merit, and it intends to defend the action 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 United States District Court for the Southern District of Texas entered summary judgment against AllVoice and dismissed all claims against Nuance on February 21, 2006. AllVoice filed a notice of appeal from the judgment on April 26, 2006. The Company believes the claims have no merit, and it intends to defend the action 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

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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. On April 24, 2006, the court held a fairness hearing in connection with the motion for final approval of the settlement. The court has yet to issue a ruling on the motion for final approval. On December 5, 2006, the Court of Appeals for the Second Circuit reversed the Court s order certifying a class in several test cases that had been selected by the underwriter defendants and plaintiffs in the coordinated proceeding. The settlement remains subject to a number of conditions, including final court approval. In the event the 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 consolidated financial statements. However, even if the 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 into which 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 each of the Former Nuance and Dictaphone merger agreements, the Company is required to indemnify the former members of the Former Nuance and Dictaphone boards of directors, on similar terms as described above, for a period of six

NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

years from the acquisition date. In connection with these indemnifications, the Company has purchased director and officer insurance policies related to these obligations covering the full period of six years.

At December 31, 2006, the Company has $6.4 million of non-cancelable purchase commitments for inventory to fulfill customers orders currently scheduled in its backlog.

15. 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, 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. 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.

Revenue, classified by the major geographic areas in which the Company s customers are located, were as follows (in thousands):

	Three Months Ended December 31,	
	2006	2005
United States	$ 101,550	$ 49,916
International	31,871	25,636
Total	$ 133,421	$ 75,552

No country outside of the United States composed greater than 10% of total revenue.

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

	Three Months Ended December 31,	
	2006	2005
Speech	$ 115,002	$ 58,168
Imaging	18,419	17,384

Total	$ 133,421	$ 75,552

No customer accounted for greater than 10% of accounts receivable as of December 31, 2006 or September 30, 2006.

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

	December 31, 2006	September 30, 2006
United States	$ 874,706	$ 865,884
International	102,436	105,869
Total	$ 977,142	$ 971,753

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NUANCE COMMUNICATIONS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

16. Pro Forma Results

The following table reflects unaudited pro forma results of operations of the Company assuming that the Dictaphone acquisition had occurred on October 1, 2005 (in thousands, except per share data):

	Three Months Ended December 31,	
	2006	2005
Revenue	$ 133,421	$ 117,717
Net loss	(1,235)	(10,462)
Net loss per basic and diluted share	$ (0.01)	$ (0.07)

The Company has not furnished pro forma financial information relating to the MVC acquisition because such information is not material. 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 the period indicated.

17. Related Parties

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. For the three months ended December 31, 2006, no payments were made to Wilson Sonsini Goodrich & Rosati and $1.6 million were paid to Wilson Sonsini Goodrich & Rosati for professional services provided to the Company for the three months ended December 31, 2005. As of December 31, 2006 and September 2006 the Company had $1.1 million and $0.6 million, respectively, included in accounts payable and accrued expenses to Wilson Sonsini Goodrich & Rosati.

18. Subsequent Events

On January 26, 2007, the Company repurchased 261,422 shares of the Company s common stock from former MVC stockholders which were originally issued in connection with the acquisition of MVC on December 29, 2006, for a total purchase price of $3.2 million.

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

The following Management s Discussion and Analysis is intended to help the reader understand the results of operations and financial condition of our business. Management s Discussion and Analysis is provided as a supplement to, and should be read in conjunction with, our consolidated financial statements and related notes thereto included elsewhere in this Quarterly Report on Form 10-Q.

FORWARD-LOOKING STATEMENTS

This quarterly report contains forward-looking statements. These forward-looking statements include predictions regarding:

- our future revenue, cost of revenue, research and development expenses, selling, general and administrative expenses, amortization of other intangible assets and gross margin;
- our strategy relating to speech and imaging technologies;
- the potential of future product releases;
- our product development plans and investments in research and development;
- future acquisitions, and anticipated benefits from prior acquisitions;
- international operations and localized versions of our products; and
- legal proceedings and litigation matters.

You can identify these and other forward-looking statements by the use of words such as may, will, should, expects, plans, anticipates, believes, estimates, predicts, intends, potential, continue or the negative of such term comparable terminology. Forward-looking statements also include the assumptions underlying or relating to any of the foregoing statements. Our actual results could differ materially from those anticipated in these forward-looking statements for many reasons, including the risks described in Item 1A Risk Factors and elsewhere in this Quarterly Report.

You should not place undue reliance on these forward-looking statements, which speak only as of the date of this Quarterly Report on Form 10-Q. We undertake no obligation to publicly release any revisions to the forward-looking statements or reflect events or circumstances after the date of this document.

OVERVIEW

We are a leading provider of speech and imaging solutions for businesses and consumers around the world. Our technologies, applications and services are transforming the way people create, use and interact with information and make the experience of our end users a more compelling, convenient and satisfying one.

Our speech technologies enable voice-activated services over a telephone, transform speech into written word, and permit the control of devices and applications by simply speaking. With the acquisition of Dictaphone, we expanded our speech technologies in the automatic conversion of voice reports into electronic patient reports for a wide range of users in the transcription and healthcare industry. We expect our acquisition of Dictaphone to significantly expand our reach into the healthcare industry. Our imaging solutions offer cost-effective PDF applications for business users, convert paper and PDF into documents that can be easily edited, and simplify scanning and document management using multifunction scanners and networked digital copiers.

Our software can be delivered as part of a larger integrated system, such as systems for customer service call centers, or as an independent application, such as dictation, medical transcription, document or PDF conversion, navigation systems in automobiles or digital copiers on a network. In select situations we sell or license intellectual property in conjunction with, or in place of, embedding our intellectual property in software. Our products and technologies deliver a measurable return on investment to our customers and our goal is to help our customers optimize productivity and reduce costs.

We market and distribute our products indirectly through a global network of resellers comprising system integrators, independent software vendors, value-added resellers, hardware vendors, telecommunications carriers and distributors; and directly to businesses and consumers through a dedicated direct sales force and our e-commerce website *(www.nuance.com).*

Nuance was incorporated in 1992 as Visioneer, Inc. under the laws of the state of Delaware. In 1999, we changed our name to ScanSoft, Inc. and also changed our ticker symbol to SSFT. In October 2004, we changed our fiscal year end to September 30, resulting in a nine-month fiscal year for 2004. In October 2005, we changed our name to Nuance Communications, Inc., to reflect our core mission of being the world s most comprehensive and innovative provider of speech solutions, and in November 2005 we changed our ticker symbol to NUAN.

Our business is predicated on providing our partners and customers with a comprehensive portfolio of value-added solutions, ensuring technological leadership, promoting the broad adoption of our innovative technology and building global sales and channel relationships. We continue to execute on our strategy of maintaining leadership in speech and imaging through sustained growth in our ongoing operations as well as through strategic acquisitions that complement our existing capabilities.

Our focus on providing competitive and value-added solutions for our customers and partners requires a broad set of technologies, service offerings and channel capabilities. We have successfully completed 15 acquisitions since 2000 and we expect to continue to make acquisitions of other companies, businesses and technologies to complement our internal investments. We have a team that focuses on evaluating market needs and potential acquisitions to fulfill them. In addition, we have a disciplined methodology for integrating acquired companies and businesses after the transaction is complete. In recent fiscal years, we completed a number of acquisitions, including the following significant transactions:

On January 30, 2003, we acquired Royal Philips Electronics Speech Processing Telephony and Voice Control business units to expand our solutions for speech in call centers and within automobiles and mobile devices.

On August 11, 2003, we acquired SpeechWorks International, Inc. to broaden our speech applications for telecommunications, call centers and embedded environments as well as establish a professional services organization.

On February 1, 2005, we acquired Phonetic Systems Ltd. to complement our solutions and expertise in automated directory assistance and enterprise speech applications.

On September 15, 2005, we acquired the former Nuance Communications, Inc., which we refer to as Former Nuance, to expand our portfolio of technologies, applications and services for call center automation, customer self service and directory assistance.

On March 31, 2006, we acquired Dictaphone Corporation, a leading healthcare information technology company that provides a broad range of digital dictation, transcription, and report management system solutions.

CRITICAL ACCOUNTING POLICIES

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, we evaluate our estimates and judgments, in particular those related to revenue recognition; the costs to complete the development of custom software applications and valuation allowances (specifically sales returns and other allowances); accounting for patent legal defense costs; the valuation of goodwill, other intangible assets and tangible long-lived assets; estimates used in the accounting for acquisitions; assumptions used in valuing stock-based compensation instruments; assumptions used in determining the obligations and assets relating to pension and post-retirement benefit plans; judgment with respect to interest rate swaps which are characterized as derivative instruments; evaluating loss contingencies; and valuation allowances for deferred tax assets. Actual amounts could

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differ significantly from these estimates. Our management 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.

Additional information about these critical accounting policies may be found in the Management s Discussion & Analysis of Financial Condition and Results of Operations section included in our Annual Report on Form 10-K/A for the fiscal year ended September 30, 2006.

RESULTS OF OPERATIONS

The following table presents, as a percentage of total revenue, certain selected financial data for the periods indicated:

	Three Months Ended December 31,	
	2006	2005
Revenue:		
Product and licensing	56.8%	70.4%
Professional services, subscription and hosting	21.0	19.3
Maintenance and support	22.2	10.3
Total revenue	100.0	100.0
Costs and expenses:		
Cost of product and licensing	7.7	6.6
Cost of professional services, subscription and hosting	15.4	14.3
Cost of maintenance and support	5.2	2.5
Cost of revenue from amortization of intangible assets	2.2	3.3
Gross margin	69.5	73.3
Research and development	12.3	16.1
Sales and marketing	32.9	37.5
General and administrative	11.5	19.4
Amortization of other intangible assets	3.9	2.6
Total operating expenses	60.6	75.6
Income (loss) from operations	8.9	(2.3)
Other income (expense), net	(5.1)	(0.2)
Income (loss) before income taxes	3.8	(2.5)
Provision for income taxes	4.7	3.1
Loss before cumulative effect of accounting changes	(0.9)	(5.6)
Cumulative effect of accounting change		(0.9)

Net loss	(0.9)%	(6.5)%

Total Revenue

The following table shows total revenue by geographic location, based on the location of our customers, in absolute dollars and percentage change (dollars in millions):

	Three Months Ended December 31, 2006	Three Months Ended December 31, 2005	Dollar Change	Percent Change
United States	$ 101.5	$ 49.9	$ 51.6	103%
International	31.9	25.6	6.3	25%
Total revenue	$ 133.4	$ 75.5	$ 57.9	77%

The increase in total revenue for the three months ended December 31, 2006, as compared to the same period ended December 31, 2005, was primarily attributable to $43.2 million of revenue related to our acquisition of Dictaphone and a $14.7 million increase in organic total revenue or 19%, across all business units. Included in this organic growth, network revenue increased 15%, dictation revenue increased 40% primarily related to our fourth quarter release of Dragon NaturallySpeaking version 9.0 during fiscal 2006, embedded revenue increased by 33% and imaging revenue increased by 7%.

Based on the location of our customers, the geographic split for the three months ended December 31, 2006 was 76% of total revenue in the United States and 24% internationally. This compares to 66% of total revenue in the United States and 34% internationally for the three months ended December 31, 2005. The increase in revenue generated in the United States was primarily due to sales of Dictaphone products, 94% of which are derived in the United States. Excluding the Dictaphone revenue, for the three months ended December 31, 2006, 67% of total revenue was derived from customers in the United States and 33% internationally.

Product and Licensing Revenue

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

	Three Months Ended December 31, 2006	Three Months Ended December 31, 2005	Dollar Change	Percent Change
Product and licensing revenue	$ 75.7	$ 53.2	$ 22.5	42%
As a percentage of total revenue	57%	70%		

The increase in product and licensing revenue was primarily due to $11.9 million of revenue attributable to our acquisition of Dictaphone. Excluding the impact of this acquisition, product and licensing revenue grew $10.6 million, or 20%, compared to the three month period ended December 31, 2005. Due to a change in revenue mix, driven primarily by the growth of maintenance and support revenue, product and licensing revenue as a percentage of total revenue declined 14% for the three month period ended December 31, 2006 as compared to the same period ended December 31, 2005.

Speech related product and licensing revenue increased $21.6 million, or 60% for the three months ended December 31, 2006 as compared to the same period ended December 31, 2005. Excluding revenue due to our acquisition of Dictaphone, speech related product and licensing revenue increased by $9.7 million, or 27%. The growth in speech revenue resulted from increased sales of our embedded products in the automotive market and handsets, as well as increased sales of our dictation products related to our fourth quarter of fiscal 2006 release of Dragon NaturallySpeaking 9.0 and increased sales of our networked-based products into enterprise customers. Product and licensing revenue from our imaging products increased by $0.9 million, or 6%, due to increased sales of our PDF product family with the September 2006 release of PDF 4.0 and the May 2006 release of PaperPort 11.

Professional Services, Subscription and Hosting Revenue

Professional services revenue primarily consists of consulting, implementation and training services for speech customers. Subscription and hosting revenue primarily relates to delivering hosted and on-site directory assistance and transcription and dictation services over a specified term. The following table shows professional services, subscription and hosting revenue in absolute dollars and as a percentage of total revenue (dollars in millions):

	Three Months Ended December 31, 2006	2005	Dollar Change	Percent Change
Professional services, subscription and hosting revenue	$ 28.0	$ 14.6	$ 13.4	92%
As a percentage of total revenue	21%	19%		

The increase in professional services revenue for the three months ended December 31, 2006, as compared to the same period ended December 31, 2005, was primarily due to a $11.7 million increase in revenue attributable to our acquisition of Dictaphone. The remaining increase is primarily attributable to a $2.5 million, or 23% increase in Network services revenue. These increases were offset by a decrease in our embedded professional services revenue.

Maintenance and Support Revenue

Maintenance and support revenue primarily consists of technical support and maintenance service for our speech products including network, embedded and dictation and transcription products. The following table shows maintenance and support revenue in absolute dollars and as a percentage of total revenue (dollars in millions):

	Three Months Ended December 31, 2006	2005	Dollar Change	Percent Change
Maintenance and support revenue	$ 29.7	$ 7.8	$ 21.9	281%
As a percentage of total revenue	22%	10%		

As a percentage of total revenue, maintenance and support revenue grew 12% for the three month period ended December 31, 2006, as compared to the same period ended December 31, 2005. $19.6 million of this increase is attributable to our acquisition of Dictaphone, which has a significant customer base of maintenance and support contracts from historic sales of product. The remaining increase in maintenance and support revenue is primarily attributable to a $2.2 million, or 30%, increase in network maintenance and support contracts due to our continued strong renewal rates as well as from new sales of our network products.

Cost of Product and Licensing Revenue

Cost of product and licensing revenue primarily consists of material and fulfillment costs, manufacturing and operations costs, third-party royalty expenses, and share-based payments. The following table shows cost of product and licensing revenue, in absolute dollars and as a percentage of product and licensing revenue (dollars in millions):

	Three Months Ended December 31, 2006	**2005**	**Dollar Change**	**Percent Change**
Cost of product and licensing revenue	$ 10.2	$ 5.0	$ 5.2	104%
As a percentage of product and licensing revenue	13%	9%		

This increase in cost of product and licensing revenue was primarily due to $3.9 million of costs attributable to our acquisition of Dictaphone. As a percentage of product and licensing revenue, cost of revenue increased 4% for

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the three months ended December 31, 2006, as compared to the same period ended December 31, 2005. The increase was largely due to the higher cost of our Dictaphone healthcare products resulting from the inclusion of third party hardware in the solutions licensed to customers. Excluding the impact of this acquisition, cost of revenue increased by $1.4 million, or a decrease in gross margin of 1%. This increase in cost is due to higher material and fulfillment costs net of a decrease in royalties driven largely by contractual changes for our embedded product lines royalties.

Cost of Professional Services, Subscription and Hosting Revenue

Cost of professional services, subscription and hosting revenue primarily consists of compensation for consulting personnel, outside consultants, overhead, and share-based payments, as well as the hardware and communications fees that support our subscription and hosted solutions. The following table shows cost of professional services, subscription and hosting revenue, in absolute dollars and as a percentage of professional services, subscription and hosting revenue (dollars in millions):

	Three Months Ended December 31, 2006	Three Months Ended December 31, 2005	Dollar Change	Percent Change
Cost of professional services, subscription and hosting revenue	$ 20.6	$ 10.8	$ 9.8	91%
As a percentage of professional services, subscription and hosting revenue	74%	74%		

The increase in cost of professional services, subscription and hosting revenue for the three months ended December 31, 2006, as compared to the same period ended December 31, 2005, was primarily due to a $10.4 million increase in cost attributable to our acquisition of Dictaphone which has a large subscription-based licensing and hosted application customer base. Excluding the impact of this acquisition, cost of professional services revenue decreased by $0.6 million, or 12% as a percentage of revenue, as synergies were realized from the merging of the service teams of acquired businesses into our service teams.

Cost of Maintenance and Support Revenue

Cost of maintenance and support revenue primarily consists of compensation for product support personnel and overhead, as well as share-based payments. The following table shows cost of maintenance and support revenue, in absolute dollars and as a percentage of maintenance and support revenue (dollars in millions):

	Three Months Ended December 31, 2006	Three Months Ended December 31, 2005	Dollar Change	Percent Change
Cost of maintenance and support revenue	$ 7.0	$ 1.9	$ 5.1	268%
As a percentage of maintenance and support revenue	24%	24%		

The increase in cost of maintenance and support revenue for the three months ended December 31, 2006, as compared to the same period ended December 31, 2005, was primarily due to a $4.4 million increase in cost attributable to our acquisition of Dictaphone which has a significant customer base of maintenance and support contracts from historic licensing of product. Excluding the impact of this acquisition, cost of maintenance and support as a percentage of the revenue remains consistent with the prior period.

Cost of Revenue from Amortization of Intangible Assets

Cost of revenue from amortization of intangible assets consists of the amortization of acquired patents and core and completed technology using the straight-line basis over their estimated useful lives. We evaluate the recoverability of intangible assets periodically or whenever events or changes in business circumstances indicate that the carry value of our intangible assets may not be recoverable. The following table shows cost of revenue from amortization of intangible assets in absolute dollars and as a percentage of total revenue (dollars in millions):

	Three Months Ended December 31, 2006	2005	Dollar Change	Percent Change
Cost of revenue from amortization of intangible assets	$ 2.9	$ 2.5	$ 0.4	16%
As a percentage of total revenue	2%	3%		

The increase in amortization of other intangible assets for the three months ended December 31, 2006, as compared to the same period in fiscal 2006, was attributable to a $0.8 million increase in the amortization of identifiable intangible assets acquired in connection with our acquisition of Dictaphone on March 31, 2006. The increase was offset by a $0.4 million decrease in amortization expense related to a purchased technology which was written down to its net realizable value during the fourth quarter of fiscal 2006.

Research and Development Expense

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

	Three Months Ended December 31, 2006	2005	Dollar Change	Percent Change
Total research and development expense	$ 16.5	$ 12.2	$ 4.3	35%
As a percentage of total revenue	12%	16%		

The increase in research and development expense in absolute dollars for the three months ended December 31, 2006, as compared to the same period ended December 31, 2005, was primarily due to a $1.9 million increase in compensation related expenses associated with increased average headcount of 38 employees mainly resulting from our acquisition of Dictaphone. The remaining increase was attributable to an increase of $1.2 million in outside contractor related expenses and $1.2 million increase in other headcount related expenses, including share-based payments, travel and infrastructure related expenses. While continuing to increase in absolute dollars, research and development expense has decreased relative to our total revenue. This decrease in expense as a percentage of total revenue reflects synergies resulting from the integration of the research and development organizations of acquired businesses into our research and development organization.

We believe that the development of new products and the enhancement of existing products are essential to our success. Accordingly, we plan to continue to invest in research and development activities. To date, we have not capitalized any internal development costs as the cost incurred after technological feasibility but before release of products has not been significant.

Sales and Marketing Expense

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

	Three Months Ended December 31, 2006	Three Months Ended December 31, 2005	Dollar Change	Percent Change
Total sales and marketing expense	$ 43.9	$ 28.3	$ 15.6	55%
As a percentage of total revenue	33%	37%		

The increase in sales and marketing expenses in absolute dollars for the three months ended December 31, 2006, as compared to the same period ended December 31, 2005, was primarily due to a $10.8 million increase in compensation and headcount related expenses, including commissions, travel and infrastructure related expenses, associated with increased average headcount of 131 sales employees and 24 marketing employees primarily resulting from our acquisition of Dictaphone. The remaining increase was attributable to a $2.5 million increase in share-based payments as well as a $2.3 million increase in advertising and marketing spending for existing products as well as healthcare products from Dictaphone. While continuing to increase in absolute dollars, sales and marketing expense has decreased relative to our total revenue. This decrease in expense as a percentage of total revenue reflects synergies resulting from the integration of the sales and marketing organizations of acquired businesses into our sales and marketing organization.

General and Administrative Expense

General and administrative expenses primarily consist of personnel costs (including share-based payments and other overhead), for administration, finance, human resources, information systems, facilities and general management, fees for external professional advisors including accountants and attorneys, insurance, and provisions for doubtful accounts. The following table shows general and administrative expense in absolute dollars and as a percentage of total revenue (dollars in millions):

	Three Months Ended December 31, 2006	Three Months Ended December 31, 2005	Dollar Change	Percent Change
Total general and administrative expense	$ 15.4	$ 14.6	$ 0.8	6%
As a percentage of total revenue	12%	19%		

The general and administrative expense in absolute dollars remained relatively flat for the three months ended December 31, 2006, as compared to the same period ended December 31, 2005. The acquisition of Dictaphone added additional expense of $2.4 million, including $0.4 million paid to Dictaphone staff for non-recurring activities necessary to transition knowledge and processes post-acquisition. Excluding the impact of this acquisition, general and administrative expense decreased $1.6 million due primarily to a decrease of $0.8 million in bonus and compensation expenses as well as a decrease of $2.6 million in outside services. These decreases were offset by an increase of $1.8 million in share-based payments. The decrease in outside services is due to a reduction in legal services as well as staffing and contractors needed to comply with the provisions of Sarbanes Oxley and the implementation of SFAS 123R during the first quarter of fiscal 2006. While the expense increased slightly in absolute dollars, general and administrative expense has decreased relative to our total revenue. This decrease in expense as a percentage of total revenue reflects synergies resulting from the integration of the general and administrative organizations of acquired businesses into our general and administrative organization.

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Amortization of Other Intangible Assets

Amortization of other intangible assets into operating expense includes amortization of acquired customer and contractual relationships, non-competition agreements and acquired trade names and trademarks. Customer relationships are amortized on an accelerated basis based upon the pattern in which the economic benefit of customer relationships are being utilized. Other identifiable intangible assets are amortized on a straight-line basis over their estimated useful lives. We evaluate these assets for impairment and for appropriateness of their remaining life on an ongoing basis. The following table shows amortization of other intangible assets in absolute dollars and as a percentage of total revenue (dollars in millions):

	Three Months Ended December 31,		Dollar	Percent
	2006	2005	Change	Change
Cost of revenue from amortization of intangible assets	$ 5.2	$ 2.0	$ 3.2	160%
As a percentage of total revenue	4%	3%		

The increase in amortization of other intangible assets for the three months ended December 31, 2006, as compared to the same period ended December 31, 2005, was attributable to the amortization of identifiable intangible assets acquired from the acquisition of Dictaphone on March 31, 2006.

Restructuring and Other Charges (Credits), Net

Current activity charged against the restructuring accrual for the three months ended December 31, 2006 was as follows (dollars in millions):

	Facilities	Personnel	Total
Balance at September 30, 2006	$ 0.5	$ 0.4	$ 0.9
Cash payments and foreign exchange	(0.3)		(0.3)
Balance at December 31, 2006	$ 0.2	$ 0.4	$ 0.6

The remaining personnel-related accrual as of December 31, 2006 is primarily comprised of amounts due under a restructuring charge taken in the fourth quarter of fiscal 2005 which is expected to be paid during fiscal 2007.

Other Income (Expense), Net

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

	Three Months Ended December 31, 2006	2005	Dollar Change	Percent Change
Interest income	$ 1.4	$ 0.7	$ 0.7	100%
Interest expense	(7.7)	(1.0)	$ (6.7)	670%
Other income (expense), net	(0.5)		$ (0.5)	
Total other income (expense), net	$ (6.8)	$ (0.3)	$ (6.5)	2,167%
As a percentage of total revenue	(5)%	%		

The increase in interest income was primarily due to higher cash balances during the three month period ended December 31, 2006, as compared to the same period ended December 31, 2005. The increase in interest expense was mainly due to interest expense paid as well as the amortization of debt issuance costs associated with the credit facility we entered into on March 31, 2006. Other income (expense) principally consisted of foreign exchange gains (losses) as a result of the changes in foreign exchange rates on certain of our foreign subsidiaries whose operations

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are denominated in other than their local currencies, as well as the translation of certain of our intercompany balances.

Provision for Income Taxes

The following table shows the provision for income taxes in absolute dollars and the effective income tax rate (in millions):

	Three Months Ended December 31, 2006	Three Months Ended December 31, 2005	Dollar Change	Percent Change
Income tax provision	$ 6.3	$ 2.3	$ 4.0	174%
Effective income tax rate	124%	(120)%		

The income tax provision for the quarter ended December 31, 2006 includes provisions for current and deferred federal, state, and foreign taxes of approximately $2.7 million and an increase in the valuation allowance of approximately $3.6 million.

The variance of our effective income tax rate from the federal statutory rate of 35% is due primarily to state income taxes, the disallowance for tax purposes of certain share based compensation charges, and the increase in our valuation allowance with respect to certain deferred tax assets.

Valuation allowances have been established for deferred tax assets which we believe do not meet the more likely than not realization criteria established by SFAS 109, Accounting for Income Taxes and that are not otherwise offset by deferred tax liabilities. The U.S. deferred tax assets relate primarily to net operating loss and tax credit carryforwards (resulting both from business combinations and from operations). Deferred tax liabilities have been recorded that relate primarily to intangible assets established in connection with business combinations. Certain of these intangible assets have indefinite lives, and the resulting deferred tax liability associated with these assets is not allowed as an offset to our deferred tax assets for purposes of determining the required amount of our valuation allowance. At December 31, 2006, the amount of this deferred tax liability was approximately $20.9 million.

Our utilization of deferred tax assets that were acquired in a business combination results in a reduction of our valuation allowance and an increase to goodwill. Our establishment of new deferred tax assets as a result of operating activities requires an increase in our valuation allowance that causes an increase to tax expense.

The tax provision also includes state and foreign tax expense as determined on a legal entity and tax jurisdiction basis.

LIQUIDITY AND CAPITAL RESOURCES

Cash and cash equivalents totaled $129.7 million as of December 31, 2006, an increase of $17.4 million compared to $112.3 million as of September 30, 2006. This increase was composed of cash provided by operating activities of $26.1 million, offset by the net impact of cash used in financing activities and investing activities. Our working capital was $67.4 million at December 31, 2006 as compared to $51.3 million at the end of fiscal 2006. As of December 31, 2006, total accumulated deficit was $191.4 million. We do not expect our accumulated deficit will impact our future ability to operate given our strong cash and financial position.

Cash provided by operating activities

Cash provided by operating activities for the three months ended December 31, 2006 was $26.1 million, an increase of $27.2 million, or 2,473%, as compared to net cash used in operating activities of $1.1 million for the three months ended December 31, 2005. The increase was primarily composed of changes relating to the net loss after adding back non-cash items such as depreciation and amortization, and share-based payments; in the first quarter of fiscal 2007 this amount was $23.6 million compared to $8.3 million in the first quarter of fiscal 2006, an increase of $15.3 million, or 184%. Accounts payable provided $8.5 million in cash from operations, having changed from a $1.9 million use of cash in the fiscal 2006 period to a $6.6 million source of cash in the fiscal 2007 period. The increase in deferred revenue also contributed $4.7 million to the operating cash flow improvement during the fiscal 2007 period.

Cash used in investing activities

Cash used in investing activities for the three months ended December 31, 2006 was $8.4 million, an increase of $11.6 million, or 363%, as compared to net cash provided by investing activities of $3.2 million for the three months ended December 31, 2005. The increase in cash used in investing activities was primarily driven by a decrease of $20.4 million in cash proceeds from maturities of marketable securities as well as an increase of $1.5 million related to cash paid for capitalized patent defense costs and capital expenditures for property and equipment. These increases were partially offset by a $10.3 million decrease in cash payments related to acquisitions.

Cash provided by financing activities

Cash provided by financing activities for the three months ended December 31, 2006 was $42,000, as compared to net cash used in financing activities of $6.1 million for the three months ended December 31, 2005. The change was composed of a net decrease of $11.5 million in deferred acquisition payments, a decrease of $0.5 million in cash payment related to treasury stock as well as a $0.7 million increase in excess tax benefits from share-based payments. These additional cash provided by financing activities were partially offset by a net decrease in proceeds of $6.5 million, or 60.6% from the issuance of common stock under employee share-based payment plans.

Credit Facility

On March 31, 2006 we entered into a new senior secured credit facility, the 2006 Credit Facility. The 2006 Credit Facility consists of a $355.0 million, 7-year term loan which matures on March 31, 2013 and a $75.0 million revolving credit line which matures on March 31, 2012. The available revolving credit line capacity is reduced, as necessary, to account for letters of credit outstanding. As of December 31, 2006, there were $17.2 million of letters of credit issued under the revolving credit line and there were no outstanding borrowings under the revolving credit line.

Borrowings under the 2006 Credit Facility bear interest at a rate equal to the applicable margin plus, at our option, either (a) a base rate (which is the higher of the corporate base rate of UBS AG, Stamford Branch, or the federal funds rate plus 0.50% per annum) or (b) a LIBOR rate determined by reference to the British Bankers Association Interest Settlement Rates for deposits in U.S. dollars. The applicable margin for borrowings under the 2006 Credit Facility ranges from 0.50% to 1.00% per annum with respect to base rate borrowings and from 1.50% to 2.00% per annum with respect to LIBOR-based borrowings, depending upon our leverage ratio. As of December 31, 2006, our applicable margin is 1.00% for base rate borrowings and 2.00% for LIBOR-based borrowings. We are required to pay a commitment fee for unutilized commitments under the revolving credit facility at a rate ranging from 0.375% to 0.50% per annum, based upon our leverage ratio. As of December 31, 2006, our commitment fee rate is 0.50%.

We capitalized approximately $9.0 million in debt issuance costs related to the opening of the 2006 Credit Facility. The costs associated with the revolving credit facility are being amortized as interest expense over six years, through March 2012, while the costs associated with the term loan are being amortized as interest expense over seven years, through March 2013, which is the maturity date of the revolving line and term facility, respectively under the 2006 Credit Facility. The effective interest rate method is used to calculate the amortization of the debt issuance costs for both the revolving credit facility and the term loan. These debt issuance costs, net of accumulated amortization of $1.0 million, are included in other assets in the consolidated balance sheet as of December 31, 2006.

The $355.0 million term loan is subject to repayment consisting of a baseline amortization of 1% per annum ($3.55 million per year, due in four equal quarterly installments), and an annual excess cash flow sweep, as defined in the 2006 Credit Facility, which will be first payable beginning in the first quarter of fiscal 2008, based on the excess cash flow generated in fiscal 2007. As of December 31, 2006, we have repaid $2.7 million of principal under the term loan agreement. Any borrowings not paid through the baseline repayment, the excess cash flow sweep, or any other mandatory or optional payments that we may make, will be repaid upon maturity. If only the baseline repayments are made, the aggregate annual maturities of the term loan would be as follows (in thousands):

Year Ending September 30,	**Amount**
2007 (January 1, 2007 to September 30, 2007)	$ 2,663
2008	3,550
2009	3,550
2010	3,550
2011	3,550
2012	3,550
Thereafter	331,925
Total	$ 352,338

Our obligations under the 2006 Credit Facility are unconditionally guaranteed by, subject to certain exceptions, each of our existing and future direct and indirect wholly-owned domestic subsidiaries. The 2006 Credit Facility and the guarantees thereof are secured by first priority liens and security interests in the following: 100% of the capital stock of substantially all of our domestic subsidiaries and 65% of the outstanding voting equity interests and 100% of the non-voting equity interests of first-tier foreign subsidiaries, material tangible and intangible assets, and present and future intercompany debt. The 2006 Credit Facility also contains provisions for mandatory prepayments of outstanding term loans, subject to certain exceptions, with: 100% of net cash proceeds of asset sales, 100% of net cash proceeds of issuance or incurrence of debt, and 100% of extraordinary receipts. We may voluntarily prepay the 2006 Credit Facility without premium or penalty other than customary breakage costs with respect to LIBOR-based loans.

The 2006 Credit Facility contains a number of covenants that, among other things, restrict, subject to certain exceptions, our ability to: incur additional indebtedness, create liens on assets, enter into certain sale and lease-back transactions, make investments, make certain acquisitions, sell assets, engage in mergers or consolidations, pay dividends and distributions or repurchase our capital stock, engage in certain transactions with affiliates, change the business conducted by us, amend certain charter documents and material agreements governing subordinated indebtedness, prepay other indebtedness, enter into agreements that restrict dividends from subsidiaries and enter into certain derivatives transactions. The 2006 Credit Facility is governed by financial covenants that include, but are not limited to, maximum total leverage and minimum interest coverage ratios, as well as to a maximum capital expenditures limitation. The 2006 Credit Facility also contains certain customary affirmative covenants and events of default. As of December 31, 2006, we were in compliance with the covenants.

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

Off-Balance Sheet Arrangements, Contractual Obligations, Contingent Liabilities and Commitments

Contractual Obligations

The following table summarizes our outstanding contractual obligations as of December 31, 2006 (in millions):

		Payments Due by Period				
Contractual Obligations	**Total**	**Remaining Fiscal 2007**	**Fiscal 2008**	**Fiscal 2009 and 2010**	**Fiscal 2011 and 2012**	**Thereafter**
Term loan under credit facility	$ 352.4	$ 2.7	$ 3.5	$ 7.1	$ 7.1	$ 332.0
Deferred payments on acquisitions(1)	17.5	17.5				
Lease obligations:						
Capital leases	0.8	0.3	0.4	0.1		
Operating leases	51.9	4.9	7.8	14.0	10.5	14.7
Other lease obligations associated with the closing of duplicate facilities related to restructurings and acquisitions(2)	6.3	1.4				