SCANSOFT INC
Form 10-KT
January 06, 2005

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

FORM 10-K/T

(Mark One)

[ ] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

[X] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM JANUARY 1, 2004 TO SEPTEMBER 30, 2004

COMMISSION FILE NUMBER 0-27038
SCANSOFT, INC.
(Exact name of Registrant as Specified in its Charter)

DELAWARE	94-3156479
(State of Incorporation)	(I.R.S. Employer Identification No.)
9 CENTENNIAL DRIVE PEABODY, MASSACHUSETTS 01960	(978) 977-2000
(Address of Principal Executive Offices, Including Zip Code)	(Registrant's Telephone Number, Including Area Code)

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 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 [X] No [ ]

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/T or any amendment to this Form 10-K/T. [ ]

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). Yes [X] No [ ]

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 $341,451,698 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 December 31, 2004, was 106,249,600.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's definitive Proxy Statement to be delivered to stockholders in connection with the Registrant's 2005 Annual Meeting of Stockholders are incorporated by reference into Part III of this Form 10-K/T.

SCANSOFT, INC.

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FORWARD LOOKING STATEMENTS

THIS TRANSITION REPORT ON FORM 10-K/T 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 FLOW 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 2005 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," "BELIEVES," "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.

PART I

ITEM 1. BUSINESS

INTRODUCTION

ScanSoft, Inc. ("ScanSoft") offers businesses and consumers market-leading speech and imaging solutions that facilitate the way people access, share, manage and use information in business and in daily life. 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.scansoft.com). The value of our solutions is best realized in vertical markets that are information and process intensive, such as healthcare, telecommunications, financial services, legal and government.

ScanSoft was incorporated in 1992 as Visioneer. In 1999, we changed our name to ScanSoft, Inc. and ticker symbol to SSFT. Our corporate headquarters and executive offices are located at 9 Centennial Drive, Peabody, Massachusetts 01960. Our telephone number is 978-977-2000. We have approximately 25 regional sales and research and development (R&D) offices throughout North America, Europe and Asia. Our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Proxy Statements relating to our annual meetings of stockholders, Current Reports on Form 8-K and amendments to these reports are available free of charge on our website (www.scansoft.com), as well as from the SEC website at www.sec.gov.

On October 23, 2004, ScanSoft's Board of Directors approved a change in ScanSoft's fiscal year end from December 31 to September 30, effective beginning September 30, 2004. All references in this Form 10-K/T to the period ended September 30, 2004 refer to the nine months ended September 30, 2004. References to fiscal 2005, refers to the period beginning on October 1, 2004 and ending on September 30, 2005.

MARKET OPPORTUNITY

In the past decade, information has become an increasingly important source of capital for businesses and enterprises, and the speed and sophistication of information exchange is often a defining characteristic of the most successful entities worldwide. Many organizations define their strategy, 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 medium and optimal format for vital business information is wide and varied, ranging from paper, electronic files and Web content to the spoken word in multiple languages and in multiple locations.

Confronted by exponentially increasing information through more and more channels, consumers and business personnel employ a variety of resources for retrieving information, conducting transactions and performing their jobs. The Internet and related corporate infrastructure have emerged as a powerful global communications network and channel for business. These electronic systems have fundamentally changed the way organizations and consumers obtain information, communicate, purchase goods and conduct business.

Businesses around the world share a common motivation to improve operating efficiency and enhance customer service. Customer satisfaction, employee productivity and company operating results can often be linked to an organization's ability to effectively manage, utilize and communicate information.

We believe there is a significant opportunity for our solutions to help simplify the way people access, share, manage and use information in business and in daily life. Our strategy is to deliver premier, comprehensive technologies and services as an independent application (software) or as part of a larger integrated system in two areas -- speech and imaging. 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. Our imaging solutions eliminate the need to manually reproduce documents, automate the integration of documents into business systems, and enable the use of electronic documents and forms within XML, Internet, mobile and other business applications. Our software is delivered as part of a larger integrated system, such as systems for customer service call centers, or as an independent application, such as dictation, document conversion or PDF, navigation systems in automobiles or digital copiers on a network. Our products and technologies deliver a measurable return on investment to our customers.

BACKGROUND

From our founding in 1992 until December 2001, we focused exclusively on delivering imaging solutions that simplified converting and managing information as it moved from paper formats to electronic systems. On March 13, 2000, we merged with Caere Corporation, a California-based digital imaging software company, to expand our applications for document and electronic forms conversion. 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 they serve similar vertical markets with information intensive requirements. We continue to execute against our strategy of being the market leader in speech and imaging through the organic growth of our business as well as through strategic acquisitions. Since the beginning of 2003, we have completed a number of acquisitions, including:

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

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

- On December 19, 2003, we acquired LocusDialog, Inc. ("LocusDialog") to expand our speech application portfolio with automated attendant solutions for business.

- On June 15, 2004, we acquired Telelogue, Inc. ("Telelogue") to enhance our automated directory assistance solutions.

- On September 16, 2004, we acquired Brand & Groeber Communications GbR ("B&G") to enhance our embedded speech solutions, which will make mobile phones accessible to the visually impaired using ScanSoft's text-to-speech technology.

- On December 6, 2004, we acquired Rhetorical Systems, Inc. ("Rhetorical") to complement our text-to-speech solutions and add capabilities for creating custom voices.

Subsequent to September 30, 2004, we also announced agreements to acquire ART Advanced Recognition Technologies, Inc. ("ART") to expand our portfolio of embedded speech solutions and Phonetic Systems Ltd. ("Phonetic") to complement our position in automated directory assistance and enterprise speech applications. We anticipate closing both of these transactions during the quarter ended March 31, 2005.

Our focus on providing market leading solutions that enable the capture and conversion of information and the automation of systems requires a broad set of technologies and channel capabilities. We have made and expect to continue to make acquisitions of other companies, businesses and technologies to complement our internal investments in these areas. 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.

OUR MARKETS AND SOLUTIONS

We are a leading provider of software and services that allow users to incorporate speech, images and documents in digital applications, systems and devices. Our products and technologies automate manual processes and help enterprises, professionals and consumers increase productivity, reduce costs and save time. We deliver premier, comprehensive technologies and services in two markets: speech and imaging.

OVERVIEW OF SPEECH MARKET

ScanSoft delivers field-proven speech solutions that use the human voice to interact with information systems and devices. Today, thousands of companies and millions of users depend on ScanSoft solutions to deliver vital business information and simplify everyday tasks. With our solutions, people can direct calls, obtain information, conduct transactions and control devices by simply using their voice.

ScanSoft is working toward our vision of the future where natural conversations are the preferred way people interact with automated systems and devices. To achieve this, we are investing in technologies and solutions which enable conversational, speech-based applications to become more dynamic, sound more natural and perform tasks on multiple devices that adapt to personal preferences. We are investing in three speech areas -- network speech, embedded speech and dictation.

Network Speech. Organizations are looking for ways to improve the quality of the customer care that they deliver, while reducing the associated costs. They seek to automate revenue-generating transactions requiring immediate delivery of goods and services. They also demand solutions that efficiently and effectively connect a mobile workforce with real-time enterprise information, including customer data, email and schedules.

Our network speech solutions, comprising automatic speech recognition and text-to-speech technologies and applications that reside on a company's network or server-based resources, can be used to implement applications that achieve these goals. We are a leading provider of software products and professional services that enable enterprises, telecommunications companies and government organizations to offer automated, speech-activated services over any telephone. Our network-based speech solutions allow users to direct their own calls, obtain information and conduct transactions by simply speaking naturally over any telephone. Our network-based text-to-speech solutions deliver natural sounding results by using segments of real human speech, thereby increasing listener satisfaction especially in the delivery of multiple phrases and sentences.

Our solutions adhere to global industry standards and we provide speech technologies and services in more languages than any other vendor.

Our solutions are used within a wide range of applications, across many customer-service intensive industries including financial services, telecommunications, utilities, government, travel and entertainment. Our network-based speech software is used in applications such as call centers, unified messaging systems, and voice portals that deliver enhanced information services ranging from advanced call routing, and transaction information (order placement, status) to customer service information and access to sports scores, news and stock quotes. In addition, we offer packaged solutions for applications that are common across a large set of customers and vertical markets. Currently, we offer packaged applications for directory assistance, corporate voice dialing and natural language routing for global telecommunication firms. We also offer applications designed to serve specific verticals, including the healthcare, utilities and insurance industries.

We license our network speech products to businesses as well as systems integrators, technology providers and telecommunications companies that in turn sell an integrated solution to businesses and end-users. We license our text-to-speech solutions to developers of telephony applications, including Avaya, Cisco, Genesys, Intervoice and Nortel, which integrate our solutions into hardware and software platforms.

We complement our technologies and products with a professional services organization that supports customers and partners with business and systems consulting project management, user interface design and application development assistance. Our professional services are designed to shorten time-to-market, assist clients, reduce implementation risks and improve clients' competitive position. Our professional services staff is located in Boston, New York and San Francisco and internationally in Canada, Mexico, the United Kingdom, France, Germany, Australia, Japan, Korea and Singapore.

Embedded Speech. Automotive, mobile communications, consumer electronics and computer game manufacturers and their suppliers are accelerating the development of products that require enhanced voice control capabilities. In addition, a growing number of independent software and hardware vendors are incorporating voice control into multimedia applications and devices that allow users to interact with these systems by speaking.

Our embedded speech solutions add voice control capabilities to applications integrated on a variety of automobiles and devices, such as mobile phones, PDAs, consumer electronics and navigation systems. This technology identifies specific words and phrases at any moment in time, converting spoken words into instructions that control functions within applications. Our solutions support dynamic vocabularies and have sophisticated noise management capabilities that ensure accuracy, even at high vehicle speeds. 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 for up to 18 languages. We include toolkits with our software that help developers add our technologies to applications such as navigation systems, hands-free cell phone devices and voice-activated controls in an automobile.

Our embedded speech solutions are used by tier-one automobile, cell phone, entertainment and aftermarket system manufacturers, including Bosch-Blaupunkt, Delphi, Microsoft, Motorola, Nokia, Pioneer and Sony. 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 qualifies them to be direct suppliers to the major automotive manufacturers, and in-dash radio, navigation system and other electronic device manufacturers, also known as aftermarket systems providers.

Dictation. Organizations demand solutions that increase productivity by automating repetitive business processes, including the creation of documents, data entry and completing forms. They also look for ways to maximize the productivity of their existing workers, including those with disabilities, and to comply with government requirements relating to workplace safety and accessibility. Organizations also seek solutions that can reduce the cost associated with manual transcription of professional documents. Since most people can

speak more quickly than they can type, speech is a natural and efficient way to interact with computers to address these problems.

Our speech recognition and dictation solutions, the Dragon NaturallySpeaking family of products, increase productivity in the workplace by using speech to create documents, streamline repetitive and complex tasks, input data, complete forms and automate manual transcription processes. Our solutions allow users to automatically convert speech into text at up to 160 words-per-minute, much faster than most people can type. Our software supports a vocabulary of more than 300,000 words that can be expanded by users to include specialized words and phrases. Our software is designed to adapt to individual voice patterns and accents and is highly accurate, able to achieve accuracy rates of approximately 99%, with the ability to achieve still greater accuracy with frequent use. Our software supports multiple languages, including Dutch, French, German, Italian, Japanese, Spanish, Swedish, and U.S./U.K. English.

Our solutions are valuable within enterprises and workgroups for a number of reasons. Our software can operate within a distributed network environment, where speaker profiles can be stored on a server and accessed from any networked computer. Our solutions can also speech-enable existing business systems and applications, including Microsoft Office, customer service and practice management applications. Our software allows a user to interact with a computer completely by voice, increasing the productivity of disabled workers and those suffering from repetitive stress injury. Our solutions can also help government agencies address accessibility mandates, such as those described in Section 508 of the U.S. Government Rehabilitation Act. We also deliver versions of our products that are specialized for the medical and legal markets.

We offer a range of desktop and server solutions, each with features that match a specific customer target. Our solutions are also used in enterprises and workgroups, particularly in the medical, legal, government, finance and education sectors. The Dragon NaturallySpeaking family of products includes our legal vocabulary and 14 medical vocabularies; supports the creation of custom vocabularies; and delivers capabilities that allow a user to access the application from within distributed care provider facilities. A growing number of healthcare vendors and integrators, including Agfa, Cerner CoPath, Dictaphone, IDX and SoftMed Systems, have joined with ScanSoft to speech-enable their healthcare solutions.

Our software is available in eight languages. We utilize a combination of our global reseller network and direct sales to distribute our speech recognition and dictation products. We believe we gain a competitive advantage through our established value-added reseller community, which provide local sales, integration, training and support services to our professional end-user customers. We also license our dictation software to companies such as Corel, Panasonic, and Sony, which bundle our solutions with some of their products.

OVERVIEW OF IMAGING MARKET

The Internet has changed many things, including the way people create and share information. The ease and popularity of email has reduced people's dependency on fax machines and postal service, while magazines and newspapers now deliver as much information through Web-based material as they do in print. Almost every office worker and many consumers at home use a computer, and a vast majority of those are connected to the Internet or a network. Despite advances in technology and networks, businesses are still confronted with productivity challenges associated with creating, sharing and working with documents

We believe there is a market opportunity for software solutions that maximize value and efficiency for information and documents processes. Our imaging solutions simplify the way businesses and consumers create, access and share documents.

Document and PDF Conversion. Despite the broad use of computing systems in enterprises, the majority of business information is still maintained in paper form. The proliferation of PDF as a digital document standard does not resolve the problem of accessing and utilizing information trapped in a static form. In addition, manually reproducing static documents in digital form is time consuming, costly and subject to error, taking valuable resources away from more productive activities. Enterprises and workgroups seek solutions that integrate paper and static PDF documents into their business processes, allowing them to automate the way they store, edit, use and share information.

Our solutions help businesses save time and money by automatically converting paper documents and PDF files into editable and usable business documents. Our Optical Character Recognition ("OCR") software, the OmniPage product family, delivers highly accurate document and PDF conversion, replacing the need to manually re-create documents. Our software preserves document formatting and provides editing capabilities that re-create the complex components in a typical document, including formatted text, columns, graphics, tables and spreadsheets. Our products can be used with existing business applications and enable the distribution and publishing of documents to email, Internet and mobile applications using standard file formats, including XML, HTML, PDF and Open eBook.

The proliferation of multifunction devices and digital copiers connected over a network has increased the number of documents that individuals within an enterprise are transforming into digital format. Our software solutions create a more efficient method to process static documents in enterprise content management and database systems, thereby enhancing the value of their investments in these systems. All of these documents can then be more easily archived, edited and combined within the enterprise.

Our solutions are used in professional office settings, particularly in the government, legal, finance and education sectors. Our software is available in 11 languages. We utilize a combination of our global reseller network and direct sales to distribute our document and PDF conversion products. We license our software to companies such as Brother, Dell, HP, Konica and Xerox, which bundle our solutions with multifunction devices, digital copiers, printers and scanners. In 2003, we introduced PDF Converter, a new product that converts PDF files into fully formatted Microsoft Word documents. Developed in collaboration with Microsoft Corporation, PDF Converter eliminates the need to manually create PDF content in Microsoft Word, and enables the editing of content in the PDF format. In 2004, we introduced PDF Create!, which enables users to create PDF from virtually any Windows based application. By enabling the conversion between two popular document formats -- PDF and Microsoft Word -- we enhance access to content within documents and lower the costs associated with converting documents. Our PDF solutions also provide a cost-effective alternative to those offered by Adobe Systems.

We also license software development toolkits to independent software vendors, integrators and in-house developers to add document and PDF conversion capabilities to their applications. Our independent software vendor customers include vendors, such as Canon, Captiva, Kofax, Sharp and Verity. Our technology is also used within high-end enterprise systems from vendors such as Kofax and Lockheed Martin.

Digital Paper Management. As the volume and complexity of corporate data continues to multiply, organizations are increasingly challenged in their efforts to manage all of their paper and digital documents. The wide dispersion of documents makes finding information even more difficult, time-consuming and costly. As a result, businesses need solutions that allow individuals, workgroups or the entire organization to more efficiently organize, find and share business documents.

Our digital paper management solutions, the PaperPort product family, convert 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. In a single search, users can quickly find scanned documents and existing digital files that match the search criteria.

Within enterprises, workgroups and distributed teams, our solution can also facilitate the movement of scanned paper and digital documents into email, print and other business applications. This streamlines the flow of documents between workers, decreasing the time and costs associated with managing and using paper documents. Our solution integrates with established file systems to simplify the transfer of documents between desktop and enterprise content management systems.

Our solutions are used in enterprises and workgroups, especially those within the legal, healthcare, financial, government, real estate and education industries. Our software is available in eight languages. 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, which bundle our solutions with multifunction devices, digital copiers, printers and scanners.

OUR COMPETITIVE STRENGTHS

Core Technology Assets. In recent years, we have developed and acquired extensive technology assets, intellectual property and industry expertise in speech and imaging. Our technologies are based on complex mathematical formulas, which require extensive 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 the advancement of our technologies to maintain our market leading position and to develop new applications. As of September 30, 2004, we had 309 full-time employees in research and development, and our technologies were covered by more than 650 patents and patent applications, expiring on various dates between 2005 and 2020.

Broad Distribution Channels. We maintain an extensive network of resellers to address the needs of specific markets, such as financial, legal, healthcare and government. We believe that our extensive channel relationships increase the difficulty for competitors to develop a similar channel network and make it difficult for our products to be displaced. In addition, our far-reaching channel network enables us to introduce new products quickly and effectively throughout the global marketplace.

Leading Market Share. We have a strong market position in most of our product categories and are the market leader in document and PDF conversion, network-based speech recognition and text-to-speech, and dictation. Organizations tend to look to established market leading vendors when making product selections. As the established brand in our markets, we believe we can target and win more partnership arrangements and new customers than our competition.

International Focus. The broad language coverage within our product offerings increases the likelihood that vendors selling globally will select our technology. Our language coverage is difficult for competitors to duplicate, and our presence in global markets limits the potential entry of new regional competitors. With nearly one half of our employees located outside of North America, we are able to efficiently compete on a global basis.

Multiple End Markets. We license to a range of end markets and maintain a tiered distribution model that provides a diversified revenue stream and broad market exposure. We are not dependent on any single market segment or set of end customers and earn revenue from both established and emerging markets.

Specialized Professional Services. We complement our technologies and products with a professional services organization that supports customers and partners, particularly in speech, with business and systems consulting, project management, user interface design and application development assistance. Our professional services are designed to shorten time-to-market, assist clients, reduce implementation risks and improve clients' competitive position.

OUR STRATEGY

Pursue High Growth Markets In Speech. We intend to leverage our technologies and market 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 technology 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 solutions and resources in the telecommunications, automotive and electronics markets.

Expand PDF and Imaging Solutions. We intend to enhance the value of our imaging solutions for 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 introduce new products or new versions of existing products to take advantage of these growth opportunities. We also plan to

enhance our software development toolkits so our technologies can be integrated with more third-party solutions.

Focus on Specific Vertical Markets. We intend to focus our marketing and sales resources to generate demand and deliver solutions in specific vertical markets. The value of our solutions is best realized in vertical markets that are information and process intensive, such as healthcare, telecommunications, financial services, legal and government. In addition, we intend to offer custom versions of certain applications and products for specific vertical markets such as medical, legal and utilities.

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. In particular, we intend to replicate our successful North American value-added reseller channel in Europe. 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.

Pursue Strategic Acquisitions. We have selectively pursued strategic acquisitions to expand our technology, channel and service resources and to complement our organic growth. For example, during 2003 we completed the LocusDialog, SpeechWorks and Philips acquisitions and completed the Telelogue, B&G and Rhetorical acquisitions in 2004. We intend to continue to pursue strategic acquisitions as a part of our growth strategy.

SALES, DISTRIBUTION AND FULFILLMENT

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 through our dedicated direct sales force and through our e-commerce website (www.scansoft.com). As of September 30, 2004, we have 226 sales and marketing employees worldwide.

We have established relationships with more than 2,000 channel partners, including leading system vendors, independent software vendors, value-added resellers and distributors, through which we market and distribute our products and solutions. In speech, companies such as Avaya, Cisco, Genesys, Dictaphone, Microsoft and Nortel embed our technologies into telecommunications systems, as well as automotive, PC 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. In addition, 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.

The majority of our software products are manufactured, packaged and shipped by Hewlett-Packard.

PROPRIETARY TECHNOLOGY

We exploit our proprietary technology, trade secrets, know-how, continuing technological innovations and licensing opportunities to maintain our competitive position. We rely on patent law, copyright law, trade secret laws, secrecy, technical measures, licensee agreements and non-disclosure agreements to protect our technology, trade secrets and other proprietary rights. Our policy is to file patent applications to protect technology, inventions and improvements that are important to the development of our business, to maintain a technological advantage over our competitors and to generate licensing revenue. In this regard, we have obtained patents that directly relate to our products. Our speech and imaging technologies are covered by more than 650 patents and patent applications. These patents expire on various dates between 2005 and 2020.

To protect our ownership rights in our software products, we license our products to OEMs and resellers on a non-exclusive basis with contractual restrictions on reproduction, distribution and transferability. In addition, we generally license our software in object code form only. We license certain of our software products to end-users by use of a "shrink-wrap" or "click wrap" customer license that restricts the end-user to personal use of the product.

We require our employees to execute confidentiality and invention assignment agreements in order to protect our proprietary technology and other proprietary rights. We also rely on trade secrets and proprietary know-how to protect our proprietary rights.

RESEARCH AND DEVELOPMENT

The market for our products and services is characterized by rapid technological change, frequent new product introductions and enhancements, evolving industry standards, and rapidly changing client requirements. As a result, we believe that our future growth is highly dependent on the timely and efficient introduction of new and updated products and technology. As of September 30, 2004, we employed 309 people in research and development, slightly over half of whom are located in international locations. Our employees based in overseas facilities extend our global focus while often lowering our overall cost of research and development. To promote efficiency in our research and development efforts, we have organized the effective use of global development teams and a comprehensively integrated development process. In addition, we have developed and refined our time-to-market process, which contributes to cost-effective resource management while promoting technology sharing across programs.

Our future success will depend in part on our ability to anticipate changes, enhance our current products, develop and introduce new products that keep pace with technological advancements and address the increasingly sophisticated needs of our clients. Our research and development expenses for the nine months ending September 30, 2004, and the twelve months ended December 31, 2003 and 2002 were $26.2 million, $33.9 million and $27.6 million, respectively. We expect that we will continue to commit significant resources to research and development in the future. To date we have not capitalized any research and development expenses and all costs have been expensed as incurred.

INTERNATIONAL OPERATIONS

We currently have offices in a number of international locations including: Australia, Belgium, Canada, Denmark, England, France, Germany, Hong Kong, Hungary, Italy, Japan, the Netherlands, Poland, Spain, Sweden and Taiwan. The scope of our international operations includes research and development, customer support and sales and marketing. Our international research and development is conducted in Budapest, Hungary; Merelbeke, Belgium; and Aachen, Germany. Additionally sales and support offices are located throughout the world to support our current international customers and to expand our international revenue opportunities.

Geographic revenue classification is based on the country in which the sale is invoiced. Revenue for the nine months ended September 30, 2004 was 70% North America and 30% international, versus 72% North America and 28% international for the year ended December 31, 2003.

Additional financial information relating to foreign and domestic sales and operations for each of the nine months ended September 30, 2004 and the two years in the period ended December 31, 2003 is set forth in Note 17, "Segment & Geographic Information and Significant Customers," of the Notes to Consolidated Financial Statements.

For a discussion of risks attendant to our foreign operations, see "Management's Discussion and Analysis of Financial Condition and Results of Operations -- 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."

COMPETITION

There are a number of companies that develop or may develop products that compete in our targeted markets; however, currently there is no one company that competes with us in all of our product areas. The individual markets in which we compete are highly competitive, and are subject to rapid technology changes. Within imaging, we compete directly with ABBYY, Adobe, I.R.I.S. and NewSoft. Within speech, we compete with AT&T, Fonix, IBM, Microsoft, Nuance and Philips. 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.

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.

EMPLOYEES

As of September 30, 2004, we employed 832 people on a full-time basis, 396 in the United States and 436 internationally. Of the total, 309 were in product research and development, 226 in sales and marketing, 139 professional service consultants, 56 in operations and support, and 102 in finance and administration. Our employees may be subject to collective bargaining agreements at a company or industry level in those countries where this is part of the local labor law or practice. We have experienced no work stoppages and believe that our employee relations are good. We have utilized the services of consultants, third-party developers, and other vendors in our sales, development, manufacturing activities and finance and administration functions.

AVAILABLE INFORMATION

Our reports filed with Securities and Exchange Commission, including this Transition Report on Form 10-K/T, our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to reports filed pursuant to Sections 13(a) and 15(d) of the Securities Exchange Act of 1934, as amended, are available free of charge on our website at www.scansoft.com, as soon as reasonably practicable after such reports are filed electronically with the Securities and Exchange Commission.

ITEM 2. PROPERTIES

Our corporate headquarters and administrative, sales, marketing and support functions for imaging occupy 37,636 square feet of space that we lease in Peabody, Massachusetts. We also lease 25,233 square feet of space in Waltham, Massachusetts where our North American speech research and development is performed. In connection with the acquisition of SpeechWorks, we assumed a lease for approximately 35,862 square feet of sales, marketing and support office space for speech, in Boston Massachusetts. These leases expire in July 2006, September 2006, and September 2006, respectively. We currently anticipate consolidating our Massachusetts locations in the summer of 2005, which could require us to incur restructuring expenses, which we have not quantified to date. Additionally, we lease approximately 21,180 square feet of research and development space located in Budapest, Hungary and 20,085 square feet in Merelbeke, Belgium, which houses additional research and development space and our international headquarters, respectively. These leases expire in December 2006 and April 2008, respectively. In connection with the Philips acquisition, we assumed a lease for approximately 30,000 square feet of speech research and development space located in Aachen, Germany. This lease expires in March 2006. In addition, we assumed two leases for approximately 8,000 square feet and 15,000 square feet, respectively, of speech research and development space located in Montreal, Canada. These leases expire in January 2005 and March 2013,

respectively. Also in connection with the acquisition of SpeechWorks we acquired 26,200 square feet of space in New York, New York that we subleased to another company. The lease and sublease expire in February, 2016. In connection with the acquisition of LocusDialog, we assumed a lease for approximately 12,000 square feet of speech research and development and fulfillment space located in Montreal, Canada which expires in June, 2006. In connection with the acquisition of Telelogue we assumed a lease for approximately 5,892 square feet of research and development space in New Jersey which expires in March, 2006. We also lease a number of small sales and marketing offices in the United States, Asia and Europe.

As of September 30, 2004, we were productively utilizing substantially all of the space in our facilities, except for space that has been subleased or restructured. We believe that our existing facilities are adequate for our needs for at least the next twelve months.

ITEM 3. LEGAL PROCEEDINGS

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

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

On September 9, 2004, BIS Advanced Software Systems, Ltd. ("BIS") filed an action against us in the United States District Court for the District of Massachusetts claiming patent infringement. Damages are sought in an unspecified amount. In the lawsuit, BIS alleges that the Company is infringing United States Patent No. 6,401,239 entitled "System and Method for Quick Downloading of Electronic Files." We believe this claim has no merit, and we intend to defend the action vigorously.

On August 5, 2004, Compression Labs, Inc. filed an action against the Company in the United States District Court for the Eastern District of Texas claiming patent infringement. Damages are sought in an unspecified amount. In the lawsuit, Compression Labs alleges that the Company is infringing United States Patent No. 4,698,672 entitles "Coding System for Reducing Redundancy." We believe this claim has no merit, and we intend to defend the action vigorously.

On April 23, 2004, Millennium L.P. filed an action against the Company in the United Sates District Court for the Southern District of New York claiming patent infringement. Damages are sought in an unspecified amount. In the lawsuit, Millennium alleges that the Company is infringing United States Patent No. 5,258,855 entitled "Information Processing Methodology"; No. 5,369,508 entitled "Information Processing Methodology"; No. 5,625,465 entitled "Information Processing Methodology"; No. 5,678,416 entitled "Information processing Methodology; and No. 6,094,505 entitled "Information Processing Methodology." The Company filed an Answer on June 17, 2004. We believe this claim has no merit, and we intend to defend the action vigorously.

On July 15, 2003, Elliott Davis ("Davis") filed an action against SpeechWorks in the United States District Court for the Western District for New York (Buffalo) claiming patent infringement. Damages are sought in an unspecified amount. In the lawsuit, Davis alleges that SpeechWorks is infringing United States Patent No. 4,802,231 entitled "Pattern Recognition Error Reduction System" (the "'231 Patent"). The '231 Patent generally discloses techniques for a pattern recognition system and method wherein errors are reduced by creating independent error templates that correspond to patterns that tend to be erroneously matched and linked error templates that are linked to specified reference templates that are stored for comparison. In addition, on November 26, 2003, Davis filed an action against the Company in the United

States District Court for the Western District for New York (Buffalo) claiming that the Company infringed the '231 Patent. Damages are sought in an unspecified amount. Although the Company has, both prior to and as a result of the SpeechWorks acquisition, several products in the speech recognition technology field, the Company believes that the products do not infringe the '231 Patent because neither the Company nor SpeechWorks use the claimed techniques. SpeechWorks filed an Answer and Counterclaim to Davis's Complaint in its case on August 25, 2003, and the Company filed an Answer and Counterclaim to Davis's Complaint in its case on December 22, 2003. The Company believes Davis's claims have no merit and intends to defend the actions vigorously.

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

The Company believes that the final outcome of these matters will not have a significant adverse effect on its financial position and results of operations. However, even if its defense is successful, the litigation could require significant management time and could be costly. Should the Company not prevail in any such litigation, its operating results, financial position and cash flows could be adversely impacted.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

PART II

ITEM 5. MARKET FOR THE REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

MARKET FOR COMMON STOCK

Our common stock commenced trading on the Nasdaq National Market on December 11, 1995 under the symbol "VSNR," and traded under that symbol until March 3, 1999. Our common stock is now traded on the Nasdaq National Market under the symbol "SSFT." As of December 31, 2004, there were outstanding 106,249,600 shares of common stock. The following table sets forth for the periods indicated the high and low sale prices for our common stock as reported on the Nasdaq National Market.

	HIGH	LOW

FISCAL 2004:		
First quarter	$6.36	$4.63
Second quarter	5.84	4.58
Third quarter	5.00	3.61
FISCAL 2003:		
First quarter	$6.50	$3.81
Second quarter	6.55	4.45
Third quarter	5.98	3.32
Fourth quarter	6.50	4.15

The equity compensation plan information incorporated by reference into Part III, Item 12 of this Form 10-K/T is hereby incorporated by reference into this Part II, Item 5.

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As of December 31, 2004, there were 736 stockholders of record and the last reported sale price of our common stock on the Nasdaq National Market was $4.19 per share.

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.

Our loan and security agreement with Silicon Valley Bank, as amended on March 31, 2004, contains a restrictive covenant which prohibits us from paying or declaring any dividends on our capital stock during the term of the agreement (except for dividends payable solely in capital stock) without Silicon Valley Bank's prior written consent. In addition, the zero coupon convertible subordinated debenture due in 2006 that was issued to Koninklijke Royal Philips Electronics N.V. in connection with our acquisition of the Speech Processing Telephony and Voice Control business units of Philips contains a restrictive covenant which prohibits us from paying or declaring any dividend or distribution (other than distributions of our equity securities) on our capital stock while the debenture is outstanding. This restriction terminates if one half or more of the debenture is converted by Philips into common stock.

ITEM 6. SELECTED FINANCIAL DATA

On October 23, 2004, ScanSoft's Board of Directors approved a change in ScanSoft's fiscal year end from December 31 to September 30, effective beginning September 30, 2004. All references in this Form 10-K/T to the period ended September 30, 2004 refer to the nine months ended September 30, 2004.

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/T. 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

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of normal recurring adjustments, necessary for a fair presentation of results of operations for the nine months ended September 30, 2003.

	NINE MONTH PERIOD ENDED SEPTEMBER 30, 2004(4)	YEAR ENDED DECEMBER 31, 2003(3)	2002	2001(2)	2000(1)	NINE MONT ENDED SEPTEMBER 2003 (UNAUDITE
	(IN THOUSANDS, EXCEPT PER SHARE DATA)					
CONSOLIDATED STATEMENT OF OPERATIONS DATA:						
Total revenue...........	$130,907	$135,399	$106,619	$ 62,717	$ 47,961	$ 88,529
Gross margin............	89,179	98,760	80,730	35,676	23,700	65,405
Income (loss) from operations............	(7,993)	(6,462)	6,603	(16,931)	(52,497)	(7,033
Income (loss) before income taxes..........	(8,045)	(5,787)	6,587	(17,194)	(52,779)	(6,375
Provision for (benefit from) income taxes.....	1,333	(269)	254	(317)	472	473
Net income (loss)........	$ (9,378)	$ (5,518)	$ 6,333	$(16,877)	$(53,251)	$ (6,848
Net income (loss) per share: basic and diluted...............	$ (0.09)	$ (0.07)	$ 0.09	$ (0.34)	$ (1.26)	$ (0.10
Weighted average common shares outstanding: Basic.................	103,780	78,398	67,010	49,693	42,107	71,286
Diluted...............	103,780	78,398	72,796	49,693	42,107	71,286

	AS OF SEPTEMBER 30, 2004	AS OF DECEMBER 31, 2003	2002	2001	2000
	(IN THOUSANDS)				
CONSOLIDATED BALANCE SHEET DATA:					
Cash, cash equivalents and short and long-term investments...........	$ 47,691	$ 42,584	$ 18,853	$ 14,324	$ 2,633
Working capital (deficit)..........	27,940	44,305	16,842	9,318	(6,484
Total assets.......................	392,653	401,940	143,690	142,070	109,480
Long-term debt.....................	27,700	27,859	--	3,273	--
Total stockholders' equity.........	301,745	303,226	119,378	114,534	87,461

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(1) On March 13, 2000, the Company merged with Caere Corporation, a California-based digital imaging software company.

(2) On December 12, 2001, the Company acquired the Speech and Language Technology Business of Lernout & Hauspie Speech Products, N.V.

(3) On January 30, 2003, the Company acquired Royal Philips Electronic Speech Processing Telephony and Voice Control business units, and related intellectual property. See Note 19 to Notes to Consolidated Financial Statements.

On August 11, 2003, the Company acquired SpeechWorks International, Inc. See Note 19 to Notes to Consolidated Financial Statements.

On December 19, 2003, the Company acquired LocusDialog, Inc. See Note 19 to Notes to Consolidated Financial Statements.

(4) On June 15, 2004, the Company acquired Telelogue, Inc. See Note 19 to Notes to Consolidated Financial Statements.

On September 16, 2004, the Company acquired Brand & Groeber Communications Gbr. See Note 19 to Notes to Consolidated Financial Statements.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

THE FOLLOWING DISCUSSION OF OUR FINANCIAL CONDITION AND RESULTS OF OPERATIONS SHOULD BE READ IN CONJUNCTION WITH OUR CONSOLIDATED FINANCIAL STATEMENTS AND RELATED NOTES THERETO INCLUDED ELSEWHERE IN THIS TRANSITION REPORT ON FORM 10-K/T. THIS DISCUSSION CONTAINS FORWARD-LOOKING STATEMENTS, WHICH INVOLVE RISKS AND UNCERTAINTIES. OUR ACTUAL RESULTS COULD DIFFER MATERIALLY FROM THOSE ANTICIPATED IN THESE FORWARD-LOOKING STATEMENTS FOR MANY REASONS, INCLUDING THE RISKS DESCRIBED IN "RISK FACTORS" STARTING ON PAGE 31 AND ELSEWHERE IN THIS ANNUAL REPORT.

OVERVIEW OF THE BUSINESS

We offer businesses and consumers market-leading speech and imaging solutions that facilitate the way people access, share, manage and use information in business and in daily life. 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.scansoft.com). The value of our solutions is best realized in vertical markets that are information and process intensive, such as healthcare, telecommunications, financial services, legal and government.

Our strategy is to deliver premier, comprehensive technologies and services as an independent application or as part of a larger integrated system in two areas -- speech and imaging. 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. Our imaging solutions eliminate the need to manually reproduce documents, automate the integration of documents into business systems, and enable the use of electronic documents and forms within XML, Internet, mobile and other business applications. Our software is delivered as part of a larger integrated system, such as systems for customer service call centers, or as an independent application, such as dictation, document conversion or PDF, navigation systems in automobiles or digital copiers on a network. Our products and technologies deliver a measurable return on investment to our customers.

Our extensive technology assets, intellectual property and industry expertise in speech and digital capture create high barriers to entry 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, and we continue to build upon our leadership position. Our speech technology has industry-leading recognition accuracy, provides recognition for 48 languages and natural sounding synthesized speech in 22 languages, and supports a broad range of hardware platforms and operating systems. Our digital capture technology is recognized as the most accurate in the industry, with rates as high as 99.8%, and supports more than 100 languages. Our technologies are covered by more than 650 patents or patent applications.

Our strategy includes pursuing high growth markets in speech, expanding our PDF and imaging solutions, providing our partners and customers with a comprehensive portfolio of solutions, promoting the broad adoption of our technology, focusing and leverage our vertical expertise, building global sales and channel relationships and pursuing strategic acquisitions that complement our resources.

ScanSoft was incorporated in 1992 as Visioneer. In 1999, we changed our name to ScanSoft, Inc. and ticker symbol to SSFT. 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. On

March 13, 2000, we merged with Caere Corporation, a California-based digital imaging software company, to expand our applications for document and electronic forms conversion. 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 through the organic growth of our business as well as through strategic acquisitions. Since the beginning of 2003, we have completed a number of acquisitions, including:

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

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

- On December 19, 2003, we acquired LocusDialog, Inc. ("LocusDialog") to expand our speech application portfolio with automated attendant solutions for business.

- On June 15, 2004, we acquired Telelogue, Inc. ("Telelogue") to enhance our automated directory assistance solutions.

- On September 16, 2004, we acquired Brand & Groeber Communications GbR ("B&G") to enhance our embedded speech solutions, which will make mobile phones accessible to the visually impaired using ScanSoft's text-to-speech technology.

- On December 6, 2004, we acquired Rhetorical Systems, Inc. ("Rhetorical") to complement our text-to-speech solutions and add capabilities for creating custom voices.

Subsequent to September 30, 2004, we also announced agreements to acquire ART Advanced Recognition Technologies, Inc. ("ART") to expand our portfolio of embedded speech solutions and Phonetic Systems Ltd. ("Phonetic") to complement our position in automated directory assistance and enterprise speech applications. We anticipate closing both of these transactions during the quarter ended March 31, 2005.

Our focus on providing solutions that enable the capture and conversion of information and the automation of systems requires a broad set of technologies and channel capabilities. We have made and expect to continue to make acquisitions of other companies, businesses and technologies to complement our internal investments in these areas. 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.

CRITICAL ACCOUNTING POLICIES, JUDGMENTS AND ESTIMATES

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

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

As a result of SpeechWorks acquisition in August 2003, professional services became a material component of our business. As a result of this and the implementation of Oracle, in January 2004, we began to separately track and disclose professional services revenues and cost of revenue. Prior to 2004, we did not separately disclose professional services revenue and cost of revenue as they were immaterial and it is not practical to reclassify these revenues and associated costs retroactively.

We recognize revenue in accordance with Statement of Position ("SOP") 97-2, Software Revenue Recognition, as amended by SOP 98-9, "Modification of SOP 97-2 with Respect to Certain Transactions", SOP 81-1 Accounting for Performance of Construction Type and Certain Performance Type Contracts and the Securities and

Exchange Commission's Staff Accounting Bulletin No. 104, "Revenue Recognition in Financial Statements" ("SAB 104") and Emerging Issues Task Force ("EITF") 01-09 "Accounting for Consideration Given by a Vendor (Including a Reseller of the Vendors Products)" and Financial Accounting Standards Board No. 48 ("SFAS 48") "Revenue Recognition When Right of Return Exists". In general we recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, collectibility is probable, and vendor specific objective evidence ("VSOE") exists for any undelivered elements. We reduce revenue recognized for estimated future returns, price protection and rebates and certain marketing funds at the time the related revenue is recorded.

Certain distributors and value-added resellers have been granted rights of return for as long as the distributors or resellers hold the inventory. We have not aggregated and analyzed historical returns from distributor and resellers to form a basis in order to estimate the future sales returns by distributor and resellers. As a result, we recognize revenues from sales to these distributors and resellers when they have sold products through to retailers and end-users. Title and risk of loss pass to the distributor or reseller upon shipment, at which time the transaction is invoiced and payment is due. Based on reports from distributors and resellers of their inventory balances at the end of each period, we record an allowance against accounts receivable for the sales price of all inventories subject to return.

We also make an estimate of sales returns by retailers or end users directly or through our distributors or resellers based on historical returns experience. We have aggregated and analyzed historical returns from retailers and end users which forms the basis of our estimate of future sales returns by retailers or end users. In accordance with SFAS 48, the provision for these estimated returns is recorded as a reduction of revenue at the time that the related revenue is recorded. If actual returns from retailers differ significantly from our estimates, such differences could have a material impact on our results of operations for the period in which the actual returns become known. Our accounts receivable balance, including accounts receivable from a related party, was $36.5 million and $42.4 million at September 30, 2004 and December 31, 2003, respectively. These balances are net of sales returns and other allowances of $8.8 million and $8.8 million and allowances for doubtful accounts of $2.5 million and $1.4 million as of September 30, 2004 and December 31, 2003, respectively.

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

When we provide professional services considered essential to the functionality of the software, such as custom application development for a fixed fee, we recognize revenue from the fees for such services and any related software licenses based on the percentage-of-completion method in accordance with SOP 81-1. We generally determine the percentage of completion by comparing the labor hours incurred to date to the estimated 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 a loss, such loss is recorded

in the period identified. Significant judgments and estimates are involved in determining total estimated costs, and therefore the percent complete of each contract. If our estimates change, the adjustment could have a material effect on our results of operations in the period of the change.

When we provide services on a time and materials basis, we recognize revenue as we perform the services based on actual time incurred. Other professional services not considered essential to the functionality of the software are limited and primarily include training and feasibility studies, which are recognized as revenue when the related services are performed.

When we provide software support and maintenance services, we recognize the revenue ratably over the term of the related contracts, typically one year.

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

We follow the guidance of EITF 01-09 in determining whether consideration given to a customer should be recorded as an operating expense or a reduction of revenue recognized from that same customer. Consideration given to a customer is recorded as a reduction of revenue unless both of the following conditions are met:

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

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

Consideration, including that in the form of our equity instruments (if applicable), is recorded as a reduction of revenue, to the extent we have recorded cumulative revenue from the customer or reseller. As a result of this policy, we have recorded a $0.3 million, $0.2 million and $0.3 million reduction in total revenue for the nine months ended September 30, 2004 and the years ended December 31, 2003 and 2002, respectively.

We follow the guidance of EITF Issue No. 01-14, Income Statement Characterization of Reimbursements for "Out-of-Pocket" Expenses Incurred, and record reimbursements received for out-of-pocket expenses as revenue, with offsetting costs recorded as cost of revenue. Out-of-pocket expenses generally include, but are not limited to, expenses related to airfare, hotel stays and out-of-town meals.

ACCOUNTING FOR PATENT LEGAL DEFENSE COSTS

We have capitalized external legal costs incurred in the defense of our patents where we believe that the future economic benefit of the patent will be increased. We monitor the legal costs incurred and the anticipated outcome of the legal action and, if changes in the anticipated outcome occur, write off capitalized costs, if any, in the period the change is determined.

VALUATION OF LONG-LIVED TANGIBLE AND INTANGIBLE ASSETS AND GOODWILL

We have significant long-lived tangible and intangible assets and goodwill, 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 and trademarks which are typically amortized using the straight-line method over their estimated useful lives. The values of intangible assets, with the exception of goodwill, 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 value 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.

Effective January 1, 2002, we adopted Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets ("SFAS 142"). SFAS 142 requires, among other things, the discontinuance of goodwill amortization. The standard also includes provisions for the assessment of the useful lives of existing recognized intangible assets and the identification of reporting units for purposes of assessing potential future impairments of goodwill. We have assessed the useful lives of our existing intangible assets, other than goodwill, and believe that estimated useful lives remain appropriate. In addition, we have determined that we operate in one reporting unit. As a result, we use the market value approach on the enterprise level basis to determine fair value of the Company in the initial step of our goodwill impairment testing. Based on this, we performed the annual assessment during the last quarter of fiscal 2004 and determined that these intangible assets were not impaired. We complete goodwill impairment analyses at least annually, or more frequently when events and circumstances occur indicating that the recorded goodwill might be impaired.

Significant judgments and estimates are involved in determining the useful lives of our intangible assets, determining what reporting units exist and assessing when events or circumstances would require an interim impairment analysis of goodwill or other long-lived assets to be performed. Changes in 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 multiple 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. We completed the acquisition of Rhetorical in December 2004 and have announced our agreements to acquire ART and Phonetic. 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 revenues 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

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assets. The impact of prior or future acquisitions on our financial position or results of operations may be materially impacted by the change in or initial selection of assumptions and estimates. 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 STOCK-BASED COMPENSATION INSTRUMENTS

We apply the principles of FASB Statement No. 123 "Accounting for Stock-based Compensation" to value any grants of equity instruments to non-employees as well as to calculate pro forma information relative to our employee awards for disclosure purposes. Application of this principle inherently includes a number of estimates and assumptions including stock price volatility factors. We based our estimates and assumptions on the best information available at the time of valuation, however, changes in these estimates and assumptions including stock price volatility factors could have a material effect on the valuation of the underlying instruments.

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. 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.

ACCOUNTING FOR INCOME TAXES

As part of the process of preparing our consolidated financial statements, we are required to calculate our income tax expense based on taxable income by jurisdiction. There are many transactions and calculations where the ultimate tax outcome is uncertain. Some of these uncertainties arise as a consequence of revenue-sharing and cost-reimbursement arrangements among related entities and the differing tax treatment of revenue and cost items across various jurisdictions.

Additionally, we monitor the realization of our deferred tax assets based on changes in circumstances, for example, recurring periods of income for tax purposes following historical periods of cumulative losses or changes in tax laws or regulations. Our income tax provisions and our assessment of the realizability of our deferred tax assets involve significant judgments and estimates. If we continue to generate taxable income through profitable operations in future years 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 stock compensation.

OVERVIEW OF RESULTS OF OPERATIONS

On October 23, 2004, ScanSoft's Board of Directors approved a change in ScanSoft's fiscal year end from December 31 to September 30, effective beginning September 30, 2004. All references in this Form 10-K/T to the period ended September 30, 2004 refer to the nine months ended September 30, 2004. References to fiscal 2005, refers to the period beginning on October 1, 2004 and ending on September 30, 2005.

The following table presents, as a percentage of total revenue, certain selected financial data for the nine months ended September 30, 2004 and September 30, 2003 and for the two years ended December 31, 2003 and 2002. 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, necessary for a fair presentation of results of operations for the nine months ended September 30, 2003.

	NINE MONTH PERIOD ENDED SEPTEMBER 30, 2004	YEAR ENDED DECEMBER 31, 2003	2002	NINE MONTHS ENDED SEPTEMBER 30, 2003 (UNAUDITED)
Revenue:				
Revenue	74.6%	100%	100%	100%
Professional services	25.4	--	--	--
Total revenue	100.0%	100.0%	100.0%	100.0%
Costs and expenses:				
Cost of revenue	7.9	19.3	15.4	17.7
Cost of professional services	17.5	--	--	--
Cost of revenue from amortization of				

intangible assets	6.5	7.8	8.9	8.4
Gross Margin	68.1	72.9	75.7	73.9
Research and development	20.0	25.1	25.9	28.3
Sales and marketing	37.5	36.0	30.9	35.3
General and administrative	13.6	12.0	10.1	13.0
Amortization of other intangible assets(1)	1.5	1.7	1.6	1.6
Stock based compensation expense	1.0	0.2	0.1	0.2
Restructuring and other charges, net(2)	0.6	2.7	0.9	3.4
Total costs and expenses	106.1	104.8	93.8	107.9
Income (loss) from operations	(6.1)	(4.8)	6.2	(7.9)
Other income (expense), net	(0.1)	0.5	0.0	0.7
Income (loss) before income taxes	(6.2)	(4.3)	6.2	(7.2)
Provision for (benefit from) income taxes	1.0	(0.2)	0.2	0.5
Net income (loss)	(7.2)%	(4.1)%	6.0%	(7.7)%

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(1) See Note 5 of Notes to Consolidated Financial Statements.

(2) See Note 8 of Notes to Consolidated Financial Statements.

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RESULTS OF OPERATIONS

NINE MONTHS ENDED SEPTEMBER 30, 2004 COMPARED TO THE YEAR ENDED DECEMBER 31, 2003 AND TO THE YEAR ENDED DECEMBER 31, 2002

We derive our revenue from licensing our software products to customers through distribution partners and value-added resellers, royalty revenues from OEM partners, license fees from sales of our products to customers and from professional services, which include, but are not limited to, custom software applications and other services considered essential to the functionality of the software, training, and maintenance associated with software license transactions. Our speech technologies enable voice-activated services over a telephone, transform speech into text and text into speech, and permit voice control of devices and applications by simply speaking. Our imaging solutions eliminate the need to manually reproduce documents, automate the integration of documents into business systems, and enable the use of electronic documents and forms within XML, Internet, mobile and other business applications.

Total Revenue

Total revenue for the nine month transition period ended September 30, 2004 decreased by $4.5 million, or 3.3%, compared to the twelve months ended December 31, 2003. The decrease in revenue is attributable to a shorter fiscal period due to our changing our fiscal year end from December 31 to September 30, the omission of the period October through December from the transition period as this three month period is historically the strongest revenue quarter of the calendar year, offset by the inclusion of nine months of SpeechWorks revenue in the nine month transition period compared to approximately four months in the twelve months ended December 31, 2003 and organic growth in the nine month period over the comparable period in 2003.

As a result of SpeechWorks acquisition in August 2003, professional services became a material component of our business. As a result of this and the implementation of Oracle, in January 2004, we began to separately track and disclose professional services revenues and cost of revenue. Prior to 2004, we did not separately disclose professional services revenue and cost of revenue as they were immaterial and it is not practical to reclassify these revenues and associated costs retroactively.

Our speech revenues increased to 66.1% of total revenues in the nine months ended September 30, 2004, up from 57.6% in the twelve months ended December 31, 2003 due to the increased SpeechWorks revenue described above. Revenue from our speech products was $86.6 million for the nine months ended September 30, 2004, an $8.7 million increase over the twelve months ended December 31, 2003. Within speech, network revenues increased to 38.4% of total revenues from 25.9% in the twelve months ended December 31, 2003 due to full period results for SpeechWorks revenue, embedded revenue rose to 10.6% of total revenues from 7.5% in the twelve months ended December 31, 2003 due to increased professional services from current period design wins and net increase in royalties, while dictation revenues declined to 17.1% of total revenues in 2004 from 24.1% in the twelve months ended December 31, 2003 due to a disproportionate increase in network and embedded revenues described above. Imaging revenue declined to 33.9% of total revenues for the nine months ended September 30, 2004 from 42.4% of total revenues in the twelve months ended December 31, 2003 due to the disproportionate increase in speech revenues described above. Revenue for our imaging products was $44.3 million for the nine months ended September 30, 2004, a $13.2 million decline from the twelve months ended December 31, 2003 as a result of our change in fiscal year end from December to September. Our imaging products showed 14.0% growth for the nine months ended September 30, 2004 when compared to the nine months ended September 30, 2003.

Total revenue for the twelve months ended December 31, 2003 increased by $28.8 million or 27% compared to the twelve months ended December 31, 2002. The growth in revenue is attributed to a $33.8 million growth in our speech revenues, offset by an overall decrease of $5.0 million in our imaging revenues from 2002. Revenue from our speech products was $77.9 million and $44.2 million for 2003 and 2002, respectively. The increase in our speech revenues is primarily related to a $24.7 million increase in our networked speech technologies, a $4.9 million increase in our embedded speech technologies, as well as a

$4.2 million increase in our dictation product lines, from the year 2002. The $5.0 million overall decrease in our Imaging products can be attributed to a $10.0 million decrease in revenues recognized from our OCR products. This overall decrease is due, in part, to the fact that OmniPage Pro 12 was launched earlier in 2002 than OmniPage Pro 14 was launched in 2003, as well as the recognition in 2002 of revenue previously deferred. The decrease in the OCR revenues was offset to some extent by an overall strengthening of our other Imaging product lines, in particular, PaperPort and the revenues derived from the launch of our new product, PDF Converter, during the fourth quarter of 2003.

Related-party revenue declined in 2004 because Xerox ceased to be a related party as of June 30, 2004. Related-party revenue increased $1.6 million for the twelve months ended December 31, 2003, or 32%, compared to the twelve months ended December 31, 2002. This increase was related to the inclusion of our products in expanded product offerings of our related parties, primarily Xerox.

The geographic revenue split for the nine months ended September 30, 2004 was 70% North America and 30% international versus 72% North America and 28%

international for the twelve months ended December 31, 2003 and 73% North America and 27% international for the twelve months ended December 31, 2002. Geographic revenue classification is based on the country, in which the sale is invoiced.

For the twelve months ended September 30, 2005 (fiscal year 2005), we expect revenue growth of 15% to 20% in speech revenues and 5% to 10% in imaging revenues, annualized, from the nine month fiscal 2004 total.

Cost of Revenue

As a result of the SpeechWorks acquisition in August 2003, professional services became a material component of our business. As a result of this and the implementation of Oracle in January 2004, we began to separately track and disclose professional services revenue and cost of revenue. Prior to 2004, we did not separately disclose professional services revenue and associated cost of revenue as they were immaterial and it is not practical to reclassify these revenues and associated costs retroactively.

Cost of revenue as a percentage of related and third party revenue for the nine months ended September 30, 2004 was 10.6% compared to 19.3% for the twelve months ended December 31, 2003 and 15.4% for the twelve months ended December 31, 2002. For the nine month period ended September 30, 2004, cost of revenue consists primarily of material and fulfillment costs and third-party royalties, excluding cost of professional services. Cost of revenue for the nine months ended September 30, 2003 and the years ended December 31, 2003 and 2002, consists of material and fulfillment costs, third-party royalties, and professional services costs including salaries for product support personnel, and engineering costs associated with certain contracts which were accounted for under percentage-of-completion method of accounting.

Cost of professional services revenue for the nine months ended September 30, 2004 was 69.2% of professional services revenue. Cost of professional services revenue consists primarily of salaries for professional consulting staff, salaries for product support personnel, and engineering costs associated with certain contracts which were accounted for under percentage-of-completion method of accounting.

During fiscal 2005, we expect cost of revenue as a percentage of related and third party revenue to be consistent with results for the nine months ended September 30, 2004.

During fiscal 2005, we expect cost of professional services revenues to decline as a percentage of professional services revenue relative to results for the nine months ended September 30, 2004 as a result of higher utilization of our new services personnel and anticipated increases in revenue.

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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.

Cost of revenue from amortization of intangible assets was 6.4% of total revenue for the nine months ended September 30, 2004, compared to 7.8% of revenue for the twelve months ended December 31, 2003 and 8.9% for the twelve months ended December 31, 2002. In absolute dollars, increases in amortization of intangible assets results from the inclusion of a full nine months of amortization from the SpeechWorks and LocusDialog acquisitions versus only four months and one month of amortization in the prior year given the acquisitions closed in August of 2003 and December 2003, respectively. During fiscal 2005, we anticipate cost of revenue from amortization of other intangible assets to be approximately $7.6 million, based on the current intangible assets at September 30, 2004 and their remaining useful lives.

The increase in cost of revenue from amortization of intangible assets in absolute dollars for the twelve months ended December 31, 2003, compared to the twelve months ended December 31, 2002, is attributable to $1.7 million of amortization related to the exclusive worldwide license of certain desktop dictation products and technologies, $0.7 million related to the Philips acquisition which was closed on January 30, 2003 and $0.2 million related to the SpeechWorks acquisition which was closed on August 11, 2003, partially offset by $1.6 million of intangible assets that became fully amortized during the twelve months ended December 31, 2002.

Gross Margin

Gross margin was 68.1% of revenues for the nine months ended September 30, 2004 as compared to 72.9% for the twelve months ended December 31, 2003 and 75.7% for the twelve months ended December 31, 2002. The decrease is directly attributable to the increase in professional services revenue, which increased to 25.4% of total revenue for the nine months ended September 30, 2004 from 8.6% for the twelve months ended December 31, 2003 and from 3.8% the twelve months ended December 31, 2002. The increase in professional services revenue, which has a lower gross margin, was directly attributed to the acquisitions of SpeechWorks and Phillips.

Research and Development Expense

Research and development expense consists primarily of salary and benefits costs of engineers. 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 product has not been significant.

Research and development expense for the nine months ended September 30, 2004 was 20.0% of total revenue, compared to 25.1% and 25.9% of total revenue for the twelve months ended December 31, 2003 and 2002, respectively. In absolute dollars, research and development expenses in 2004 increased by 4.4% over the comparable nine months ended September 30, 2003, significantly less than related sales growth of 47.9%. Research and development expenses for the twelve months ended December 31, 2003 increased in absolute dollars over the twelve months ended December 31, 2002 due to increased speech and language development efforts resulting from both the Philips and SpeechWorks acquisitions. While we will continue to invest significantly in research and development, in fiscal 2005, we expect research and development expense to decline as a percentage of revenue due to growth in total revenue.

Sales and Marketing Expense

Sales and marketing expenses include salaries, commissions, advertising, direct mail, public relations, trade shows, travel and other related sales and marketing expenses.

Sales and marketing expense was 37.5% of total revenue for the nine months ended September 30, 2004, compared to 36.0% and 30.9% for the twelve months ended December 31, 2003 and 2002, respectively. The increase in sales and marketing expenses in absolute dollars and as a percentage of total revenue in 2004 was the result of increased compensation costs resulting primarily from the investment in additional of sales and marketing personnel added as part of the SpeechWorks and LocusDialog acquisitions completed late in 2003. The increase for the twelve months ended December 31, 2003 compared to 2002 was primarily due to the Philips and SpeechWorks acquisitions. We expect sales and marketing expenses to decrease as a percentage of revenue in fiscal 2005 as a result of increased revenues.

General and Administrative Expense

General and administrative expenses include personnel costs for administration, finance, human resources, information systems and general management, in addition to legal and accounting expenses and other professional services.

General and administrative expenses were 13.6% of total revenue for the nine months ended September 30, 2004, compared to 12.0% and 10.0% for the twelve months ended December 31, 2003 and 2002, respectively. The proportionate increase in general and administrative expenses in 2004 is due primarily to increased professional fees of approximately $1.4 million related to the restatement of certain historical financial statements of SpeechWorks and approximately $1.0 million of professional fees related to compliance with Sarbanes Oxley regulatory requirements. The increase for the twelve months ended December 31, 2003 compared to 2002 was primarily due to the Phillips and SpeechWorks acquisitions. We expect general and administrative expenses in absolute dollars to increase but to decrease as a percentage of revenues in fiscal 2005 because of growth in total revenues. We attempt to control general and administrative expense; however, if revenue continues to grow, we expect general and administrative expenses to increase to support our growing operations. In addition, we may increase general and administrative expenses in advance of revenue to support expected future revenue growth in specific product lines or geographic regions.

Amortization of Other Intangible Assets

Amortization of other intangible assets includes amortization of acquired customer and contractual relationships, non-compete agreements and acquired trade names and trademarks.

Amortization of other intangible assets was 1.5% of total revenue for the nine months ended September 30, 2004, compared to 1.7% and 1.6% for the twelve months ended December 31, 2003 and 2002, respectively. The decrease in amortization for the nine months ended September 30, 2004 compared to the twelve months ended December 31, 2003 was directly related to the nine month transition period versus a twelve month period in the prior year. The increase in amortization for the twelve months ended December 31, 2003 compared to 2002 was primarily related to the Philips and SpeechWorks acquisitions, partially offset by certain intangible assets that became fully amortized in 2002. During fiscal 2005, we expect amortization of other intangible assets to be approximately $1.8 million, based on the current intangible assets and their remaining useful lives at September 30, 2004.

Stock-Based Compensation

Stock-based compensation expenses result from non-cash charges for common shares issued with exercise or purchase prices that are less than the fair market value of the common stock on the date of grant.

Stock-based compensation expense was 1.0% of total revenue for the nine months ended September 30, 2004, as compared to 0.2% and 0.1% for the twelve months ended December 31, 2003 and 2002 respectively. The absolute dollar increase of $1.1 million is directly attributed to increased non-cash compensation expense associated with the granting of approximately 1.0 million shares of restricted stock (or restricted stock purchase rights) during the nine months ended September 30, 2004. We expect stock-based compensation expense to increase significantly in fiscal 2005 due to the adoption of Financial Accounting Standards Board Statement No. 123 "Accounting for Stock-Based Compensation" which will be effective for our fourth quarter beginning July 1, 2005.

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Restructuring and Other Charges, Net

Restructuring and other charges, net were 0.6% of total revenue for the nine months ended September 30, 2004, as compared to 2.7% and 0.9% for the twelve months ended December 31, 2003 and 2002 respectively. For the nine months ended September 30, 2004, we recorded a charge of $0.8 million related to separation agreements with two former members of our senior management team. Restructuring and other charges for the twelve months ended December 31, 2003 were $3.7 million compared to $1.0 million for the twelve months ended December 31, 2002. The 2003 charges reflect $2.4 million related to the termination of 106 employees as a result of the Philips and SpeechWorks acquisitions and $0.8 million and $0.4 million of employee and facility related costs, respectively, associated with the restructuring of various corporate activities during 2003.

Income (Loss) from Operations

As a result of the factors described above, loss from operations was (6.1)% of revenue for the nine months ended September 30, 2004 compared to a loss of (4.8)% for the twelve months ended December 31, 2003, and income of 6.2% for the twelve months ended December 31, 2002.

Other Income (Expense), Net

Other income (expense), net was (0.1)% of revenue for the nine months ended September 30, 2004, compared to 0.5% of revenue for the twelve months ended December 31, 2003 and 0.0% for the twelve months ended December 31, 2002. Other income (expense), net in the twelve months ended December 31, 2003, included foreign exchange gains of $1.2 million, which more than offset net interest expense and other expenses of $0.2 million.

Income (Loss) Before Income Taxes

Loss before income taxes was (6.2)% of revenue for the nine months ended September 30, 2004, compared with a loss of (4.3)% of revenue for the twelve months ended December 31, 2003 and income of 6.2% of revenue for the twelve months ended December 31, 2002.

Income Taxes

The provision for income taxes of 1.0% of revenues for the nine months ended September 30, 2004, compared with a benefit of 0.2% of revenues for the twelve months ended December 31, 2003 and a provision of 0.2% of revenues for the twelve months ended December 31, 2002.

In 2004, the Company's effective tax rate was a provision of 16.6% versus a benefit of 4.6% in 2003. The variance from the federal statutory rate for 2004 was primarily due to state, federal and foreign credits for research and development, offset by increases in the valuation allowance.

In 2003, the Company's effective tax rate was a benefit of 4.6% versus a provision of 3.9% in 2002. The variance from the statutory rate for 2003 was due primarily to a federal refund received relating to Caere Corporation for taxes paid prior to its acquisition by ScanSoft, offset by increases in the valuation allowance.

In 2002, the Company's effective tax rate was a provision of 3.9%. The variance from the statutory rate for 2002 was primarily due to foreign and state provisions offset, in part, by the federal tax benefit related to a refund of taxes paid by Caere Corporation prior to its acquisition by ScanSoft.

At September 30, 2004, ScanSoft had net deferred tax assets of approximately $78 million which were subject to consideration of a valuation allowance. A full valuation allowance has been provided against the net deferred tax assets in the United States due to the uncertainty of their realization as a result of cumulative historical losses. In the future, a period of sustained profitability will cause us to reassess the need for the valuation allowance. 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 and adjustments to recorded goodwill and shareholder equity in the period in which the benefit is determined.

Net Income (Loss)

As a result of the factors described above, net loss totaled (7.2)% of revenues for the nine months ended September 30, 2004, compared with a loss of (4.1)% of revenue for the twelve months ended December 31, 2003 and income of 6.0% of revenue for the twelve months ended December 31, 2002.

LIQUIDITY AND CAPITAL RESOURCES

As of September 30, 2004, we had cash and cash equivalents of $23.0 million, marketable securities of $7.4 million, long term marketable securities of $17.4 million and working capital of $27.9 million as compared to $42.6 million in cash and cash equivalents and working capital of $44.3 million at December 31, 2003. During 2004, we adopted a formal investment policy in order to achieve a higher yield on our cash position by investing in short and long-term marketable securities.

We have reported a net loss of $(9.4) million for the nine months ended September 30, 2004, a net loss of $(5.5) million and net income of $6.3 million for the years ended December 31, 2003 and 2002, respectively. We had an accumulated deficit of $161.8 million at September 30, 2004.

Net cash provided by operating activities for the nine months ended September 30, 2004 was $6.3 million as compared to $5.2 million for the twelve months ended December 31, 2003. Cash provided by operations in the 2004 period came primarily from income from operations, after adjustments for non-cash amortization, depreciation and stock compensation, and lower accounts receivable balances; this was offset primarily by lower deferred revenues.

Net cash used in investing activities for the nine months ended September 30, 2004 was $28.7 million compared to cash provided by investing activities of $24.1 million for the twelve months ended December 31, 2003. Net cash used in investing activities in 2004 consisted of $25.0 million invested in marketable securities, $3.3 million in capital expenditures and $0.7 million in net cash paid for acquisitions. Net cash provided by investing activities for the twelve months ended December 31, 2003 consisted of $40.0 million acquired in the SpeechWorks acquisition, $1.1 million received from Philips in accordance with provisions in the purchase agreement and $0.6 million due to the maturity of marketable securities, partially offset by $2.9 million in capital expenditures, $8.5 million of payments associated with acquisitions and $6.1 million of payments associated with an exclusive licensing agreement.

Net cash provided by financing activities for the nine months ended September 30, 2004 was $2.7 million compared to net cash used in financing activities of $5.1 million for the twelve months ended December 31, 2003. Net cash provided in 2004 consisted of $6.1 million in proceeds from issuance of common stock under employee stock compensation plans and $0.6 million in proceeds from the issuance of common stock warrants. This was partially offset by a $2.8 million payment associated with a licensing agreement, a $0.7 million payment of note payable and deferred acquisition payments and a $0.4 million payment to the former Caere president and CEO in connection with the settlement of a non-competition and consulting agreement.

Net cash used in financing activities for the twelve months ended December 31, 2003 consisted of the payment of $6.9 million (6.0 million euros) related to the 5.0 million euro note payable and 1.0 million euro deferred payment due in connection with the Philips acquisition, the payment of the $3.3 million note related to the acquisition of certain Lernout & Hauspie assets during 2001, a $1.6 million payment to the former Caere President and CEO in connection with the settlement of a non-competition and consulting agreement, $2.9 million of payments to repurchase outstanding common shares and the payment of $0.3 million related to outstanding equipment lines of credit. This was partially offset by proceeds of $5.5 million from an underwritten offering of our common stock in the first quarter of 2003 and proceeds of $4.4 million from the issuance of common stock in connection with employee stock compensation plans.

On October 31, 2002, we entered into a two year Loan and Security Agreement (as amended, the "Loan Agreement") with Silicon Valley Bank (the "Bank") that consisted of a $10.0 million revolving loan (the "Credit Facility"). We amended this Loan and Security Agreement, as of March 31, 2004, through March 31, 2006. Under this amendment, we must comply with both a minimum adjusted quick ratio and minimum

tangible net worth calculation, as defined in the Loan Agreement. Depending on our adjusted quick ratio, borrowings under the Credit Facility bear interest at the Bank's prime rate plus 0.0% or 0.75% (4.75% at September 30, 2004), as defined in the Loan Agreement. The maximum aggregate amount of borrowings outstanding at any one time was amended to the lesser of $20.0 million or a borrowing base equal to the aggregate amounts of un-drawn on outstanding letters of credit, minus either 80% or 70% of eligible accounts receivable, as defined in the Loan Agreement, based on the Company's adjusted quick ratio. Borrowings under the Loan Agreement cannot exceed the borrowing base and must be repaid in the event they exceed the calculated borrowing base or upon expiration of the two-year term loan. Borrowings under the Loan Agreement are collateralized by substantially all of the Company's personal property, predominantly its accounts receivable, but not its intellectual property. As of September 30, 2004, we were in compliance with all covenants.

As of September 30, 2004, no amounts were outstanding under the Credit Facility and $9.1 million was available for borrowing in addition to approximately $1.9 million previously committed under this line of credit for outstanding Letters of Credit. We can make no guarantees as to our ability to satisfy our future financial covenant calculations.

For the nine months ended September 30, 2004, we paid a total of $1.6 million in severance payments, of which $0.3 million relates to the 2004 restructuring, $1.1 million relates to the March 2002 restructuring and $0.2

million relates to severance paid to the former Caere President and CEO, pursuant to a 2000 restructuring charge.

At September 30, 2004, the remaining restructuring accrual from the current and prior restructuring activities amounted to $0.6 million. The balance is comprised of $0.2 million of lease exit costs and $0.4 million of employee-related severance costs, of which $0.1 million are for severance to the former Caere President and CEO, and $0.3 million is for severance costs related to actions taken during 2003 and 2004.

The lease exit costs and severance due to the former Caere President and CEO will be paid through March 2005. Severance costs related to restructuring actions undertaken during 2003 and 2004 will be paid through March 2009.

As part of the underwritten offering completed for L&H in February 2003, we sold 1,000,000 shares and raised approximately $3.8 million in gross proceeds. After considering offering costs, the estimated net proceeds equaled approximately $2.1 million. On March 11, 2003, the Company received approximately $3.8 million of net proceeds from the exercise of the over-allotment option of 1,072,500 shares granted to the underwriters as part of the underwritten offering.

Although we generated $6.3 million of cash from operations for 2004 and ended the year with a cash balance of $23.0 million, a market- able securities balance of $7.4 million and long-term marketable securities of $17.4 million, there can be no assurance that we will be able to continue to generate cash from operations or secure additional equity or debt financing if required.

In connection with the Philips Speech Processing Telephony and Voice Control Business Unit acquisition we issued a $27.5 million, zero interest convertible debenture due January 2006. Additionally, in connection with the SpeechWorks acquisition we acquired certain long-term lease obligations that begin to come due in the next 12-24 months. In connection with the ART acquisition, we agreed to pay approximately $10.0 million at closing, expected in January 2005, and $16.5 million in December 2005. In connection with the pending Phonetic acquisition, we agreed to (i) pay $17.5 million at closing, expected in February 2005, and $17.5 million 24 months after closing, (ii) make contingent payments of up to an additional $35.0 million in cash, in 2006 through 2008 if at all, upon the achievement of certain performance targets, and (iii) issue unvested warrants to purchase 750,000 shares of our common stock that will vest, if at all, upon the achievement of certain performance targets. The cash consideration for these acquisitions is expected to be provided by existing cash, marketable securities, cash generated from operations, or debt or equity offerings. In connection with the Rhetorical acquisition, we paid approximately $4.9 million in cash on December 6, 2004.

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 the debt obligation issued in connection with the Philips acquisition, lease obligations assumed in the SpeechWorks acquisition, and cash obligations related to acquisitions completelders subject to Section 451(b) of the Code. This discussion applies only to holders that

You should consult your tax advisor concerning the U.S. federal income tax and other tax consequences of your investment in the Notes in your particular circumstances, including the application of state, local or other tax laws and the possible effects of changes in federal or other tax laws.

NO STATUTORY, JUDICIAL OR ADMINISTRATIVE AUTHORITY DIRECTLY DISCUSSES HOW THE NOTES SHOULD BE TREATED FOR U.S. FEDERAL INCOME TAX PURPOSES. AS A RESULT, THE U.S.

FEDERAL INCOME TAX CONSEQUENCES OF AN INVESTMENT IN THE NOTES ARE UNCERTAIN. BECAUSE OF THE UNCERTAINTY, YOU SHOULD CONSULT YOUR TAX ADVISOR IN DETERMINING THE U.S. FEDERAL INCOME TAX AND OTHER TAX CONSEQUENCES OF YOUR INVESTMENT IN THE NOTES, INCLUDING THE APPLICATION OF STATE, LOCAL OR OTHER TAX LAWS AND THE POSSIBLE EFFECTS OF CHANGES IN FEDERAL OR OTHER TAX LAWS.

We will not attempt to ascertain whether any of the entities whose stock is included in the Reference Asset would be treated as a "passive foreign investment company" within the meaning of Section 1297 of the Code, or a "U.S. real property holding corporation," within the meaning of Section 897 of the Code. If any of the entities whose stock is included in the Reference Asset were so treated, certain adverse U.S. federal income tax consequences could possibly apply to a holder. You should refer to any available information filed with the SEC and other authorities by the entities whose stock is included in the Reference Asset and consult your tax advisor regarding the possible consequences to you in this regard, if any.

Royal Bank intends to treat any interest with respect to the Notes, as determined for U.S. federal income tax purposes, as from sources within the U.S.

We intend to take the position that the Notes will be treated as debt instruments subject to the special tax rules governing contingent payment debt instruments for U.S. federal income tax purposes. Under those rules, the amount of interest you are required to take into account for each accrual period will be determined by constructing a projected payment schedule for the Notes, and applying the rules similar to those for accruing original issue discount on a hypothetical noncontingent debt instrument with that projected payment schedule. This method is applied by first determining the yield at which we would issue a noncontingent fixed rate debt instrument with terms and conditions similar to the Notes (the "comparable yield") and then determining a payment schedule as of the issue date that would produce the comparable yield. A projected payment schedule with respect to a note generally is a series of projected payments, the amount and timing of which would produce a yield to maturity on that note equal to the comparable yield. This projected payment schedule is solely for tax purposes and will consist of the Payment at Maturity. These rules will generally have the effect of requiring you to include amounts as income in respect of the Notes prior to your receipt of cash attributable to that income.

The amount of interest that you will be required to include in income during each accrual period for the Notes will equal the product of the adjusted issue price for the Notes at the beginning of the accrual period and the comparable yield for the Notes for such period. The adjusted issue price of the Notes will equal the Notes' original offering price plus any interest deemed to be accrued on the Notes (under the rules governing contingent payment debt instruments).

To obtain the comparable yield and projected payment schedule for your Note, you should call RBC Capital Markets, LLC toll free at 1-877-688-2301. You are required to use such comparable yield and projected payment schedule in determining your interest accruals in respect of your Notes, unless you timely disclose and justify on your federal income tax return the use of a different comparable yield and projected payment schedule.

The comparable yield and projected payment schedule are not provided to you for any purpose other than the determination of your interest accruals in respect of the Notes, and we make no representations regarding the amount of contingent payments with respect to the Notes.

If the contingent payment on the Notes becomes fixed on a day that is more than 6 months before the payment is due, applicable Treasury regulations provide that you should make adjustments to the prior and future interest inclusions in respect of your Notes over the remaining term for the Notes in a reasonable manner. You should consult your tax advisor as to what would be a "reasonable manner" in your particular situation.

You will recognize gain or loss on the sale or maturity of the Notes in an amount equal to the difference, if any, between the amount of cash you receive at such time and your adjusted basis in the Notes. In general, your adjusted basis in the Notes will equal the amount you paid for the Notes, increased by the amount of interest you previously accrued with respect to the Notes (in accordance with the comparable yield for the Notes).

Any gain you recognize on the sale or maturity of the Notes will be ordinary interest income. Any loss you recognize at such time will be ordinary loss to the extent of interest you included as income in the current or previous taxable years in respect of the Notes, and thereafter, capital loss. The deductibility of capital losses is limited.

Backup Withholding and Information Reporting. Payments made with respect to the Notes and proceeds from the sale of the Notes may be subject to a backup withholding tax unless, in general, the holder complies with certain procedures or is an exempt recipient. Any amounts so withheld generally will be refunded by the Internal Revenue Service ("IRS") or allowed as a credit against the holder's U.S. federal income tax, provided the holder makes a timely filing of an appropriate tax return or refund claim.

Reports will be made to the IRS and to holders that are not exempted from the reporting requirements.

Non-U.S. Holders. The following discussion applies to non-U.S. holders of the Notes. You are a non-U.S. holder if you are a beneficial owner of a Note and are for U.S. federal income tax purposes a non-resident alien individual, a foreign corporation, or a foreign estate or trust.

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Except as discussed below, payments made to a non-U.S. holder, and any gain realized on the sale or maturity of the Notes, generally should be exempt from U.S. federal income and withholding tax, subject to generally applicable exceptions set forth in the rules exempting "portfolio interest" from U.S. withholding tax, provided that (i) the holder complies with applicable certification requirements, which certification may be made on Form W-8BEN or W-8BEN-E (or a substitute or successor form) on which the holder certifies, under penalties of perjury, that the holder is not a U.S. person and provides its name and address, (ii) the payment or gain is not effectively connected with the conduct by the holder of a U.S. trade or business, and (iii) if the holder is a non-resident alien individual, the holder is not present in the U.S. for 183 days or more during the taxable year of the sale or maturity of the Notes. In the case of (ii) above, the holder generally should be subject to U.S. federal income tax with respect to any income or gain in the same manner as if the holder were a U.S. holder and, in the case of a holder that is a corporation, the holder may also be subject to a branch profits tax equal to 30% (or such lower rate provided by an applicable U.S. income tax treaty) of a portion of its earnings and profits for the taxable year that are effectively connected with its conduct of a trade or business in the U.S., subject to certain adjustments. Payments made to a non-U.S. holder may be subject to information reporting and to backup withholding unless the holder complies with applicable certification and identification requirements as to its foreign status.

Under Section 871(m) of the Code, a "dividend equivalent" payment is treated as a dividend from sources within the United States. Such payments generally would be subject to a 30% U.S. withholding tax if paid to a non-U.S. holder. Under U.S. Treasury Department regulations, payments (including deemed payments) with respect to equity-linked instruments ("ELIs") that are "specified ELIs" may be treated as dividend equivalents if such specified ELIs reference an interest in an "underlying security," which is generally any interest in an entity taxable as a corporation for U.S. federal income tax purposes if a payment with respect to such interest could give rise to a U.S. source dividend. However, the IRS has issued guidance that states that the U.S. Treasury Department and the IRS intend to amend the effective dates of the U.S. Treasury Department regulations to provide that withholding on dividend equivalent payments will not apply to specified ELIs that are not delta-one instruments and that are issued before January 1, 2019. Based on our determination that the Notes are not delta-one instruments, non-U.S. holders should not be subject to withholding on dividend equivalent payments, if any, under the Notes. However, it is possible that the Notes could be treated as deemed reissued for U.S. federal income tax purposes upon the occurrence of certain events affecting the Reference Asset or the Notes (for example, upon a Reference Asset rebalancing), and following such occurrence the Notes could be treated as subject to withholding on dividend equivalent payments. Non-U.S. holders that enter, or have entered, into other transactions in respect of the Reference Asset or the Notes should consult their tax advisors as to the application of the dividend equivalent withholding tax in the context of the Notes and their other transactions. If any payments are treated as dividend equivalents subject to withholding, we (or the applicable withholding agent) would be entitled to withhold taxes without being required to pay any additional amounts with respect to amounts so withheld.

Foreign Account Tax Compliance Act. The Foreign Account Tax Compliance Act ("FATCA"), imposes a 30% U.S. withholding tax on certain U.S. source payments of interest (and OID), dividends, or other fixed or determinable annual or periodical gain, profits, and income, and on the gross proceeds from a disposition of property (including payments at maturity, or upon a redemption or sale) of a type which can produce U.S. source interest or dividends ("withholdable payments"), if paid to a foreign financial institution (including amounts paid to a foreign financial institution on your behalf) unless such institution enters into an agreement with the U.S. Treasury Department to collect and provide to the U.S. Treasury Department certain information regarding U.S. account holders, including certain account holders that are foreign entities with U.S. owners, with such institution or otherwise complies with FATCA. In addition, the Notes may constitute a "financial account" for these purposes and thus, be subject to information reporting requirements pursuant to

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FATCA. The legislation also generally imposes a withholding tax of 30% on withholdable payments made to a non-financial foreign entity, unless that entity provides the withholding agent with a certification that it does not have any substantial U.S. owners or a certification identifying the direct and indirect substantial U.S. owners of the entity. The U.S. Treasury Department and the IRS have announced that withholding on payments of gross proceeds from a sale or redemption of the Notes will only apply to payments made after December 31, 2018. We will not pay additional amounts with respect to any FATCA withholding. Therefore, if such withholding applies, any payments on the Notes will be significantly less than what you would have otherwise received. Depending on your circumstances, these amounts withheld may be creditable or refundable to you. Foreign financial institutions and non-financial foreign entities located in jurisdictions that have an intergovernmental agreement with the United States governing FATCA may be subject to different rules. You are urged to consult with your own tax advisor regarding the possible implications of FATCA on your investment in the Notes.

SUPPLEMENTAL PLAN OF DISTRIBUTION (CONFLICTS OF INTEREST)

We expect that delivery of the Notes will be made against payment for the Notes on or about May 31, 2018, which is the third (3rd) business day following the Pricing Date (this settlement cycle being referred to as "T+3"). See "Plan of Distribution" in the prospectus dated January 8, 2016. For additional information as to the relationship between us and RBCCM, please see the section "Plan of Distribution - Conflicts of Interest" in the prospectus dated January 8, 2016. We expect to deliver the Notes on a date that is greater than two business days following the Pricing Date. Under Rule 15c6-1 of the Exchange Act, trades in the secondary market generally are required to settle in two business days, unless the parties to any such trade expressly agree otherwise. Accordingly, purchasers who wish to trade the Notes more than two business days prior to the original issue date will be required to specify alternative settlement arrangements to prevent a failed settlement.

In the initial offering of the Notes, they will be offered to investors at a purchase price equal to par, except with respect to certain accounts as indicated on the cover page of this document.

The value of the Notes shown on your account statement may be based on RBCCM's estimate of the value of the Notes if RBCCM or another of our affiliates were to make a market in the Notes (which it is not obligated to do). That estimate will be based upon the price that RBCCM may pay for the Notes in light of then prevailing market conditions, our creditworthiness and transaction costs. For a period of approximately 12 months after the issue date of the Notes, the value of the Notes that may be shown on your account statement may be higher than RBCCM's estimated value of the Notes at that time. This is because the estimated value of the Notes will not include the underwriting discount and our hedging costs and profits; however, the value of the Notes shown on your account statement during that period may initially be a higher amount, reflecting the addition of RBCCM's underwriting discount and our estimated costs and profits from hedging the Notes. This excess is expected to decrease over time until the end of this period. After this period, if RBCCM repurchases your Notes, it expects to do so at prices that reflect their estimated value.

We may use this terms supplement in the initial sale of the Notes. In addition, RBCCM or another of our affiliates may use this terms supplement in a market-making transaction in the Notes after their initial sale. Unless we or our agent informs the purchaser otherwise in the confirmation of sale, this terms supplement is being used in a market-making transaction.

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No Prospectus (as defined in Directive 2003/71/EC (as amended, the "Prospectus Directive")) will be prepared in connection with the Notes. Accordingly, the Notes may not be offered to the public in any member state of the European Economic Area (the "EEA"), and any purchaser of the Notes who subsequently sells any of the Notes in any EEA member state must do so only in accordance with the requirements of the Prospectus Directive, as implemented in that member state.

The Notes are not intended to be offered, sold or otherwise made available to, and should not be offered, sold or otherwise made available to, any retail investor in the EEA. For these purposes, the expression "offer" includes the communication in any form and by any means of sufficient information on the terms of the offer and the Notes to be offered so as to enable an investor to decide to purchase or subscribe the Notes, and a "retail investor" means a person who is one (or more) of: (a) a retail client, as defined in point (11) of Article 4(1) of Directive 2014/65/EU (as amended, "MiFID II"); or (b) a customer, within the meaning of Insurance Distribution Directive 2016/97/EU, as amended, where that customer would not qualify as a professional client as defined in point (10) of Article 4(1) of MiFID II; or (c) not a qualified investor as defined in the Prospectus Directive. Consequently, no key information document required by Regulation (EU) No 1286/2014 (as amended, the "PRIIPs Regulation") for offering or selling the Notes or otherwise making them available to retail investors in the EEA has been prepared, and therefore, offering or selling the Notes or otherwise making them available to any retail investor in the EEA may be unlawful under the PRIIPs Regulation.

STRUCTURING THE NOTES

The Notes are our debt securities, the return on which is linked to the performance of the Reference Asset. As is the case for all of our debt securities, including our structured notes, the economic terms of the Notes reflect our actual or perceived creditworthiness at the time of pricing. In addition, because structured notes result in increased operational, funding and liability management costs to us, we typically borrow the funds under these Notes at a rate that is more favorable to us than the rate that we might pay for a conventional fixed or floating rate debt security of comparable maturity. Using this relatively lower implied borrowing rate rather than the secondary market rate, is a factor that is likely to reduce the initial estimated value of the Notes at the time their terms are set. Unlike the estimated value included in this terms supplement or in the final pricing supplement, any value of the Notes determined for purposes of a secondary market transaction may be based on a different funding rate, which may result in a lower value for the Notes than if our initial internal funding rate were used.

In order to satisfy our payment obligations under the Notes, we may choose to enter into certain hedging arrangements (which may include call options, put options or other derivatives) on the issue date with RBCCM or one of our other subsidiaries. The terms of these hedging arrangements take into account a number of factors, including our creditworthiness, interest rate movements, the volatility of the Reference Asset, and the tenor of the Notes. The economic terms of the Notes and their initial estimated value depend in part on the terms of these hedging arrangements.

The lower implied borrowing rate is a factor that reduces the economic terms of the Notes to you. The initial offering price of the Notes also reflects the underwriting discount and our estimated hedging costs. These factors result in the initial estimated value for the Notes on the Pricing Date being less than their public offering price. See "Selected Risk Considerations—The Initial Estimated Value of the Notes Will Be Less than the Price to the Public" above.