Nuance Communications, Inc.
Form 10-K/A
December 15, 2006

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THIS DOCUMENT IS A COPY OF THE FORM 10-K/A FILED ON DECEMBER 15, 2006
PURSUANT TO A RULE 201 TEMPORARY HARDSHIP EXEMPTION

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

Form 10-K/A
(Amendment No. 1 to Form 10-K)

(Mark One)

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended September 30, 2006

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from to

Commission file number 0-27038

NUANCE COMMUNICATIONS, INC.
(Exact name of Registrant as Specified in its Charter)

Delaware	**94-3156479**
(State or Other Jurisdiction of Incorporation or Organization)	*(I.R.S. Employer Identification No.)*
1 Wayside Road Burlington, Massachusetts	**01803**
(Address of Principal Executive Offices)	*(Zip Code)*

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

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:
None

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:
Common Stock, par value $0.001 per share
Preferred Share Purchase Rights

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes þ No o

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No þ

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. 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). Yes o No þ

The aggregate market value of the outstanding common equity held by non-affiliates of the Registrant as of the last business day of the Registrant s most recently completed second fiscal quarter was approximately $1,514,563,908 based upon the last reported sales price on the Nasdaq National Market for such date. For purposes of this disclosure, shares of Common Stock held by officers and directors of the Registrant and by persons who hold more than 5% of the outstanding Common Stock have been excluded because such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily conclusive.

The number of shares of the Registrant s Common Stock, outstanding as of November 30, 2006, was 170,981,880.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant s definitive Proxy Statement to be delivered to stockholders in connection with the Registrant s 2007 Annual Meeting of Stockholders are incorporated by reference into Part III of this Form 10-K.

NUANCE COMMUNICATIONS, INC.

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Explanatory Note

The Amendment No. 1 is being filed solely to file a conforming electronic copy of our Annual Report on Form 10-K/A that was filed with the Securities and Exchange Commission on December 15, 2006 pursuant to a rule 201 temporary hardship exemption.

PART I

This Annual Report on Form 10-K contains forward-looking statements within the meaning of the Federal securities laws that involve risks, uncertainties and assumptions that, if they never materialize or if they prove incorrect, could cause our results to differ materially from those expressed or implied by such forward-looking statements. All statements other than statements of historical fact are statements that could be deemed forward-looking, including statements pertaining to: our revenue, earnings, cash flows and liquidity; 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; international operations and localized versions of our products; our contractual commitments; our 2007 revenue expectations 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, estimates, predicts, intends, potential, continue or the negative of such terms, or other 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 as a result of various factors, including those set forth in this Annual Report under the heading Risk Factors. All forward-looking statements included in this document are based on information available to us on the date hereof. We will not undertake and specifically decline any obligation to update any forward-looking statements.

Item 1. *Business*

Introduction

Nuance Communications, Inc. is 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.

The value of our solutions is best realized in markets that are information and process-intensive, such as healthcare, telecommunications, financial services, legal services and government administration. We deliver premier, comprehensive technologies and services as an independent application or as part of a larger integrated system. We are an active participant in rapidly growing markets for speech, including healthcare dictation and transcription, call center automation, mobile search and communication and embedded technologies for consumer products. In imaging, we are positioned to benefit from increasing demand for PDF and networked imaging solutions.

Every day, millions of users and thousands of businesses experience Nuance by calling directory assistance, getting account information over a telephone, dictating patient records, controlling mobile phones using their voice or reproducing documents that can be shared and searched. As of September 30, 2006, we have deployed thousands of speech applications for some of the world s most respected companies, manufacturers and healthcare organizations. Our imaging devices are used by millions of business professionals and are included in hundreds of imaging devices and applications.

Today, we offer the world s largest portfolio of speech and imaging products backed by the expertise of our professional services organization and a partner network that can create solutions for businesses and organizations around the globe. 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).*

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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. From our founding until 2001, we focused exclusively on delivering imaging solutions that simplified converting and managing information as it moved from paper formats to electronic systems. In December 2001, we entered the speech market through the acquisition of the Speech & Language Technology Business from Lernout & Hauspie. We believed speech solutions were a natural complement to our imaging solutions as both are developed, marketed and delivered through similar resources and channels. We continue to execute against our strategy of being the market leader in speech solutions through the organic growth of our business as well as through strategic acquisitions. 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. Acquisitions completed in recent fiscal years include 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.

To partially finance our acquisition of Dictaphone, on March 31, 2006 we entered into a new senior secured credit facility which consists of a $355.0 million 7-year term loan and a $75.0 million six-year revolving credit line.

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. Except as otherwise indicated, all references in this report to Nuance , the Company , we , our or ScanSoft, refer to Nuance Communications, Inc.

Market Opportunity

In the past decade, information has become an increasingly important resource for businesses and enterprises. The ability to access, exchange and manage information with speed and sophistication through various means information systems, dictation processes, call centers, documents, mobile devices is often an important characteristic of the most successful organizations worldwide. Many organizations define their strategy and assess their ability to compete and manage their customer relationships based on the quality, diversity and availability of their information products, services and resources. The format of vital information is wide and varied, ranging from the spoken word in multiple languages to customer database systems to paper, electronic files and Internet content.

Confronted by exponentially increasing information through more and more channels, consumers, business personnel and healthcare professionals employ a variety of resources for retrieving information, transcribing patient information, conducting transactions and performing their jobs. The Internet, telecommunications systems, wireless and mobile networks and related corporate infrastructure have emerged as powerful global communications networks and channels for conducting business.

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These electronic systems have fundamentally changed the way organizations and consumers obtain information, communicate, purchase goods and conduct business. Today, businesses and manufacturers around the world share a common motivation to enhance the service they provide to their customers and differentiate their offerings while improving operating efficiency. Customer satisfaction, employee productivity and company operating results can often be linked to an organization s ability to manage, utilize and communicate information effectively.

Nuance Solutions

We create technologies, applications and solutions that transform the way people access, share, manage and use information, both in business and in daily life. We help enterprises, professionals and consumers increase productivity, reduce costs and save time by developing and commercializing new technologies that make the user experience more compelling and productive. Our speech offerings utilize the human voice, and we are advancing towards our vision of the future where natural conversations will be the preferred interface for these interactions and will make the user experience more compelling. Our imaging solutions build on decades of experience and technology development to deliver businesses, manufacturers and consumers a broad set of PDF and document offerings.

We provide a broad set of speech and imaging offerings to our customers that increase their end users productivity, reduce costs and save time in the following areas:

Customer Care and Call Center Automation

Organizations turn to our speech solutions as a means to improve the quality of their customer care while reducing the associated costs and ensuring a positive customer experience. Our speech solutions allow users to direct their own calls, obtain information and conduct transactions by simply speaking naturally over any telephone.

Our speech solutions are used within a wide range of applications across many customer-service intensive sectors, including financial services, telecommunications, healthcare, utilities, government, travel and entertainment. For example, our software is integrated into applications that provide flight information, personal banking, equipment repair and claims processing. We provide an extensive portfolio of speech technologies and applications that offer superior accuracy, support up to 49 languages and dialects for our speech recognition and offer 26 languages in our natural sounding synthesized speech. Our solutions adhere to global industry standards and we provide speech technologies and services in more languages than any other vendor worldwide.

These speech solutions are licensed to enterprises, such as those in the Fortune 1000, and telecommunications carriers. Although in certain cases we sell directly to our customer, the majority of our solutions are fulfilled through our channel networks comprised of telecommunications equipment companies, systems integrators and technology providers, such as Avaya, Cisco, Genesys, Intervoice and Nortel, that integrate our solutions into their proprietary hardware and software platforms.

We complement our technologies and products with a global professional services organization that supports customers and partners with business and systems consulting project management, user interface design and application development assistance. We service our customers from our corporate headquarters in Burlington, Massachusetts and through other principal offices located in the United States, Canada, Belgium, Israel and Japan.

Healthcare Dictation and Transcription

The healthcare industry is under pressure to streamline operations and reduce costs while at the same time find new ways to improve patient care. In recent years, the healthcare industry comprising hospitals, clinics, medical groups, physicians offices, insurance providers and service organizations has increasingly turned to speech solutions to automate manual processes, especially with respect to dictation and transcription.

Today, clinical documentation is based largely on the manual transcription of recorded physician dictation, representing a significant industry worldwide. This presents an opportunity for us to apply speech technologies to automate manual processes, reduce costs, speed access to accurate data, and significantly improve patient care.

We are a leading supplier of speech recognition solutions to the healthcare industry through desktop and integrated OEM dictation products, and recently through complete transcription processing and workflow solutions. In March 2006, we acquired Dictaphone Corporation to expand our product portfolio, market reach and revenue streams within the large and rapidly growing healthcare vertical.

Today, more than 3,000 hospitals, clinics, and group practices, and over 400,000 physicians, use our Dictaphone healthcare solutions to manage the dictation and transcription of patient records. Our voice platform helps reduce the high cost of medical reporting, manage both a traditional transcription workflow and the use of in-house speech recognition and reduce the reliance on manual transcription. Our enterprise-level speech recognition includes phone-based dictation, transcriptionist editing tools and physician self-completion control.

Desktop Dictation

Our desktop dictation applications increase productivity by using speech to create documents, streamline repetitive and complex tasks, input data, complete forms and automate manual transcription processes. The Dragon NaturallySpeaking family of products delivers enhanced productivity for professionals and consumers who need to create documents and transcripts. Professionals and consumers also look to our dictation solutions as a way to maximize the productivity of their existing workers, including those with disabilities, and to comply with government requirements relating to workplace safety and accessibility.

Our Dragon NaturallySpeaking solutions allow users to automatically convert speech into text at up to 160 words-per-minute. Our software supports a vocabulary of more than 300,000 words that can be expanded by users to include specialized words and phrases, is designed to adapt to individual voice patterns and accents and is able to achieve accuracy rates of up to 99%.

We offer a range of desktop and server solutions, each with features that match a specific customer target. Our dictation software is currently available in eight languages. We utilize a combination of our global reseller network and direct sales to distribute our speech recognition and dictation products.

Embedded Speech for Mobile Devices and Consumer Products

Voice capabilities are becoming ubiquitous in consumer and mobile devices, from cell phones and PDAs to automobiles and navigation systems. Our embedded speech solutions add voice control capabilities to these devices, allowing people to use spoken words or commands for dialing a mobile phone by saying a name, entering destination information into an automotive navigation system, dictating a text message or having emails and screen information read aloud.

Our embedded speech solutions identify specific words and phrases at any moment in time and convert these spoken words into instructions that control specific functions within applications. Our solutions support dynamic vocabularies and have sophisticated noise management capabilities that improve accuracy, even in noisy environments. Our products scale to meet the size and accuracy requirements for automotive and navigation systems and offer rapid application development tools, extensive compatibility with hardware and operating systems and support of multiple languages.

Our embedded speech solutions are used by automobile, cell phone, entertainment and aftermarket system manufacturers and their suppliers including Alpine, Bosch-Blaupunkt, Delphi, General Motors, LG, Microsoft, Motorola, Nokia, Pioneer, Samsung, Sony and Visteon. These technologies are included as part of a larger system, application or solution that is designed, manufactured and sold by our customers. These customers include handset and other device manufacturers and tier-one suppliers; companies whose size and importance qualify them to be direct suppliers to the major automotive manufacturers as well as in-dash radio, navigation system and other electronic device manufacturers.

Mobile Search and Communication

The mobile device and wireless phone market is one of the fastest growing technology markets in the world and the opportunity to provide content, advertising, and services creates a significant opportunity. While many phones and devices today have Web and data capabilities, advanced mobile phone functionality and much of the available mobile content remains virtually invisible to users because it is too deeply hidden in confusing menu hierarchies. We believe speech technology provides a means to overcome these challenges and create growth for mobile services.

Our mobile speech solutions, comprising elements from many of our dictation, network and embedded speech solutions, offer an innovative approach to accessing search and communications services on mobile devices. We offer user interaction with mobile search and communications applications that enable consumers to significantly increase the utility of their mobile devices, while enabling handset vendors and service providers to tap into significant new sources of revenue.

Our search and communication solutions allow consumers to use their voices to browse and download mobile content including ringtones, music, videos, wallpapers, and games; search local information databases for business listings, yellow pages, restaurant guides and movie schedules by naturally speaking their requests; dictate text messages to mobile instant messaging and mobile email dictation significantly faster than with the keypad; and allow wireless subscribers to access their personal or public address books, calendar and a range of information services using simple speech commands.

PDF and Document Imaging Solutions

Our PDF and document imaging solutions help businesses and consumers by automating a range of document processes increasing productivity, saving time and reducing costs. With products for enterprises, small-to-medium-sized businesses and home offices, our ScanSoft 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 OmniPage product family uses optical character recognition technology to deliver highly accurate document and PDF conversion, replacing the need to manually re-create documents. Our OmniPage applications are used by individuals and in professional office settings. We utilize a combination of our global reseller network and direct sales to distribute our document conversion and PDF products. We license our software to companies such as Brother, Canon, Dell, HP and Xerox, which bundle our solutions with multifunction devices, digital copiers, printers and scanners. We also license software development toolkits to independent software vendors who use our technology for production capture or desktop applications, including vendors such as Autodesk, Canon, EMC/Captiva, Filenet, Kofax, Microsoft, Sharp and Verity.

Our PaperPort product family converts paper into digital documents that can be easily archived, retrieved and shared. Our software can be used in conjunction with network scanning devices to preserve an image of a document exactly as it appears on paper. Our software automatically indexes the scanned image so that it can be stored together with other digital documents on a desktop, over a network or within an enterprise content management system. We utilize a combination of our global reseller network and direct sales to distribute our digital paper management products. We also license our software to companies such as Brother, Hewlett-Packard, and Xerox, who bundle our solutions with multifunction devices, digital copiers, printers and scanners.

Our PDF Converter product family comprises affordable solutions used to create PDF files and turn existing PDF files into fully-formatted Microsoft Word, Microsoft Excel and Corel WordPerfect documents that can be edited. Our PDF solutions are used by business professionals and consumers and have proven to be a cost-effective alternative to those offered by Adobe Systems. PDF Converter Professional, our flagship PDF application, allows users to view, manipulate and edit PDF documents as well as create and complete PDF forms. PDF Create! is an affordable solution to enable the creation of PDF from all PC applications, including support for PDF security, font embedding and other advanced features.

Sales, Marketing and Distribution

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

We have established relationships with more than 2,000 channel partners, including leading system vendors, independent software vendors, value-added resellers and distributors, through whom we market and distribute our products and solutions. In speech, companies such as Avaya, Bosch-Blaupunkt, Cisco, Delphi, Genesys, LG, Microsoft, Nokia, Nortel, Samsung and Visteon embed our technologies into telecommunications systems and automotive, PC, handset, healthcare or multimedia applications. In Imaging, companies such as Brother, Dell, Hewlett-Packard, Visioneer and Xerox include our technology in digital copiers, printers and scanners, as well as multifunction devices that combine these capabilities and companies such as Corel, Canon, Captiva, Kofax, Sharp and Verity embed our imaging technology into their commercial software applications.

We license our applications to enterprises, professionals and consumers through distribution and fulfillment partners, including 1450, Ingram Micro, Tech Data and Digital River. These distribution and fulfillment partners provide our products to computer superstores, consumer electronic stores, eCommerce Web sites, mail order houses and office superstores, such as Amazon.com, Best Buy, CDW, MicroWarehouse, Circuit City, CompUSA, Fry s Electronics, Office Depot, PC Connection and Staples.

As of September 30, 2006, we had 448 full-time employees in sales and marketing, with 298 in the United States and 150 internationally.

Research and Development/Intellectual Property

In recent years, we have developed and acquired extensive technology assets, intellectual property and industry expertise in speech and imaging which provide us with a competitive advantage in markets where we compete. Our technologies are based on complex mathematical formulas which require extensive amounts of linguistic and image data, acoustic models and recognition techniques. A significant investment in capital and time would be necessary to replicate our current capabilities.

We continue to invest in our technologies to maintain our market-leading position and to develop new applications. Our technologies are covered by more than 550 patents or patent applications, expiring on various dates between 2006 and 2023. Our intellectual property, whether purchased and included as an asset on our balance sheet, or developed internally and thus not generally included as an asset on our balance sheet, is critical to our success and competitive position and, ultimately, to our market value. We rely on a combination of patents, copyrights, trademarks, services marks, trade secrets, confidentiality provisions and licensing arrangements to establish and protect our intellectual property and proprietary rights.

As of September 30, 2006, we had 417 full-time employees in research and development. Our research and development expenses for the twelve months ended September 30, 2006 and 2005, and the nine months ending September 30, 2004 were $59.4 million, $39.2 million and $26.4 million, respectively.

International Operations

Our international headquarters are located in Belgium and we have additional principal offices in a number of international locations including: Canada, Germany, Hungary, Israel, Japan and the United Kingdom. The responsibilities of our international operations include research and development, customer support, sales and marketing and administration. Additionally, we maintain smaller sales, services and support offices throughout the world to support our international customers and to expand international revenue opportunities.

Geographic revenue classification is based on the geographic areas in which our customers are located. For fiscal 2006, 2005 and 2004, 74%, 69% and 70% of revenue was generated in the United States and 26%, 31% and 30% of revenue was generated by our international operations, respectively.

For a discussion of risks attendant to our international operations, see Risk Factors *A significant portion of our revenue is derived from sales in Europe and Asia. Our results could be harmed by economic, political, regulatory and other risks associated with these and other international regions.*

Strategy

We focus on providing competitive and value-added solutions for our customers and partners through a broad set of technologies, service offerings and channel capabilities. To continue to provide industry leading solutions, through acquisitions and organic growth, we intend to:

Participate Broadly In Speech. We intend to leverage our comprehensive technologies and leadership in speech to expand our opportunities in the call center, automotive, healthcare, telecommunications and mobile markets. We also intend to pursue emerging opportunities to use our speech technologies within consumer devices, games and other embedded applications. To expand our position in speech, we intend to introduce new versions of our products and applications complete new license agreements with customers and partners that will resell our technologies; and continue to make strategic acquisitions that we believe complement our existing capabilities in the telecommunications, automotive and electronics markets.

Pursue Opportunities for Dictation and Transcription in Healthcare. We intend to increase our investments and efforts in providing dictation solutions to the healthcare market, where we believe there is a large and attractive opportunity to automate transcription processes and information workflow. We have formed a healthcare-specific sales organization to aggressively pursue sales into healthcare provider organizations; expanded our reseller and system integrator channels within healthcare; and entered into OEM license agreements with leading healthcare IT hardware and software vendors.

Pursue Strategic Acquisitions. We have selectively pursued strategic acquisitions to expand our technology, channel and service resources and to complement our organic growth. We expect to continue to make acquisitions of other companies, businesses and technologies to complement our existing capabilities and our internal investments in these areas and have a team that focuses on evaluating market needs and potential acquisitions to fulfill them. We have a disciplined methodology for integrating acquired companies and businesses after the transaction is complete.

Expand Worldwide Channels. We intend to expand our global channel network and build upon our existing distribution channels, especially in Europe, Asia and Latin America. Along these lines, we have added sales employees in different geographic regions and launched programs and events to help recruit new partners for our channel network.

Expand PDF and Imaging Solutions. We intend to enhance the value and functionality of our PDF and imaging solutions to enable enterprises to address the proliferation of PDF, the expanded use of content management systems and the widespread adoption of networked multifunction and digital scanning devices. We intend to continue to introduce new and improved versions of our products to take advantage of developing market opportunities. We also plan to enhance our software development toolkits so our technologies can be integrated with more third-party and OEM solutions.

Competition

The individual markets in which we compete are highly competitive and are subject to rapid technology changes. There are a number of companies that develop or may develop products that compete in our target markets; however, currently there is no one company that competes with us in all of our product areas. While we expect competition to continue to increase both from existing competitors and new market entrants, we believe that we will compete effectively based on many factors, including:

> *Technological Superiority.* Our speech and imaging technologies, applications and solutions are often recognized as the most proficient products in their respective categories. Our speech technology has

industry-leading recognition accuracy and provides a natural, speech-enabled interaction with systems, devices and applications. Our imaging technology is viewed as the most accurate in the industry, with rates as high as 99.8%. Technology publications, analyst research and independent benchmarks have indicated our products rank at or above performance levels of alternative solutions.

Broad Distribution Channels. Our extensive global network of resellers, comprising system integrators, independent software vendors, value-added resellers, hardware vendors, telecommunications carriers and

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distributors; our dedicated direct sales force; and, our e-commerce website *(www.nuance.com)* enables us to address the needs of specific markets, such as financial, legal, healthcare and government, and introduce new products quickly and effectively.

International Appeal. The international reach of our products is due to the broad language coverage of our offerings, including our speech technology which provides recognition for up to 49 languages and dialects and natural sounding synthesized speech in 26 languages and supports a broad range of hardware platforms and operating systems. Our imaging technology supports more than 100 languages. We currently have a significant portion of our operations located outside of the United States, including 259 employees in research and development, 150 employees in sales and marketing and 137 employees providing professional services and other post-sales support activities.

Specialized Professional Services. Our superior technology when coupled with the high quality of our professional services, allows our customers and partners to place a high degree of confidence and trust in our ability to deliver results.

Within speech, we compete with AT&T, Fonix, IBM, Loquendo, Microsoft, Philips, Telisma and Voice Signal. Within healthcare dictation and transcription, we compete with Philips Medical, Spheris and other smaller providers. Within imaging, we compete directly with ABBYY, Adobe, eCopy, and I.R.I.S. In speech, some of our partners such as Avaya, Cisco, Edify, Genesys and Nortel develop and market products that can be considered substitutes for our solutions. In addition, a number of smaller companies in both speech and imaging produce technologies or products that are competitive with our solutions in some markets. Current and potential competitors have established, or may establish, cooperative relationships among themselves or with third parties to increase the ability of their technologies to address the needs of our prospective customers.

Some of our competitors or potential competitors in our markets, such as Adobe, IBM and Microsoft, have significantly greater financial, technical and marketing resources than we do. These competitors may be able to respond more rapidly than we can to new or emerging technologies or changes in customer requirements. They may also devote greater resources to the development, promotion and sale of their products than we do. See Risk Factors *The markets in which we operate are highly competitive and rapidly changing, and we may be unable to compete successfully.*

Employees

As of September 30, 2006, Nuance employed 1,681 full-time employees worldwide in 16 countries, including 448 in sales and marketing, 417 in research and development, 329 in professional service consulting, 211 in customer service and support and 276 in general and administration, including information services personnel. Our employees are not represented by any labor union and are not organized under a collective bargaining agreement, and we have never experienced a work stoppage. We believe that our relationships with our employees are generally good.

Company Information

Our website is located at www.nuance.com. This Annual Report on Form 10-K, our Quarterly Reports on Form 10-Q, our Current Reports on Form 8-K, and all amendments to these reports, as well as proxy statements and other information we file with or furnish to the Securities and Exchange Commission (SEC) are accessible free of charge on our website. We make these documents available as soon as reasonably practicable after we file them with, or furnish them to, the SEC. Except as otherwise stated in these documents, the information contained on our website or available by hyperlink from our website is not incorporated by reference into this report or any other documents we file with or furnish to the SEC.

Item 1A. ***Risk Factors***

You should carefully consider the risks described below when evaluating our company and when deciding whether to invest in our company. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties not presently known to us or that we do not currently believe are important to an investor may also harm our business operations. If any of the events, contingencies, circumstances or conditions described in the following risks actually occurs, our business, financial condition or our results of operations could be seriously harmed. If that happens, the trading price of our common stock could decline and you may lose part or all of the value of any of our shares held by you.

Risks Related to Our Business

Our operating results may fluctuate significantly from period to period, and this may cause our stock price to decline.

Our revenue and operating results have fluctuated in the past and we expect our revenue and operating results to continue to fluctuate in the future. Given this fluctuation, we believe that quarter to quarter comparisons of our revenue and operating results are not necessarily meaningful or an accurate indicator of our future performance. As a result, our results of operations may not meet the expectations of securities analysts or investors in the future. If this occurs, the price of our stock would likely decline. Factors that contribute to fluctuations in our operating results include the following:

- slowing sales by our distribution and fulfillment partners to their customers, which may place pressure on these partners to reduce purchases of our products;
- volume, timing and fulfillment of customer orders;
- our efforts to generate additional revenue from our portfolio of intellectual property;
- concentration of operations with one manufacturing partner and ability to control expenses related to the manufacture, packaging and shipping of our boxed software products;
- customers delaying their purchasing decisions in anticipation of new versions of our products;
- customers delaying, canceling or limiting their purchases as a result of the threat or results of terrorism;
- introduction of new products by us or our competitors;
- seasonality in purchasing patterns of our customers;
- reduction in the prices of our products in response to competition or market conditions;
- returns and allowance charges in excess of accrued amounts;
- timing of significant marketing and sales promotions;
- impairment charges against goodwill and other intangible assets;
- write-offs of excess or obsolete inventory and accounts receivable that are not collectible;
- increased expenditures incurred pursuing new product or market opportunities;
- general economic trends as they affect retail and corporate sales; and

higher than anticipated costs related to fixed-price contracts with our customers.

Due to the foregoing factors, among others, our revenue and operating results are difficult to forecast. Our expense levels are based in significant part on our expectations of future revenue, and we may not be able to reduce our expenses quickly to respond to a shortfall in projected revenue. Therefore, our failure to meet revenue expectations would seriously harm our operating results, financial condition and cash flows.

We have grown, and may continue to grow, through acquisitions, which could dilute our existing shareholders and could involve substantial integration risks.

As part of our business strategy, we have in the past acquired, and expect to continue to acquire, other businesses and technologies. In connection with past acquisitions, we issued a substantial number of shares of our common stock as transaction consideration and also incurred significant debt to finance the cash consideration used for our acquisition of Dictaphone Corporation. We may continue to issue equity securities for future acquisitions that would dilute our existing stockholders, perhaps significantly depending on the terms of the acquisition. We may also incur additional debt in connection with future acquisitions, which, if available at all, may place additional restrictions on our ability to operate our business. Furthermore, our prior acquisitions required substantial integration and management efforts. Our recently completed acquisition of Dictaphone Corporation will likely pose similar challenges. Acquisitions of this nature involve a number of risks, including:

- difficulty in transitioning and integrating the operations and personnel of the acquired businesses, including different and complex accounting and financial reporting systems;
- potential disruption of our ongoing business and distraction of management;
- potential difficulty in successfully implementing, upgrading and deploying in a timely and effective manner new operational information systems and upgrades of our finance, accounting and product distribution systems;
- difficulty in incorporating acquired technology and rights into our products and technology;
- unanticipated expenses and delays in completing acquired development projects and technology integration;
- management of geographically remote units both in the United States and internationally;
- impairment of relationships with partners and customers;
- customers delaying purchases of our products pending resolution of product integration between our existing and our newly acquired products;
- entering markets or types of businesses in which we have limited experience; and
- potential loss of key employees of the acquired company.

As a result of these and other risks, we may not realize anticipated benefits from our acquisitions. Any failure to achieve these benefits or failure to successfully integrate acquired businesses and technologies could seriously harm our business.

Purchase accounting treatment of our acquisitions could decrease our net income in the foreseeable future, which could have a material and adverse effect on the market value of our common stock.

Under accounting principles generally accepted in the United States of America, we have accounted for our acquisitions using the purchase method of accounting. Under purchase accounting, we record the market value of our common stock or other form of consideration issued in connection with the acquisition and the amount of direct transaction costs as the cost of acquiring the company or business. We have allocated that cost to the individual assets acquired and liabilities assumed, including various identifiable intangible assets such as acquired technology, acquired trade names and acquired customer relationships based on their respective fair values. Intangible assets generally will be amortized over a five to ten year period. Goodwill and certain intangible assets with indefinite lives, are not subject to amortization but is subject to at least an annual impairment analysis, which may result in an impairment charge if the carrying value exceeds its implied fair value. As of September 30, 2006, we had identified intangible assets amounting to approximately $220.0 million and goodwill of approximately $699.3 million.

Our significant debt could adversely affect our financial health and prevent us from fulfilling our obligations under our credit facility.

We have a significant amount of debt. On March 31, 2006, we entered into a credit facility which consists of a $355.0 million 7-year term loan and a $75.0 million six-year revolving credit line. As of September 30, 2006, $353.2 million remained outstanding under the term loan and there were no outstanding borrowings under the revolving credit line. Our high level of debt could have important consequences, for example it could:

- require us to use of a large portion of our cash flow to pay principal and interest on the credit facility, which will reduce the availability of our cash flow to fund working capital, capital expenditures, research and development expenditures and other business activities;

restrict us from making strategic acquisitions or exploiting business opportunities;

place us at a competitive disadvantage compared to our competitors that have less debt; and

limit, along with the financial and other restrictive covenants in our debt, our ability to borrow additional funds, dispose of assets or pay cash dividends.

In addition, a substantial portion of our debt bears interest at variable rates. If market interest rates increase, our debt service requirements will increase, which would adversely affect our cash flow. While we have entered into an interest rate swap agreement limiting our exposure for a portion of our debt, such agreement does not offer complete protection from this risk.

We have a history of operating losses, and we may incur losses in the future, which may require us to raise additional capital on unfavorable terms.

We reported net losses of approximately $22.9 million, $5.4 million and $9.4 million for fiscal years 2006, 2005 and 2004, respectively. We had an accumulated deficit of approximately $190.1 million at September 30, 2006. If we are unable to achieve and maintain profitability, the market price for our stock may decline, perhaps substantially. We cannot assure you that our revenue will grow or that we will achieve or maintain profitability in the future. If we do not achieve profitability, we may be required to raise additional capital to maintain or grow our operations. The terms of any additional capital, if available at all, may be highly dilutive to existing investors or contain other unfavorable terms, such as a high interest rate and restrictive covenants.

We depend on limited or sole source suppliers for critical components. The inability to obtain sufficient components as required, and under favorable purchase terms, would harm our business.

We are dependent on certain suppliers, including limited and sole source suppliers, to provide key components used in our products. We have experienced, and may continue to experience, delays in component deliveries, which in turn could cause delays in product shipments and require the redesign of certain products. In addition, if we are unable to procure necessary components under favorable purchase terms, including at favorable prices and with the order lead-times needed for the efficient and profitable operation of our business, our results of operations could suffer.

Speech technologies may not achieve widespread acceptance by businesses, which could limit our ability to grow our speech business.

We have invested and expect to continue to invest heavily in the acquisition, development and marketing of speech technologies. The market for speech technologies is relatively new and rapidly evolving. Our ability to increase revenue in the future depends in large measure on acceptance of speech technologies in general and our products in particular. The continued development of the market for our current and future speech solutions will also depend on the following factors:

consumer demand for speech-enabled applications;

development by third-party vendors of applications using speech technologies; and

continuous improvement in speech technology.

Sales of our speech products would be harmed if the market for speech software does not continue to develop or develops more slowly than we expect, and, consequently, our business could be harmed and we may not recover the costs associated with our investment in our speech technologies.

The markets in which we operate are highly competitive and rapidly changing, and we may be unable to compete successfully.

There are a number of companies that develop or may develop products that compete in our targeted markets. The individual markets in which we compete are highly competitive, and are rapidly changing. Within imaging, we compete directly with ABBYY, Adobe, I.R.I.S. and NewSoft. Within speech, we compete with AT&T, Fonix, IBM, Microsoft and Philips. Within healthcare dictation and transcription, we compete with Philips Medical, Spheris and other smaller providers. In speech, some of our partners such as Avaya, Cisco, Edify, Genesys and Nortel develop and market products that can be considered substitutes for our solutions. In addition, a number of smaller companies in both speech and imaging produce technologies or products that are in some markets competitive with our solutions. Current and potential competitors have established, or may establish, cooperative relationships among themselves or with third parties to increase the ability of their technologies to address the needs of our prospective customers.

The competition in these markets could adversely affect our operating results by reducing the volume of the products we license or the prices we can charge. Some of our current or potential competitors, such as Adobe, IBM and Microsoft, have significantly greater financial, technical and marketing resources than we do. These competitors may be able to respond more rapidly than we can to new or emerging technologies or changes in customer requirements. They may also devote greater resources to the development, promotion and sale of their products than we do.

Some of our customers, such as IBM and Microsoft, have developed or acquired products or technologies that compete with our products and technologies. These customers may give higher priority to the sale of these competitive products or technologies. To the extent they do so, market acceptance and penetration of our products, and therefore our revenue, may be adversely affected.

Our success will depend substantially upon our ability to enhance our products and technologies and to develop and introduce, on a timely and cost-effective basis, new products and features that meet changing customer requirements and incorporate technological advancements. If we are unable to develop new products and enhance functionalities or technologies to adapt to these changes, or if we are unable to realize synergies among our acquired products and technologies, our business will suffer.

The failure to successfully maintain the adequacy of our system of internal control over financial reporting could have a material adverse impact on our ability to report our financial results in an accurate and timely manner.

Our management s assessment of the effectiveness of our internal control over financial reporting, as of September 30, 2005, identified a material weakness in our internal controls related to tax accounting, primarily as a result of a lack of necessary corporate accounting resources and ineffective execution of certain controls designed to prevent or detect actual or potential misstatements in the tax accounts. While we have taken remediation measures to correct this material weakness, which measures are more fully described in Item 9A of this Annual Report on Form 10-K, we cannot assure you that we will not have material weaknesses in our internal controls in the future. Any failure in the effectiveness of our system of internal control over financial reporting could have a material adverse impact on our ability to report our financial results in an accurate and timely manner.

A significant portion of our revenue is derived from sales in Europe and Asia. Our results could be harmed by economic, political, regulatory and other risks associated with these and other international regions.

Since we license our products worldwide, our business is subject to risks associated with doing business internationally. We anticipate that revenue from international operations will continue to increase in their total U.S. dollar value. Reported international revenue, classified by the major geographic areas in which our customers are located, for fiscal 2006, 2005 and 2004 represented approximately $100.2 million, $71.5 million and $39.4 million, respectively. Most of our international revenue is generated by sales in Europe and Asia. In addition, some of our products are developed and manufactured outside the United States. A significant portion of the development and manufacturing of our speech products are completed in Belgium, and a significant portion of our imaging research and development is conducted in Hungary. In connection with the Philips acquisition, we added an additional research and development location in Aachen, Germany, and in connection with the acquisitions of Locus Dialog and the former Nuance Communications, In., which we refer to as Former Nuance, we added additional research and development centers in Montreal, Canada. Our acquisitions of ART and Phonetic added research and development and professional services operations in Tel Aviv, Israel. Accordingly, our future results could be harmed by a variety of factors associated with international sales and operations, including:

changes in a specific country s or region s economic conditions;

geopolitical turmoil, including terrorism and war;

trade protection measures and import or export licensing requirements imposed by the United States or by other countries;

compliance with foreign and domestic laws and regulations;

negative consequences from changes in applicable tax laws;

difficulties in staffing and managing operations in multiple locations in many countries;

difficulties in collecting trade accounts receivable in other countries; and

less effective protection of intellectual property.

We are exposed to fluctuations in foreign currency exchange rates.

Because we have international subsidiaries and distributors that operate and sell our products outside the United States, we are exposed to the risk of changes in foreign currency exchange rates or declining economic conditions in these countries. In certain circumstances, we have entered into forward exchange contracts to hedge against foreign currency fluctuations on intercompany balances with our foreign subsidiaries. We use these contracts to reduce our risk associated with exchange rate movements, as the gains or losses on these contracts are intended to offset any exchange rate losses or gains on the hedged transaction. We do not engage in foreign currency speculation. Hedges are designated and documented at the inception of the hedge and are evaluated for effectiveness monthly. Forward exchange contracts hedging firm commitments qualify for hedge accounting when they are designated as a hedge of the foreign currency exposure and they are effective in minimizing such exposure. With our increased international presence in a number of geographic locations and with international revenue projected to increase in fiscal 2007, we are exposed to changes in foreign currencies including the Euro, British Pound, Canadian Dollar, Japanese Yen, Israeli New Shekel and the Hungarian Forint. Changes in the value of the Euro or other foreign currencies relative to the value of the U.S. dollar could adversely affect future revenue and operating results.

Impairment of our intangible assets could result in significant charges which would adversely impact our future operating results.

We have significant intangible assets, including goodwill and intangibles with indefinite lives, which are susceptible to valuation adjustments as a result of changes in various factors or conditions. The most significant intangible assets are patents and core technology, completed technology, customer relationships and trademarks. Customer relationships are amortized on an accelerated basis based upon the pattern in which the economic benefit of customer relationships are being utilized. Other identifiable intangible assets are amortized on a straight-line basis over their estimated useful lives. We assess the potential impairment of identifiable intangible assets whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors 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 our overall business;

significant negative industry or economic trends;

significant decline in our stock price for a sustained period; and

a decline in our market capitalization below net book value.

Future adverse changes in these or other unforeseeable factors could result in an impairment charge that would impact our results of operations and financial position in the reporting period identified. As of September 30, 2006,

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we had identified intangible assets amounting to approximately $220.0 million and goodwill of approximately $699.3 million.

If we are unable to attract and retain key personnel, our business could be harmed.

If any of our key employees were to leave us, we could face substantial difficulty in hiring qualified successors and could experience a loss in productivity while any successor obtains the necessary training and experience. Our employment relationships are generally at-will and we have had key employees leave us in the past. We cannot assure you that one or more key employees will not leave us in the future. We intend to continue to hire additional highly qualified personnel, including software engineers and operational personnel, but we may not be able to attract, assimilate or retain qualified personnel in the future. Any failure to attract, integrate, motivate and retain these employees could harm our business.

Our medical transcription services may be subject to legal claims for failure to comply with laws governing the confidentiality of medical records.

Healthcare professionals who use our medical transcription services deliver to us health information about their patients including information that constitutes a record under applicable law that we may store on our computer systems. Numerous federal and state laws and regulations, the common law and contractual obligations govern collection, dissemination, use and confidentiality of patient-identifiable health information, including:

- state and federal privacy and confidentiality laws;
- our contracts with customers and partners;
- state laws regulating healthcare professionals;
- Medicaid laws; and
- the Health Insurance Portability and Accountability Act of 1996 and related rules proposed by the Health Care Financing Administration.

The Health Insurance Portability and Accountability Act of 1996 establishes elements including, but not limited to, federal privacy and security standards for the use and protection of protected health information. Any failure by us or by our personnel or partners to comply with applicable requirements may result in a material liability to us.

Although we have systems and policies in place for safeguarding protected health information from unauthorized disclosure, these systems and policies may not preclude claims against us for alleged violations of applicable requirements. There can be no assurance that we will not be subject to liability claims which could have a material adverse affect on our business, results of operations and financial condition.

Risks Related to Our Intellectual Property and Technology

Unauthorized use of our proprietary technology and intellectual property will adversely affect our business and results of operations.

Our success and competitive position depend in large part on our ability to obtain and maintain intellectual property rights protecting our products and services. We rely on a combination of patents, copyrights, trademarks, service marks, trade secrets, confidentiality provisions and licensing arrangements to establish and protect our intellectual property and proprietary rights. Unauthorized parties may attempt to copy aspects of our products or to obtain, license, sell or otherwise use information that we regard as proprietary. Policing unauthorized use of our products is difficult and we may not be able to protect our technology from unauthorized use. Additionally, our competitors may independently develop technologies that are substantially the same or superior to ours and that do not infringe our rights. In these cases, we would be unable to prevent our competitors from selling or licensing these similar or superior technologies. In addition, the laws of some foreign countries do not protect our proprietary rights to the same extent as the laws of the United States. Although the source code for our proprietary software is protected both as a trade secret and as a copyrighted work, litigation may be necessary to enforce our intellectual property rights, to protect our trade secrets, to determine the validity and scope of the proprietary rights of others, or to defend against claims of infringement or invalidity. Litigation, regardless of the outcome, can be very expensive and can divert management efforts.

Third parties have claimed and may claim in the future that we are infringing their intellectual property, and we could be exposed to significant litigation or licensing expenses or be prevented from selling our products if such claims are successful.

From time to time, we are subject to claims that we or our customers may be infringing or contributing to the infringement of the intellectual property rights of others. We may be unaware of intellectual property rights of others that may cover some of our technologies and products. If it appears necessary or desirable, we may seek licenses for these intellectual property rights. However, we may not be able to obtain licenses from some or all claimants, the terms of any offered licenses may not be acceptable to us, and we may not be able to resolve disputes without litigation. Any litigation regarding intellectual property could be costly and time-consuming and could divert the attention of our management and key personnel from our business operations. In the event of a claim of intellectual property infringement, we may be required to enter into costly royalty or license agreements. Third parties claiming intellectual property infringement may be able to obtain injunctive or other equitable relief that could effectively block our ability to develop and sell our products.

On November 9, 2006, VoiceSignal Technologies, Inc. filed an action against us and eleven of our resellers 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, VoiceSignal alleges that we are infringing United States Patent No. 5,855,000 which is related to improving correction in a dictation application based on a two input analysis. We believe these claims have no merit and intend to defend the actions vigorously.

On May 31, 2006 GTX Corporation (GTX), filed an action against us 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 we are infringing United States Patent No. 7,016,536 entitled Method and Apparatus for Automatic Cleaning and Enhancing of Scanned Documents. We believe these claims have no merit and intend to defend the action vigorously.

On November 27, 2002, AllVoice Computing plc (AllVoice) filed an action against us in the United States District Court for the Southern District of Texas claiming patent infringement. In the lawsuit, AllVoice alleges that we are 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 we have several products in the speech recognition technology field, we believe that our 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. We filed an Answer on December 23, 2002. 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 this judgment on April 26, 2006.

We believe that the final outcome of the current litigation matters described above will not have a significant 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 could be costly. Should we not prevail in these litigation matters, we may be unable to sell and/or license certain of our technologies we consider to be proprietary, and our operating results, financial position and cash flows could be adversely impacted.

Our software products may have bugs, which could result in delayed or lost revenue, expensive correction, liability to our customers and claims against us.

Complex software products such as ours may contain errors, defects or bugs. Defects in the solutions or products that we develop and sell to our customers could require expensive corrections and result in delayed or lost revenue, adverse customer reaction and negative publicity about us or our products and services. Customers who are not satisfied with any of our products may also bring claims against us for damages, which, even if unsuccessful,

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would likely be time-consuming to defend, and could result in costly litigation and payment of damages. Such claims could harm our reputation, financial results and competitive position.

Risks Related to Our Corporate Structure, Organization and Common Stock

The holdings of our two largest stockholders may enable them to influence matters requiring stockholder approval.

On March 19, 2004, Warburg Pincus, a global private equity firm agreed to purchase all outstanding shares of our stock held by Xerox Corporation for approximately $80 million. Additionally, on May 9, 2005 and September 15, 2005 we sold shares of common stock, and warrants to purchase common stock to Warburg Pincus for aggregate gross proceeds of approximately $75.1 million. As of September 30, 2006, Warburg Pincus beneficially owned approximately 23.4% of our outstanding common stock, including warrants exercisable for up to 7,066,538 shares of our common stock and 3,562,238 shares of our outstanding Series B Preferred Stock, each of which is convertible into one share of our common stock. Franklin Resources, Inc. is our second largest stockholder, owning approximately 5.3% of our common stock as of September 30, 2006. Because of their large holdings of our capital stock relative to other stockholders, each of these two stockholders acting individually, or together, have a strong influence over matters requiring approval by our stockholders.

The market price of our common stock has been and may continue to be subject to wide fluctuations.

Our stock price historically has been and may continue to be volatile. Various factors contribute to the volatility of our stock price, including, for example, quarterly variations in our financial results, new product introductions by us or our competitors and general economic and market conditions. While we cannot predict the individual effect that these factors may have on the market price of our common stock, these factors, either individually or in the aggregate, could result in significant volatility in our stock price during any given period of time. Moreover, companies that have experienced volatility in the market price of their stock often are subject to securities class action litigation. If we were the subject of such litigation, it could result in substantial costs and divert management s attention and resources.

Compliance with changing regulation of corporate governance and public disclosure may result in additional expenses.

Changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new regulations promulgated by the Securities and Exchange Commission and the rules of the NASDAQ Global Select Market, are resulting in increased general and administrative expenses for companies such as ours. These new or changed laws, regulations and standards are subject to varying interpretations in many cases, and as a result, their application in practice may evolve over time as new guidance is provided by regulatory and governing bodies, which could result in higher costs necessitated by ongoing revisions to disclosure and governance practices. We are committed to maintaining high standards of corporate governance and public disclosure. As a result, we intend to invest resources to comply with evolving laws, regulations and standards, and this investment may result in increased general and administrative expenses and a diversion of management time and attention from revenue-generating activities to compliance activities. If our efforts to comply with new or changed laws, regulations and standards differ from the activities intended by regulatory or governing bodies, our business may be harmed.

We have implemented anti-takeover provisions, which could discourage or prevent a takeover, even if an acquisition would be beneficial to our stockholders.

Provisions of our certificate of incorporation, bylaws and Delaware law, as well as other organizational documents could make it more difficult for a third party to acquire us, even if doing so would be beneficial to our stockholders. These provisions include:

authorized blank check preferred stock;

prohibiting cumulative voting in the election of directors;

limiting the ability of stockholders to call special meetings of stockholders;

requiring all stockholder actions to be taken at meetings of our stockholders; and

establishing advance notice requirements for nominations of directors and for stockholder proposals.

Item 1B. ***Unresolved Staff Comments***

None.

Item 2. ***Properties***

Our corporate headquarters and administrative, sales, marketing, research and development and support functions occupy approximately 105,000 square feet of space that we lease in Burlington, Massachusetts. We also lease additional properties in the United States and a number of foreign countries. The following table summarizes our significant properties as of September 30, 2006:

Location	Sq. Ft. (approx.)	Lease Term	Primary Use
Burlington, Massachusetts	105,000	May 2015	Corporate headquarters and administrative, sales, marketing, research and development and support functions.
Menlo Park, California(1)	34,000	August 2009	Sales, marketing and support functions.
Aachen, Germany	20,000	March 2011	Research and development.
Budapest, Hungary	21,000	December 2009	Research and development.
Merelbeke, Belgium	25,000	April 2010	International headquarters and research and development.
Montreal, Quebec	48,000	June 2006 to March 2011	Sales, marketing, research and development, customer support and order fulfillment functions.
Pacific Shores, Redwood City, California(2)	141,000	July 2012	Seventy-five percent of this facility is unoccupied, the remainder has been sublet to a third party.
Melbourne, Florida(3)	130,000	Owned	Administrative, sales, marketing, and support functions. Small portion of the facility has been sublet to a third party.
New York, New York(4)	34,000	February 2016	Subleased to two separate third-party tenants.

(1) This is a lease that was assumed as part of our acquisition of Former Nuance. 10,000 sq ft of the 34,000 is unoccupied.

(2)

The lease for this property was assumed as part of our acquisition of Former Nuance. See Note 12 of Notes to Consolidated Financial Statements.

(3) This building is owned and was acquired during the Dictaphone acquisition.

(4) The lease for this property was assumed as part of our SpeechWorks acquisition.

In addition to the properties referenced above, we also lease a number of small sales and marketing offices in the United States and internationally. As of September 30, 2006, we were productively utilizing substantially all of the space in our facilities, except for space identified above as unoccupied or that has been subleased to third parties.

Item 3. *Legal Proceedings*

Like many companies in the software industry, we have from time to time been notified of claims that we 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, 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.

On November 9, 2006, VoiceSignal Technologies, Inc. filed an action against us and eleven of our resellers in the United States District Court for the Eastern District of Texas claiming patent infringement. VoiceSignal is seeking damages and injunctive relief. In the lawsuit, VoiceSignal alleges that we are infringing United States Patent No. 5,855,000 which is related to improving correction in a dictation application based on a two input analysis. We believe the claims have no merit and intend to defend the action vigorously.

On August 22, 2006, z4 Technologies, Inc. filed an action against us and five other defendants, including Symantec, Adobe, Quark, ABBYY and Mathsoft, 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, z4 Technologies alleged that we are infringing United States Patent Nos. 6,044,471 and 6,785,825 which are directed to a method and apparatus for reducing unauthorized software use. On December 4, 2006 we entered into a settlement agreement with z4 Technologies regarding this action.

On May 31, 2006 GTX Corporation, or GTX, filed an action against us 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 we are infringing United States Patent No. 7,016,536 entitled Method and Apparatus for Automatic Cleaning and Enhancing of Scanned Documents. We believe the claims have no merit and intend to defend the action vigorously.

On November 27, 2002, AllVoice Computing plc, or AllVoice, filed an action against us 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, or the 273 Patent. The 273 Patent generally discloses techniques for manipulating audio data associated with text generated by a speech recognition engine. Although we have several products in the speech recognition technology field, we believe that our 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. We 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 this judgment on April 26, 2006.

In August 2001, the first of a number of complaints was filed in the United States District Court for the Southern District of New York, on behalf of a purported class of persons who purchased Former Nuance stock between April 12, 2000 and December 6, 2000. Those complaints have been consolidated into one action. The complaint generally alleges that various investment bank underwriters engaged in improper and undisclosed activities related to the allocation of shares in Former Nuance s initial public offering of securities. The complaint makes claims for violation of several provisions of the federal securities laws against those underwriters, and also against Former

Nuance and some of the Former Nuance s directors and officers. Similar lawsuits, concerning more than 250 other companies initial public offerings, were filed in 2001. In February 2003, the Court denied a motion to dismiss with respect to the claims against Former Nuance. In the third quarter of 2003, a proposed settlement in principle was reached among the plaintiffs, issuer defendants (including Former Nuance) and the issuers insurance carriers. The settlement calls for the dismissal and release of claims against the issuer defendants, including Former Nuance, in exchange for a contingent payment to be paid, if necessary, by the issuer defendants insurance carriers and an assignment of certain claims. The timing of the conclusion of the settlement remains unclear, and the settlement is subject to a number of conditions, including approval of the Court. The settlement is not expected to have any material impact upon Former Nuance or us, as payments, if any, are expected to be made by insurance

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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, we intend to defend the litigation vigorously. We believe we have meritorious defenses to the claims against Former Nuance.

We believe that the final outcome of the current litigation matters described above will not have a significant adverse effect on our financial position or 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 in these litigation matters, our operating results, financial position and cash flows could be adversely impacted.

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

No matters were submitted to a vote of security holders in the fourth quarter of the fiscal year covered by this Annual Report on Form 10-K.

PART II

Item 5. ***Market for the Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities***

Market Information

Our common stock is traded on the NASDAQ Global Select Market under the symbol NUAN . The table below shows the high and low sale prices of our common stock for each quarter of the fiscal years ended September 30, 2006 and 2005, respectively, on the NASDAQ Global Select Market.

	High	Low
Fiscal 2006:		
First quarter	$ 7.89	$ 4.60
Second quarter	12.04	7.41
Third quarter	13.48	7.37
Fourth quarter	10.39	6.94
Fiscal 2005:		
First quarter	$ 4.51	$ 3.25
Second quarter	4.80	3.43
Third quarter	4.64	3.42
Fourth quarter	5.38	3.74

Holders

As of November 30, 2006, there were 923 stockholders of record of our common stock.

Dividend Policy

We have never declared or paid any cash dividends on our capital stock. We currently expect to retain future earnings, if any, to finance the growth and development of our business and do not anticipate paying any cash dividends in the foreseeable future. The terms of our credit facility place restrictions on our ability to pay dividends except for stock dividends (see Item 7, Management s Discussion and Analysis of Financial Condition and Results

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of Operations Liquidity and Capital Resources and Note 10 Debt in the Notes to Consolidated Financial Statements).

Issuer Purchases of Equity Securities

We have not announced any currently effective authorization to repurchase shares of our common stock. However, upon vesting of restricted stock awards, employees are permitted to return to us a portion of the newly vested shares to satisfy the tax withholding obligations that arise in connection with such vesting. The following table summarizes repurchases of our common stock during the fourth quarter of fiscal 2006, which represent shares returned to satisfy tax withholding obligations:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares that May Yet be Purchased Under the Plans or Programs
July 2, 2006 July 31, 2006		$		
August 1, 2006 August 31, 2006	43,687	$ 7.59		
September 1, 2006 September 30, 2006				
Total	43,687	$ 7.59		

Item 6. ***Selected Consolidated Financial Data***

On October 23, 2004, our Board of Directors approved a change in the Company s fiscal year end from December 31 to September 30, effective beginning September 30, 2004. All references in this Form 10-K to the fiscal 2004 refer to the nine month period ended September 30, 2004. References to fiscal 2005 and 2006, refer to the twelve month periods ended September 30. References to fiscal 2003 and prior years, refer to the twelve month periods ended December 31.

The following selected consolidated financial data is not necessarily indicative of the results of future operations and should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations and our consolidated financial statements and related notes included elsewhere in this Annual Report on Form 10-K. The interim statement of operations for the nine months ended September 30, 2003 is unaudited and, in the opinion of management, reflects all adjustments, consisting of normal recurring adjustments,

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necessary for a fair statement of results of operations for the nine months ended September 30, 2003. (Amounts in thousands, except per share dollars and percentages).

	Year Ended September 30,		Nine Month Period Ended September 30,		Year Ended December 31,	
	2006(1),(2)	2005(4),(5)	2004(6)	2003(7) (Unaudited)	2003(7)	2002
Operations:						
Total revenue	$ 388,510	$ 232,388	$ 130,907	$ 88,529	$ 135,399	$ 106,619
Gross margin	267,467	163,185	89,113	65,405	98,760	80,730
Income (loss) from operations	8,370	2,032	(7,993)	(7,033)	(6,462)	6,603
Income (loss) before income taxes	(7,071)	1,395	(8,045)	(6,375)	(5,787)	6,587
Provision for (benefit from) income taxes	15,144	6,812	1,333	473	(269)	254
Income (loss) before cumulative effect of accounting change	(22,215)	(5,417)	(9,378)	(6,848)	(5,518)	6,333
Cumulative effect of accounting change(2)	(672)					
Net income (loss)	$ (22,887)	$ (5,417)	$ (9,378)	$ (6,848)	$ (5,518)	$ 6,333
Basic and Diluted Earnings Per Share Data:						
Income (loss) before cumulative effect of accounting change	$ (0.13)	$ (0.05)	$ (0.09)	$ (0.10)	$ (0.07)	$ 0.09
Net income (loss)	$ (0.14)	$ (0.05)	$ (0.09)	$ (0.10)	$ (0.07)	$ 0.09
Weighted average common shares outstanding:						
Basic	163,873	109,540	103,780	71,286	78,398	67,010
Diluted	163,873	109,540	103,780	71,286	78,398	72,796
Financial Position:						
Cash, cash equivalents and short and long-term marketable securities	$ 112,334	$ 95,814	$ 47,691	$ 48,038	$ 42,584	$ 18,853

Total assets	1,235,074	757,212	392,653	376,341	401,940	143,690
Long-term debt, net of current portion(3)	349,990	35	27,700	28,085	27,859	
Total stockholders equity	576,596	514,665	301,745	288,512	303,226	119,378
Selected Data and Ratios:						
Working capital	51,273	12,130	27,940	36,375	44,305	16,842
Depreciation of property and equipment	8,366	5,019	2,919	1,549	2,443	2,007
Amortization of other intangible assets	30,083	13,134	10,399	8,927	12,813	11,152
Gross margin percentage	68.8%	70.2%	68.1%	73.9%	72.9%	75.7%

(1) On March 31, 2006, we acquired all of the outstanding shares of Dictaphone Corporation. See Note 3 of the Notes to our Consolidated Financial Statements.

(2) Nuance adopted the provision of SFAS 123(R), Share-Based Payment effective October 1, 2005, the beginning of fiscal 2006. As a result, the results of operations included incremental share-based payments over what would have been recorded had the company continued to account for share-based compensation under APB No. 25, Accounting for Stock Issued to Employees. See Note 16 of the Notes to our Consolidated Financial Statements.

(3) During fiscal 2006, we entered into a new senior secured credit facility which consists of a $355.0 million 7-year term loan and a $75.0 million six-year revolving credit line to partially finance our acquisition of Dictaphone. As of September 30, 2006, there were no outstanding borrowings under the revolving credit line. See Note 10 of the Notes to our Consolidated Financial Statements.

(4) During fiscal 2005, we acquired all of the outstanding shares of Rhetorical Systems, Ltd., ART Advanced Recognition Technologies, Inc., Phonetic Systems Ltd., MedRemote, Inc. and Nuance Communications, Inc. (Former Nuance) See Note 3 of the Notes to our Consolidated Financial Statements.

(5) Income from operations for the year ended September 30, 2005 reflects $7.2 million in restructuring charges, consisting of $2.9 million related to the elimination of personnel and $4.3 million related to the abandoned leased facilities, including the write-off of leasehold improvements. See Note 13 of the Notes to our Consolidated Financial Statements.

(6) During fiscal 2004, we acquired all of the outstanding shares of Telelogue, Inc. and Brand & Groeber Communications GbR. See Note 3 of the Notes to our Consolidated Financial Statements.

(7) During fiscal 2003, we acquired Royal Philips Electronic Speech Processing Telephony and Voice control business units, and related intellectual property. We also acquired all of the outstanding shares of SpeechWorks International, Inc. and LocusDialog, Inc.

Item 7. *Management s Discussion and Analysis of Financial Condition and Results of Operations*

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

Forward-looking Statements

This annual 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 Annual Report.

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Overview of the Business

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 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 and integrated 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.

RESULTS OF OPERATIONS

The following table presents, as a percentage of total revenue, certain selected financial data for the twelve months ended September 30, 2006 and 2005, and the nine months ended September 30, 2004.

	Year Ended September 30, 2006	Year Ended September 30, 2005	Nine-Month Period Ended September 30, 2004
Revenue:			
Product and licensing	60.7%	73.7%	75.0%
Professional services, subscription and hosting	20.9	20.3	19.4
Maintenance and support	18.4	6.0	5.6
Total revenue	100.0	100.0	100.0
Costs and expenses:			
Cost of product and licensing	8.1	8.8	7.9
Cost of professional services, subscription and hosting	15.2	14.9	15.5
Cost of maintenance and support	4.6	2.1	2.0
Cost of revenue from amortization of intangible assets	3.3	3.9	6.5
Gross Margin	68.8	70.3	68.1
Research and development	15.3	16.9	20.2
Sales and marketing	33.1	33.9	37.8
General and administrative	14.2	13.8	14.1
Amortization of other intangible assets	4.4	1.7	1.5
Restructuring and other charges (credits), net	(0.3)	3.1	0.6
Total operating expenses	66.7	69.4	74.2
Income (loss) from operations	2.1	0.9	(6.1)
Other income (expense), net	(3.9)	(0.3)	(0.1)
Income (loss) before income taxes	(1.8)	0.6	(6.2)
Provision for income taxes	3.9	2.9	1.0

Loss before cumulative effect of accounting changes	(5.7)	(2.3)	(7.2)
Cumulative effect of accounting change	(0.2)	0.0	0.0
Net loss	(5.9)%	(2.3)%	(7.2)%

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REVENUE

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

Total Revenue

	Fiscal 2006	Fiscal 2005	Nine-Month Period Ended September 30, 2004	% Change 2006 vs 2005	% Change 2005 vs 2004
United States	$ 288,300	$ 160,927	$ 91,472	79.1%	75.9%
International	100,210	71,461	39,435	40.2	81.2
Total Revenue	$ 388,510	$ 232,388	$ 130,907	67.2%	77.5%

Fiscal 2006 Compared to Fiscal 2005

Total revenue for the fiscal year ended September 30, 2006 increased by $156.1 million as compared to the fiscal year ended September 30, 2005. The increase was primarily due to $112.4 million of revenue related to our acquisitions of Former Nuance and Dictaphone. Organic total revenue increased $43.7 million, or 19%, in fiscal 2006. Included in this organic growth, network revenue increased 20%, dictation revenue increased 26% primarily as a result of the release of Dragon NaturallySpeaking version 9.0, while embedded revenue increased by 37% and imaging revenue increased by 6%.

Based on the location of the customers, the geographic split in fiscal 2006 was 74% of total revenue in the United States and 26% internationally. This compares to 69% of total revenue in the United States and 31% internationally for the year ended September 30, 2005. The increase in revenue generated in the United States was primarily due to sales of Dictaphone products, 93.0% of which revenue is derived in in the United States. Excluding the Dictaphone revenue for fiscal 2006, 68% of total revenue was derived from customers in the United States and 32% internationally.

Fiscal 2005 Compared to Fiscal 2004

Total revenue for fiscal 2005 increased by $101.5 million as compared to fiscal 2004. The increase in revenue was due to several factors, including a twelve-month fiscal period in 2005, which included a seasonally strong fourth calendar quarter that contributed $60.6 million of total revenue. Excluding that incremental quarter, total revenue increased $40.9 million, or 31.2%. The substantial majority of the growth derived from comparative periods due to organic growth in product lines existing as of January 1, 2004 and to a lesser extent based on revenue related to acquisitions consummated in late fiscal 2004 and during fiscal 2005.

The geographic revenue split, based on the location of our customers, was 69% of total revenue in fiscal 2005 in the United States and 31% internationally. This compares to 70% of total revenue in the United States and 30% internationally for the nine month period ended September 30, 2004.

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 (in thousands, except percentages):

	Fiscal 2006	Fiscal 2005	Nine Month Period Ended September 30, 2004	% Change 2006 vs 2005	% Change 2005 vs 2004
Product and licensing revenue	$ 235,825	$ 171,200	$ 98,262	37.7%	74.2%
As a percentage of total revenue	60.7%	73.7%	75.0%		

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Fiscal 2006 Compared to Fiscal 2005

Product and licensing revenue for fiscal 2006 increased by $64.6 million compared to fiscal 2005. This increase in product and licensing revenue was primarily due to $39.8 million of revenue attributable to our acquisitions of Former Nuance and Dictaphone. Excluding the impact of these acquisitions, product and licensing revenue grew $24.8 million, or 15%, compared to the fiscal year ended September 30, 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 13% in fiscal 2006 as compared to fiscal 2005.

Speech related product and licensing revenue increased 56% in fiscal 2006 compared to fiscal 2007, growing to 70% of total product and licensing revenue in fiscal 2006, up from 60% in fiscal 2005. Excluding revenue due to our acquisitions of Former Nuance and Dictaphone, speech related product and licensing revenue increased by $19.6 million, or 19%, in fiscal 2006 compared to fiscal 2005. The growth in speech revenue resulted from increased sales of our legacy network products, embedded products in automotive and handsets, as well as increased sales in dictation fueled by our fourth quarter release of Dragon NaturallySpeaking 9.0. Product and licensing revenue from our imaging products increased by $5.2 million, or 8%, 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.

Fiscal 2005 Compared to Fiscal 2004

Product and licensing revenue for fiscal 2005 increased by $72.9 million compared to fiscal 2004. The increase in product and licensing revenue is generally attributable to the factors discussed above with respect to total revenue, including the seasonably strong fourth calendar quarter of calendar 2004 that contributed $46.8 million of increased product and licensing revenue. Excluding the revenue from the additional three-month period, product and licensing revenue increased $26.1 million, or 26.6%. The substantial majority of the growth in addition to the additional three months was growth from organic products that we had in our product portfolio as of January 1, 2004, and to a lesser extent was based on revenue related to recent acquisitions. Speech related product and licensing revenue increased to 60% of total product and licensing revenue for fiscal 2005, up from 55% of total product and licensing revenue in fiscal 2004. Expressed in dollars, revenue from speech related products totaled $104.2 million for fiscal 2005, as compared to $54.6 million for fiscal 2004. Within speech, network revenue remained relatively stable at 25% of total product and licensing revenue in fiscal 2005, while embedded revenue increased to 10% of total product and licensing revenue in fiscal 2005, up from 7% in fiscal 2004. The increase in embedded revenue was largely attributable to the acquisition of ART in January 2005. Dictation revenue in fiscal 2005 increased to 25% of total product and licensing revenue, up from 22% for fiscal 2004, primarily due to the release of Dragon NaturallySpeaking 8.0 in the first quarter of fiscal 2005, as well as the May 2005 acquisition of MedRemote.

Imaging related product and licensing revenue increased to $66.9 million for fiscal 2005, up 53% from fiscal 2004. Of this increase, 33% is due to the additional three months included in fiscal 2005, with the majority of the remaining increase attributable to increased sales of our PaperPort product family, which had a new release in the first quarter of fiscal 2005.

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 (in thousands, except percentages):

	Fiscal 2006	Fiscal 2005	Nine Month Period Ended September 30, 2004	% Change 2006 vs 2005	% Change 2005 vs 2004
Professional services, subscription and hosting revenue	$ 81,320	$ 47,308	$ 25,358	71.9%	86.6%
As a percentage of total revenue	20.9%	20.3%	19.4%		

Fiscal 2006 Compared to Fiscal 2005

Professional services, subscription and hosting revenue for fiscal 2006 increased by $34.0 million as compared to fiscal 2005. The largest component of this increase in professional services revenue was $22.0 million of revenue due to our acquisitions of Former Nuance and Dictaphone. Included in the Dictaphone revenue is $16.0 million of revenue relating to the subscription and hosting customer base. Excluding the impact of these acquisitions, our professional services revenue increased by $12.0 million, or 26% compared to fiscal 2005, with most product lines contributing to this growth. Network services, excluding revenue attributable to Former Nuance, provided $9.0 million, or 26% organic growth, based on growth in core network consulting, subscription and hosting and training revenue.

Fiscal 2005 Compared to Fiscal 2004

Professional services, subscription and hosting revenue for fiscal 2005 increased by $22.0 million as compared to fiscal 2004. The increase in professional services revenue was partially attributed to the inclusion of the seasonably strong fourth calendar quarter of calendar 2004 that contributed $11.0 million of increased professional services revenue. In addition to the revenue from that extra three-month period, professional services revenue increased $11.0 million, or 43%. The substantial majority of the growth was derived from organic growth in products existing as of January 1, 2004 and a lesser portion was attributable to acquisitions made in fiscal 2005. The organic growth is primarily due to the continued demand for consulting services, both in project size and in the volume of projects. Also contributing to the total growth, but to a lesser extent, was revenue from subscription based licensing and hosting services.

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 (in thousands, except percentages):

	Nine Month Period Ended	% Change	% Change

	Fiscal 2006	Fiscal 2005	September 30, 2004	2006 vs 2005	2005 vs 2004
Maintenance and support revenue	$ 71,365	$ 13,880	$ 7,287	414.2%	90.5%
As a percentage of total revenue	18.4%	6.0%	5.6%		

Fiscal 2006 Compared to Fiscal 2005

Maintenance and support revenue increased by $57.5 million in fiscal 2006 compared to fiscal 2005. As a percentage of total revenue, maintenance and support revenue grew 12.4% in fiscal 2006, up from 6% in fiscal 2005.
$50.5 million of this increase is due to our acquisitions of Former Nuance and Dictaphone, both of which have a significant customer base of maintenance and support contracts from historic sales of product. Excluding the impact of these acquisitions, maintenance and support revenue increased $7.0 million, or 50%, in fiscal 2006 compared to fiscal 2005, due to our continued strong renewal rates as well as from new sales in our network products.

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Fiscal 2005 Compared to Fiscal 2004

Maintenance and support revenue for fiscal 2005 increased by $6.6 million compared to fiscal 2004. $2.8 million of this increase is attributable to the additional three months included in fiscal 2005. Excluding that incremental quarter, maintenance and support revenue increased $3.3 million, or 45%. The substantial majority of the growth derived from comparative periods was the result of organic growth in product lines existing as of January 1, 2004, and to a lesser extent the acquisitions consummated in late fiscal 2004 and during fiscal 2005.

COSTS AND EXPENSES

In fiscal 2006, stock-based compensation includes the amortization of the fair value of share-based payments made to employees and to members of our Board of Directors, under the provisions of SFAS 123R, which we adopted on October 1, 2005 (see Note 2, Summary of Significant Accounting Policies, in the accompanying Notes to Consolidated Financial Statements included in this Annual Report on Form 10-K). As a result of the adoption of SFAS 123R, we have recorded $22.5 million of expense related to share-based payments during fiscal 2006 as compared to $3.0 million in fiscal 2005 and $1.5 million in fiscal 2004. To isolate the effects of the accounting change and to facilitate comparative review of our operations between the fiscal 2006, fiscal 2005 and fiscal 2004 periods, we have presented below each cost and expense line in tabular format, with and without the amounts recorded in each period relating to share-based payments. Unless noted otherwise, discussion of fiscal 2006 compared to fiscal 2005 represents discussion of costs and expenses excluding share-based payments.

Cost of Product and Licensing Revenue

Cost of product and licensing revenue primarily consists of material and fulfillment costs, manufacturing and operations costs, and third-party royalty expenses. The following table shows cost of product and licensing revenue including and excluding the cost of product and licensing revenue attributable to stock-based compensation, in absolute dollars and as a percentage of product and licensing revenue (in thousands, except percentages):

	Fiscal 2006	Fiscal 2005	Nine Month Period Ended September 30, 2004	% Change 2006 vs 2005	% Change 2005 vs 2004
Cost of product and licensing revenue	$ 31,394	$ 20,378	$ 10,348	54.1%	96.9%
Share-based payments	88	10			
Cost of product and licensing revenue, excluding share-based payments	$ 31,306	$ 20,368	$ 10,348	53.7%	96.8%
As a percentage of product and licensing revenue:					
Including share-based payments	13.3%	11.9%	10.5%		
Excluding share-based payments	13.3%	11.9%	10.5%		

Fiscal 2006 Compared to Fiscal 2005

Cost of product and licensing revenue, excluding share-based payments, for fiscal 2006 increased $10.9 million as compared to fiscal 2005 primarily due to $9.3 million of costs due to our acquisitions of Former Nuance and Dictaphone. As a percentage of product and licensing revenue, cost of product and licensing revenue increased 1.4% in fiscal 2006, largely due to Dictaphone products that have higher cost of goods sold relative to our other products. The added costs of goods sold for Dictaphone products are primarily due to third party hardware that is included in the solutions licensed to customers.

Excluding Dictaphone, in fiscal 2006 the cost of product and licensing revenue increased by $1.9 million, while declining to 9.2% of product and licensing revenue. The decrease as a percent of revenue was due to several factors. Most notably, the materials costs decreased by 0.7%, to 3.9% of product and licensing revenue, due to a decrease in imaging boxed products relative to speech products which carry lower materials costs. Additionally, royalties decreased by $0.5 million compared to fiscal 2005 driven largely by contractual changes for our embedded product lines royalties.

Fiscal 2005 Compared to Fiscal 2004

Cost of product and licensing revenue for fiscal 2005 grew $10.0 million compared to fiscal 2004. This 96.9% increase is due to a number of factors, most significant of which is the additional three months included in 2005 as compared to 2004. Additionally, the expenses have increased along with the 75.2% growth in product and licensing revenue as compared to fiscal 2004. As a percentage of product and licensing revenue, cost of product and licensing revenue for fiscal 2005 increased to 11.9% as compared to 10.6% in fiscal 2004. This increase is primarily due to higher third party royalty expense that amounted to $4.2 million for fiscal 2005, compared to $1.2 million in fiscal 2004. The $3.0 million increase is due to a number of factors including more products that have royalties associated with them, higher royalties associated with renegotiated contracts with third parties for certain imaging products, and the 75.2% increase in product and licensing revenue. Partially offsetting the royalty increase was a modest decrease in material costs of product and licensing revenue, from 5.0% of product and licensing revenue in fiscal 2004 to 4.6% for fiscal 2005.

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 and overhead, as well as the hardware and communications fees that support our subscription and hosted solutions. The following table shows cost of revenue including and excluding the cost of revenue attributable to stock-based compensation, in absolute dollars and as a percentage of professional services, subscription and hosting revenue (in thousands, except percentages):

	Fiscal 2006	Fiscal 2005	Nine Month Period Ended September 30, 2004	% Change 2006 vs 2005	% Change 2005 vs 2004
Cost of professional services, subscription and hosting revenue	$ 59,015	$ 34,737	$ 20,456	69.9%	69.8%
Share-based payments	1,873	107	59		
Cost of professional services, subscription and hosting revenue, excluding share-based payments	$ 57,142	$ 34,630	$ 20,397	65.0%	69.8%
As a percentage of professional services, subscription and hosting revenue:					
Including share-based payments	72.6%	73.4%	80.7%		
Excluding share-based payments	70.3%	73.2%	80.4%		

Fiscal 2006 Compared to Fiscal 2005

Cost of professional services, subscription and hosting revenue, excluding share-based payments, increased $22.5 million in fiscal 2006 as compared to fiscal 2005 primarily due to $14.9 million of costs due to our acquisitions of Former Nuance and Dictaphone, both of which have robust professional services organizations to support revenue streams. Additionally, Dictaphone has a large subscription-based licensing and hosted application customer base. The 65.0% growth in costs supports the 71.9% growth in related revenue for fiscal 2006. Cost of professional services as a percentage of the revenue, excluding share-based payments, improved 2.9% as synergies were realized from the merging of the service teams from Former Nuance and Dictaphone. These improvements were offset partially by increased expenses for the subscription and hosting services.

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Fiscal 2005 Compared to Fiscal 2004

Cost of professional services, subscription and hosting revenue for fiscal 2005 increased $14.2 million compared to fiscal 2004. This increase was due to a number of factors including the additional three months included in fiscal 2005. Additionally, incremental costs were necessary to support the 86.6% growth in related revenue. As a percentage of the related revenue, cost of professional services, subscription and hosting revenue for fiscal 2005 decreased to 73.2% compared to 80.4% in fiscal 2004. The percentage decrease in professional services cost as a percent of professional services revenue is attributable to a number of factors, including a reduction in outside consultant expenses and a more efficient utilization of existing headcount.

Cost of Maintenance and Support Revenue

Cost of maintenance and support revenue primarily consists of compensation for product support personnel and overhead. The following table shows cost of maintenance and support revenue including and excluding the cost of maintenance and support revenue attributable to stock-based compensation, in absolute dollars and as a percentage of maintenance and support revenue (in thousands, except percentages):

	Fiscal 2006	Fiscal 2005	Nine Month Period Ended September 30, 2004	% Change 2006 vs 2005	% Change 2005 vs 2004
Cost of maintenance and support revenue	$ 17,723	$ 4,938	$ 2,559	258.9%	93.0%
Share-based payments	525	15	7		
Cost of maintenance and support revenue, excluding share-based payments	$ 17,198	$ 4,923	$ 2,552	249.3%	92.9%
As a percentage of maintenance and support revenue:					
Including share-based payments	24.8%	35.6%	35.1%		
Excluding share-based payments	24.1%	35.5%	35.0%		

Fiscal 2006 Compared to Fiscal 2005

Cost of maintenance and support revenue, excluding share-based payments, for fiscal 2006 increased $12.3 million compared to fiscal 2005 due primarily to $8.0 million of costs for the additional headcount to support the additional revenue from our acquisitions of Former Nuance and Dictaphone. As a percentage of maintenance and support revenue, cost of revenue decreased 11.4% in fiscal 2006 to 24.1%. This decrease in percentage is primarily attributable to lower costs relative to the revenue in our healthcare maintenance and support business following our acquisition of Dictaphone. Speech margins, excluding the acquisition of Dictaphone, also improved in fiscal 2006, primarily due to synergies we realized upon the combination of pre-existing and acquired product lines following our acquisition of Former Nuance.

Fiscal 2005 Compared to Fiscal 2004

Cost of maintenance and support revenue for fiscal 2005 grew $2.4 million as compared to fiscal 2004. This increase was due to a number of factors including the additional three months included in fiscal 2005. Additionally, incremental costs were necessary to support the 79.6% growth in related revenue. As a percentage of maintenance revenue, cost of maintenance revenue increased 2.5% in fiscal 2005 as compared to fiscal 2004. The percentage increase was attributable to increased staffing made in advance of the anticipation of increasing revenue.

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

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amortization of intangible assets in absolute dollars and as a percentage of total revenue (in thousands, except percentages):

	Fiscal 2006	Fiscal 2005	Nine Month Period Ended September 30, 2004	% Change 2006 vs 2005	% Change 2005 vs 2004
Cost of revenue from amortization of intangible assets	$ 12,911	$ 9,150	$ 8,431	41.1%	8.5%
As a percentage of total revenue	3.3%	3.9%	6.5%		

Fiscal 2006 Compared to Fiscal 2005

Cost of revenue from amortization of intangible assets increased $3.8 million in fiscal 2006 as compared to fiscal 2005. The increase was primarily attributable to the $4.4 million in amortization of intangible assets acquired in connection with our acquisitions of Dictaphone in March 2006 and Former Nuance in September 2005. Additionally, the increase was due to $0.4 million in expense relative to amortization of the license that resulted from our December 4, 2006 settlement and licensing of technology from z4 Technologies, Inc. (refer to Note 23 of Notes to our Consolidated Financial Statements for discussion of this subsequent event). In addition, during the fourth quarter of fiscal 2006, we determined that we would not make additional investments to support a technology licensed from a non-related third-party in 2003. As a result, we revised the cash flow estimates related to the purchased technology and recorded an additional $2.6 million in cost of revenue to write down the purchased technology to its net realizable value. These increases were offset in part by the cessation of the amortization of technology and patents that was established in connection with our acquisitions consummated in 1999 and 2000.

Based on the amortizable intangible assets as of September 30, 2006, and assuming no impairment or reduction in expected lives, we expect cost of revenue from amortization of intangible assets for fiscal 2007 to be $11.2 million.

Fiscal 2005 Compared to Fiscal 2004

Cost of revenue from amortization of intangible assets increased $0.7 million in fiscal 2005 as compared to fiscal 2004. The increase was attributable to the additional three months included in the fiscal 2005 period, partially offset by the net amount of amortization of intangible assets that became fully amortized in fiscal 2004 and new amortization on assets established in connection with our acquisitions during fiscal 2004 and 2005.

Research and Development Expense

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

	Fiscal 2006	Fiscal 2005	Nine Month Period Ended September 30, 2004	% Change 2006 vs 2005	% Change 2005 vs 2004
Total research and development expense	$ 59,403	$ 39,190	$ 26,390	51.6%	48.5%
Share-based payments	4,578	241	228		
Research and development expense, excluding share-based payments	$ 54,825	$ 38,949	$ 26,162	40.8%	48.9%
As a percentage of total revenue:					
Including share-based payments	15.3%	16.9%	20.2%		
Excluding share-based payments	14.1%	16.8%	20.0%		

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Fiscal 2006 Compared to Fiscal 2005

Research and development expense, excluding share-based payments, increased $15.9 million in fiscal 2006 compared to fiscal 2005 primarily due to a $12.9 million increase in compensation related expense associated with increased average headcount of 80 employees mainly resulting from our acquisitions of Former Nuance and Dictaphone. The remaining increase was attributable to an increase in other headcount related expenses, including travel and infrastructure related expenses as we continued to invest in our products. 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 following previous acquisitions.

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. While we will continue to invest in research and development in fiscal 2007, we expect research and development expenses to decline as a percentage of revenue.

Fiscal 2005 Compared to Fiscal 2004

Research and development expense, excluding share-based payments, increased $12.8 million in fiscal 2005 as compared to fiscal 2004. The increase in expenses after reflecting the effect of the three months ended December 2004 in fiscal 2004, results in additional expenses of $3.9 million, or 11% in fiscal 2005 as compared to fiscal 2004 on an annualized basis. While increasing in absolute dollars, research and development expense decreased relative to our total revenue. This decrease in expense as a percentage of total revenue reflects synergies following previous acquisitions.

Sales and Marketing Expense

Sales and marketing expense includes salaries and benefits, 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 including and excluding the sales and marketing expense attributable to share-based payments, in absolute dollars and as a percentage of total revenue (in thousands, except percentages):

	Fiscal 2006	Fiscal 2005	Nine Month Period Ended September 30, 2004	% Change 2006 vs 2005	% Change 2005 vs 2004
Total sales and marketing expense	$ 128,412	$ 78,797	$ 49,554	63.0%	59.0%
Share-based payments	7,332	872	420		
Sales and marketing expense, excluding share-based payments	$ 121,080	$ 77,925	$ 49,134	55.4%	58.6%
As a percentage of total revenue:					
Including share-based payments	33.1%	33.9%	37.8%		

Excluding share-based payments	31.2%	33.5%	37.5%

Fiscal 2006 Compared to Fiscal 2005

Sales and marketing expense, excluding share-based payments, increased $43.2 million in fiscal 2006 as compared to fiscal 2005. $34.7 million of this increase was attributable to an increase in salaries and other variable costs, commissions and travel expenses relating to an increase in average headcount of 207 employees primarily resulting from our acquisitions of Former Nuance and Dictaphone and continued investment in the sales force for our existing products. In addition, our marketing expenses increased $7.8 million primarily to support new product releases made during 2006, including PaperPort 11 and Dragon Naturally Speaking 9.0, as well as additional marketing expenses of Dictaphone and Former Nuance products. While the expense in absolute dollars increased, sales and marketing expense as a percentage of revenue decreased as we achieved higher sales volumes while controlling our cost structure.

We expect sales and marketing expenses to increase as we continue to pursue our strategic goals. While increasing in absolute dollars, we expect to see a decrease in sales and marketing expenses as a percentage of revenue in fiscal 2007 as the expected revenue growth outpaces the expenses in this area.

Fiscal 2005 Compared to Fiscal 2004

Sales and marketing expense, excluding share-based payments, increased $28.8 million in fiscal 2005 compared to fiscal 2004. The increase in expenses after reflecting the effect of the three months ended December 2004, resulted in additional expenses of $10.2 million, or 15% in fiscal 2005 compared to fiscal 2004 on an annualized basis. While increasing in absolute dollars, sales and marketing expense as a percent of total revenue dropped 4.0% in fiscal 2005 compared to fiscal 2004. Decreases in expenses as a percent of revenue were derived largely from an improved efficiency of the sales organization, allowing for total compensation of sales and marketing employees to decrease as a percentage of revenue, to 18.9% of total revenue for fiscal 2005, down from 21.1% for fiscal 2004. Additionally, while the cost of marketing programs increased in absolute dollars to $16.9 million for fiscal 2005 from $10.7 million for fiscal 2004, this represents a decrease in terms of the percentage compared to total revenue of 0.9%, from 8.2% in fiscal 2004 to 7.3% in fiscal 2005.

General and Administrative Expense

General and administrative expenses primarily consist of personnel costs, (including 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 including and excluding the general and administrative expense attributable to share-based payments, in absolute dollars and as a percentage of total revenue (in thousands, except percentages):

	Fiscal 2006	Fiscal 2005	Nine Month Period Ended September 30, 2004	% Change 2006 vs 2005	% Change 2005 vs 2004
Total general and administrative expense	$ 55,343	$ 31,959	$ 18,394	73.2%	73.7%
Share-based payments	7,471	1,751	587		
General and administrative expense, excluding share-based payments	$ 47,872	$ 30,208	$ 17,807	58.5%	69.6%
As a percentage of total revenue:					
Including share-based payments	14.2%	13.8%	14.1%		
Excluding share-based payments	12.3%	13.0%	13.6%		

Fiscal 2006 Compared to Fiscal 2005

General and administrative expense, excluding share-based payments, increased $17.7 million in fiscal 2006 compared to fiscal 2005. The acquisition of Dictaphone contributed $7.7 million of this increase, including $3.0 million paid to Dictaphone staff for non-recurring activities necessary to transition knowledge and processes post-acquisition and $0.8 million in non-recurring activities performed by certain advisors who supported planning and integration efforts for this acquisition. General and administrative expenses, excluding those related to Dictaphone, increased $10.0 million due primarily to compensation for increased employees and external contractors in the finance, human resources, legal and other general and administrative functions. This increase in spending on staff and contractors was related to the integration of the acquisitions we made in fiscal 2005, as well as to compliance with new regulations, such as the implementation of SFAS 123R in fiscal 2006. These new initiatives were partially offset by a reduction in overall costs for staffing and contractors needed to comply with the provisions of Sarbanes Oxley in fiscal 2006 compared to fiscal 2005. While the expense increased in absolute dollars, general and administrative expense as a percentage of revenue decreased as we achieved higher sales volumes while controlling our cost structure.

We expect to continue to see general and administrative expenses as a percentage of total revenue decrease as revenue growth outpaces expense growth. Notwithstanding the decrease as a percentage of total revenue, we expect to increase the total amount expended relating to general and administrative expenses as we support the growth of our business.

Fiscal 2005 Compared to Fiscal 2004

General and administrative expense, excluding share-based payments, increased $13.6 million in fiscal 2005 compared to fiscal 2004. The increase in expenses after reflecting the effect of the three months ended December 2004 in fiscal 2004, results in additional expenses of $6.3 million, or 24.7% in fiscal 2005 as compared to fiscal 2004 on an annualized basis. The increase in fiscal 2005 was primarily the result of costs relating to incremental headcount and fees for professional consultants. The costs relating to headcount were mainly attributable to additional team members in the finance, facilities and IT departments. The increase in expenditures for professional consultants includes fees for Sarbanes Oxley compliance, accounting and legal advisors, and advisors supporting our planning and integration efforts related to our acquisition of Former Nuance.

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 (in thousands, except percentages):

	Fiscal 2006	Fiscal 2005	Nine Month Period Ended September 30, 2004	% Change 2006 vs 2005	% Change 2005 vs 2004
Amortization of other intangible assets	$ 17,172	$ 3,984	$ 1,967	331.0%	102.5%
As a percentage of total revenue	4.4%	1.7%	1.5%		

Fiscal 2006 Compared to Fiscal 2005

Amortization of intangible assets increased $13.2 million in fiscal 2006 as compared to fiscal 2005 largely attributable to the $10.8 million of amortization of identifiable intangible assets related to our acquisition of Dictaphone and full year amortization relating to our acquisitions of Former Nuance, Rhetorical, ART, Phonetic and MedRemote acquisitions.

Based on the amortizable intangible assets as of September 30, 2006, and assuming no impairment or reduction in expected lives, we expect that the fiscal 2007 amortization included in operating expenses will be $20.4 million.

Fiscal 2005 Compared to Fiscal 2004

Operating expenses derived from the amortization of intangible assets increased $2.0 million in fiscal 2005 as compared to fiscal 2004. The increase relates to the additional three months included in fiscal 2005, and to the amortization of intangible assets that were purchased in connection with our acquisitions during fiscal 2004 and 2005.

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Restructuring and Other Charges (Credits), Net

During the second quarter of fiscal 2006, we recorded a $1.3 million reduction to existing restructuring reserves as a result of the execution of a favorable sublease agreement relating to one of the facilities included in our 2005 restructuring plan. The amount was partially offset by other net adjustments of $0.1 million associated with prior years restructuring programs.

In fiscal 2005, we incurred restructuring charges of $7.2 million. The charges were related to the elimination of ten employees during the first quarter of 2006, a plan of restructuring relative to certain of our facilities in June 2005, and a September 2005 plan of restructuring to eliminate additional facilities and a reduction of approximately 40 employees in connection with our acquisition of Former Nuance. The facilities charges included $0.2 million related to the write-down of leasehold improvements based on their net book value relative to the fair market value for their shortened lives. The reduction in personnel was primarily from the research and development and sales and marketing teams, and was based on the elimination of redundancies resulting from our acquisition of Former Nuance.

The following table sets forth the activity relating to the restructuring accruals in fiscal 2006, 2005 and 2004 (in thousands):

	Personnel Related	Facilities Costs	Asset Impairment	Total
Balance at December 31, 2003	$ 1,552	$ 309	$	$ 1,861
Restructuring and other charges	801			801
Non-cash write-off	(348)			(348)
Cash payments	(1,599)	(141)		(1,740)
Balance at September 30, 2004	406	168		574
Restructuring and other charges	2,928	4,083	212	7,223
Non-cash write-off			(212)	(212)
Cash payments	(1,548)	(232)		(1,780)
Balance at September 30, 2005	1,786	4,019		5,805
Restructuring and other charges (credits)	(52)	(1,181)		(1,233)
Cash payments	(1,360)	(2,308)		(3,668)
Balance at September 30, 2006	$ 374	$ 530	$	$ 904

The remaining personnel related accrual as of September 30, 2006 is primarily composed of amounts due under the 2005 restructuring plans which will be paid in fiscal 2007.

Other Income (Expense), Net

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

	%	%

	Fiscal 2006	Fiscal 2005	Nine Month Period Ended September 30, 2004	Change 2006 vs 2005	Change 2005 vs 2004
Interest income	$ 3,305	$ 1,244	$ 429	165.7%	190.0%
Interest expense	(17,614)	(1,644)	(340)	971.4	383.5
Other income (expense), net	(1,132)	(237)	(141)	377.6	68.1
Total other income (expense), net	$ (15,441)	$ (637)	$ (52)		
As a percentage of total revenue	(3.9)%	(0.3)%	(0.1)%		

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Fiscal 2006 Compared to Fiscal 2005

Interest income increased $2.1 million in fiscal 2006, as compared to fiscal 2005, primarily due to higher cash and investment balances during fiscal 2006, as compared to the prior year, and to a lesser degree to greater yields on our cash and investments. Interest expense increased by $16.0 million during fiscal 2006, as compared to fiscal 2005, mainly due to $12.2 million of interest expense paid quarterly on the new credit facility we entered into on March 31, 2006. Additionally, we have recorded $4.6 million of non-cash interest expense mainly related to imputed interest in association with certain lease obligations included in our accrued business combination costs and accrued restructuring charges, the amortization of debt issuance costs associated with the new credit facility we entered into on March 31, 2006 as well as to the accretion of the interest related to the note payable from our Phonetic acquisition in February 2005. 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 are denominated in other than their local currencies, as well as the translation of certain of our intercompany balances.

We expect interest expense to increase in during fiscal 2007, relative to fiscal 2006, as we pay interest on the 2006 credit facility, and amortize the debt issuance costs, for the full year as compared to the six month period that the debt was outstanding in fiscal 2006. We will continue to record interest expense as it relates to certain lease obligations included in our accrued restructuring and accrued business combination costs.

Fiscal 2005 Compared to Fiscal 2004

Interest income increased $0.8 million in fiscal 2005, as compared to fiscal 2004, primarily attributable to higher cash and investment balances during the year. Interest expense increased $1.3 million in fiscal 2005, as compared to fiscal 2004, mainly due to the recognition of non cash interest expense in association with the deferred installment payments of $16.4 million and $17.5 million, respectively, in connection with our acquisitions of ART and Phonetic during the second quarter of fiscal 2005.

Provision for Income Taxes

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

	Fiscal 2006	Fiscal 2005	Nine Month Period Ended September 30, 2004	% Change 2006 vs 2005	% Change 2005 vs 2004
Income tax provision (benefit)	$ 15,144	$ 6,812	$ 1,333	122.3%	411.0%
Effective income tax rate	(214.2)%	488.3%	(16.6)%		

Fiscal 2006 Compared to Fiscal 2005 and Fiscal 2004

The variance from the federal statutory rate in all periods was due primarily to the increase in our valuation allowance with respect to certain deferred tax assets. Valuation allowances have been established for the U.S. net deferred tax asset, which we believe do not meet the more likely than not realization criteria established by SFAS 109, Accounting for Income Taxes. Due to a history of cumulative losses in the United States, a full valuation allowance has been recorded against the net deferred assets of our U.S. entities. At September 30, 2006, we had a valuation allowance for U.S. net deferred tax assets of approximately $312.1 million. The U.S. net deferred tax assets is composed of tax assets primarily related to net operating loss carryforwards (resulting both from business combinations and from operations) and tax credits, offset by deferred tax liabilities primarily related to intangible assets. 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.

Our utilization of deferred tax assets that were acquired in a business combination (primarily net operating loss carryforwards) results in a reduction in the associated valuation allowance and an increase to goodwill. Our establishment of new deferred tax assets as a result of operating activities requires the establishment of valuation allowances based upon the SFAS 109 more likely than not realization criteria. The establishment of a valuation allowance relating to operating activities is recorded as an increase to tax expense.

Our tax provision also includes state and foreign tax expense, which is determined on either a legal entity or separate tax jurisdiction basis.

LIQUIDITY AND CAPITAL RESOURCES

Cash and cash equivalents totaled $112.3 million as of September 30, 2006, an increase of $16.5 million compared to $95.8 million including marketable securities of $24.1 million as of September 30, 2005. In addition, we had $0.8 million and $11.7 million of certificates of deposit relating to certain of our facilities leases as of September 30, 2006 and 2005, respectively. We completed fiscal 2006 with working capital of $51.3 million as compared to $12.1 million in fiscal 2005. As of September 30, 2006, total retained deficit was $190.1 million. We do not expect our retained deficit will impact our future ability to operate given our strong cash and financial position. Our cash and cash equivalents increased by $40.6 million in fiscal 2006. This increase was composed of cash provided by operating activities of $47.9 million, partially offset by the net impact of cash provided by financing activities and cash used in investing activities.

Cash provided by operating activities

Cash provided by operating activities for fiscal 2006 was $47.9 million, an increase of $31.7 million, or 196%, from $16.2 million provided by operating activities in fiscal 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 compensation; in fiscal 2006 this amount was $54.9 million compared to $20.9 million in fiscal 2005, an increase of $34.0 million, or 163%. This increase was offset by changes in working capital of $2.3 million, of which an $8.7 million use of cash for non-Dictaphone operations was offset by $6.4 million source of cash due to changes in Dictaphone working capital. The change in non-Dictaphone working capital was due to improved billing and collection processes resulting in improved days outstanding for accounts receivable billings. The Dictaphone working capital was also positive due to the collection of accounts receivable and acquired unbilled accounts receivable. For both non-Dictaphone and Dictaphone working capital, the cash provided from net accounts receivable was offset by payments relative to accounts payable and accrued expenses, a net decrease in deferred revenue, and a net increase in prepaid and other assets. Deferred revenue of Dictaphone and non-Dictaphone decreased largely due to amounts that were included in the beginning balance sheet relating to customer contracts also included in acquired unbilled accounts receivable, including the deferred revenue accounts of Former Nuance in the case of the non-Dictaphone changes.

Cash provided by operating activities for fiscal 2005 was $16.2 million, an increase of $9.9 million or 159%, as compared to $6.3 million in fiscal 2004. The increase in cash from operations was primarily due to a decrease in net loss by $4.0 million, increased non-cash items including an increase of $4.8 million in depreciation and amortization expense and an increase in deferred tax provision of $2.1 million. Also contributing to the increase in cash from operations was an increase in accounts payable, accrued expenses and deferred revenue totaling $19.2 million, offset by a $24.8 million growth in accounts receivable driven by our revenue growth of 77.5% in fiscal 2005.

Cash used in investing activities

Cash used in investing activities for fiscal 2006 was $366.0 million, an increase of $321.4 million, or 721%, as compared to $44.6 million for fiscal 2005. The increase in cash used in investing was primarily driven by an increase of $331.5 million in cash paid for our acquisitions, of which the majority of the fiscal 2006 payments related to our acquisition of Dictaphone on March 31, 2006. $3.8 million of the increase related to incremental additions to property and equipment. The increase in cash used in investing activities was partially offset by an $11.1 million decrease in restricted cash and $3.1 million of incremental maturities of marketable securities.

Cash used in investing for fiscal 2005 was $44.6 million, an increase of $15.9 million, or 55.3%, as compared to $28.7 million in fiscal 2004. The increase in cash used in investing was primarily driven by an increase of

$60.6 million in cash paid relating to various acquisitions during fiscal 2005 and $1.3 million increase in additions to property and equipment. These increases were partially offset by $21.1 million of cash proceeds from maturities of marketable securities.

Cash provided by financing activities

Cash provided by financing activities for fiscal 2006 was $358.6 million, an increase of $282.1 million compared to $76.5 million in fiscal 2005. The increase in cash provided by financing activities was primarily driven by $346.0 million net proceeds from the new credit facility we entered into in March 2006. Additionally, the proceeds from the issuance of common stock under employee based compensation plans increased $24.6 million, or 397%. These increases were partially offset by $73.8 million in net proceeds from the issuance of common stock under private placements that occurred in fiscal 2005 and deferred acquisition payments of $14.4 million related to our acquisition of ART in fiscal 2005.

Cash provided by financing activities for fiscal 2005 was $76.5 million, an increase of $73.8 million compared to $2.7 million in fiscal 2004. The increase in financing activities was driven by net cash proceeds of $73.9 million from the issuance of stock and warrants in a private equity offering during fiscal 2005.

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 September 30, 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 September 30, 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 September 30, 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 $0.7 million, are included in other assets in the consolidated balance sheet as of September 30, 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 September 30, 2006, we have repaid $1.8 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	$ 3,550
2008	3,550
2009	3,550
2010	3,550
2011	3,550
Thereafter	335,475
Total	$ 353,225

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 September 30, 2006, we were in compliance with the covenants.

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, including our settlement and licensing agreement with z4 Technologies and our anticipated acquisition of Mobile Voice Control, Inc., 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.

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

Contractual Obligations

The following table summarizes our outstanding contractual obligations as of September 30, 2006 (in thousands):

		Payments Due by Period			
Contractual Obligations	**Total**	**Less Than 1 Year**	**2-3 Years**	**4-5 Years**	**Next 5 Years**
Term loan under credit facility(1)	$ 353,225	$ 3,550	$ 7,100	$ 7,100	$ 335,475
Deferred payments on acquisitions(2)	19,563	19,563			
Lease obligations:					
Capital leases	738	407	323	8	
Operating leases	49,662	6,028	13,740	10,469	19,425
Other lease obligations associated with the closing of duplicate facilities related to restructurings and acquisitions(3)	7,051	2,035	2,991	1,103	922
Pension, minimum funding requirement(4)	7,723	1,685	3,370	2,668	
Purchase commitments(5)	7,506	7,506			
Royalty commitments	332	71	141	57	63
Other long-term liabilities assumed(6)	88,918	12,371	25,982	27,811	22,754
Total contractual cash obligations	$ 534,718	$ 53,216	$ 53,647	$ 49,216	$ 378,639

(1) Refer to Note 10 of Notes to our Consolidated Financial Statements for additional information related to credit facility. The amounts above included principal portion only, interest is payable quarterly in arrears, based on the interest rates as of September 30, 2006, and the payment of principle presented herein, we would be obligated to pay, quarterly in arrears, at a per annum amount ranging from $25.9 million in fiscal 2007 to $24.4 million at the end of the seven year term.

(2) Obligations include deferred payments of $2.0 million withheld by us to satisfy claims against the former ART shareholders under the purchase agreement and deferred payment of $17.5 million in connection with acquisition of Phonetic System Ltd. (Phonetic) which is due in February 2007. See Note 3 of Notes to our Consolidated Financial Statements.

(3) Obligations include contractual lease commitments related to two facilities that were part of a 2005 restructuring plan. As of September 30, 2006, total gross lease obligations are $3.6 million and are included in the contractual obligations herein. The remaining obligations represents contractual lease commitments associated with the implemented plans to eliminate duplicate facilities in conjunction with our acquisitions of Former Nuance and Phonetic during fiscal 2005 and our acquisition of Dictaphone during fiscal 2006, and have been included as liabilities in our consolidated balance sheet as part of purchase accounting. As of September 30, 2006, we have subleased two of the facilities to unrelated third parties with total sublease income of $4.4 million through fiscal 2013. See Note 12 and Note 13 of Notes to our Consolidated Financial Statements.

(4)

Our U.K. pension plan has a minimum funding requirement of £859,900 (approximately $1.6 million based on exchange rate at September 30, 2006) for each of the next 5 years, through fiscal 2011. See Note 18 of Notes to our Consolidated Financial Statements.

(5) These amounts include non-cancelable purchase commitments for inventory in the normal course of business to fulfill customers orders currently scheduled in our backlog.

(6) Obligations include assumed long-term liabilities relating to restructuring programs initiated by the predecessors prior to our acquisition of SpeechWorks International, Inc. in August 2003, and our acquisition of Former Nuance in September 2005. These restructuring programs related to the closing of two facilities with lease terms set to expire in 2016 and 2012, respectively. Total contractual obligations under these two leases are $88.9 million. As of September 30, 2006, we have sub-leased certain of the office space related to these two

facilities to unrelated third parties. Total sublease income under contractual terms is expected to be $17.4 million, which ranges from $1.2 million to $2.3 million on an annualized basis through 2016. See Note 12 of Notes to our Consolidated Financial Statements.

Contingent Liabilities and Commitments

In addition to the $17.5 million due to the former shareholders of Phonetic as described above, we also agreed to make contingent payments of up to $35.0 million upon the achievement of certain performance targets in accordance with the purchase agreement. On June 1, 2006, we 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. We are currently in an early stage of discussions with the former shareholders of Phonetic in regards to this matter.

In connection with the acquisition of Brand & Groeber Communications GbR (B&G) in September 2004, we agreed to make contingent payments that could amount to 5.5 million based on the achievement of certain performance targets. From the date of acquisition through December 31, 2005, 0.4 million was paid based on the attainment of certain performance targets. The remaining 5.1 million (approximately $6.5 million based on the currency exchange rates as of September 30, 2006) may be earned based on the attainment of performance targets for calendar 2006 and, to the extent earned, would be paid in January 2007.

In connection with our acquisition of Dictaphone Corporation in March 2006, we are committed to pay $1.2 million in severance and related one-time payments to former employees of Dictaphone so long as they remain with us through specified dates in fiscal 2007. These $1.2 million in payments are not accrued as of September 30, 2006, as they are related to future performance obligations of these employees.

Pension and Post-Retirement Benefit Plans

We have defined benefit pension plans that were assumed as part of the acquisition of Dictaphone Corporation on March 31, 2006, which provide certain retirement and death benefits for former Dictaphone employees located in the United Kingdom and Canada. These plans require periodic cash contributions. The Canadian plan is fully funded and expected to remain fully funded during fiscal 2007, without additional funding by us. In fiscal 2006, total cash funding for the UK pension plan was $0.6 million. For the UK pension plan, we have a minimum funding requirement of £859,900 (approximately $1.6 million based on the exchange rate at September 30, 2006) for each of the next 5 years, through fiscal 2011.

We have also assumed a post-retirement health care and life insurance benefit plan in connection with the acquisition of Dictaphone Corporation. The plan, which is frozen, provides certain post-retirement health care and life insurance benefits and consists of a fixed subsidy for qualifying employees in the United States and Canada. The plan is non-funded and cash contributions are made each year to cover claim costs incurred in that year. Total cash paid during fiscal 2006 for the post-retirement health care and life insurance benefit plan was not material.

Off-Balance Sheet Arrangements

Through September 30, 2006, we have not entered into any off-balance sheet arrangements or material transactions with unconsolidated entities or other persons.

CRITICAL ACCOUNTING POLICIES, JUDGMENTS AND 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, we evaluate our estimates, assumptions and judgments, including those related to revenue recognition; allowance for doubtful accounts and returns; accounting for patent legal defense costs; the costs to complete the development of custom software applications; the valuation of goodwill, other intangible assets and tangible long-lived assets; accounting for acquisitions; share-based payments; 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. Our management bases its estimates on historical experience and various other factors that are believed to be reasonable under the circumstances. Actual results could differ from these estimates.

We believe the following critical accounting policies most significantly affect the portrayal of our financial condition and results of operations and require our most difficult and subjective judgments.

Revenue Recognition: We recognize product and licensing revenue in accordance with Statement of Position (SOP) 97-2, Software Revenue Recognition, and SOP 98-9, Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transactions, and related authoritative literature. The application of SOP 97-2 requires judgment, including whether a software arrangement includes multiple elements, and if so, whether vendor-specific objective evidence (VSOE) of fair value exists for those elements. Our software arrangements generally include software and post contract support which includes telephone support and the right to receive unspecified upgrades/enhancements on a when-and-if-available basis, typically for one to three years. Changes to the elements in a software arrangement, the ability to identify VSOE for those elements and the fair value of the respective elements could materially impact the amount of earned and unearned revenue. Judgment is also required to assess whether future releases of certain software represent new products or upgrades and enhancements to existing products. In accordance with SOP 97-2, revenue is recognized when (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred, (iii) the fee is fixed or determinable and (iv) collectibility is probable.

Non-software revenue is recognized in accordance with, the Securities and Exchange Commission s Staff Accounting Bulletin (SAB) 104, Revenue Recognition in Financial Statements. Under SAB 104, we recognize revenue when (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred or services have been rendered, (iii) the fees are fixed or determinable and (iv) collectibility is reasonably assured.

Professional services revenue is recognized in accordance with SOP 81-1, Accounting for Performance of Construction Type and Certain Performance Type Contracts on the percentage-of-completion method. We generally determine the percentage-of-completion by comparing the labor hours incurred to date to the estimated total labor hours required to complete the project. We consider labor hours to be the most reliable, available measure of progress on these projects. Adjustments to estimates to complete are made in the periods in which facts resulting in a change become known. When the estimate indicates that a loss will be incurred, such loss is recorded in the period identified. Significant judgments and estimates are involved in determining the percent complete of each contract. Different assumptions could yield materially different results.

We make 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. We also make estimates and reduce revenue recognized for price protection and rebates, and certain marketing allowances at the time the related revenue is recorded. If actual results differ significantly from our estimates, such differences could have a material impact on our results of operations for the period in which the actual results become known.

Our revenue recognition policies require management to make significant estimates. Management analyzes various factors, including a review of specific transactions, historical experience, creditworthiness of customers and current market and economic conditions. Changes in judgments based upon these factors could impact the timing and amount of revenue and cost recognized and thus affects our results of operations and financial condition.

Capitalized Patent Defense Costs: We monitor the anticipated outcome of legal actions, and if we determine that the success of the defense of a patent is probable, and so long as we believe that the future economic benefit of the patent will be increased, we then capitalize 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, we write off any capitalized costs in the period the change is determined. As of September 30, 2006 and 2005, capitalized patent defense costs totaled $6.4 million and $2.3 million, respectively.

Research and Development Costs: We account for the internal costs relating to research and development activities in accordance with SFAS 2, Accounting for Research and Development Costs, and SFAS 86, Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed. Research and development costs incurred for new software products and enhancements to existing products, other than certain software development costs that qualify for capitalization, are expensed as incurred. Software development costs incurred subsequent to the establishment of technological feasibility, but prior to the general release of the product, are capitalized and amortized to cost of revenue over the estimated useful life of the related products. Judgment is required in determining when technological feasibility of a product is established. We have determined that technological feasibility for our software products is reached shortly before the products are released to manufacturing. Costs incurred after technological feasibility is established have not been material, and accordingly, we have expensed the internal costs relating to research and development when incurred.

Purchased Computer Software: The cost of purchased computer software to be sold, leased, or otherwise marketed is capitalized if the purchased software has an alternative future use. Otherwise, the cost is expensed as incurred. Capitalized purchased computer software is amortized to cost of revenue over the estimated useful life of the related products. At each balance sheet date, we evaluate these assets for impairment by comparing the unamortized cost to the net realizable value. Amortization expense was $5.1 million, $2.1 million and $1.6 million for fiscal 2006, 2005 and 2004, respectively. Included in the fiscal 2006 amortization expense was an additional $2.6 million of expense representing an impairment determined to exist in order to value the purchased computer software at its net realizable value. See Note 8 of the Notes to our Consolidated Financial Statements. The net unamortized purchased computer software included in other intangible assets at September 30, 2006 and 2005 were $1.6 million and $5.2 million, respectively.

Valuation of Long-lived Tangible and Intangible Assets and Goodwill: We have 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 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 customer relationships 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. We assess 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 and at least annually. Factors we consider 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 our overall business;
- significant negative industry or economic trends;
- significant decline in our stock price for a sustained period; and
- a decline in our market capitalization below net book value.

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

In accordance with SFAS 142, Goodwill and Other Intangible Assets, we test goodwill and intangible assets with indefinite lives 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. We have reviewed the provisions of SFAS 142 with respect to the criteria necessary to evaluate the number of reporting units that exist.

Based on our review, we have determined that we operate in one reporting unit. Based on this assessment, we have not had any impairment charges during our history as a result of our 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, we periodically review 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 carrying value for the asset. If impairment is indicated, the asset is written down to its estimated fair value based on a discounted cash flow analysis. No impairment charges were taken in fiscal 2006, 2005 or 2004, based on the review of long-lived assets under SFAS 144.

Significant judgments and estimates are involved in determining the useful lives of our 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 our organization or our 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 our consolidated financial statements through accelerated amortization and/or impairment charges.

Accounting for Acquisitions: We have completed a number of significant business and other asset acquisitions over the preceding five years which have resulted in significant goodwill and other intangible asset balances. Our future business strategy contemplates that we may continue to pursue additional acquisitions in the future. Our accounting for acquisitions involves significant judgments and estimates primarily, but not limited to: the fair value of certain forms of consideration, the fair value of acquired intangible assets, which involve projections of future revenue and cash flows, the fair value of other acquired assets and assumed liabilities, including potential contingencies, and the useful lives and, as applicable, the reporting unit, of the assets. Our financial position or results of operations may be materially impacted by changes in our initial assumptions and estimates relating to prior or future acquisitions. Additionally, under SFAS 142, we determine the fair value of the reporting unit, for purposes of the first step in our annual goodwill impairment test, based on our market value. If prior or future acquisitions are not accretive to our results of operations as expected, our market value declines dramatically, or we determine we have more than one reporting unit, we may be required to complete the second step which requires significant judgments and estimates and which may result in material impairment charges in the period in which they are determined.

Accounting for Long-Term Facility Obligations: We have historically acquired companies which have previously established restructuring charges relating to lease exit costs, and we have recorded restructuring charges of our own that include lease exit costs. We follow the provisions of EITF 95-3 Recognition of Liabilities in Connection with a Purchase Business Combination or SFAS 146 Accounting for Costs Associated with Exit or Disposal Activities as applicable. In accounting for these obligations, we are required to make assumptions relating to the time period over which the facility will remain vacant, sublease terms, sublease rates and discount rates. We base our estimates and assumptions on the best information available at the time of the obligation having arisen. These estimates are reviewed and revised as facts and circumstances dictate; changes in these estimates could have a material effect on the amount accrued on the balance sheet.

Accounting for Share-Based Payments: We account for share-based payments in accordance with SFAS 123(R), Share-Based Payment. Under the fair value recognition provisions of this statement, share-based compensation cost is measured at the grant date based on the value of the award and is recognized as expense over the requisite service period which is generally the vesting period. Determining the fair value of share-based awards at the grant date requires judgment, including estimating expected dividends, share price volatility and the amount of share-based awards that are expected to be forfeited. If actual results differ significantly from these estimates, share-based compensation expense and our results of operations could be materially impacted.

Pension and Post-Retirement Benefit Plans: We have defined benefit pension plans that were assumed as part of the acquisition of Dictaphone Corporation on March 31, 2006, 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 is frozen relative to new enrollment, and 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. We use several actuarial and other factors which attempt to estimate the ultimate expense, liability and assets values related to our pension and post-retirement benefit plans. These factors include assumptions about discount rates, expected return on plan assets and the rate of future compensation increases. In addition, subjective assumptions, such as withdrawal and mortality rates, are also utilized. The assumptions may differ materially from actual results due to the changing market and economic condition or other factors, and depending on their magnitude, could have a significant impact on the amount we recorded. Pension and post-retirement benefit plan assumptions are included in Note 18 of Notes to the Consolidated Financial Statements.

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. We do not provide for U.S. income taxes on the undistributed earnings of its foreign subsidiaries, which we 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.

We make judgments regarding the realizability of our 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 we will generate sufficient future taxable income to realize these deferred tax assets after consideration of all available evidence. We regularly review our 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 we believe do not meet the more likely than not criteria established by SFAS 109. If we are subsequently able to utilize all or a portion of the deferred tax assets for which a valuation allowance has been established, then we may be required to recognize these deferred tax assets through the reduction of the valuation allowance which would result in a material benefit to our 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.

Loss Contingencies: We are subject to legal proceedings, lawsuits and other claims relating to labor, service and other matters arising in the ordinary course of business, as discussed in Note 17 of Notes to the Consolidated Financial Statements. Quarterly, we review the status of each significant matter and assess our potential financial exposure. If the potential loss from any claim or legal proceeding is considered probable and the amount can be reasonably estimated, we accrue a liability for the estimated loss. Significant judgment is required in both the determination of probability and the determination as to whether an exposure is reasonably estimable. Because of uncertainties related to these matters, accruals are based only on the best information available at the time. As additional information becomes available, we reassess the potential liability related to our pending claims and litigation and may revise our estimates. Such revisions in the estimates of the potential liabilities could have a material impact on our results of operations and financial position.

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RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

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). 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, we 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 our fiscal year ended September 30, 2009. We are currently evaluating the impact that SFAS 158 will have on our consolidated financial statements.

In September 2006, the United States Securities and Exchange Commission issued SAB 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements. This SAB provides guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. SAB 108 establishes an approach that requires quantification of financial statement errors based on the effects of each of our financial statements and the related financial statement disclosures. The SAB permits existing public companies to record the cumulative effect of initially applying this approach in the first year ending after November 15, 2006 by recording the necessary correcting adjustments to the carrying values of assets and liabilities as of the beginning of that year with the offsetting adjustment recorded to the opening balance of retained earnings. Additionally, the use of the cumulative effect transition method requires detailed disclosure of the nature and amount of each individual error being corrected through the cumulative adjustment and how and when it arose. We do not anticipate that SAB 108 will have a material impact on our 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 our fiscal year beginning October 1, 2007. We are currently evaluating the effect that the adoption of FIN 48 will have on our 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) that 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 we are required to adopt this standard as of January 1, 2007, in the second quarter of our fiscal year 2007. We are evaluating the impact, if any, that EITF 06-03 may have on our consolidated financial statements.

In February 2006, the FASB issued SFAS 155, Accounting for Certain Hybrid Financial Instruments, which amends SFAS 133, Accounting for Derivative Instruments and Hedging Activities and SFAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. SFAS 155 simplifies the accounting for certain derivatives embedded in other financial instruments by allowing them to be accounted for as a whole if the holder elects to account for the whole instrument on a fair value basis. SFAS 155 also clarifies and amends certain other provisions of SFAS 133 and SFAS 140. SFAS 155 is effective for all financial instruments acquired, issued or subject to a remeasurement event occurring in fiscal years beginning after September 15, 2006 and is therefore required to be adopted by us as of October 1, 2006. We do not anticipate the adoption of SFAS 155 will have any impact on our consolidated financial statements.

In May 2005, the FASB issued SFAS 154, Accounting Changes and Error Corrections, which replaces APB 20, Accounting Changes and SFAS 3, Reporting Accounting Changes in Interim Financial Statements An Amendment of APB Opinion No. 28. SFAS 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. It establishes retrospective application, or the latest practicable date, as the required method for reporting a change in accounting principle and the reporting of a correction of an error. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005 and is therefore required to be adopted by us as of October 1, 2006. To the extent we make any accounting changes or error correction in future periods the adoption of SFAS 154 could have a material impact on our consolidated financial statements.

Item 7A. *Quantitative and Qualitative Disclosures about Market Risk*

We are exposed to market risk from changes in foreign currency exchange rates and interest rates, which could affect operating results, financial position and cash flows. We manage our exposure to these market risks through our regular operating and financing activities and, when appropriate, through the use of derivative financial instruments.

Exchange Rate Sensitivity

We are exposed to changes in foreign currency exchange rates. Any foreign currency transaction, defined as a transaction denominated in a currency other than the U.S. dollar, will be reported in U.S. dollars at the applicable exchange rate. Assets and liabilities are translated into U.S. dollars at exchange rates in effect at the balance sheet date and income and expense items are translated at average rates for the period. The primary foreign currency denominated transactions include revenue and expenses and the resulting accounts receivable and accounts payable balances reflected on our balance sheet. Therefore, the change in the value of the U.S. dollar as compared to foreign currencies will have either a positive or negative effect on our financial position and results of operations. Historically, our primary exposure has related to transactions denominated in the Euro, British Pound, Canadian Dollar, Japanese Yen, Israeli New Shekel, and Hungarian Forint.

Assuming a 10% appreciation or depreciation in foreign currency exchange rates from the quoted foreign currency exchange rates at September 30, 2006, the impact to our revenue, operating results or cash flows could be adversely affected.

In certain instances, we have entered into forward exchange derivative contracts to hedge against foreign currency fluctuations. In all cases, we use these derivative instruments to reduce our foreign exchange risk by essentially creating offsetting market exposures. The success of the hedging program depends on our forecasts of transaction activity in the various currencies. We do not use derivative instruments for trading or speculative purposes. At September 30, 2006, there were no outstanding derivative foreign exchange hedging instruments and we did not enter into any forward exchange derivative contracts during fiscal 2006.

On November 3, 2003, we entered into a forward exchange derivative contract to hedge our foreign currency exposure related to 3.5 million euros of inter-company receivables from our Belgian subsidiary to the United States. The contract had a one-year term that expired on November 1, 2004. On November 1, 2004, we renewed this forward hedge contract; the renewed contract had a one-year term expiring on November 1, 2005; however it was cancelable at our discretion. In February 2005, the Company liquidated the contract. For fiscal year 2005 and 2004, the Company realized a loss of $0.4 million, and recognized a gain of less than $0.1 million, respectively, related to this hedge.

On November 5, 2003, we entered into a forward exchange derivative contract to hedge our foreign currency exposure related to 7.5 million Singapore Dollars of inter-company receivables from our Singapore subsidiary to the United States. The original contract expired on January 30, 2004, but was extended to October 29, 2004. The contract was terminated on October 29, 2004. We realized a loss of approximately $0.2 million in connection with the termination of this hedge.

Interest Rate Sensitivity

We are exposed to interest rate risk as a result of our significant cash and cash equivalents, and the outstanding debt under the 2006 Credit Facility.

At September 30, 2006, we held approximately $112.3 million of cash and cash equivalents primarily consisting of cash and money-market funds. Due to the low current market yields and the short-term nature of our

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investments, a hypothetical change in market rates is not expected to have a material effect on the fair value of our portfolio or results of operations.

At September 30, 2006, our total outstanding debt balance exposed to variable interest rates was $353.2 million. To partially offset this variable interest rate exposure, the Company entered into a $100 million interest rate swap derivative contract. The interest rate swap is structured to offset period changes in the variable interest rate without changing the characteristics of the underlying debt instrument. A hypothetical change in market rates would have a significant impact on the interest expense and amounts payable relating to the $253.2 million of debt that is not offset by the interest rate swap; assuming a 1.0% change in interest rates, the interest expense would increase $2.5 million per annum.

Item 8. *Financial Statements and Supplementary Data*

Nuance Communications, Inc. Consolidated Financial Statements

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NUANCE COMMUNICATIONS, INC.

INDEX TO FINANCIAL STATEMENTS

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders
Nuance Communications, Inc.
Burlington, Massachusetts

We have audited the accompanying consolidated balance sheets of Nuance Communications, Inc. (the Company) as of September 30, 2006 and 2005, and the related consolidated statements of operations, stockholders equity and comprehensive income (loss), and cash flows for each of the two years in the period ended September 30, 2006, and for the nine-month period ended September 30, 2004. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Nuance Communications, Inc. at September 30, 2006 and 2005, and the results of its operations and its cash flows for each of the two years in the period ended September 30, 2006, and for the nine-month period ended September 30, 2004, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Nuance Communications, Inc. s internal control over financial reporting as of September 30, 2006, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated December 14, 2006, expressed an unqualified opinion thereon.

As described in note 16 of the Notes to Consolidated Financial Statements, Nuance Communications, Inc. adopted Statement of Financial Accounting Standards No. 123(R), Share-Based Payment, effective October 1, 2005.

/s/ BDO SEIDMAN, LLP
BDO Seidman, LLP

Boston, Massachusetts
December 14, 2006

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders
Nuance Communications, Inc.
Burlington, Massachusetts

We have audited management s assessment, included in the accompanying Management s Report on Internal Control over Financial Reporting, that Nuance Communications, Inc. (the Company) maintained effective internal control over financial reporting as of September 30, 2006, based on the criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management s assessment and an opinion on the effectiveness of the Company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management s assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

As indicated in the accompanying Management s Report on Internal Control Over Financial Reporting, management s assessment of and conclusion on the effectiveness of internal control over financial reporting did not include the internal controls of Dictaphone Corporation, which the Company acquired on March 31, 2006, and which is included in the 2006 consolidated financial statements of Nuance Communications, Inc. from the date of the acquisition and constituted approximately 42.8% of consolidated assets as of September 30, 2006, and approximately 20.1% of consolidated revenue for the year ended September 30, 2006. Management did not assess the effectiveness of internal controls over financial reporting of Dictaphone Corporation because the Company acquired this entity during its fiscal year ended September 30, 2006. Refer to Note 3 to the consolidated financial statements for further discussion of this acquisition and its impact on the Company s consolidated financial statements. Our audit of internal control over financial reporting of Nuance Communications, Inc. also did not include an evaluation of the internal control over financial reporting of Dictaphone Corporation.

In our opinion, management s assessment that Nuance Communications, Inc. maintained effective internal control over financial reporting as of September 30, 2006, is fairly stated, in all material respects, based on the criteria established in *Internal Control-Integrated Framework* issued by COSO. Also, in our opinion, Nuance Communications, Inc. maintained, in all material respects, effective internal control over financial reporting as of September 30, 2006, based on the criteria established in *Internal Control-Integrated Framework* issued by COSO.

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We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the 2006 consolidated financial statements of Nuance Communications, Inc. and our report dated December 14, 2006 expressed an unqualified opinion thereon and indicated that the Company adopted Statement of Financial Accounting Standards No. 123(R), Share-Based Payment, effective October 1, 2005.

/s/ BDO SEIDMAN, LLP
BDO Seidman, LLP

Boston, Massachusetts
December 14, 2006

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NUANCE COMMUNICATIONS, INC.

CONSOLIDATED BALANCE SHEETS

	September 30, 2006	September 30, 2005
	(In thousands, except share and per share amounts)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 112,334	$ 71,687
Marketable securities		24,127
Accounts receivable, less allowances of $18,201 and $13,118, respectively	110,778	66,488
Acquired unbilled accounts receivable	19,748	3,052
Inventories, net	6,795	313
Prepaid expenses and other current assets	13,245	9,235
Deferred tax assets	421	
Total current assets	263,321	174,902
Land, building and equipment, net	30,700	14,333
Goodwill	699,333	458,313
Other intangible assets, net	220,040	92,350
Other long-term assets	21,680	17,314
Total assets	$ 1,235,074	$ 757,212
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term debt and obligations under capital leases	$ 3,953	$ 27,711
Accounts payable	27,768	17,347
Accrued expenses	52,674	60,153
Current portion of accrued business combination costs	14,810	17,027
Deferred maintenance revenue	63,269	13,298
Unearned revenue and customer deposits	30,320	10,822
Deferred acquisition payments, net	19,254	16,414
Total current liabilities	212,048	162,772
Long-term debt and obligations under capital leases, net of current portion	349,990	35
Accrued business combination costs, net of current portion	45,255	54,972
Deferred maintenance revenue, net of current portion	9,800	291
Deferred tax liability	19,926	4,241
Deferred acquisition payments, net Phonetic		16,266
Other liabilities	21,459	3,970

Total liabilities	658,478	242,547
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; 173,182,430 and 159,431,907 shares issued and 170,152,247 and 156,585,046 shares outstanding, respectively	174	160
Additional paid-in capital	773,120	699,427
Treasury stock, at cost (3,030,183 and 2,846,861 shares, respectively)	(12,859)	(11,432)
Deferred compensation		(8,782)
Accumulated other comprehensive income (loss)	1,656	(2,100)
Accumulated deficit	(190,126)	(167,239)
Total stockholders equity	576,596	514,665
Total liabilities and stockholders equity	$ 1,235,074	$ 757,212

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

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NUANCE COMMUNICATIONS, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

	Year Ended September 30, 2006	Year Ended September 30, 2005	Nine Months Ended September 30, 2004
	(In thousands, except per share amounts)		
Revenue:			
Product and licensing	$ 235,825	$ 171,200	$ 98,262
Professional services, subscription and hosting	81,320	47,308	25,358
Maintenance and support	71,365	13,880	7,287
Total revenue	388,510	232,388	130,907
Costs and Expenses:			
Cost of revenue:			
Cost of product and licensing	31,394	20,378	10,348
Cost of professional services, subscription and hosting	59,015	34,737	20,456
Cost of maintenance and support	17,723	4,938	2,559
Cost of revenue from amortization of intangible assets	12,911	9,150	8,431
Total cost of revenue	121,043	69,203	41,794
Gross margin	267,467	163,185	89,113
Operating expenses:			
Research and development	59,403	39,190	26,390
Sales and marketing	128,412	78,797	49,554
General and administrative	55,343	31,959	18,394
Amortization of other intangible assets	17,172	3,984	1,967
Restructuring and other charges (credits), net	(1,233)	7,223	801
Total operating expenses	259,097	161,153	97,106
Income (loss) from operations	8,370	2,032	(7,993)
Other income (expense):			
Interest income	3,305	1,244	429
Interest expense	(17,614)	(1,644)	(340)
Other (expense) income, net	(1,132)	(237)	(141)
Income (loss) before income taxes	(7,071)	1,395	(8,045)
Provision for income taxes	15,144	6,812	1,333
Loss before cumulative effect of accounting change	(22,215)	(5,417)	(9,378)
Cumulative effect of accounting change	672		

Net loss	$ (22,887)	$ (5,417)	$ (9,378)
Basic and diluted earnings per share:			
Loss before cumulative effect of accounting change	$ (0.13)	$ (0.05)	$ (0.09)
Cumulative effect of accounting change	(0.01)		
Net loss per share	$ (0.14)	$ (0.05)	$ (0.09)
Weighted average common shares outstanding:			
Basic and diluted	163,873	109,540	103,780

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

NUANCE COMMUNICATIONS, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY AND COMPREHENSIVE INCOME/(LOSS)

Preferred Stock		Common Stock		Additional Paid-In	Treasury Stock		Deferred	Accumulated Other Comprehensive Income	Accumulated	St
Shares	Amount	Shares	Amount	Capital	Shares	Amount	Compensation	(Loss)	Deficit	
(In thousands, except share amounts)										
3,562,238	$ 4,631	105,327,485	$ 105	$ 464,350	2,735,466	$ (10,925)	$ (1,743)	$ (748)	$ (152,444)	$
		2,570,697	3	6,221						
		706,504	1	5,253	4,000		(5,254)			
				382						