Nuance Communications, Inc.
Form 10-Q
May 10, 2011

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

Form 10-Q

(Mark One)

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended March 31, 2011

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 *(State or Other jurisdiction of incorporation or organization)*	**94-3156479** *(I.R.S. Employer Identification No.)*
1 Wayside Road **Burlington, Massachusetts** *(Address of principal executive offices)*	**01803** *(Zip Code)*

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

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

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

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

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

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

The number of shares of the Registrant s Common Stock, outstanding as of April 30, 2011, was 302,709,456.

NUANCE COMMUNICATIONS, INC.

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NUANCE COMMUNICATIONS, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

	Three Months Ended March 31, 2011	Three Months Ended March 31, 2010	Six Months Ended March 31, 2011	Six Months Ended March 31, 2010
	(Unaudited) (In thousands, except per share amounts)			
Revenues:				
Product and licensing	$ 141,580	$ 113,161	$ 275,436	$ 226,388
Professional services and hosting	128,911	116,228	251,731	219,923
Maintenance and support	48,471	43,616	95,624	89,671
Total revenues	318,962	273,005	622,791	535,982
Cost of revenues:				
Product and licensing	14,984	10,702	32,130	23,293
Professional services and hosting	86,490	73,000	164,702	134,996
Maintenance and support	9,536	7,714	17,809	15,704
Amortization of intangible assets	14,163	12,184	27,454	23,202
Total cost of revenues	125,173	103,600	242,095	197,195
Gross profit	193,789	169,405	380,696	338,787
Operating expenses:				
Research and development	46,272	37,931	87,653	74,881
Sales and marketing	74,137	63,899	152,481	129,461
General and administrative	37,188	31,305	68,370	58,756
Amortization of intangible assets	21,572	22,201	44,249	44,327
Acquisition-related costs, net	2,314	7,962	5,315	20,767
Restructuring and other charges, net	2,428	12,372	4,479	12,987
Total operating expenses	183,911	175,670	362,547	341,179
Income (loss) from operations	9,878	(6,265)	18,149	(2,392)
Other income (expense):				
Interest income	659	173	1,486	609
Interest expense	(8,838)	(10,172)	(18,065)	(20,409)
Other income (expense), net	2,423	3,156	8,564	5,146
Income (loss) before income taxes	4,122	(13,108)	10,134	(17,046)
Provision for income taxes	2,387	2,288	8,408	2,628
Net income (loss)	$ 1,735	$ (15,396)	$ 1,726	$ (19,674)

Net income (loss) per share:				
Basic	$ 0.01	$ (0.05)	$ 0.01	$ (0.07)
Diluted	$ 0.01	$ (0.05)	$ 0.01	$ (0.07)
Weighted average common shares outstanding:				
Basic	300,937	284,994	299,772	281,998
Diluted	314,756	284,994	313,152	281,998

See accompanying notes.

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NUANCE COMMUNICATIONS, INC.

CONSOLIDATED BALANCE SHEETS

	March 31, 2011 (Unaudited)	September 30, 2010
	(In thousands, except per share amounts)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 641,712	$ 516,630
Restricted cash (Note 9)	7,054	24,503
Marketable securities	26,305	5,044
Accounts receivable, less allowances for doubtful accounts of $5,881 and $6,301	228,622	217,587
Acquired unbilled accounts receivable	1,791	7,412
Prepaid expenses and other current assets	76,466	70,466
Total current assets	981,950	841,642
Land, building and equipment, net	69,135	62,083
Marketable securities	10,590	28,322
Goodwill	2,099,910	2,077,943
Intangible assets, net	627,368	685,865
Other assets	72,255	73,844
Total assets	$ 3,861,208	$ 3,769,699
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term debt and capital leases	$ 7,150	$ 7,764
Contingent and deferred acquisition payments	12,216	2,131
Accounts payable	84,588	78,616
Accrued expenses and other current liabilities	124,768	151,621
Deferred revenue	177,912	142,340
Total current liabilities	406,634	382,472
Long-term portion of debt and capital leases	851,963	851,014
Deferred revenue, net of current portion	78,049	76,598
Deferred tax liability	64,780	63,731
Other liabilities	84,229	98,688
Total liabilities	1,485,655	1,472,503
Commitments and contingencies (Notes 5 and 18)		
Stockholders equity:		
	4,631	4,631

Series B preferred stock, $0.001 par value; 15,000 shares authorized; 3,562 shares issued and outstanding (liquidation preference $4,631)		
Common stock, $0.001 par value; 560,000 shares authorized; 306,019 and 301,623 shares issued and 302,268 and 297,950 shares outstanding	306	302
Additional paid-in capital	2,641,136	2,581,901
Treasury stock, at cost (3,751 and 3,673 shares)	(16,788)	(16,788)
Accumulated other comprehensive income	25,897	8,505
Accumulated deficit	(279,629)	(281,355)
Total stockholders equity	2,375,553	2,297,196
Total liabilities and stockholders equity	$ 3,861,208	$ 3,769,699

See accompanying notes.

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NUANCE COMMUNICATIONS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Six Months Ended March 31,	
	2011	2010
	(Unaudited) (In thousands)	
Cash flows from operating activities:		
Net income (loss)	$ 1,726	$ (19,674)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	84,723	77,977
Stock-based compensation	75,717	44,774
Non-cash interest expense	6,369	6,524
Non-cash restructuring and other expense		6,833
Deferred tax provision	564	(1,111)
Other	700	666
Changes in operating assets and liabilities, net of effects from acquisitions:		
Accounts receivable	(2,519)	(8,541)
Prepaid expenses and other assets	(11,196)	(3,719)
Accounts payable	(1,446)	(2,249)
Accrued expenses and other liabilities	(31,035)	(10,357)
Deferred revenue	35,845	29,457
Net cash provided by operating activities	159,448	120,580
Cash flows from investing activities:		
Capital expenditures	(16,564)	(7,850)
Payments for acquisitions, net of cash acquired	(16,808)	(159,352)
Payments for acquired technology	(715)	(7,350)
Payments for equity investment		(14,970)
Purchases of marketable securities	(10,776)	
Proceeds from sales of marketable securities	6,650	
Change in restricted cash balances	17,184	
Net cash used in investing activities	(21,029)	(189,522)
Cash flows from financing activities:		
Payments of debt and capital leases	(4,091)	(4,064)
Payments of other long-term liabilities	(5,274)	(4,818)
(Payments) proceeds on settlement of share-based derivatives, net	(628)	3,784
Excess tax benefits on employee equity awards	4,020	
Proceeds from issuance of common stock from employee stock plans	14,611	18,823
Cash used to net share settle employee equity awards	(26,426)	(9,784)

Net cash (used in) provided by financing activities	(17,788)	3,941
Effects of exchange rate changes on cash and cash equivalents	4,451	(233)
Net increase (decrease) in cash and cash equivalents	125,082	(65,234)
Cash and cash equivalents at beginning of period	516,630	527,038
Cash and cash equivalents at end of period	$ 641,712	$ 461,804

See accompanying notes.

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NUANCE COMMUNICATIONS, INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

1. Organization and Presentation

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

Although we believe the disclosures in these financial statements are adequate to make the information presented not misleading, certain information normally included in the footnotes prepared in accordance with GAAP has been omitted. Accordingly, these financial statements should be read in conjunction with the audited financial statements and the notes thereto included in our Annual Report on Form 10-K for the fiscal year ended September 30, 2010. Interim results are not necessarily indicative of the results that may be expected for a full year.

2. Summary of Significant Accounting Policies

With the exception of the adoption of the accounting pronouncements discussed below related to revenue recognition, we have made no changes to the significant accounting policies disclosed in our Annual Report on Form 10-K for the fiscal year ended September 30, 2010.

Adoption of new accounting standards

Effective October 1, 2010, we adopted the provisions in the Financial Accounting Standards Board (FASB) Accounting Standards Update (ASU) No. 2009-13, *Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements* (ASU 2009-13) and ASU 2009-14. *Software (Topic 985): Certain Revenue Arrangements that Include Software Elements* (ASU 2009-14). The provisions of ASU 2009-13 apply to arrangements that are outside the scope of software revenue recognition guidance and amend Accounting Standards Codification (ASC) Topic 605 to (1) provide updated guidance on whether multiple deliverables exist, how the deliverables in an arrangement should be separated, and the consideration allocated; (2) require an entity to allocate revenue in an arrangement using the best estimated selling prices (BESP) of deliverables if a vendor does not have vendor-specific objective evidence (VSOE) or third-party evidence (TPE) of selling price; and (3) eliminate the use of the residual method and require an entity to allocate revenue using the relative selling price method. ASU 2009-14 modifies the scope of ASC Topic 985 to remove industry specific revenue accounting guidance for software and software related transactions, tangible products containing software components and non-software components that function together to deliver the product s essential functionality. The adoption of these provisions did not have a material impact on our consolidated financial statements.

ASU 2009-13 does not generally change the units of accounting for our revenue transactions. For multiple-element arrangements that contain both software and non-software elements such as our hosted offerings, we allocate revenue to software or software related elements and any non-software elements separately based on the selling price hierarchy. We determine the selling price for each deliverable using VSOE of selling price, if it exists, or TPE of selling price. If neither VSOE nor TPE of selling price exist for a deliverable, we use our BESP for that deliverable. Revenue allocated to each element is then recognized when the basic revenue recognition criteria are met for each element.

To determine the selling price in multiple-element arrangements, we establish VSOE of fair value for the majority of our post-contract customer support, professional services, and training based on historical stand-alone sales to third-parties. Typically, we are unable to determine TPE of selling price and therefore when neither VSOE nor TPE of selling price exist, we use BESP for the purposes of allocating the arrangement consideration. We determine BESP for a product or service by considering multiple factors including, but not limited to, major product groupings, market conditions, competitive landscape, price list and discounting practice.

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NUANCE COMMUNICATIONS, INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Recently Issued Accounting Standards

In January 2010, the FASB issued ASU No. 2010-06, *Improving Disclosures about Fair Value Measurements (Topic 820) Fair Value Measurements and Disclosures* to add additional disclosures about the different classes of assets and liabilities measured at fair value, the valuation techniques and inputs used, the activity in Level 3 fair value measurements, and transfers between Levels 1, 2, and 3. Levels 1, 2 and 3 of fair value measurements are defined in Note 8 below. ASU 2010-06 was effective for us for the interim reporting period beginning January 1, 2010, except for the provisions related to activity in Level 3 fair value measurements. Those provisions are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. ASU 2010-06 impacts disclosure only and therefore, did not, and is not expected to, have a material impact on our financial statements.

In December 2010, the FASB issued ASU No. 2010-28, *Intangibles Goodwill and Other (Topic 350): When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts*. ASU 2010-28 is effective for fiscal years beginning after December 15, 2010 and amends the criteria for performing Step 2 of the goodwill impairment test for reporting units with zero or negative carrying amounts and requires performing Step 2 if qualitative factors indicate that it is more likely than not that a goodwill impairment exists. We do not believe that this will have a material impact on our consolidated financial statements.

3. Comprehensive Income (Loss)

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

	Three Months Ended March 31,		Six Months Ended March 31,	
	2011	**2010**	**2011**	**2010**
Net income (loss)	$ 1,735	$ (15,396)	$ 1,726	$ (19,674)
Other comprehensive income (loss):				
Foreign currency translation adjustment	18,416	(11,158)	16,745	(12,022)
Unrealized gain on cash flow hedge derivatives	12	727	519	1,538
Unrealized gain (loss) on marketable securities, net	77		(2)	
Recognition of pension loss amortization	89		130	
Other comprehensive income (loss)	18,594	(10,431)	17,392	(10,484)
Comprehensive income (loss)	$ 20,329	$ (25,827)	$ 19,118	$ (30,158)

4. Business Acquisitions

Proforma Results

On December 30, 2009, we acquired all of the outstanding capital stock of SpinVox Limited (Spinvox), a UK-based privately-held company engaged in the business of providing voicemail-to-text services. The following table shows unaudited pro forma results of operations as if we had acquired SpinVox on October 1, 2009 (dollars in thousands, except per share amounts):

	Three Months Ended March 31,		Six Months Ended March 31,	
	2011	**2010**	**2011**	**2010**
Revenue	$ 318,962	$ 273,005	$ 622,791	$ 547,958
Net income (loss)	1,735	(15,396)	1,726	(51,236)
Net income (loss) per share	$ 0.01	$ (0.05)	$ 0.01	$ (0.18)

We have not furnished pro forma financial information related to our other fiscal 2011 and 2010 acquisitions because such information is not material, individually or in the aggregate, to our financial results. 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 periods indicated.

NUANCE COMMUNICATIONS, INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Acquisition-Related Costs, net

The components of acquisition-related costs, net are as follows (dollars in thousands):

	Three Months Ended March 31,		Six Months Ended March 31,	
	2011	2010	2011	2010
Transition and integration costs	$ 96	$ 5,199	$ 1,053	$ 8,652
Professional service fees	1,994	2,556	3,332	11,854
Acquisition-related adjustments	224	207	930	261
Total	$ 2,314	$ 7,962	$ 5,315	$ 20,767

The decrease in acquisition-related costs, net for the three months ended March 31, 2011, as compared to the three months ended March 31, 2010, was primarily driven by a reduction in transition and integration costs. For the three months ended March 31, 2010, transition and integration costs consisted primarily of costs associated with transitional employees from our acquisitions of SpinVox and eCopy.

The decrease for the six months ended March 31, 2011, as compared to the six months ended March 31, 2010, was primarily driven by a reduction in transition and integration costs and professional services fees. For the six months ended March 31, 2010, transition and integration costs consisted primarily of the costs associated with transitional employees from our acquisitions of SpinVox and eCopy; professional services consisted of expenses related to our acquisition of SpinVox in December 2009 and approximately $2.2 million that had been capitalized as of September 30, 2009 related to transaction costs incurred in prior periods that was required to be expensed upon our adoption of ASC 805, *Business Combinations*, in fiscal 2010.

5. Contingent Acquisition Payments

Earn-out Payments

For business combinations occurring subsequent to the adoption of ASC 805 in fiscal 2010, the fair value of any contingent consideration is established at the acquisition date and included in the total purchase price. The contingent consideration is then adjusted to fair value as an increase or decrease in current earnings in each reporting period. Contingent consideration related to acquisitions prior to our adoption of ASC 805 have been and will continue to be recorded as additional purchase price when the contingency is resolved and additional consideration is attributable.

In connection with our acquisition of Vocada, Inc. (Vocada) in November 2007, we agreed to make contingent earn-out payments of up to $21.0 million upon the achievement of certain financial targets measured over defined periods through December 31, 2010, in accordance with the merger agreement. We have notified the former shareholders of Vocada that the financial targets were not achieved. In December 2010, the former shareholders filed a demand for arbitration in accordance with their rights under the merger agreement. At March 31, 2011, we have not recorded any obligation relative to these earn-out provisions.

In connection with the acquisition of Commissure, Inc. (Commissure) in September 2007, we agreed to make contingent earn-out payments of up to $8.0 million payable in stock or cash, solely at our discretion, upon the achievement of certain financial targets for the fiscal years 2008, 2009 and 2010. In February 2011, we paid $1.0 million upon determination of the final earn-out achievement and recorded the payment as additional purchase price allocated to goodwill.

Escrow and Holdback Arrangements

In connection with certain of our acquisitions, we have placed either cash or shares of our common stock in escrow to satisfy any claims we may have. If no claims are made, the escrowed amounts will be released to the

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

former shareholders of the acquired companies. Historically, under the previous accounting guidance of SFAS No. 141, *Business Combinations* (SFAS 141), we could not make a determination, beyond a reasonable doubt, whether the escrow would become payable to the former shareholders of these companies until the escrow period had expired. Accordingly, these amounts were treated as contingent purchase price until it was determined that the escrow was payable, at which time the escrowed amounts would be recorded as additional purchase price and allocated to goodwill. Under the revised accounting guidance of ASC 805, escrow payments are generally considered part of the initial purchase consideration and accounted for as goodwill.

During the six months ended March 31, 2011, the last remaining escrowed amounts accounted for under previous accounting guidance expired. Payments totaling $5.2 million were released to former shareholders of X-Solutions Group B.V. and eCopy and were recorded as an increase to goodwill during the period.

6. Goodwill and Intangible Assets

The changes in the carrying amount of goodwill and intangible assets for the six months ended March 31, 2011, are as follows (dollars in thousands):

	Goodwill	Intangible Assets
Balance as of September 30, 2010	$ 2,077,943	$ 685,865
Acquisitions	7,586	8,811
Purchase accounting adjustments	4,645	648
Amortization		(71,703)
Effect of foreign currency translation	9,736	3,747
Balance as of March 31, 2011	$ 2,099,910	$ 627,368

During the six months ended March 31, 2011, in addition to several small purchases of intellectual property, we made an immaterial acquisition of a business that provides voice biometric products for total cash consideration of $12.6 million. Purchase accounting adjustments to goodwill recorded during the six months ended March 31, 2011, included $5.2 million of releases of escrow cash related to our fiscal 2009 acquisitions. This increase in goodwill was partially offset by a $1.4 million reduction resulting from the finalization of the Spinvox purchase accounting.

7. Financial Instruments and Hedging Activities

Cash Flow Hedges

Forward Currency Contracts

We enter into foreign currency contracts to hedge the variability of cash flows in Canadian Dollars (CAD) and Hungarian Forints (HUF) which are designated as cash flow hedges. These contracts settle monthly through October 2011. At March 31, 2011 and September 30, 2010, the notional value and the aggregate cumulative unrealized gains on the outstanding contracts were as follows:

	Notional Value		Aggregate Cumulative Unrealized Gains	
	March 31, 2011	September 30, 2010	March 31, 2011	September 30, 2010
Canadian Dollars	$ 4,917	$ 13,032	$ 412	$ 286
Hungarian Forints	1,591	4,564	333	443
Total contracts designated as cash flow hedges	$ 6,508	$ 17,596	$ 745	$ 729

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NUANCE COMMUNICATIONS, INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Other Derivatives not Designated as Hedges

Forward Currency Contracts

We operate our business in countries throughout the world and transact business in various foreign currencies. Our foreign currency exposures typically arise from transactions denominated in currencies other than the local functional currency of our operations. During fiscal 2011, we commenced a program that primarily utilizes foreign currency forward contracts to offset the risks associated with foreign currency denominated assets and liabilities. We established this program so that gains and losses from remeasurement or settlement of these assets and liabilities are offset by gains or losses on the foreign currency forward contracts thus mitigating the risks and volatility associated with our foreign currency transactions. Generally, we enter into contracts with terms of 30 days or less, and at March 31, 2011 we had outstanding contracts with a total notional value of $96.9 million.

We have not designated these forward contracts as hedging instruments pursuant to ASC 815, *Derivatives and Hedging* and accordingly, we recorded the fair value of these contracts at the end of each reporting period in our consolidated balance sheet, with changes in the fair value recorded in earnings as other income (expense), net in our consolidated statement of operations. During the three and six month periods ended March 31, 2011, we recorded gains of $2.2 million and losses of $0.5 million respectively, associated with these contracts.

Security Price Guarantees

From time to time we enter into agreements that allow us to issue shares of our common stock as part or all of the consideration related to partnering and technology acquisition activities. Generally these shares are issued subject to security price guarantees which are accounted for as derivatives. We have determined that these instruments would not be considered equity instruments if they were freestanding. The security price guarantees require payment from either us to a third party, or from a third party to us, based upon the difference between the price of our common stock on the issue date and an average price of our common stock approximately six months following the issue date. Changes in the fair value of these security price guarantees are reported in earnings in each period as other income (expense), net. During the three and six months ended March 31, 2011, we recorded gains of $3.2 million and $10.4 million, respectively, associated with these contracts. At March 31, 2011, the remaining contracts have matured and we have recorded a receivable of $10.0 million which was collected in April 2011.

The following table provides a summary of the fair value of our derivative instruments as of March 31, 2011 and September 30, 2010 (dollars in thousands):

		Fair Value	
Description	**Balance Sheet Classification**	**March 31, 2011**	**September 30, 2010**
Derivatives Not Designated as Hedges:			
Foreign currency contracts	Prepaid expenses and other current assets	$ 191	$ 767
Security price guarantees	Accrued expenses and other current liabilities		(982)

Net asset (liability) value of non-hedge derivative instruments		$	191	$	(215)
Derivatives Designated as Hedges:					
Foreign currency contracts	Prepaid expenses and other current assets	$	745	$	729
Interest rate swaps	Accrued expenses and other current liabilities				(503)
Net asset value of hedge derivative instruments		$	745	$	226

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NUANCE COMMUNICATIONS, INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following tables summarize the activity of derivative instruments for the three and six months ended March 31, 2011 and 2010, respectively (dollars in thousands):

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

	Amount of Gain (Loss) Recognized in OCI		Location and Amount of Gain (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)		
	2011	2010		2011	2010
Foreign currency contracts	$ 351	$ 64	Other income (expense), net	$ 339	$ 92
Interest rate swaps	$	$ 751	N/A	$	$

Derivatives Designated as Hedges for the Six Months Ended March 31,

	Amount of Gain (Loss) Recognized in OCI		Location and Amount of Gain (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)		
	2011	2010		2011	2010
Foreign currency contracts	$ 513	$ 217	Other income (expense), net	$ 497	$ 92
Interest rate swaps	$	$ 1,408	Interest expense	$ (503)	$

Derivatives Not Designated as Hedges

		Amount of Gain (Loss) Recognized in Income			
		Three Months Ended March 31,		Six Months Ended March 31,	
	Location of Gain (Loss) Recognized in Income	2011	2010	2011	2010
Foreign currency contracts	Other income (expense), net	$ 2,223	$	$ (458)	$
Security price guarantees	Other income (expense), net	$ 3,234	$ 2,636	$ 10,449	$ 4,708

Other Financial Instruments

Financial instruments, including cash equivalents, restricted cash, marketable securities, accounts receivable, accounts payable and derivative instruments, are carried in the consolidated financial statements at amounts that approximate their fair value.

The fair value of our long-term debt was estimated to be $948.9 million and $902.2 million at March 31, 2011 and September 30, 2010, respectively. The increase in the fair value is primarily related to the convertible debt, reflecting the increase in the underlying stock price during the period. These fair value amounts represent the value at which our lenders could trade our debt within the financial markets, and do not represent the settlement value of these long-term debt liabilities to us at each reporting date. The fair value of the long-term debt issues will continue to vary each period based on fluctuations in market interest rates, changes to our credit ratings and, for the outstanding convertible debt, changes in our stock price. These fluctuations may have little to no correlation to our reported debt balances. The term loan portion of our Credit Facility is traded and the fair values are based upon traded prices as of the reporting dates. The fair values of the 2.75% Convertible Debentures at each respective reporting date were estimated using the averages of the March 31, 2011 and September 30, 2010 bid and ask trading quotes. We had no outstanding balance on the revolving credit line portion of our Credit Facility. Our capital lease obligations and other debt are not traded and the fair values of these instruments are assumed to approximate their carrying values as of March 31, 2011 and September 30, 2010.

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NUANCE COMMUNICATIONS, INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

8. Fair Value Measures

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

ASC 820, *Fair Value Measures and Disclosures,* establishes a value hierarchy based on three levels of inputs, of which the first two are considered observable and the third is considered unobservable:

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

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

Level 3. Unobservable inputs.

Assets and liabilities measured at fair value on a recurring basis at March 31, 2011 and September 30, 2010 consisted of the following(dollars in thousands):

	March 31, 2011			
	Level 1	**Level 2**	**Level 3**	**Total**
Assets:				
Money market funds(a)	$ 495,926	$	$	$ 495,926
Time Deposits(b)		26,765		26,765
US government agency securities(a)	1,000			1,000
Marketable securities, $36,867 at cost(b)		36,895		36,895
Foreign currency exchange contracts(b)		936		936
Total assets at fair value	$ 496,926	$ 64,596	$	$ 561,522
Liabilities:				
Contingent earn-out(d)			1,679	1,679
Total liabilities at fair value	$	$	$ 1,679	$ 1,679

	September 30, 2010			
	Level 1	**Level 2**	**Level 3**	**Total**
Assets:				

Money market funds(a)	$ 470,845	$	$	$ 470,845
US government agency securities(a)	1,000			1,000
Marketable securities, $33,337 at cost(b)		33,366		33,366
Foreign currency exchange contracts(b)		1,496		1,496
Total assets at fair value	$ 471,845	$ 34,862	$	$ 506,707
Liabilities:				
Security price guarantees(c)	$	$ 982	$	$ 982
Interest rate swaps(e)		503		503
Contingent earn-out(d)			724	724
Total liabilities at fair value	$	$ 1,485	$ 724	$ 2,209

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NUANCE COMMUNICATIONS, INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(a) Money market funds and US government agency securities, included in cash and cash equivalents in the accompanying balance sheet, are valued at quoted market prices in active markets.

(b) The fair value of our time deposits, marketable securities and foreign currency exchange contracts is based on the most recent observable inputs for similar instruments in active markets or quoted prices for identical or similar instruments in markets that are not active or are directly or indirectly observable.

(c) The fair values of the security price guarantees are determined using a modified Black-Scholes model, derived from observable inputs such as US treasury interest rates, our common stock price, and the volatility of our common stock. The valuation model values both the put and call components of the guarantees simultaneously, with the net value of those components representing the fair value of each instrument.

(d) The fair value of our contingent consideration arrangement is determined based on the Company s evaluation as to the probability and amount of any earn-out that will be achieved based on expected future performance by the acquired entity, as well as our common stock price since the contingent consideration arrangement is payable in shares of our common stock.

(e) The fair values of the interest rate swaps are estimated using discounted cash flow analyses that factor in observable market inputs such as LIBOR based yield curves, forward rates, and credit spreads.

The changes in the fair value of contingent earn-out liabilities during the three and six months ended March 31, 2011 are as follows (dollars in thousands):

	Three Months Ended March 31, 2011	Six Months Ended March 31, 2011
Balance at beginning of period	$ 1,347	$ 724
Charges to acquisition-related costs, net	332	955
Balance as of March 31, 2011	$ 1,679	$ 1,679

Earn-out payments are generally payable based on achieving certain financial targets during defined post-acquisition time periods as specified in the purchase and sale agreement for each acquisition. Changes in the fair value during the three months and six months ended March 31, 2011 resulted from improved revenue performance together with an increase in our stock price during the earn-out period.

9. Current Liabilities

Accrued expenses and other current liabilities consisted of the following (dollars in thousands):

	March 31, 2011		September 30, 2010	
Compensation	$	52,944	$	56,047
Sales and marketing incentives(a)		17,182		40,780
Cost of revenue related liabilities		9,839		10,028
Accrued business combination costs		9,754		10,197
Professional fees		9,099		9,908
Sales and other taxes payable		8,435		5,211
Acquisition costs and liabilities		5,749		4,970
Income taxes payable		1,895		4,357
Security price guarantee				1,034
Other		9,871		9,089
Total	$	124,768	$	151,621

NUANCE COMMUNICATIONS, INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(a) The decrease in accrued sales and marketing incentives was driven by an 18.0 million ($23.4 million equivalent) payment in December 2010 for a fixed obligation assumed in connection with our acquisition of SpinVox. The related 18.0 million of restricted cash was placed in an irrevocable standby letter of credit account at the end of fiscal year 2010 and was released upon satisfaction of the liability in December 2010. At March 31, 2011, we have an additional 5.0 million ($7.1 million equivalent) of restricted cash that has been placed in an irrevocable standby letter of credit for a related liability.

10. Deferred Revenues

Deferred revenue consisted of the following (dollars in thousands):

	March 31, 2011	September 30, 2010
Current Liabilities:		
Deferred maintenance revenue	$ 99,005	$ 90,969
Unearned revenue	78,907	51,371
Total current deferred revenue	$ 177,912	$ 142,340
Long-term Liabilities:		
Deferred maintenance revenue	$ 18,187	$ 12,902
Unearned revenue	59,862	63,696
Total long-term deferred revenue	$ 78,049	$ 76,598

Deferred maintenance revenue consists of prepaid fees received for post-contract customer support for our products, including telephone support and the right to receive unspecified upgrades/enhancements on a when-and-if-available basis. Unearned revenue includes upfront fees for setup and implementation activities related to hosted offerings; certain software arrangements for which we do not have fair value of post-contract customer support, resulting in ratable revenue recognition for the entire arrangement on a straight-line basis; and fees in excess of estimated earnings on percentage-of-completion service contracts.

The increase in the deferred maintenance revenue is primarily related to an increase in Enterprise application maintenance as well as an increase in Imaging maintenance and support. Unearned revenue increased as a result of billings in excess of revenues earned on several large professional service implementation projects as well as set-up fees on new hosting arrangements that will be recognized ratably over the longer of the contract lives, or the expected lives of the customer relationship.

11. Business Combination Costs

The activity for the six months ended March 31, 2011, relating to all facilities and personnel recorded in accrued business combination costs, is as follows (dollars in thousands):

	Facilities	Personnel	Total
Balance at September 30, 2010	$ 23,871	$ 159	$ 24,030
Charged to restructuring and other charges, net	93	(100)	(7)
Charged to interest expense	472		472
Cash payments, net of sublease receipts	(6,076)	(59)	(6,135)
Balance at March 31, 2011	$ 18,360	$	$ 18,360

NUANCE COMMUNICATIONS, INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	March 31, 2011	September 30, 2010
Reported as:		
Other current liabilities	$ 9,754	$ 10,197
Other liabilities	8,606	13,833
Total	$ 18,360	$ 24,030

12. Restructuring and Other Charges, net

The following table sets forth the six months ended March 31, 2011 accrual activity relating to restructuring and other charges (dollars in thousands):

	Personnel	Facilities	Other	Total
Balance at September 30, 2010	$ 1,838	$ 283	$	$ 2,121
Restructuring and other charges, net	3,031	1,362	93	4,486
Cash payments	(3,424)	(629)	(93)	(4,146)
Balance at March 31, 2011	$ 1,445	$ 1,016	$	$ 2,461

For the six months ended March 31, 2011, we recorded net restructuring and other charges of $4.5 million, which included $3.0 million of severance and other costs related to the elimination of approximately 90 personnel across multiple functions worldwide, primarily within costs of sales, and $1.4 million related to facilities that we no longer occupy.

13. Credit Facilities and Debt

2.75% Convertible Debentures

We have $250 million of 2.75% convertible senior debentures due in August 2027. As of March 31, 2011, no conversion triggers were met. If the conversion triggers were met, we could be required to repay all or some of the principal amount in cash prior to maturity.

Credit Facility

We have a credit facility which consists of a $75 million revolving credit line, reduced by outstanding letters of credit, a $355 million term loan entered into on March 31, 2006, a $90 million term loan entered into on April 5, 2007 and a $225 million term loan entered into on August 24, 2007 (collectively the Credit Facility). The term loans are due March 2013 and the revolving credit line is due March 2012. As of March 31, 2011, $640.2 million remained outstanding under the term loans, there were $21.3 million of letters of credit issued under the revolving credit line and there were no other outstanding borrowings under the revolving credit line. As of March 31, 2011, we were in compliance with the covenants under the Credit Facility.

As of March 31, 2011, based on our leverage ratio, the applicable margin for our term loan was 0.75% for base rate borrowings and 1.75% for LIBOR-based borrowings. This results in an effective interest rate of 2.02%. No payments under the excess cash flow sweep provision were due in the first quarter of fiscal 2011 as no excess cash flow, as defined, was generated in fiscal 2010. At the current time, we are unable to predict the amount of the outstanding principal, if any, that we may be required to repay in future fiscal years pursuant to the excess cash flow sweep provisions.

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NUANCE COMMUNICATIONS, INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

14. Net Income (Loss) Per Share

The following table sets forth the computation for basic and diluted net income (loss) per share for the three and six months ended March 31, 2011 and 2010. (amounts in thousands, except per share amounts):

	Three Months Ended March 31,		Six Months Ended March 31,	
	2011	2010	2011	2010
Numerator:				
Basic				
Net income (loss) available to common stockholders basic	$ 1,735	$ (15,396)	$ 1,726	$ (19,674)
Diluted				
Net income (loss) available to common stockholders diluted	$ 1,735	$ (15,396)	$ 1,726	$ (19,674)
Denominator:				
Basic				
Weighted average common shares outstanding	300,937	284,994	299,772	281,998
Diluted				
Weighted average common shares outstanding basic	300,937	284,994	299,772	281,998
Weighted average effect of dilutive common equivalent shares:				
Assumed conversion of Series B Preferred Stock	3,562		3,562	
Employee stock compensation plan	8,593		8,264	
Warrants	1,514		1,367	
Other contingently issuable shares	150		187	
Weighted average common shares outstanding diluted	314,756	284,994	313,152	281,998
Net income (loss) per share:				
Basic	$ 0.01	$ (0.05)	$ 0.01	$ (0.07)
Diluted	$ 0.01	$ (0.05)	$ 0.01	$ (0.07)

Common equivalent shares are excluded from the computation of diluted net income (loss) per share if their effect is anti-dilutive. Potentially dilutive common equivalent shares aggregating to 3.9 million shares for the three and six months ended March 31, 2011, and 21.8 million and 23.6 million shares for the three and six months ended March 31, 2010, respectively, have been excluded from the computation of diluted net income (loss) per share because their inclusion would be anti-dilutive.

15. Stockholders Equity

We have, from time to time, entered into stock and warrant agreements with Warburg Pincus. In connection with these agreements, we granted Warburg Pincus the right to request that we use commercially reasonable efforts to register some or all of the shares of common stock issued to them pursuant to the purchase agreements, including

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NUANCE COMMUNICATIONS, INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

shares of common stock underlying the warrants. At March 31, 2011, Warburg Pincus holds the following warrants to purchase shares of our common stock:

Issuance Date	Price per Share	Total Shares	Expiration Date
January 29, 2009	$ 11.57	3,862,422	January 29, 2013
May 20, 2008	20.00	3,700,000	May 20, 2012

16. Stock-Based Compensation

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

	Three Months Ended March 31,		Six Months Ended March 31,	
	2011	2010	2011	2010
Cost of product and licensing	$ 21	$ 9	$ 27	$ 18
Cost of professional services and hosting	9,062	2,913	14,750	5,561
Cost of maintenance and support	637	202	1,027	417
Research and development	8,041	2,419	12,908	4,449
Sales and marketing	12,097	8,779	22,407	17,297
General and administrative	13,761	10,386	24,598	17,032
Total	$ 43,619	$ 24,708	$ 75,717	$ 44,774

Included in stock-based compensation for the three and six months ended March 31, 2011 is $6.9 million and $13.1 million, respectively, of expense related to awards that will be made as part of the fiscal 2011 annual bonus plan to employees. The annual bonus pool is determined by management and approved by the Compensation Committee of the Board of Directors based on financial performance targets approved at the beginning of the year. If these targets are achieved, the awards will be settled in shares based on the total bonus earned and the grant date fair value of the shares awarded to each employee.

Stock Options

The table below summarizes activity relating to stock options for the six months ended March 31, 2011:

	Weighted	Weighted Average

	Number of Shares		Average Exercise Price	Remaining Contractual Term		Aggregate Intrinsic Value(1)
Outstanding at September 30, 2010	10,703,237	$	8.44			
Granted	1,000,000	$	16.44			
Exercised	(1,279,908)	$	6.56			
Forfeited	(83,928)	$	13.02			
Expired	(35,681)	$	13.81			
Outstanding at March 31, 2011	10,303,720	$	9.39	3.4 years	$	104.7 million
Exercisable at March 31, 2011	8,051,151	$	7.90	2.7 years	$	93.9 million
Exercisable at March 31, 2010	8,461,430	$	6.74	3.1 years	$	84.2 million

(1) The aggregate intrinsic value in this table was calculated based on the positive difference, if any, between the closing market value of our common stock on March 31, 2011 ($19.55) and the exercise price of the underlying options.

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NUANCE COMMUNICATIONS, INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

As of March 31, 2011, the total unamortized fair value of stock options was $8.1 million with a weighted average remaining recognition period of 1.0 years. A summary of weighted-average grant-date fair value of stock options granted and intrinsic value of stock options exercised is as follows:

	Six Months Ended March 31, 2011	Six Months Ended March 31, 2010
Weighted-average grant-date fair value per share	$ 6.13	$ 5.90
Total intrinsic value of stock options exercised (in millions)	$ 15.3	$ 27.0

We use the Black-Scholes option pricing model to calculate the grant-date fair value of an award. The fair value of the stock options granted during the six months ended March 31, 2011 and 2010 were calculated using the following weighted-average assumptions:

	Six Months Ended March 31, 2011	Six Months Ended March 31, 2010
Dividend yield	0.0%	0.0%
Expected volatility	46.1%	50.9%
Average risk-free interest rate	1.2%	2.4%
Expected term (in years)	4.1	4.2

Restricted Units

Restricted Units are not included in issued and outstanding common stock until the shares are vested and released. The table below summarizes activity relating to Restricted Units for the six months ended March 31, 2011:

	Number of Shares Underlying Restricted Units Contingent Awards	Number of Shares Underlying Restricted Units Time-Based Awards
Outstanding at September 30, 2010	2,867,840	7,795,114
Granted	970,233	2,920,937
Earned/released	(1,236,111)	(2,648,134)
Forfeited	(254,682)	(395,492)
Outstanding at March 31, 2011	2,347,280	7,672,425

Weighted average remaining contractual term of outstanding Restricted Units		1.1 years		1.2 years
Aggregate intrinsic value of outstanding Restricted Units(1)	$	45.9 million	$	150.0 million
Restricted Units vested and expected to vest		2,155,566		7,088,778
Weighted average remaining contractual term of Restricted Units vested and expected to vest		1.1 years		1.2 years
Aggregate intrinsic value of Restricted Units vested and expected to vest(1)	$	42.1 million	$	138.6 million

(1) The aggregate intrinsic value in this table was calculated based on the positive difference between the closing market value of our common stock on March 31, 2011 ($19.55) and the exercise price of the underlying Restricted Units.

The purchase price for vested Restricted Units is $0.001 per share. As of March 31, 2011, unearned stock-based compensation expense related to all unvested Restricted Units is $126.5 million, which will, based on

NUANCE COMMUNICATIONS, INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

expectations of future performance vesting criteria, where applicable, be recognized over a weighted-average period of 1.7 years.

A summary of weighted-average grant-date fair value and intrinsic value of all Restricted Units vested is as follows:

	Six Months Ended, March 31,	
	2011	2010
Weighted-average grant-date fair value per share	$ 17.34	$ 15.05
Total intrinsic value of shares vested (in millions)	$ 67.7	$ 36.2

17. Income Taxes

	Three Months Ended March 31,		Six Months Ended March 31,	
	2011	2010	2011	2010
Income (loss) before income taxes	$ 4,122	$ (13,108)	$ 10,134	$ (17,046)
Provision for income taxes	$ 2,387	$ 2,288	$ 8,408	$ 2,628
Effective tax rate	57.9%	(17.5)%	83.0%	(15.4)%

The change in the effective tax rate primarily relates to the tax provision on U.S. profits in the three and six months ended March 31, 2011 as compared to U.S. losses in the prior periods for which no tax benefit has been recognized as the realization of such tax benefit is not more likely than not.

The increase in the income tax provision for the six months ended March 31, 2011 as compared to the same period in 2010 is substantially due to higher income before income taxes for the current period. The increase in income tax expense was offset by a decrease in our foreign withholding taxes and certain discrete foreign tax benefits recorded in the six months ended March 31, 2010 that did not recur.

At March 31, 2011 and September 30, 2010, the liability for income taxes associated with uncertain tax positions was $13.2 million and $12.8 million, respectively. The increase is primarily attributable to accrued interest. We do not expect a significant change in the amount of unrecognized tax benefits within the next twelve months.

18. Commitments and Contingencies

Litigation and Other Claims

Like many companies in the software industry, we have, from time to time, been notified of claims that we may be infringing, or contributing to the infringement of, the intellectual property rights of others. These claims have been referred to counsel, and they are in various stages of evaluation and negotiation. If it appears necessary or desirable, we may seek licenses for these intellectual property rights. There is no assurance that licenses will be offered by all claimants, that the terms of any offered licenses will be acceptable to us or that in all cases the dispute will be resolved without litigation, which may be time consuming and expensive, and may result in injunctive relief or the payment of damages by us.

Vianix LLC has filed three legal actions against us, consisting of two breach of contract actions and a copyright infringement claim. These matters were concluded during the three months ended March 31, 2011. The resolution of these matters did not have a material impact on our financial statements or liquidity.

We do not believe that the final outcome of the above litigation matters will have a material adverse effect on our financial position and results of operations. However, even if our defense is successful, the litigation could require significant management time and will be costly. Should we not prevail, our operating results, financial position and cash flows could be adversely impacted.

NUANCE COMMUNICATIONS, INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Guarantees and Other Commitments

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

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

19. Segment and Geographic Information and Significant Customers

We follow the provisions of ASC 280, *Segment Reporting*, which establishes standards for reporting information about operating segments. ASC 280 also established standards for disclosures about products, services and geographic areas. Operating segments are defined as components of an enterprise for which separate financial information is available and evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance. Our chief operating decision maker (CODM) is the Chief Executive Officer of the Company.

We have four customer-facing market groups that oversee the core markets where we conduct business. These groups are referred to as Healthcare, Mobile and Consumer, Enterprise and Imaging. These groups do not directly manage centralized or shared resources or make allocation decisions regarding the activities related to these functions, which include sales and sales operations, certain research and development initiatives, business development and all general and administrative activities. Our CODM oversees these groups as well as each of the functions that provide the shared and centralized activities noted above. To manage the business, allocate resources and assess performance, the CODM regularly reviews revenue data by market group, while reviewing gross margins, operating margins, and other measures of income or loss on a consolidated basis. Thus, we have determined that we operate in one segment.

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

	Three Months Ended March 31,		Six Months Ended March 31,	
	2011	2010	2011	2010

Healthcare	$ 120,697	$ 105,831	$ 238,134	$ 211,357
Mobile and Consumer	93,116	77,768	179,229	141,861
Enterprise	72,315	70,935	143,364	146,300
Imaging	32,834	18,471	62,064	36,464
Total Revenue	$ 318,962	$ 273,005	$ 622,791	$ 535,982

NUANCE COMMUNICATIONS, INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

	Three Months Ended March 31, 2011	Three Months Ended March 31, 2010	Six Months Ended March 31, 2011	Six Months Ended March 31, 2010
United States	$ 232,261	$ 187,544	$ 463,951	$ 374,042
International	86,701	85,461	158,840	161,940
Total	$ 318,962	$ 273,005	$ 622,791	$ 535,982

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

	March 31, 2011	September 30, 2010
United States	$ 2,425,817	$ 2,479,952
International	453,441	448,105
Total	$ 2,879,258	$ 2,928,057

20. Subsequent Event

On May 10, 2011, we entered into an agreement to acquire Equitrac Corporation, a provider of intelligent print management and cost recovery software, for approximately $157 million in cash. We expect to close this transaction in the fourth quarter of fiscal 2011, subject to certain closing conditions.

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CAUTIONARY NOTE CONCERNING FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q including the sections entitled Management s Discussion and Analysis of Financial Condition and Results of Operations and Quantitative and Qualitative Disclosure About Market Risk under Items 2 and 3, respectively, of Part I of this report, and the sections entitled Legal Proceedings, Risk Factors, and Unregistered Sales of Equity Securities and Use of Proceeds under Items 1, 1A and 2, respectively, of Part II of this report, contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 that involve risks, uncertainties and assumptions that, if they never materialize or if they prove incorrect, could cause our consolidated results to differ materially from those expressed or implied by such forward-looking statements. These forward-looking statements include predictions regarding:

- our future revenues, cost of revenues, research and development expenses, selling, general and administrative expenses, amortization of intangible assets and gross margin;
- our strategy relating to our core markets;
- the potential of future product releases;
- our product development plans and investments in research and development;
- future acquisitions, and anticipated benefits from 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 on Form 10-Q.

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. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. 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.

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

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

OVERVIEW

Business Overview

Nuance Communications, Inc. is a leading provider of voice and language solutions for businesses and consumers around the world. Our technologies, applications and services make the user experience more compelling by transforming the way people interact with devices and systems. Our solutions are used every day by millions of people and thousands of businesses for tasks and services such as requesting information from a phone-based self-service solution, dictating medical records, searching the mobile Web by voice, entering a destination into a navigation system, or working with PDF documents. Our solutions help make these interactions, tasks and experiences more productive, compelling and efficient.

Core Markets

Our technologies address our four core markets, each of which is described in greater detail below.

Healthcare. Our healthcare products and services enable our customers to automate manual functions, and manage information and workflows. A significant component of sales in our healthcare market are for on-demand solutions hosted by Nuance and priced by the volume of services used by the customer, primarily for healthcare information management. With these solutions, we provide software and labor to transcribe information dictated by healthcare providers that go into patient files, and to manage the associated workflows. The healthcare information management market is migrating away from unstructured, distributed files toward structured, computer-accessible, searchable files generally known as electronic medical records or EMRs. Our solutions address both the old unstructured files and EMRs, and we are able to provide technology and services that help our customers through this transition. In addition to healthcare information management, we provide solutions for areas such as radiology, diagnostics, critical test results management, mobile access to systems, and processing data contained in medical records. Trends in our healthcare business include a growing customer preference for hosted solutions, increasing interest in the use of mobile devices to access healthcare systems and records, and increasing international interest. Over the last several quarters, we have signed several new contracts for our hosted solutions, and the volume of lines processed in these services has steadily increased. We are investing to expand our product set to address these opportunities, expand our international capabilities, and reduce our time from contract signing to initiation of billable services.

Mobile and Consumer. The majority of sales in our mobile-consumer market are for voice recognition, text-to-speech and enhanced keyboard functionality that is embedded in a device (such as a cell phone, car or tablet computer) or installed on a personal computer. There is a growing trend toward supplementing those solutions with mobile connected services such as Internet search, dictation and transcription of voice messages, that are performed on hosted Nuance servers and accessed by mobile devices using the Internet or mobile telephony network, and also for applications that can be downloaded onto mobile devices. Trends in our mobile-consumer market also include device manufacturers requiring custom applications to deliver unique and differentiated products, broadening keyboard technologies to take advantage of touch screens, increasing hands-free capabilities on cell phones and automobiles to address the growing concern of distracted driving, and the adoption of our technology on a broadening scope of devices, such as televisions, set-top boxes, e-book readers and tablet computers. We are investing to increase our capabilities and capacity to help device manufacturers build custom applications, to increase the capacity of our data centers, to increase the number, kinds and capacity of network services, to enable developers to access our technology, and to expand both awareness and channels for our direct-to-consumer products.

Enterprise. Sales in our enterprise market include on-demand solutions hosted by Nuance and priced by the volume of services used by the customer, as well as professional services to design, implement and integrate custom call center applications. Our objective for enterprise is to increase revenue, primarily by enabling customers to automate call center operations and call handling, and also to provide improved ability to analyze and use call center data, to enable mobile access, and to improve cross-channel coordination among call center, Internet and mobile customer-care functions. The call center market is migrating away from simple menu-driven applications toward more sophisticated, easier to use applications based on natural language capabilities. Our solutions address both menu-driven and natural language applications. In addition, we provide solutions for areas such as mobile access to customer care systems and call center analytics. Trends in our enterprise business include increasing interest in the use of mobile applications to access customer care systems and records, increasing interest in coordinating actions and data across customer care channels, and the ability of a broader set of hardware providers and systems integrators to serve the market. We are investing to expand our product set to address these opportunities, to increase efficiency of our hosted applications, expand our capabilities and capacity to help customers build custom applications, and broaden our relationships with new hardware and systems integrator partners serving the market.

Imaging. Sales in our imaging market include document capture solutions embedded in copiers and multi-function printers and packaged software for document management. The imaging market is evolving to include more networked solutions, mobile access to networked solutions, and multi-function devices. We are investing to improve mobile access to our networked products, expand our distribution channels and embedding relationships, and expand our language coverage.

Acquisitions

We have supplemented organic growth with acquisitions. Over the last few years, our acquisitions have focused on adding new solutions that take advantage of our core technology, adding functionality to our existing solutions, expanding our sales and professional services teams, and expanding our customer base. We expect that new uses for our core technologies will continue to emerge and that international opportunities will grow. We expect that we will continue to serve evolving market opportunities through a combination of organic growth, acquisitions and strategic partnerships.

We believe we can fund our future acquisitions with our internally available cash, cash equivalents and marketable securities, cash generated from operations, amounts available under our existing debt capacity, additional borrowings or from the issuance of additional securities. We estimate the financial impact of any potential acquisition with regard to earnings, operating margin and cash flow targets before deciding to move forward with an acquisition.

Key Metrics

In evaluating the financial condition and operating performance of our business, management focuses on revenue, net income, gross margins, operating margins and cash flow from operations. A summary of these key financial metrics for the six months ended March 31, 2011, as compared to the six months ended March 31, 2010, is as follows:

Total revenue increased by $86.8 million to $622.8 million;

Net income increased by $21.4 million to $1.7 million;

Gross margins decreased by 2.1 percentage points to 61.1%;

Operating margins increased by 3.3 percentage points to 2.9%; and

Cash provided by operating activities increased by $38.8 million to $159.4 million.

In addition to the above key financial metrics, we also focus on certain non-financial performance indicators. A summary of these key non-financial performance indicators for the six months ended March 31, 2011, as compared to the six months ended March 31, 2010, is as follows:

Annualized line run-rate in our on-demand healthcare solutions increased 16% to approximately 3.650 billion lines per year. The annualized line run-rate is determined using billed equivalent line counts in a given quarter, multiplied by four;

Enterprise professional services backlog hours increased 25% to 333,000 hours. Professional services backlog hours reflect the accumulated estimated hours necessary to fulfill all of our existing, executed professional services contracts within the enterprise business, including those that are cancelable by customers, based on the original estimate of hours sold;

Estimated 3-year value of on-demand contracts increased 20% to $1.2 billion We determine this value by using our best estimate of all anticipated future revenue streams under signed on-demand contracts currently in place, whether or not they are guaranteed through a minimum commitment clause. Our best estimate is based on assumptions about launch dates, volumes and renewal rates within the three year period. Most of these contracts are priced by volume of usage and typically have no or low minimum commitments. Actual revenue could vary from our estimates due to factors such as cancellations, non-renewals or volume fluctuations.

RESULTS OF OPERATIONS

TOTAL REVENUES

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

	Three Months Ended March 31, 2011	Three Months Ended March 31, 2010	Dollar Change	Percent Change	Six Months Ended March 31, 2011	Six Months Ended March 31, 2010	Dollar Change	Percent Change
Healthcare	$ 120.7	$ 105.8	$ 14.9	14.1%	$ 238.1	$ 211.3	$ 26.8	12.7%
Mobile and Consumer	93.1	$ 77.8	15.3	19.7%	$ 179.2	$ 141.9	$ 37.3	26.3%
Enterprise	72.3	70.9	1.4	2.0%	143.4	146.3	(2.9)	(2.0)%
Imaging	32.9	18.5	14.4	77.8%	62.1	36.5	25.6	70.1%
Total Revenues	$ 319.0	$ 273.0	$ 46.0	16.8%	$ 622.8	$ 536.0	$ 86.8	16.2%
United States	$ 232.3	$ 187.5	$ 44.8	23.9%	$ 464.0	$ 374.1	$ 89.9	24.0%
International	86.7	85.5	1.2	1.4%	158.8	161.9	(3.1)	(1.9)%
Total Revenues	$ 319.0	$ 273.0	$ 46.0	16.8%	$ 622.8	$ 536.0	$ 86.8	16.2%

For the three months ended March 31, 2011, revenues increased in all of our core markets as compared to the three months ended March 31, 2010. The increase in Healthcare was primarily driven by increases in professional services and hosting revenues of $11.1 million. Mobile and Consumer revenue increased primarily as a result of the $7.3 million of additional product and licensing revenues as well as a $6.7 million increase in professional services and hosting revenues. The Imaging revenue increase was attributable to growth in product and licensing revenues.

For the six months ended March 31, 2011, revenue increased in Healthcare, Mobile and Consumer and Imaging as compared to the six months ended March 31, 2010. These increases in revenue were offset by a slight decrease in Enterprise revenues. Healthcare revenues increased $26.8 million driven by a $21.1 million increase in professional services and hosting revenues. Mobile and Consumer revenues increased $37.3 million, with a $17.7 million increase in product and license revenues as well as an $18.7 million increase in professional services and hosting revenues. Enterprise revenues decreased slightly, consisting of an $8.8 million decrease in professional services and hosting revenue, offset by an increase of $4.9 million in product and licensing revenues. Imaging revenues increased all driven by growth in product and licensing revenues.

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Product and Licensing Revenue

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

	Three Months Ended March 31,		Dollar	Percent	Six Months Ended March 31,	Dollar	Percent
	2011	2010	Change	Change			