

PEGASYSTEMS INC  
Form 10-Q  
August 07, 2006  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

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(Mark One)

**Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the quarterly period ended June 30, 2006

or

**Transition Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 1-11859

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**PEGASYSTEMS INC.**

*(Exact name of Registrant as specified in its charter)*

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Massachusetts  
*(State or other jurisdiction of  
incorporation or organization)*

101 Main Street  
Cambridge, MA

04-2787865  
*(IRS Employer  
Identification No.)*

02142-1590

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*(Address of principal executive offices)*

**(617) 374-9600**

*(Zip Code)*

*(Registrant's telephone number including area code)*

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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  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

There were 35,455,987 shares of the Registrant's common stock, \$.01 par value per share, outstanding on August 1, 2006.

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**PEGASYSTEMS INC.**

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(in thousands, except share-related data)

|   | June 30,<br>2006  | December 31,<br>2005 |
|---|-------------------|----------------------|
| <b><u>ASSETS</u></b>  |                   |                      |
| Current assets:   |                   |                      |
| Cash and cash equivalents   | \$ 27,862         | \$ 21,314            |
| Short-term investments  | 98,209            | 93,421               |
| <b>Total cash and short-term investments</b>  | <b>126,071</b>    | <b>114,735</b>       |
| Trade accounts receivable, net of allowance for doubtful accounts of \$365 as of June 30, 2006 and December 31, 2005  | 24,720            | 25,486               |
| Short-term license installments   | 24,228            | 26,537               |
| Prepaid expenses and other current assets   | 3,274             | 1,953                |
| <b>Total current assets</b>   | <b>178,293</b>    | <b>168,711</b>       |
| Long-term license installments, net of unearned interest income   | 22,297            | 31,371               |
| Equipment and improvements, net of accumulated depreciation and amortization  | 2,019             | 1,947                |
| Computer software for internal use, net of accumulated amortization   | 1,255             | 845                  |
| Other assets  | 333               | 143                  |
| Goodwill  | 2,346             | 2,346                |
| <b>Total assets</b>   | <b>\$ 206,543</b> | <b>\$ 205,363</b>    |
| <b><u>LIABILITIES AND STOCKHOLDERS' EQUITY</u></b>  |                   |                      |
| Current liabilities:  |                   |                      |
| Accrued payroll related expenses  | \$ 6,866          | \$ 8,197             |
| Accounts payable and accrued expenses   | 13,091            | 10,769               |
| Deferred revenue  | 22,190            | 18,749               |
| Current portion of capital lease obligation   | 106               | 103                  |
| <b>Total current liabilities</b>  | <b>42,253</b>     | <b>37,818</b>        |
| Long-term deferred income taxes   | 0                 | 510                  |
| Capital lease obligation, net of current portion  | 9                 | 63                   |
| Other long-term liabilities   | 1,543             | 1,171                |
| <b>Total liabilities</b>  | <b>43,805</b>     | <b>39,562</b>        |
| Commitments and contingencies   |                   |                      |
| Stockholders' equity:   |                   |                      |
| Preferred stock, \$.01 par value, 1,000,000 shares authorized; no shares issued and outstanding   |                   |                      |
| Common stock, \$.01 par value, 70,000,000 shares authorized; 35,392,352 and 35,565,918 shares issued and outstanding at June 30, 2006 and December 31, 2005, respectively | 354               | 356                  |
| Additional paid-in capital  | 117,849           | 118,968              |
| Stock warrants  | 107               | 107                  |
| Retained earnings   | 44,024            | 46,007               |

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|   |                   |                   |
|---|-------------------|-------------------|
| Accumulated other comprehensive income (loss):        |                   |                   |
| Net unrealized loss on investments available-for-sale | (722)             | (623)             |
| Foreign currency translation adjustments              | 1,126             | 986               |
| <b>Total stockholders' equity</b>                     | <b>162,738</b>    | <b>165,801</b>    |
| <b>Total liabilities and stockholders' equity</b>     | <b>\$ 206,543</b> | <b>\$ 205,363</b> |

See notes to unaudited condensed consolidated financial statements.

**Table of Contents****PEGASYSTEMS INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (unaudited)**

(in thousands, except per share amounts)

|  | Three months ended<br>June 30, |               | Six months ended<br>June 30, |               |
|--|--------------------------------|---------------|------------------------------|---------------|
|  | 2006                           | 2005          | 2006                         | 2005          |
| <b>Revenue:</b>  |                                |               |                              |               |
| Software license   | \$ 6,954                       | \$ 8,004      | \$ 13,855                    | \$ 18,884     |
| Services   | 22,669                         | 15,784        | 42,885                       | 29,134        |
| <b>Total revenue</b>   | <b>29,623</b>                  | <b>23,788</b> | <b>56,740</b>                | <b>48,018</b> |
| <b>Cost of revenue:</b>  |                                |               |                              |               |
| Cost of software license   | 1                              | 87            | 32                           | 175           |
| Cost of services   | 12,356                         | 8,045         | 24,994                       | 15,592        |
| <b>Total cost of revenue</b>                                     | <b>12,357</b>                  | <b>8,132</b>  | <b>25,026</b>                | <b>15,767</b> |
| <b>Gross profit</b>  | <b>17,266</b>                  | <b>15,656</b> | <b>31,714</b>                | <b>32,251</b> |
| <b>Operating expenses:</b>                                       |                                |               |                              |               |
| Research and development   | 5,682                          | 4,876         | 11,083                       | 9,903         |
| Selling and marketing  | 10,173                         | 7,920         | 19,949                       | 16,853        |
| General and administrative                                       | 3,385                          | 2,990         | 6,022                        | 6,327         |
| <b>Total operating expenses</b>                                  | <b>19,240</b>                  | <b>15,786</b> | <b>37,054</b>                | <b>33,083</b> |
| <b>Loss from operations</b>                                      | <b>(1,974)</b>                 | <b>(130)</b>  | <b>(5,340)</b>               | <b>(832)</b>  |
| Installment receivable interest income                           | 454                            | 567           | 901                          | 1,131         |
| Other interest income, net                                       | 1,314                          | 744           | 2,428                        | 1,370         |
| Other income (expense), net                                      | 404                            | (700)         | 648                          | (1,015)       |
| <b>Income (loss) before provision (benefit) for income taxes</b> | <b>198</b>                     | <b>481</b>    | <b>(1,363)</b>               | <b>654</b>    |
| Provision (benefit) for income taxes                             | (232)                          | 125           | (447)                        | 225           |
| <b>Net income (loss)</b>   | <b>\$ 430</b>                  | <b>\$ 356</b> | <b>\$ (916)</b>              | <b>\$ 429</b> |
| Earnings (loss) per share, basic                                 | \$ 0.01                        | \$ 0.01       | \$ (0.03)                    | \$ 0.01       |
| Earnings (loss) per share, diluted                               | \$ 0.01                        | \$ 0.01       | \$ (0.03)                    | \$ 0.01       |
| Weighted average number of common shares outstanding, basic      | 35,561                         | 35,881        | 35,567                       | 35,962        |
| Weighted average number of common shares outstanding, diluted    | 37,006                         | 36,455        | 35,567                       | 36,648        |
| Dividends per share  | \$ 0.03                        |               | \$ 0.03                      |               |

See notes to unaudited condensed consolidated financial statements.

**Table of Contents****PEGASYSTEMS INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)****(in thousands)**

|  | <b>Six months ended</b> |                  |
|--|-------------------------|------------------|
|  | <b>June 30,</b>         |                  |
|  | <b>2006</b>             | <b>2005</b>      |
| <b>Cash flows from operating activities:</b>                                       |                         |                  |
| Net income (loss)  | \$ (916)                | \$ 429           |
| <b>Adjustment to reconcile net income to cash flows from operating activities:</b> |                         |                  |
| Stock option income tax benefits   | (213)                   | 51               |
| Deferred income taxes  | (797)                   | 13               |
| Depreciation, amortization, and other non cash items                               | 1,073                   | 837              |
| Loss on disposal of equipment  |                         | 14               |
| Stock-based compensation expense   | 835                     |                  |
| <b>Change in operating assets and liabilities:</b>                                 |                         |                  |
| Trade accounts receivable and license installments                                 | 12,152                  | 12,485           |
| Prepaid expenses and other current assets  | (1,269)                 | (250)            |
| Accounts payable and accrued expenses  | 227                     | (3,315)          |
| Deferred revenue   | 3,441                   | 5,501            |
| Other long-term assets and liabilities   | 350                     | 193              |
| <b>Cash flows from operating activities</b>  | <b>14,883</b>           | <b>15,958</b>    |
| <b>Cash flows from investing activities:</b>                                       |                         |                  |
| Purchase of investments  | (34,534)                | (21,163)         |
| Maturing and called investments  | 29,375                  | 4,000            |
| Sale of investments  |                         | 12,475           |
| Investment in software, equipment and improvements                                 | (1,297)                 | (791)            |
| <b>Cash flows from investing activities</b>  | <b>(6,456)</b>          | <b>(5,479)</b>   |
| <b>Cash flows from financing activities:</b>                                       |                         |                  |
| Payments under capital lease obligation  | (51)                    | (48)             |
| Excess tax benefit from stock option exercises                                     | 213                     |                  |
| Exercise of stock options  | 1,173                   | 240              |
| Proceeds from the sale of stock under Employee Stock Purchase Plan                 | 102                     | 240              |
| Repurchase of common stock   | (3,481)                 | (2,353)          |
| <b>Cash flows from financing activities</b>  | <b>(2,044)</b>          | <b>(1,921)</b>   |
| <b>Effect of exchange rate on cash and cash equivalents</b>                        | <b>165</b>              | <b>(348)</b>     |
| <b>Net increase in cash and cash equivalents</b>                                   | <b>6,548</b>            | <b>8,210</b>     |
| <b>Cash and cash equivalents, beginning of period</b>                              | <b>21,314</b>           | <b>20,905</b>    |
| <b>Cash and cash equivalents, end of period</b>                                    | <b>\$ 27,862</b>        | <b>\$ 29,115</b> |
| <b>Supplemental disclosures of cash flow information:</b>                          |                         |                  |
| Cash paid during the year to date period for:                                      |                         |                  |

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|              |    |     |    |     |
|--------------|----|-----|----|-----|
| Interest     | \$ | 10  | \$ | 11  |
| Income taxes | \$ | 303 | \$ | 166 |

See notes to unaudited condensed consolidated financial statements.



**Table of Contents****PEGASYSTEMS INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****1. BASIS OF PRESENTATION**

We have prepared the accompanying unaudited condensed consolidated financial statements pursuant to the rules and regulations of the Securities and Exchange Commission (SEC) regarding interim financial reporting. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements and should be read in conjunction with our financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2005.

In the opinion of management, we have prepared the accompanying unaudited condensed consolidated financial statements on the same basis as our audited financial statements, and these financial statements include all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the results of the interim periods presented. The operating results for the interim periods presented are not necessarily indicative of the results expected for the full year 2006. Certain prior period amounts have been reclassified to conform to the current presentation as described in the following notes.

**2. SIGNIFICANT ACCOUNTING POLICIES***(a) Equipment and improvements, net of accumulated depreciation and amortization*

Equipment and improvements are recorded at cost. Depreciation and amortization are computed using the straight-line method over the estimated useful lives of the assets, which are generally three years for equipment and five years for furniture and fixtures. Leasehold improvements are amortized over the lesser of the life of the lease or the useful life of the asset. Repairs and maintenance costs are expensed as incurred. Equipment and improvements and accumulated depreciation as of December 31, 2005 have been reclassified to conform to the current presentation. The cost and accumulated depreciation of equipment and improvements consisted of the following:

(in thousands)

|   | June 30,<br>2006 | December 31,<br>2005 |
|---|------------------|----------------------|
| Computer equipment  | \$ 4,046         | \$ 3,669             |
| Furniture and fixtures                                      | 2,009            | 2,004                |
| Leasehold improvements                                      | 2,408            | 2,053                |
| Equipment under capital leases                              | 594              | 594                  |
|   | 9,057            | 8,320                |
| Less: accumulated depreciation and amortization             | (7,038)          | (6,373)              |
| Equipment and improvements, net of accumulated depreciation | \$ 2,019         | \$ 1,947             |

*(b) Computer software for internal use, net of accumulated amortization*

We capitalize and amortize costs associated with computer software developed or purchased for internal use in accordance with AICPA Statement of Position 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use* (SOP 98-1). We amortize capitalized software costs generally over three years commencing on the date the software is placed into service. During the first two quarters of 2006, we capitalized costs totaling \$0.4 million for computer software developed for internal use. The cost and accumulated amortization of computer software for internal use was as follows:

(in thousands)

| June 30,<br>2006 | December 31,<br>2005 |
|------------------|----------------------|
|------------------|----------------------|

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|   |          |          |
|---|----------|----------|
| Computer software purchased   | \$ 2,779 | \$ 2,575 |
| Computer software developed for internal use                            | 207      |          |
| Computer software developed for internal use, not yet placed in service | 489      | 317      |
|   | 3,475    | 2,892    |
| Less: accumulated depreciation and amortization                         | (2,220)  | (2,047)  |
| Computer software for internal use, net of accumulated amortization     | \$ 1,255 | \$ 845   |

**Table of Contents****PEGASYSTEMS INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(c) Stockholder s Equity**

On June 1, 2006, our Board of Directors declared the company s first quarterly cash dividend of \$.03 per share. The dividend of approximately \$1.1 million was paid on July 17, 2006 to shareholders of record as of July 3, 2006. The accrued liability for this dividend of \$1.1 million is included in Accounts payable and accrued expenses at June 30, 2006.

**(d) Earnings per share**

Basic earnings per share are computed based on the weighted average number of common shares outstanding during the period. Diluted earnings per share includes, to the extent inclusion of such shares would be dilutive to earnings per share, the effect of outstanding options and warrants, computed using the treasury stock method.

| (in thousands, except per share amounts)                                   | Three months ended |         | Six months ended |         |
|--|--------------------|---------|------------------|---------|
|  | June 30,           |         | June 30,         |         |
|  | 2006               | 2005    | 2006             | 2005    |
| <b>Basic</b>   |                    |         |                  |         |
| Net income (loss)  | \$ 430             | \$ 356  | \$ (916)         | \$ 429  |
| Weighted average common shares outstanding                                 | 35,561             | 35,881  | 35,567           | 35,962  |
| Earnings (loss) per share, basic   | \$ 0.01            | \$ 0.01 | \$ (0.03)        | \$ 0.01 |
| <b>Diluted</b>   |                    |         |                  |         |
| Net income (loss)  | \$ 430             | \$ 356  | \$ (916)         | \$ 429  |
| Weighted average common shares outstanding                                 | 35,561             | 35,881  | 35,567           | 35,962  |
| Effect of assumed exercise of stock options and warrant                    | 1,445              | 574     |                  | 686     |
| Weighted average common shares outstanding, assuming dilution              | 37,006             | 36,455  | 35,567           | 36,648  |
| Earnings (loss) per share, diluted   | \$ 0.01            | \$ 0.01 | \$ (0.03)        | \$ 0.01 |
| Outstanding options and warrants excluded as impact would be anti-dilutive | 4,664              | 5,942   | 8,886            | 5,913   |

**(e) Segment reporting**

We currently operate in one operating segment rules-based business process management, or BPM, software. We derive substantially all of our operating revenue from the sale and support of one group of similar products and services. Substantially all of our assets are located within the United States. We derived our operating revenue from the following geographic areas (sales outside the United States are principally through export from the United States):

| (\$ in thousands) | Three months ended |     |           |     | Six months ended |     |           |     |
|-------------------|--------------------|-----|-----------|-----|------------------|-----|-----------|-----|
|                   | June 30,           |     |           |     | June 30,         |     |           |     |
|                   | 2006               |     | 2005      |     | 2006             |     | 2005      |     |
| United States     | \$ 19,675          | 66% | \$ 16,289 | 69% | \$ 37,130        | 65% | \$ 33,608 | 70% |

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|                |           |      |           |      |           |      |           |      |
|----------------|-----------|------|-----------|------|-----------|------|-----------|------|
| United Kingdom | 3,798     | 13%  | 2,373     | 10%  | 7,070     | 13%  | 5,158     | 11%  |
| Europe, other  | 2,572     | 9%   | 3,133     | 13%  | 7,382     | 13%  | 5,921     | 12%  |
| Other          | 3,578     | 12%  | 1,993     | 8%   | 5,158     | 9%   | 3,331     | 7%   |
|                | \$ 29,623 | 100% | \$ 23,788 | 100% | \$ 56,740 | 100% | \$ 48,018 | 100% |

In the second quarter of 2006, one customer represented 10% of our total revenue. In the second quarter of 2005, one customer represented 17% of our total revenue. In the first half of 2006, no single customer represented more than ten percent of our total revenue. In the first half of 2005, one customer represented 11% of our total revenue.

**Table of Contents****PEGASYSTEMS INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(f) Share-Based Compensation**

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 123R, *Share-Based Payment* (SFAS 123R). This Statement is a revision of SFAS No. 123, *Accounting for Stock-Based Compensation* (SFAS 123), and supersedes Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25), and its related implementation guidance. SFAS 123R establishes accounting for equity instruments exchanged for employee services.

Under the provisions of SFAS 123R, share-based compensation is measured at the grant date, based upon the fair value of the award, and is recognized as an expense over the employee's requisite service period (generally the vesting period of the equity grant). The majority of our share-based compensation arrangements vest over either a four or five year vesting schedule.

Prior to January 1, 2006, we accounted for share-based compensation to employees in accordance with APB 25 and related interpretations. We also followed the disclosure requirements of SFAS 123 as amended by SFAS 148, *Accounting for Stock-Based Compensation Transition and Disclosure*.

Effective January 1, 2006, we adopted the provisions of SFAS 123R using the modified prospective approach, and, accordingly, prior period amounts have not been restated. Under this approach, we are required to record compensation cost for all share-based payments granted after the date of adoption based on the grant date fair value, estimated in accordance with the provisions of SFAS 123R, and for the unvested portion of all share-based payments previously granted that remain outstanding based on the grant date fair value, estimated in accordance with the original provisions of SFAS 123. We expense our share-based compensation under the ratable method, which treats each vesting tranche as if it were an individual grant.

We periodically grant stock options for a fixed number of shares of common stock to our employees, directors and non-employee contractors, with an exercise price greater than or equal to the fair market value of our common stock at the date of the grant. In June 2006, we granted unrestricted common stock to members of our Board of Directors (other than Alan Trefler, our Chairman and Chief Executive Officer) in lieu of the annual stock option grant historically made. We recorded \$275 thousand of compensation expense for this award. At June 30, 2006, we had five stock-based compensation plans, which are described more fully below. The following table presents the share-based compensation expense included in our unaudited, condensed consolidated statement of operations.

| (in thousands, except per share amounts)  | Six months ended                    |               |
|---|-------------------------------------|---------------|
|   | Three months ended<br>June 30, 2006 | June 30, 2006 |
| Stock-based compensation expense:         |                                     |               |
| Cost of services                          | \$ 68                               | \$ 137        |
| Research and development                  | 35                                  | 75            |
| Selling and marketing                     | 151                                 | 261           |
| General and administrative                | 318                                 | 362           |
| Total stock-based compensation before tax | 572                                 | 835           |
| Income tax benefit                        | (213)                               | (308)         |
| Net share-based compensation expense      | \$ 359                              | \$ 527        |
| Effect on earnings (loss) per share:      |                                     |               |
| Basic                                     | \$ (.01)                            | \$ (.01)      |
| Diluted                                   | \$ (.01)                            | \$ (.01)      |

Prior to the adoption of SFAS 123R, we presented all tax benefits resulting from the exercise of stock options as operating cash flows in our consolidated statements of cash flows. SFAS 123R requires the cash flows resulting from the tax benefits resulting from tax deductions in excess of compensation cost recognized for the options (excess tax benefits) to be classified as financing cash flows. There was \$213 thousand of

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excess tax benefit classified as a financing cash inflow that would have been classified as an operating cash inflow for the six months ended June 30, 2006, if we had not adopted SFAS 123R.

We estimate the fair value of stock options using a Black-Scholes valuation model. Key inputs used to estimate the fair value of stock options include the exercise price of the award, the expected post-vesting option life, the expected volatility of our stock over the option's expected term, the risk-free interest rate over the option's expected term, and our expected annual dividend yield. Estimates of fair value are not intended to predict actual future events or the value ultimately realized by persons who receive equity awards.

**Table of Contents****PEGASYSTEMS INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The weighted-average assumptions used in the Black-Scholes option pricing model are as follows:

|  | Three months ended |               |
|--|--------------------|---------------|
|  | June 30, 2006      | June 30, 2005 |
| Expected volatility <sup>(1)</sup>               | 76%                | 75%           |
| Expected post-vesting option life <sup>(2)</sup> | 3.6 years          | 2.5 years     |
| Interest rate (risk free) <sup>(3)</sup>         | 5.11%              | 4.18%         |
| Expected annual dividend yield <sup>(4)</sup>    | .91%               | None          |

  

|  | Six months ended |               |
|--|------------------|---------------|
|  | June 30, 2006    | June 30, 2005 |
| Expected volatility <sup>(1)</sup>               | 77%              | 75%           |
| Expected post-vesting option life <sup>(2)</sup> | 3.6 years        | 2.5 years     |
| Interest rate (risk free) <sup>(3)</sup>         | 4.95%            | 3.95%         |
| Expected annual dividend yield <sup>(4)</sup>    | .38%             | None          |

- (1) The expected volatility for each grant is determined based on the average of historical weekly price changes of our common stock over a period of time which approximates the expected option term.
- (2) The expected post-vesting option life for each grant is determined based on the historical exercise behavior of employees and post-vesting employment termination behavior.
- (3) The risk-free interest rate for the expected term of the stock option is based on the U.S. Treasury yield curve in effect at the time of grant.
- (4) The expected annual dividend yield as shown in the chart above is based on the weighted average of the dividend yield assumption used for options granted during the period. Options granted prior to the date of declaration were valued using a dividend yield of zero. Options granted after the date of declaration were valued using a dividend yield of 1.7%. The expected annual dividend yield was calculated based on the expected dividend of \$0.12 per share, per year (\$0.03 per share, per quarter \* 4 quarters) divided by the average stock price.

Through December 31, 2005, we accounted for stock-based compensation plans in accordance with the provisions of APB 25, as permitted by SFAS No. 123, and, accordingly, did not recognize compensation expense for the issuance of options to employees and non-employee directors with an exercise price equal to or greater than the market price at the date of grant. Had the fair value based method as prescribed by SFAS 123 been applied to our financial statements, the effect on net income and earnings per share would have been as follows:

| (in thousands, except per share amounts)                            | Three months ended |               |
|---|--------------------|---------------|
|   | June 30, 2005      | June 30, 2005 |
| Net income (loss), as reported                                      | \$ 356             | \$ 429        |
| Add: Stock based compensation expense for stock options included in |                    |               |
| reported net income, net of income taxes                            |                    |               |
| less: Total stock based compensation expense for stock options      |                    |               |
| determined under fair value method, net of income taxes             | (4,055)            | (5,340)       |
| Net income (loss), pro-forma  | \$ (3,699)         | \$ (4,911)    |

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|                            |    |        |           |
|----------------------------|----|--------|-----------|
| Earnings (loss) per share: |    |        |           |
| Basic as reported          | \$ | 0.01   | \$ 0.01   |
| Basic pro forma            | \$ | (0.10) | \$ (0.14) |
| Diluted as reported        | \$ | 0.01   | \$ 0.01   |
| Diluted pro forma          | \$ | (0.10) | \$ (0.13) |



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**PEGASYSTEMS INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

***1994 Long-term incentive plan***

In 1994, we adopted a 1994 Long-Term Incentive Plan (the 1994 Plan ) to provide employees, directors and consultants with opportunities to purchase stock through incentive stock options and non-qualified stock options. In addition to options, participants under the 1994 Plan were eligible to receive stock appreciation rights, restricted stock and long-term performance awards. The Compensation Committee of the Board of Directors ( Compensation Committee ) administers the 1994 Plan. Generally, the exercise price of options granted under the plan was equal to the fair market value of the underlying common stock on the date of grant. Options granted under the 1994 Plan generally vest over four years and expire no later than ten years from the date of grant. As of June 30, 2006, options to purchase an aggregate of 5.5 million shares of common stock were outstanding under the 1994 Plan. We do not intend to issue any additional options or make any other awards under the 1994 Plan in the future.

***1996 Non-employee director stock option plan***

In 1996, we adopted a 1996 Non-Employee Director Stock Option Plan (the Director Plan ), which provides for the grant to non-employee Directors of the Company of options to purchase shares of our common stock. Originally, the Director Plan provided for the grant to non-employee Directors on the date he or she first became a Director of an option to purchase 30,000 shares of common stock at a price equal to the fair market value thereof on the date of grant, such options to vest in equal annual installments over five years. In 1999, the Director Plan was amended to provide for (i) the grant to non-employee Directors on the date he or she first became a Director of an option to purchase 30,000 shares of common stock at a price per share equal to the fair market value thereof on the date of grant, such options to vest in equal annual installments over three years and (ii) the grant to each non-employee Director at the time of the regular meeting of the Board of Directors following the annual meeting of stockholders (commencing in 2000), of a fully vested option to purchase 10,000 shares of common stock at a price per share equal to the fair market value thereof on the date of grant. The Compensation Committee administers the Director Plan. At June 30, 2006, there were outstanding options under the Director Plan to purchase an aggregate of 220,000 shares. We do not intend to issue any options under the Director Plan in the future.

***1996 Employee stock purchase plan***

In 1996, we adopted a 1996 Employee Stock Purchase Plan (the 1996 Stock Purchase Plan ) pursuant to which our employees were entitled to purchase up to an aggregate of 1.0 million shares of common stock at a price equal to 85% of the fair market value of our common stock on either the commencement date or completion date for offerings under the plan, whichever is less. During 2005, we amended the 1996 Stock Purchase Plan to provide that, for each offering period beginning on May 1, 2005 or later, employees are entitled to purchase shares of common stock at a price equal to 95% of the fair market value on the completion date of the offering period. As of June 30, 2006, there had been fourteen offerings under the plan and approximately 0.7 million shares had been issued thereunder. The 1996 Stock Purchase Plan is tax qualified and as of June 30, 2006 no compensation expense related to shares issued under the plan had been recognized for financial statement purposes. The 1996 Stock Purchase Plan terminates on November 1, 2006.

***2004 Long-term incentive plan***

In 2004, we adopted a 2004 Long-Term Incentive Plan (the 2004 Plan ) to provide employees, non-employee directors and consultants with opportunities to purchase stock through incentive stock options and non-qualified stock options. In addition to options, eligible participants under the 2004 Plan may be granted stock purchase rights and other stock-based awards. As of June 30, 2006, a total of 7 million shares of common stock had been authorized under the 2004 Plan, approximately 3.3 million shares were subject to outstanding options and approximately 3.6 million shares were available for issuance. Beginning June 2006, each member of our Board of Directors (except Mr. Trefler) will receive an annual grant of unrestricted common stock; for the number of shares equal to \$55,000 divided by the fair market value of our common stock on the grant date. The Compensation Committee administers the 2004 Plan. Generally, the exercise price of options granted under the plan is equal to the fair market value of the underlying common stock on the date of grant. Options granted under the 2004 Plan generally vest over five years and expire no later than ten years from the date of grant.

***2006 Employee stock purchase plan***

In 2006, we adopted the 2006 Employee Stock Purchase Plan (the 2006 Stock Purchase Plan ) pursuant to which our employees are entitled to purchase up to an aggregate of 500,000 shares of common stock at a price equal to 85% of the fair market value of our common stock on either

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the commencement date or completion date for offerings under the plan, whichever is less, or such higher price as our Board of Directors may establish from time to time. For the first offering under the 2006 Stock Purchase Plan and for

**Table of Contents****PEGASYSTEMS INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

future offerings until our Board of Directors determines otherwise, our Board has set the purchase price at 95% of the fair market value on the completion date of the offering period. The first offering period under the 2006 Stock Purchase Plan begins November 1, 2006.

The 2006 Stock Purchase Plan is tax qualified and as of June 30, 2006 no compensation expense related to shares issued under the plan has been recognized for financial statement purposes.

**Shares reserved**

As of June 30, 2006, 4.4 million shares were reserved for future issuance under our stock plans including zero shares for the 1994 Plan, zero shares for the Director Plan, 0.3 million shares for the 1996 Stock Purchase Plan, 3.6 million shares for the 2004 Plan and 0.5 million shares for the 2006 Stock Purchase Plan.

The following table presents the combined stock option activity for the 1994 Plan, the 2004 Plan and the Director Plan for the first six months of 2006:

|                                | Shares<br>(in thousands) | Weighted<br>Average<br>Exercise Price<br>per share | Weighted-<br>Average<br>Remaining<br>Contractual<br>Term (in years) |
|--------------------------------|--------------------------|--|---|
| Outstanding at January 1, 2006 | 9,728                    | \$ 7.85  | 6.02  |
| Granted                        | 167                      | 7.86   |   |
| Exercised                      | (63)                     | 5.59   |   |
| Cancelled                      | (597)                    | 7.83   |   |
| Outstanding at March 31, 2006  | 9,235                    | 7.86   | 6.17  |
| Granted                        | 82                       | 7.27   |   |
| Exercised                      | (198)                    | 4.15   |   |
| Cancelled                      | (275)                    | 8.91   |   |
| Outstanding at June 30, 2006   | 8,844                    | 7.91   | 6.02  |

The following table presents weighted average price and contract life information about significant option groups outstanding and exercisable at June 30, 2006:

| Range of<br>Exercise<br>Prices | Number of<br>Shares<br>Outstanding<br>(in thousands) | Options Outstanding   |  |   | Number of<br>shares<br>Exercisable<br>(in thousands) | Options Exercisable   |  | Aggregate<br>Intrinsic<br>Value<br>(in<br>thousands) |
|--------------------------------|--|---|--|---|--|---|--|--|
|                                |  | Weighted<br>Average<br>Remaining<br>Contractual<br>Term<br>(in years) | Weighted<br>Average<br>Exercise<br>Price<br>per<br>share | Aggregate<br>Intrinsic<br>Value<br>(in thousands) |  | Weighted<br>Average<br>Remaining<br>Contractual<br>Term<br>(in years) | Weighted<br>Average<br>Exercise<br>Price<br>per<br>share |  |
| \$ 2.33-4.38                   | 2,315  | 5.17  | \$ 4.08  | 1,977   | 4.90   | \$ 4.07   |  |  |
| 4.48-7.50                      | 2,214  | 7.65  | 6.78   | 1,811   | 7.35   | 6.83  |  |  |
| 7.54-8.67                      | 3,244  | 6.20  | 8.18   | 3,084   | 6.02   | 8.20  |  |  |
| 8.71-25.75                     | 1,071  | 3.96  | 17.69  | 1,071   | 3.96   | 17.69   |  |  |
| <b>Total</b>                   | <b>8,844</b>   | <b>6.02</b>   | <b>7.91</b>  | <b>\$ 5,602</b>                                   | <b>7,943</b>   | <b>5.77</b>   | <b>8.14</b>  | <b>\$ 4,774</b>                                      |

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The aggregate intrinsic value in the preceding table represents the total pre-tax intrinsic value, based on the closing price of our stock of \$6.42 on June 30, 2006, which would have been received by the option holders had all option holders exercised their options as of that date. The total number of in-the-money options exercisable as of June 30, 2006 was 2.4 million.

The intrinsic value of options exercised during the first quarter of 2006 was \$0.6 million. The weighted-average grant-date fair value of options granted during the second quarter of 2006 was \$4.90 per share. The intrinsic value of options vested during the second quarter 2006 was \$0.1 million.

**Table of Contents****PEGASYSTEMS INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

As of June 30, 2006, unrecognized compensation expense related to the unvested portion of our employee stock options was approximately \$1.3 million and is expected to be recognized over a weighted-average period of approximately 1.65 years.

Cash received from option exercises under all share-based payment arrangements for the three and six months ended June 30, 2006 was \$0.8 million and \$1.3 million, respectively. The actual tax benefit for the tax deductions from option exercises for the three and six months ended June 30, 2006 totaled \$0.2 million and \$0.3 million, respectively.

During the second quarter of 2006, 37,905 unrestricted shares of our common stock were granted to members of our Board of Directors under the 2004 Long Term Incentive Plan. As this award was unrestricted, no awards remain unvested as of June 30, 2006. The weighted average grant date value per share of the awards was \$7.25.

**(g) Recently Issued Accounting Pronouncements**

In June 2006, The Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*, which clarifies FASB Statement No. 109 (FAS 109), *Accounting for Income Taxes*. This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 is effective for fiscal years beginning after December 15, 2006. We will adopt FIN 48 in the first quarter of 2007. We have not determined its impact, if any, on our financial statements.

**3. COMPREHENSIVE INCOME (LOSS)**

SFAS No. 130, *Reporting Comprehensive Income (Loss)*, requires presentation of the components of comprehensive income (loss), including the changes in equity from non-owner sources such as unrealized gains (losses) on hedging transactions, securities and foreign currency translation adjustments. Our total comprehensive income (loss) is as follows:

| (in thousands)                           | Three months ended |                  | Six months ended |                  |
|--|--------------------|------------------|------------------|------------------|
|  | June 30,<br>2006   | June 30,<br>2005 | June 30,<br>2006 | June 30,<br>2005 |
| Comprehensive income (loss):             |                    |                  |                  |                  |
| Net income (loss)                        | \$ 430             | \$ 356           | \$ (916)         | \$ 429           |
| Other comprehensive income (loss):       |                    |                  |                  |                  |
| Foreign currency translation adjustments | 107                | (120)            | 140              | (267)            |
| Unrealized gain (loss) on securities     | (70)               | 141              | (99)             | (175)            |
| Comprehensive income (loss):             | \$ 467             | \$ 377           | \$ (875)         | \$ (13)          |

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

#### **Forward-Looking Statements**

This Quarterly Report on Form 10-Q contains or incorporates forward-looking statements within the meaning of section 27A of the Securities Act of 1933 and section 21E of the Securities Exchange Act of 1934. These forward-looking statements are based on current expectations, estimates, forecasts and projections about the industry and markets in which we operate and management's beliefs and assumptions. In addition, other written or oral statements that constitute forward-looking statements may be made by us or on our behalf. Words such as "expect," "anticipate," "intend," "plan," "believe," "seek," "estimate," "may," or variations of such words and similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions that are difficult to predict. We have identified certain risk factors in Item 1A of Part II of this Quarterly Report on Form 10-Q that we believe could cause our actual results to differ materially from the forward-looking statements we make. We do not intend to update publicly any forward-looking statements, whether as a result of new information, future events or otherwise.

#### **Business Overview**

We develop and license rules-based business process management (BPM) software and provide professional services, maintenance and training relating to our software. We focus our sales efforts on target accounts, which are companies or divisions within companies, and are typically large organizations that are among the leaders in their industry. We frequently sell limited size initial licenses to these target accounts rather than selling large application licenses. This allows our customers to quickly realize business value from our software and limits their up-front investment. Once a customer has realized this initial value, we work with the customer to identify opportunities for follow-on sales. Follow-on sales are often larger than the initial sale, and the sales process for follow-on sales is often shorter as a result of the established relationship with the customer.

Our customers typically request professional services and training to assist them in implementing our products. Almost all of our customers also purchase maintenance on our products, which includes rights to upgrades and new releases, incident resolution and technical assistance. We provide maintenance and training services directly to most of our customers. Professional services are provided directly by us in some situations and through our network of partners in other cases. The amount of professional services provided by our partners has been increasing in recent years. By utilizing these partners, we have significantly increased the supply of skilled service consultants that can assist our customers. In certain situations, our partners are also able to offer lower rates to our customers due to the use of resources located in other countries, thereby reducing the overall cost. Some of our partners have more headcount dedicated to consulting services for our products than we have. We believe this trend is good for our business because of the breadth of domain expertise that our partners can bring to solutions. We expect that our services revenue may grow more slowly over time than if we did not rely on our partners.

Beginning in 2005, most of our license revenue from new license signings has involved our PegaRULES Process Commander software and related solution frameworks. These products often require less implementation assistance than prior generations of our software products. In many cases this has enabled us to shorten the length of the sales process and the time required to receive customer acceptance of the software product. Significantly, PegaRULES Process Commander and solution frameworks can be used more broadly by customers within our traditional financial services and healthcare markets, as well as by customers outside of our traditional markets, enabling us to sell to expanded markets.

In recent years, we have typically licensed our software to new customers pursuant to perpetual licenses, under which a customer pays a single license fee at the commencement of the license, rather than term licenses. Under term licenses a customer pays a monthly fee during the license term and must renew the license for additional fees to continue to use the software after the original term. We expect that perpetual licenses for new customers will continue to be a significant portion of total license signings, although we expect to enter into new term licenses in certain instances. Our use of perpetual licenses rather than term licenses may have the effect, with respect to a given transaction, of increasing our license revenue and cash flow in the short term, but of decreasing the amount of renewal revenue and cash flow in the future.

Recently, we have been entering into more term licenses with contract provisions that require the term license revenue to be recognized over the license term as payments become due, or ratably over the license term when payments are made in advance. This has the effect, with respect to a particular agreement, of reducing our term license revenue in the initial period but increasing the amount of recurring future term license revenue during the remainder of the license term, but does not change the expected cash flow. Generally, in prior periods, we entered into term licenses with contract provisions that required us to recognize the present value of committed future term license payments upon customer acceptance at the beginning of the license term.



**Table of Contents****Overview of Results of Operations***Executive Summary*

In the first half of 2006, our total revenue was \$56.7 million, an 18% increase from the first half of 2005. This increase reflected higher professional services revenue from license implementations and higher maintenance revenue, partially offset by lower license revenue. Our continued investment in expanding the number of trained services personnel to meet the increasing number and value of new license signings caused our services gross margin to decline from the first half of 2005 to the first half of 2006. Deferred revenue increased \$7.6 million from June 30, 2005 to \$22.2 million at June 30, 2006 due to a \$7.4 million increase in deferred license revenue. Our continued investments to support growth in services and sales, and stock option expense related to the adoption of SFAS 123R, resulted in a net loss of \$(0.9) million for the first half of 2006. Cash flow from operations in the first half of 2006 was \$14.9 million.

*Overview*

Total revenue in the first half of 2006 increased 18% to \$56.7 million from \$48.0 million in the first half of 2005. This increase was driven primarily by an \$11.7 million increase in professional services revenue related to license implementations and a \$2.1 million increase in maintenance revenue, partially offset by a \$5.0 million decrease in license revenue. The \$5.0 million decrease in license revenue was due to a \$2.6 million decrease in perpetual license revenue and a \$2.5 million decrease in term license revenue. The \$2.5 million decrease in term license revenue reflects our decision to increasingly enter into term licenses with contract provisions that require the term license revenue to be recognized over the license term as payments become due, or ratably over the license term when payments are made in advance. During the first half of 2006, we signed agreements with approximately \$9 million in term license fees expected to be recognized as revenue in future periods as payments become due.

The aggregate dollar value of license signings in the first half of 2006 was significantly higher than the dollar value of license signings in the first half of 2005. The number of license signings in the first half of 2006 increased significantly from the number of license signings in the first half of 2005 and was comparable to the number of license signings in the second half of 2005. The dollar value and number of license signings are likely to fluctuate considerably quarter to quarter.

Cost of services revenue in the first half of 2006 increased \$9.4 million from the first half of 2005, which reduced our overall service gross margin from 46% in the first half of 2005 to 42% in the first half of 2006. The increase in these costs resulted from our continued investment in expanding the number of trained services personnel, including new Pegasystems and partner staff, to better meet the increase in new license signings. Services gross profit increased \$4.3 million for the first half of 2006 compared to the first half of 2005 due to increased services revenue, partially offset by a decrease in services margin percentage.

Total operating expenses in the first half of 2006 increased \$4.0 million, or 12%, from the first half of 2005, due to our continued investment in expanding the number of sales and services personnel to better meet the increase in new license signings, and stock option expense related to the adoption of SFAS 123R.

Income (loss) before provision for income taxes decreased from a profit of \$0.7 million in the first half of 2005 to a loss of \$(1.4) million in the first half of 2006, primarily due to the \$5.0 million decrease in license revenue and a \$4.0 million increase in operating expenses, partially offset by a \$4.3 million improvement in services gross profit and a \$2.5 million improvement in other income and expense. Net income (loss) changed from a profit of \$0.4 million in the first half of 2005 to a loss of \$(0.9) million in the first half of 2006.

We generated \$14.9 million in cash flow from operations during the first half of 2006, and ended the period with \$126.1 million in cash and short-term investments and \$46.5 million in combined short and long-term license installment receivables.

***Revenue***

Our total revenue for the second quarter of 2006 increased 25% to \$29.6 million from \$23.8 million for the second quarter of 2005. Our total revenue for the first half of 2006 increased 18% to \$56.7 million from \$48.0 million for the first half of 2005. These increases were primarily due to increases in professional services revenue and maintenance revenue, partially offset by decreases in license revenue. The following table summarizes our revenue composition:



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| <i>(in millions)</i>               | Three months ended |                | Six months ended |                |
|------------------------------------|--------------------|----------------|------------------|----------------|
|                                    | June 30,           |                | June 30,         |                |
|                                    | 2006               | 2005           | 2006             | 2005           |
| <b>License revenue (1)</b>         |                    |                |                  |                |
| Perpetual licenses                 | \$ 3.4             | \$ 6.4         | \$ 8.4           | \$ 11.0        |
| Term licenses                      | 3.5                | 1.6            | 5.4              | 7.9            |
| Total license revenue              | 6.9                | 8.0            | 13.8             | 18.9           |
| <b>Services revenue</b>            |                    |                |                  |                |
| Professional services and training | 16.8               | 10.6           | 30.9             | 19.2           |
| Maintenance                        | 5.9                | 5.2            | 12.0             | 9.9            |
| Total services revenue             | 22.7               | 15.8           | 42.9             | 29.1           |
| <b>Total revenue</b>               | <b>\$ 29.6</b>     | <b>\$ 23.8</b> | <b>\$ 56.7</b>   | <b>\$ 48.0</b> |

(1) License revenue composition amounts reported in a similar table in previous periods have been reformatted to the current presentation. The total license revenue amount has not changed from prior presentation.

Total license revenue for the second quarter of 2006 decreased 13% to \$6.9 million from \$8.0 million for the second quarter of 2005. This decrease was the result of a \$3.0 million decrease in perpetual license revenue, partially offset by a \$1.9 million increase in term license revenue. Total license revenue for the first half of 2006 decreased 27% to \$13.8 million from \$18.9 million for the first half of 2005. This decrease was the result of a decrease of \$2.6 million in perpetual license revenue and a decrease of \$2.5 million in term license revenue. The decreases in term license revenue were primarily due to our decision to increasingly enter into term licenses with contract provisions that require the term license revenue to be recognized over the license term as payments become due, or ratably over the license term when payments are in advance. During the first half of 2006, we signed agreements with approximately \$9 million in term license fees expected to be recognized as revenue in future periods as payments become due. Term license renewals scheduled for the full year 2006 are modestly higher than actual term license renewals in the full year 2005. While historically a majority of customers have renewed their term licenses, there can be no assurance that this will continue.

The increase in professional services and training revenue of \$6.2 million in the second quarter of 2006 and \$11.7 million in the first half of 2006 reflects increased demand from our customers for professional services related to new license implementations. Typically, we derive substantial revenue from services provided in connection with the implementation of software licensed by new customers. Maintenance revenue increased 13% to \$5.9 million in the second quarter of 2006 from \$5.2 million in the second quarter of 2005. Maintenance revenue increased 21% to \$12.0 million in the first half of 2006 from \$9.9 million in the first half of 2005. The increases in maintenance revenue were due to a larger installed base of software and a higher proportion of perpetual licenses in the installed base which yield greater maintenance revenue than term licenses.

We record allowances for estimates of potential credit memos and sales returns when the related revenue is recorded. We base these estimates on historical analyses of credit memo data, current economic trends, and our experience with customer disputes, products, customer industry and other known factors. These estimated amounts are deferred or reserved until the related elements of the agreements are completed and provided to the customer or the dispute is resolved. Our allowance for credit memos was \$1.4 million at June 30, 2006, and \$0.5 million at December 31, 2005. The following reflects the activity of the allowance for credit memos:

| <i>(in thousands)</i>        | Six months ended |     | Year ended        |     |
|------------------------------|------------------|-----|-------------------|-----|
|                              | June 30, 2006    |     | December 31, 2005 |     |
|                              |                  |     |                   |     |
| Balance at beginning of year | \$               | 470 | \$                | 642 |

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|   |          |        |
|---|----------|--------|
| Revenue deferred                        | 1,966    | 378    |
| Credit memos issued that impact revenue | (1,031)  | (550)  |
| Balance at end of period                | \$ 1,405 | \$ 470 |

Deferred revenue at June 30, 2006 consisted primarily of the fees billed in connection with arrangements for which acceptance of the software license or completion of fixed price services had not occurred, and unearned portions of annual maintenance fees paid in advance. Our deferred revenue balance increased to \$22.2 million at June 30, 2006, from \$18.7 million at December 31, 2005. The \$3.5 million increase was due primarily to an increase in pre-paid annual maintenance fees and new license sales for which acceptance of the software or completion of fixed price services had not occurred. Deferred revenue at June 30, 2006 was \$7.6 million higher than deferred revenue at June 30, 2005, primarily due to our increased license signings. In certain situations where multiple license sales or implementations are ongoing with a single customer, for revenue recognition purposes these multiple arrangements may be deemed a single bundled arrangement, thereby delaying revenue recognition for the earlier license sale until all elements of the bundled arrangement are complete.

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International revenue was 34% of total revenue for the second quarter of 2006 and 32% for the second quarter of 2005. International revenue was 35% of total revenue for the first half of 2006 and 30% for the first half of 2005. The foreign currency exposure related to revenue is largely offset by the expenses we incur in foreign currencies. Our international revenue may fluctuate in the future because such revenue is generally dependent upon a small number of license transactions during a given period. We expect that due to competition from vendors who will do business in foreign currencies, more of our customer transactions may be denominated in foreign currencies in the future, which may expose us to increased currency exchange risk. See Item 3 for discussion regarding foreign currency exposure.

***Cost of revenue***

The cost of maintenance, professional services and training for the second quarter of 2006 increased 54% to \$12.4 million from \$8.0 million in the second quarter of 2005. Cost of services as a percentage of services revenue increased to 55% for the second quarter of 2006 from 51% for the second quarter of 2005. These increases were due primarily to a \$2.1 million increase in compensation costs, a \$1.3 million increase in contracted services and a \$0.9 million increase in travel expenses. These increases reflect an investment in expanding the pool of trained service personnel, including new professional services employees and partners, to support an increase in the number of license implementation projects. Services gross margin was \$10.3 million for the second quarter of 2006 compared to \$7.7 million for the second quarter of 2005. The increase in services gross margin was primarily due to an increase in professional services gross margin and an increase in maintenance gross margin, reflecting our higher professional services and maintenance revenue.

The cost of maintenance, professional services and training for the first half of 2006 increased 60% to \$25.0 million from \$15.6 million in the first half of 2005. Cost of services as a percentage of services revenue increased to 58% for the first half of 2006 from 54% for the first half of 2005. These increases were due primarily to a \$4.2 million increase in compensation costs, a \$3.1 million increase in contracted services and a \$1.9 million increase in travel expenses. These increases reflect an investment in expanding the pool of trained service personnel, including new professional services employees and partners, to support an increase in the number of license implementation projects. Services gross margin was \$17.9 million for the first half of 2006 compared to \$13.5 million for the first half of 2005. The increase in services gross margin was primarily due to an increase in maintenance gross margin, reflecting our higher maintenance revenue.

***Operating expenses***

Research and development expenses for the second quarter of 2006 increased 17% to \$5.7 million from \$4.9 million for the second quarter of 2005. As a percentage of total revenue, research and development expenses decreased to 19% in the second quarter of 2006 from 21% in the second quarter of 2005. Research and development expenses for the first half of 2006 increased 12% to \$11.1 million from \$9.9 million for the first half of 2005. These increases in research and development expenses were primarily due to increased spending on independent contractors assisting with our research and development efforts, primarily associated with the recent release of version 5.1 of PegaRULES Process Commander. As a percentage of total revenue, research and development expenses decreased to 20% for the first half of 2006 from 21% for the first half of 2005.

Selling and marketing expenses for the second quarter of 2006 increased 28% to \$10.2 million from \$7.9 million for the second quarter of 2005. As a percentage of total revenue, selling and marketing expenses increased to 34% in the second quarter of 2006 from 33% in the second quarter of 2005. Selling and marketing expenses for the first half of 2006 increased 18% to \$19.9 million from \$16.9 million for the first half of 2005. The increase in the first half of 2006 was due to increased compensation costs and hiring fees associated with additional sales staffing. As a percentage of total revenue, selling and marketing expenses were 35% in the first half of 2006 and 2005, due to the combined effect of higher selling and marketing spending in the first half of 2006 partially offset by increased total revenue in the first half of 2006.

General and administrative expenses for the second quarter of 2006 increased 13% to \$3.4 million from \$3.0 million for the second quarter of 2005. As a percentage of total revenue, general and administrative expenses decreased to 11% for the second quarter of 2006 from 13% for the second quarter of 2005. The increase in general and administrative expenses was primarily due to increased director compensation. General and administrative expenses for the first half of 2006 decreased 5% to \$6.0 million from \$6.3 million for the first half of 2005. As a percentage of total revenue, general and administrative expenses decreased to 11% for the first half of 2006 from 13% for the first half of 2005, due to the combined effect of increased revenue and lower general and administrative spending.

***Installment receivable interest income***

Installment receivable interest income, which consists of the portion of all term license fees recognized under the net present value method, decreased to \$0.5 million in the second quarter of 2006 from \$0.6 million in the second quarter of 2005. Installment receivable interest income decreased to \$0.9 million in the first half of 2006 from \$1.1 million in the first half of 2005. The decreases were due primarily to the lower total value of that portfolio, caused by our increasing use of perpetual licenses and our decision to increasingly enter into term licenses with contract

provisions that require the term license revenue to be recognized over

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the license term as payments become due, or ratably over the license term when payments are made in advance. For those term licenses for which we recognize revenue on a present value basis, a portion of the fee is initially deferred and recognized as installment receivable interest income over the remaining term of the license. For purposes of the present value calculations, the discount rates used are estimates of customers borrowing rates, typically below prime rate, and have varied between 3.25% and 6.7% during the past few years.

***Other interest income, net***

Other interest income increased to \$1.3 million in the second quarter of 2006 from \$0.7 million for the second quarter of 2005. Other interest income increased to \$2.4 million in the first half of 2006 from \$1.4 million for the first half of 2005. The increase was primarily due to improved yields and increased cash and investment balances.

***Other income (expense), net***

Other income (expense), net, which consists primarily of currency exchange gains and losses, was \$0.4 million income in the second quarter of 2006 compared to (\$0.7) million expense in the second quarter of 2005. Other income (expense), net, was \$0.6 million income in the first half of 2006 compared to (\$1.0) million expense in the first half of 2005. The favorable changes in other income (expense), net, resulted primarily from the impact of foreign exchange rate changes on transactions recorded on our financial statements in U.S. dollars which are denominated in foreign currencies, consisting primarily of cash, investments, license installments, receivables, accounts payable and accruals. In particular, changes in the exchange rates of European currencies in comparison to the U.S. dollar have favorably impacted foreign currency denominated assets.

***Income (loss) before provision for income taxes***

Income (loss) before provision for income taxes decreased to \$0.2 million income in the second quarter of 2006 from \$0.5 million income in the second quarter of 2005. This decrease was primarily due to a \$3.5 million increase in operating expenses primarily due to investments in sales and a \$1.0 million decrease in license gross margin, partially offset by a \$2.6 million increase in services gross margins, a \$1.1 million increase in other income and expense related to foreign currency transactions and a \$0.6 million improvement in other interest income, net.

Income (loss) before provision for income taxes changed to a (\$1.4) million loss in the first half of 2006 from \$0.7 million income in the first half of 2005. This change was primarily due to a \$4.9 million decrease in license gross margin and a \$4.0 million increase in operating expenses primarily due to investments in sales, partially offset by a \$4.3 million increase in services gross margins and a \$1.7 million increase in other income and expense related to foreign currency transactions and a \$1.1 million improvement in other interest income, net.

***Provision for income taxes***

The provision for income taxes in the first half of 2006 was a benefit of \$(0.4) million, compared to a tax provision of \$0.2 million in the first half of 2005. The income tax provision during 2006 is expected to benefit from research and experimentation tax credits, deductions related to export activity and claims filed for refunds of foreign income taxes.

**Liquidity and capital resources**

We have funded our operations primarily from cash flow from operations. At June 30, 2006, we had cash and equivalents and short-term investments of \$126.1 million, an \$11.4 million increase from \$114.7 million at December 31, 2005. This increase was primarily due to \$14.9 million of cash flow from operations and \$1.2 million from the exercise of stock options, partially offset by \$3.5 million used to repurchase outstanding shares of our common stock and \$1.3 million used for investments in equipment and software.

Working capital was \$136.0 million at June 30, 2006, a \$5.1 million increase from \$130.9 million at December 31, 2005. Working capital increased primarily due to an \$11.4 million increase in cash and investments, partially offset by a \$3.4 million increase in deferred revenue. The \$3.4 million increase in deferred revenue was primarily due to an increase in pre-paid annual maintenance fees and new license signings for which acceptance of the software or completion of fixed price services had not occurred.

Cash flow from operating activities for the first half of 2006 decreased to \$14.9 million from \$16.0 million for the first half of 2005. During the first half of 2006, cash flow benefited from an \$11.4 million reduction in license installments, a \$3.4 million increase in deferred revenue, partially offset by a \$(0.9) million net loss. The decrease in license installments reflects the lower average remaining life of our term licenses recorded on the balance sheet (see discussion below in this section). Accounts receivable days billing outstanding has increased from 74 days at December 31, 2005 to 78 days at June 30, 2006, primarily due to slower payments by some large customers.

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Net cash used in investing activities for the first half of 2006 was (\$6.5) million, primarily due to net purchases of marketable debt securities. This compared with (\$5.5) million used in investing activities in the first half of 2005, which was also primarily due to net purchases of marketable debt securities. Investments in equipment and software increased to \$1.3 million in the first half of 2006 from \$0.8 million in the first half of 2005.

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In 2004, our Board of Directors authorized the repurchase of up to \$10 million of our outstanding common stock, in open market or privately negotiated transactions. During the first half of 2006, we repurchased 518,981 shares for \$3.7 million under the program in open market purchases. During 2005, we repurchased 957,112 shares for \$5.9 million under the program in open market purchases. This authorization to repurchase shares expired on June 30, 2006. Our repurchase activity in the first six months of 2006 was as follows:

| Period        | Total Number of Shares Purchased <sup>(1)</sup> | Average Price Paid per Share | Total Number   |  |
|---------------|---|------------------------------|--|--|
|               |   |                              | of Shares Purchased as Part of Publicly Announced Share Repurchase Program | Approximate Dollar Value Of Shares That May Yet Be Purchased Under The Share Repurchase Program (in thousands) |
| January 2006  |   | \$                           |  | \$ 4,123   |
| February 2006 |   |                              |  | 4,123  |
| March 2006    | 41,994  | \$ 7.42                      | 999,106  | 3,812  |
| April 2006    |   |                              |  | 3,812  |
| May 2006      | 224,092   | \$ 7.15                      | 1,223,198  | 2,210  |
| June 2006     | 252,895   | \$ 7.03                      | 1,476,093  | Program Complete   |
| <b>Total</b>  | <b>518,981</b>                                  | <b>\$ 7.11</b>               | <b>1,476,093</b>   |  |

(1) All shares were purchased pursuant to the share repurchase program.

On May 30, 2006, our Board of Directors authorized the repurchase of up to \$10 million of our outstanding common stock beginning July 1, 2006. Any purchases will be made from time to time on the open market or in privately negotiated transactions. Under the program, shares may be purchased in such amounts as market conditions warrant, subject to regulatory and other considerations.

This new authorization to repurchase shares is currently scheduled to expire on June 30, 2007.

On June 1, 2006, our Board of Directors declared the company's first quarterly cash dividend of \$.03 per share. The dividend of approximately \$1.1 million was paid on July 17, 2006 to shareholders of record as of July 3, 2006. The accrued liability for this dividend of \$1.1 million is included in Accounts payable and accrued expenses at June 30, 2006. Quarterly dividends are expected to continue at \$.03 per share, subject to change by our Board of Directors, to shareholders of record as of the first trading day of each quarter.

We believe that current cash, cash equivalents, and cash flow from operations will be sufficient to fund our business for at least the next twelve months. Material risks to cash flow from operations include delayed or reduced cash payments accompanying sales of new licenses or a decline in our services business. There can be no assurance that changes in our plans or other events affecting our operations will not result in materially accelerated or unexpected expenditures. In addition, there can be no assurance that additional capital, if needed, will be available on reasonable terms, if at all, at such time as we require.

As of June 30, 2006, we had material commitments for purchases of customer support and consulting services, and payments under capital and operating leases. Our principal administrative, sales, marketing, support, and research and development operations are located in an 85,228 square foot leased facility in Cambridge, Massachusetts. The lease for this facility expires in 2013, with the option to extend for two additional five-year periods. We also lease space for our other offices in the United States, Canada, Australia, France, and the United Kingdom. These leases expire at various dates through 2010. Rent expense under operating leases is recognized on a straight-line basis, to account for scheduled rent increases. The excess of expense over current payments is recorded as deferred rent and included in other long-term liabilities. As of June 30, 2006, our known contractual obligations were as follows:

(in thousands)

Payment due by period

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| <b>Contractual obligations:</b> | <b>Total</b> | <b>Remainder<br/>of 2006</b> | <b>2007 &amp;<br/>2008</b> | <b>2009 &amp;<br/>2010</b> | <b>2011 and<br/>after</b> |
|---------------------------------|--------------|------------------------------|----------------------------|----------------------------|---------------------------|
| Purchase commitments            | \$ 2,998     | \$ 750                       | \$ 2,190                   | \$ 58                      | \$                        |
| Capital lease obligations       | 115          | 52                           | 63                         |                            |                           |
| Operating lease obligations     | 24,757       | 1,906                        | 6,873                      | 7,067                      | 8,911                     |
| <b>Total</b>                    | \$ 27,870    | \$ 2,708                     | \$ 9,126                   | \$ 7,125                   | \$ 8,911                  |

Our liquidity is affected by the manner in which we collect cash for certain types of license transactions.



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The following amounts of cash are due for receipt in connection with our existing term license agreements:

| Years ending December 31, | License<br>installments for<br>term<br>licenses<br>recorded on the<br>balance<br>sheet | License<br>installments to<br>be recorded<br>as<br>payments<br>become due<br><br>(in thousands) |
|---------------------------|--|---|
| Remainder of 2006         | \$ 10,812  | \$ 1,968  |
| 2007                      | 20,142   | 4,028   |
| 2008                      | 10,572   | 3,276   |
| 2009                      | 3,399  | 1,653   |
| 2010                      | 2,691  | 851   |
| 2011 and thereafter       | 3,389  | 221   |
| <b>Total</b>              | <b>\$ 51,005</b>   | <b>\$ 11,997</b>  |

**Recently issued accounting pronouncements**

In June 2006, The Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*, which clarifies FASB Statement No. 109 (FAS 109), *Accounting for Income Taxes*. This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 is effective for fiscal years beginning after December 15, 2006. We will adopt FIN 48 in the first quarter of 2007. We have not determined its impact, if any, on our financial statements.

**Critical accounting policies and estimates**

Management's Discussion and Analysis of Financial Condition and Results of Operations is based upon the condensed consolidated financial statements. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. We base our estimates and judgments on historical experience, knowledge of current conditions and beliefs of what could occur in the future given available information. We consider the following accounting policies to be both those most important to the portrayal of our financial condition and those that require the most subjective judgment. If actual results differ significantly from management's estimates and projections, there could be a material effect on our financial statements. The significant accounting policies that we believe are the most critical to aid in fully understanding and evaluating our reported financial results include the following:

Revenue recognition,

Deferred revenue,

Allowance for doubtful accounts and allowance for credit memos,

Stock-based compensation,

Accounting for income taxes, and

Contingencies.

A full discussion of these accounting policies is included in our 2005 Annual Report on Form 10-K filed with the Securities and Exchange Commission and we refer the reader to that discussion. The following information regarding critical accounting policies and estimates has been updated since our 10-K.

***Revenue recognition***

Our revenue is derived from two primary sources: software license fees and service fees. Software revenue is recognized in accordance with Statement of Position (SOP) 97-2, Software Revenue Recognition, as amended. Our license arrangements, whether involving a perpetual license or a term license, generally contain multiple elements. In addition to the license, these elements generally include professional consulting services, training and maintenance services. We do not have vendor specific objective evidence of fair value for the license and, therefore, recognize revenue based on the residual value method as prescribed in Statement of Position 98-9 Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transactions. We typically determine fair value for the non-license elements as the price for such elements when sold separately. Revenue from arrangements in which the fair value of one or more undelivered elements is unknown is deferred until the fair value of those elements is known and the residual value of the license can be determined.

Perpetual license fees are generally payable at the time the software is delivered, and are generally recognized as revenue when the software is delivered, any acceptance required by contract is obtained, and no significant obligations or contingencies exist related to the software, other than maintenance support, provided all other revenue recognition criteria are met.

Term software license fees are generally payable on a monthly basis under license agreements that generally have a five-year term and

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may be renewed for additional years at the customer's option. We have a history of successfully collecting payments under such term software license arrangements, and therefore, the present value of future license payments is generally recognized as revenue upon customer acceptance, provided that no significant obligations or contingencies exist related to the software, other than maintenance support, provided all other revenue recognition criteria are met. A portion of the license fees payable under each term license agreement (equal to the difference between the total license payments and the discounted present value of those payments) is initially deferred and recognized as installment receivable interest income (and is not part of total revenue) over the license term. Many of our license agreements provide for license fee increases based on inflation. When such an increase occurs, as determined by the terms of the license agreement, we recognize the present value of such increases as revenue; the remainder of the increase is recognized as installment receivable interest income over the remaining license term. For purposes of the present value calculations, the discount rates used are estimates of customers' borrowing rates at the time of recognition, typically below prime rate, and have varied between 3.25% and 6.7% for the past few years. As a result, revenue that we recognize relative to new license arrangements of this type would be impacted by changes in market interest rates. We are increasingly entering into term licenses with contract provisions that require the term license revenue to be recognized over the term of the agreement as payments become due, or ratably over the term of the license when payments are made in advance.

Our standard license terms provide that the software is accepted upon delivery. Some of our license arrangements, however, provide that the acceptance does not occur until later, based on customer specific criteria.

Our services revenue is comprised of fees for software implementation, consulting, maintenance and training services. Implementation and consulting services generally do not involve producing new software or customizing or modifying the licensed software, but rather involve helping customers create rule sets that enable those customers to deploy the software to their specific business processes. Our software implementation and consulting agreements typically require us to provide services on a time and material basis or a fixed fee. Revenues for time and material projects are recognized as services are delivered and fees are billed. As the services provided are not essential to the functionality of the software and are described in the agreement such that the total price of the arrangement would be expected to vary as the result of the inclusion or exclusion of the services, we account separately for the services element of the arrangement and allocate revenue accordingly among the elements based on the fair value. Our fair value for the rate per service hour is established as the actual rate charged per hour for time and materials services that have been sold separately. The fair value of services is determined by multiplying the fair value rate per hour by the services hours incurred, or committed.

We do not have vendor specific objective evidence of the fair values of fixed-price services projects because we do not have a reliable track record for accurately estimating the time and resources needed to complete such projects. Revenue from fixed-price services projects is recognized as the services are provided based upon the hours incurred at amounts equal to the direct costs incurred, up to the amounts billed to date, resulting in no gross profit recognized until completion of the project. When the fixed-price services are part of a multiple element arrangement including a license sale, we account for the license sale and the fixed-price services as one unit. Revenue from such arrangements is recognized as the services are provided based on direct costs incurred up to the amounts billed to date, resulting in no gross profit being recognized with respect to either the services or the license elements until completion of the project.

Software license customers are offered the option to enter into a maintenance contract, which usually requires the customer to pay a monthly maintenance fee over the term of the maintenance agreement, typically renewable annually. Prepaid maintenance fees are deferred and are recognized evenly over the term of the maintenance agreement. We generally recognize training fees revenue as the services are provided.

We have very limited revenue through resellers; therefore we typically have not provided price protection or stock rotation rights. We have, in a small number of instances, provided limited rights of return or cancellation. We record allowances for estimates of potential credit memos and sales returns when the related revenue is recorded, and review them periodically. These estimates are based on historical analyses of credit memo data, current economic trends, and our experience with customer disputes, products, customer industry and other known factors. These estimated amounts are deferred or reserved until the related elements of the agreement are completed and provided to the customer or the dispute is resolved.

We warrant that our software products will conform to documented specifications. We have not experienced significant claims related to software warranties beyond the scope of maintenance support which we are already obligated to provide, and consequently we have not established reserves for warranty obligations.

Our agreements with customers generally require us to indemnify the customer against claims that our software infringes third party patent, copyright, trademark or other proprietary rights. Such indemnification obligations are generally limited in a variety of industry-standard respects, including our right to replace an infringing product. As of June 30, 2006, we had not experienced any material losses related to these indemnification obligations and no claims with respect thereto were outstanding. We do not expect significant claims related to these indemnification obligations, and consequently, we have not established any related reserves.



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### *Stock-based compensation*

We periodically grant stock options for a fixed number of shares to employees, non-employee directors and contractors with an exercise price greater than or equal to the fair market value of the shares at the date of the grant. Until January 1, 2006, we accounted for stock option grants to employees and directors using the intrinsic value method. Under the intrinsic value method, compensation associated with stock awards to employees and directors was determined as the difference, if any, between the current fair value of the underlying common stock on the date compensation was measured and the price the employee or director must pay to exercise the award. The measurement date for employee and director awards is generally the date of grant. Prior to January 1, 2006, we disclosed in the notes to our consolidated financial statements the pro forma effect on our statement of operations if we had employed the fair value method of accounting for stock option grants. For purposes of that disclosure, we used a Black-Scholes multiple pricing model to value the options granted which required us to make certain assumptions including the estimated life of options, the volatility of our stock price, the risk-free rate of return and dividend yield. Our assumption regarding the average life of our options and the volatility of our stock was based on an analysis of our historical stock option exercises and stock price as reported by NASDAQ over a period approximating the assumed average life of our options and ending on the date the determination was made. Our assumption regarding the risk-free rate of return was based on U.S. Treasury note yields. The dividend was equal to zero, as no dividends had been declared through December 31, 2005. Stock options granted to contractors were accounted for using the fair value method. Under the fair value method, compensation associated with stock awards to contractors is determined based on the estimated fair value of the award itself, measured using either current market data or an established option pricing model.

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 123R, *Share-Based Payment* (SFAS 123R). This Statement is a revision of SFAS No. 123, *Accounting for Stock-Based Compensation* (SFAS 123), and supersedes Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25), and its related implementation guidance. SFAS 123R establishes accounting for equity instruments exchanged for employee services. Under the provisions of SFAS 123R, share-based compensation is measured at the grant date, based upon the fair value of the award, and is recognized as an expense over the employee's requisite service period (generally the vesting period of the equity grant). The majority of our share-based compensation arrangements vest over either a four or five year vesting schedule.

Effective January 1, 2006, we adopted the provisions of SFAS 123R using the modified prospective approach, and, accordingly, prior period amounts have not been restated. Under this approach, we are required to record compensation cost for all share-based payments granted after the date of adoption based on the grant date fair value, estimated in accordance with the provisions of SFAS 123R, and for the unvested portion of all share-based payments previously granted that remain outstanding based on the grant date fair value, estimated in accordance with the original provisions of SFAS 123. We expense share-based compensation under the ratable method, which treats each vesting tranche as if it were an individual grant.

In the second quarter of 2006, we estimated the fair value of stock options using a Black-Scholes valuation model. Key inputs used to estimate the fair value of stock options include the exercise price of the award, the expected post-vesting option life, the expected volatility of our stock over the option's expected term, the risk-free interest rate over the option's expected term, and our expected annual dividend yield. If the assumed 3.6 year post-vesting option life was one year longer or shorter, the valuation of options and expense would be up to 12% higher or lower, respectively. If the assumed 76% volatility of our stock price was ten percentage points higher or lower, the valuation of options and expense would be up to 10% higher or lower, respectively. If the assumed 5.11% risk-free interest rate over the expected term of the options was up to two hundred basis points higher or lower, the valuation of options and expense would be up to 3% higher or lower, respectively. Estimates of fair value are not intended to predict actual future events or the value ultimately realized by persons who receive awards. If the assumed 1.7% dividend yield was one percentage point higher or lower, the valuation of options and expense would be up to 15% higher or lower.

As required by SFAS 123R, we reduce current expense for an estimate of expected forfeitures of stock options prior to vesting by employees whose employment with us terminates. We base our estimate on an analysis of our history of forfeited options with similar vesting terms. This estimate is trueed up for actual forfeitures of options during vesting.

As of June 30, 2006, unrecognized compensation expense related to the unvested portion of our employee stock options was approximately \$1.3 million and is expected to be recognized over a weighted-average period of approximately 1.65 years. In the first quarter of 2006, there were no changes in the quantity or type of instruments used in share-based payment programs, or the terms of share-based payment arrangements.

During the second quarter of 2006, our Board of Directors decided to provide our directors (except Mr. Trefler) with an annual award of unrestricted common stock, in lieu of a grant of stock options; for the number of shares equal to \$55,000 divided by the fair market value of our common stock on the issue date. A total of 37,905 shares were issued to our directors in June 2006.

The choice of a valuation technique, and the approach utilized to develop the underlying assumptions for that technique, involve significant judgments. These judgments reflect management's assessment of the most accurate method of valuing the stock options we issue, based on our

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historical experience, knowledge of current conditions and beliefs of what could occur in the future given available information. Our judgments could change over time as additional information becomes available to us, or the facts underlying our

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assumptions change over time, and any change in our judgments could have a material effect on our financial statements. We believe that our estimates incorporate all relevant information and represent a reasonable approximation in light of the difficulties involved in valuing non-traded stock options.

### **Inflation**

Inflation has not had a significant impact on our operating results to date, and we do not expect it to have a significant impact in the future. Our unbilled license and maintenance fees are typically subject to annual increases based on recognized inflation indices.

### **Significant customers**

During the second quarter of 2006, one customer represented 10% of our total revenue. During the second quarter of 2005, one customer represented 17% of our total revenue. During the first half of 2006, no single customer accounted for more than ten percent of our total revenue. During the first half of 2005, one customer accounted for approximately 11% of our total revenue.

### **Item 3. Quantitative and Qualitative Disclosures about Market Risk**

Market risk represents the risk of loss that may affect us due to adverse changes in financial market prices and rates. Our market risk exposure is primarily fluctuations in foreign exchange rates and interest rates. We have not entered into derivative or hedging transactions to manage risk in connection with such fluctuations.

#### *Foreign currency exposure*

We derived approximately 34% of our total revenue in the second quarter of 2006 from sales to customers based outside of the United States. Some of our international sales are denominated in foreign currencies, such as the British pound and Euro. The price in United States dollars of products and services sold outside the United States in foreign currencies will vary as the value of the United States dollar fluctuates against those foreign currencies. There can be no assurance that sales denominated in foreign currencies will not be material in the future and that there will not be increases in the value of the United States dollar against such currencies that will reduce the dollar return to us on the sale of our products and services in such foreign currencies. The foreign currency exposure related to revenue is largely offset by the expenses we incur in foreign currencies.

Because most of our transactions with customers are invoiced from our offices in the U.S., and some of those transactions are denominated in currencies other than the U.S. dollar, we have receivables and license installments that are valued in other currencies. In addition, our U.S. operating company holds some cash and investments in currencies other than the U.S. dollar in order to support operations in other countries. When there are changes in the exchange rates for those other currencies versus the U.S. dollar functional currency we recognize a currency gain or (loss) in the statement of operations as other income (expense) related to foreign currency transactions. We had net assets valued in foreign currencies, consisting primarily of cash, investments, license installments, and receivables, partially offset by accounts payable and accruals, with a carrying value of \$23 million as of June 30, 2006. A ten percent change in currency exchange rates would change by approximately \$2 million the carrying value of those net assets as reported on our balance sheet as of June 30, 2006, with most of that change recognized in the statement of operations as other income (expense).

#### *Interest rate exposure*

Our balance sheet contains interest bearing assets which have fixed rates of interest. These assets include license installments receivable generated in the normal course of business through transactions with customers and investments of excess cash in marketable debt securities.

License installments receivable bear interest at the rate in effect when the license revenue was recognized, which does not vary throughout the life of the contractual cash flow stream. We believe that at current market interest rates, the fair value of license installments receivable approximates the carrying value as reported on our balance sheets. However, there can be no assurance that the fair market value will approximate the carrying value in the future. Factors such as increasing interest rates can reduce the fair market value of the license installments receivable. Changes in market rates do not affect net earnings, as the license installments receivable are carried at cost and, since they are not financial instruments and are held until maturity, are not marked to market to reflect changes in the fair value of the portfolio. The carrying value of \$47 million as of June 30, 2006 reflects the weighted average of historic discount rates used to record each term license arrangement. The average rate changes with market rates as new license installments receivable are added to the portfolio, which mitigates exposure to market interest rate risk. A two hundred basis point increase in market interest rates would have decreased the fair value of our license installments receivable by approximately \$1 million as of June 30, 2006.





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We have invested in fixed rate marketable debt securities. A two hundred basis point increase in market interest rates would have reduced the fair value of our marketable debt securities by approximately \$3 million as of June 30, 2006. Changes in market rates and the related impact on fair value of the investments do not generally affect net earnings as our investments are fixed rate securities and are classified as available-for-sale. Investments classified as available-for-sale are carried at fair value with unrealized gains and losses recorded as a component of accumulated other comprehensive income.

**Item 4. Controls and Procedures**

(a) *Evaluation of Disclosure Controls and Procedures.* Our management, with the participation of our Chief Executive Officer, or CEO, and Chief Financial Officer, or CFO, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act) as of June 30, 2006. In designing and evaluating our disclosure controls and procedures, our management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives, and our management necessarily applied its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on this evaluation, our CEO and CFO concluded that, as of June 30, 2006, our disclosure controls and procedures were not effective as of that date, for the reasons described below.

In our Annual Report on Form 10-K for 2005, we disclosed our management's assessment that our internal control over financial reporting contained a material weakness in our ability to properly apply generally accepted accounting principles as they relate to the recognition of revenue on transactions that contain complex and non-standard terms and a material weakness relating to our ability to make accurate estimates impacting our tax provision. The assessment of our CEO and CFO, as of June 30, 2006, was that while actions have been taken to address these material weaknesses, such measures had not been sufficient to effectively remediate the noted weaknesses. As a result, we believe that a material weakness still exists in these two areas.

To address the material weakness described above relating to revenue recognition, we are in the process of improving the expertise of our staff responsible for revenue recognition and augmenting the expertise of our staff with third party expertise. In particular, we plan to improve our ability to identify when customer contracts contain non-standard features. We also intend to improve our research protocol so that we more fully understand the applicable accounting for such features.

To address the material weakness described above relating to tax decisions, we are in the process of augmenting the review and supervision procedures recently adopted (e.g. retention of third party expertise to conduct quarterly and year-end review of our tax decisions and estimates), with additional training and use of enhanced tax preparation software.

(b) *Changes in Internal Control over Financial Reporting.* No change in internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act) occurred during the first quarter of 2006 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Christopher Sullivan resigned from his position of CFO, effective June 1, 2006. While a search is conducted for his replacement, Shawn Hoyt, our Vice President and General Counsel, has assumed the role of interim CFO. James Reilly, our Vice President, Finance, was promoted to the role of Chief Accounting Officer.

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### **Part II - Other Information:**

#### **Item 1. Legal Proceedings**

Not applicable.

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

The following important factors could cause our actual business and financial results to differ materially from those contained in forward-looking statements made in this Quarterly Report on Form 10-Q or elsewhere by management from time to time.

##### ***Factors relating to our revenues***

*In recent years, we have typically licensed our software to new customers pursuant to perpetual licenses rather than term licenses, which has the effect of decreasing the amount of future term license renewal revenue and cash flow, and could reduce our overall future license revenue and cash flow if we are unable to increase the future volume of license transactions.* In prior years, we typically licensed our software under term licenses requiring the customer to make monthly payments over the license term. More recently, we have typically been selling perpetual licenses to our software with a single license fee being payable at the commencement of the license (although our term license revenue exceeded our perpetual license revenue in 2005 due to a few large term licenses). We expect that perpetual licenses for new customers will continue to be a significant portion of total license signings, although we expect to enter into new term licenses in certain instances. Our use of perpetual licenses may have the effect, with respect to such transactions, of increasing our license revenue and cash flow in the short term, but of decreasing the amount of renewal license revenue and cash flow in the future. If we are unable to increase the volume of new license transactions, given the anticipated decline in the renewal revenue from term license arrangements, our license revenue and cash flow will likely decline in future periods.

*The volume of our license transactions began to increase in the second half of 2005, and we may not be able to sustain this increased volume of license transactions unless we can provide sufficient high quality professional services, training and maintenance resources to enable our customers to realize significant business value from our software.* Our customers typically request professional services and training to assist them in implementing our products. Our customers also purchase maintenance on our products in almost all cases. As a result, an increase in the number of license transactions is likely to increase demand for professional services, training and maintenance relating to our products. Given that our volume of license transactions began to increase in the second half of 2005, we anticipate that we will need to provide our customers with more professional services, training and maintenance to enable our customers to realize significant business value from our software. Accordingly, we have been hiring additional personnel in these areas and improving our on-boarding process to ramp up new personnel in a shorter period of time. We have also been increasingly enabling our partners and our customers through training and the creation of centers of excellence to create an expanded universe of people that are skilled in the implementation of our products. However, if we are unable to provide sufficient high quality professional services, training or maintenance resources to our customers, our customers may not realize sufficient business value from our products to justify follow-on sales, which could impact our future financial performance. In addition, the growth required to meet the increased demand for our professional services could strain our ability to deliver our services engagements at desired levels of profitability, thereby impacting our overall profitability and financial results.

*We are increasingly entering into smaller initial licenses with new customers, which could adversely affect our financial performance if we are not successful in obtaining follow-on business from these customers.* Beginning in 2005, we have increasingly entered into small initial licenses with our new customers rather than selling large application licenses, to allow these new customers to realize business value from our software quickly and for a limited up-front investment. We expect this trend to continue in the near future. Once a customer has realized this initial value, we work with the customer to identify opportunities for follow-on sales, which are typically larger than the initial sale. However, we may not be successful in demonstrating this initial value to some customers, for reasons relating to the performance of our products, the quality of the services and support we provide for our products, or external reasons. For these customers, we may not obtain follow-on sales or the follow-on sales may be delayed, and our license revenue will be limited to the smaller initial sale. This could lower average transaction size and adversely affect our financial performance.

*Our term license revenue will decrease in the short term as we increasingly enter into term licenses with contract provisions that require the term license revenue to be recognized over the license term of the agreement as license payments become due or ratably over the license term when paid in advance, or if existing customers do not renew their term licenses.* A significant portion of our total revenue has been attributable to term licenses, including term license renewals. Historically, a significant portion of our term license revenue has been recognized as the present value of the committed future term license fees, as described in the Critical Accounting Policies contained in our Annual Report on Form 10-K for 2005. Beginning in 2006, we have increasingly entered into term licenses with contract provisions that require the term license revenue

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to be recognized over the term of the agreement as payments become due, or ratably over the term of the license when payments are made in advance. This has the effect, with respect to a particular agreement, of reducing our term license revenue in the initial period but increasing the amount of recurring future term license revenue during the remainder of the license term, but does not change the expected cash flow. As a result, our term license revenue will decrease in the short term. In addition, while historically a majority of customers have renewed their term licenses, there can be no assurance that a majority of customers will continue to renew expiring term licenses. A decrease in term license renewal revenue absent offsetting revenue from other sources would have a material adverse effect on future financial performance.

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*Our professional services revenue is dependent to a significant extent on closing license transactions with new customers.* We derive a substantial portion of our professional services revenue from implementation of software licensed by new customers and the development of applications by our customers using our software. Increasingly, we are relying on business partners to provide the implementation services for our customers, thus reducing the amount of professional services revenue we derive relative to a given level of license revenue. Accordingly, it is imperative that we close more license transactions with new customers if we are to maintain or grow our services revenue.

***Factors relating to fluctuations in our financial results***

*The timing of our license revenue is difficult to predict accurately, due to the uncertain timing of the completion of implementation services, product acceptance by the customer and closing of additional sales.* Our quarterly revenue may fluctuate significantly, in part because a large portion of our revenue in any quarter is attributable to product acceptance or license renewal by a relatively small number of customers. Fluctuations also reflect our policy of recognizing revenue upon product acceptance or, in the case of term licenses, license renewal. In some cases, customers will not accept products until the end of a lengthy sales cycle and an implementation period, typically ranging from three to twelve months. Our PegaRULES products typically have a shorter sales cycle and implementation period than our historical application products. Risks over which we have little or no control, including customers' budgets, staffing allocation, and internal authorization reviews, can significantly affect the sales and acceptance cycles. Any increases in the length of our sales or acceptance cycles may adversely affect our financial performance, due in part to the recognition of sales staff and commission costs in advance of revenue recognition. Changes requested by customers may further delay product implementation and revenue recognition. Furthermore, in certain situations where multiple license sales or implementations are ongoing with a single customer, for revenue recognition purposes these multiple arrangements may be deemed a single bundled arrangement, thereby delaying revenue recognition for the earlier license sales until all elements of the bundled arrangement are complete, which could decrease the predictability of the timing of our license revenue.

*Our financial results may be adversely affected if we are required to change certain estimates, judgments and positions relative to our income taxes.* In the ordinary course of conducting a global business enterprise, there are many transactions and calculations undertaken whose ultimate tax outcome cannot be certain. Some of these uncertainties arise as a consequence of positions we have taken regarding valuation of deferred tax assets, transactions and arrangements made among related parties, transfer pricing for transactions with our subsidiaries, and potential challenges to nexus and tax credit estimates. We estimate our exposure to unfavorable outcomes related to these uncertainties and estimate the probability for such outcomes. Although we believe our estimates are reasonable, no assurance can be given that the final tax outcome of these matters or our current estimates regarding these matters will not be different from what is reflected in our historical income tax provisions, returns and accruals. Such differences, or changes in estimates relating to potential differences, could have a material impact, unfavorable or favorable, on our income tax provisions, require us to change the recorded value of deferred tax assets and adversely affect our financial results.

*Our quarterly operating results have varied considerably in the past and are likely to vary considerably in the future.* Historically, most of our revenue in a quarter has been attributable to a small number of transactions. This has caused our revenue to fluctuate, sometimes significantly. These fluctuations could cause us to be unprofitable on an annual or quarterly basis and to fail to meet analysts' expectations regarding our earnings or revenue. Our current strategy to rely more heavily on third party services in support of license sales may increase these fluctuations because we will have less control over the timing of closing sales or customer acceptance of our software. While future fluctuations in our quarterly operating results may be buffered to some extent by the increasing percentages of our total revenue from maintenance services and by an increase in the number of license transactions, we expect those fluctuations will continue to be significant at least in the near term. We plan selling and marketing expenses, product development and other expenses based on anticipated future revenue. If revenue falls below expectations, financial performance is likely to be adversely affected because only small portions of expenses vary with revenue. As a result, period-to-period comparisons of operating results are not necessarily meaningful and should not be relied upon to predict future performance.

*We are investing heavily in sales and marketing and professional services in anticipation of increased license signings, and we may experience decreased profitability or losses if we are unsuccessful in increasing the value of license signings in the future.* Demand for our products began to increase in the second half of 2005, and we anticipate that this increase in demand will continue. Consequently, we have been increasing our investment in sales and marketing by hiring additional sales and marketing personnel. We also anticipate that we will need to provide our customers with more professional services, training and maintenance as a result of this anticipated increase in demand, and have been hiring additional personnel in these areas. These investments have resulted in increased fixed costs that do not vary with the level of revenue. If the anticipated demand for our products does not materialize, or if we are unsuccessful in increasing the value of new license signings, we could experience decreased profitability or losses as a result of these increased fixed costs, and our financial performance and results of operations could be adversely affected. We experienced a net loss of \$0.9 million for the first six months of 2006, largely due to lower-than-expected license revenue that was not sufficient to offset these increased costs.

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*We will need to develop new products, evolve existing ones, and adapt to technology change.* Technical developments, customer requirements, programming languages and industry standards change frequently in our markets. As a result, success in current markets and new markets will depend upon our ability to enhance current products, to develop and introduce new products that meet customer needs, keep pace with technology changes, respond to competitive products, and achieve market acceptance. Product development requires substantial investments for research, refinement and testing. There can be no assurance that we will have sufficient resources to make necessary product development investments. We may experience difficulties that will delay or prevent the successful development, introduction or implementation of new or enhanced products. Inability to introduce or implement new or enhanced products in a timely manner would adversely affect future financial performance. Our products are complex and may contain errors. Errors in products will require us to ship corrected products to customers. Errors in products could cause the loss of or delay in market acceptance or sales and revenue, the diversion of development resources, injury to our reputation, or increased service and warranty costs which would have an adverse effect on financial performance.

*The market for our offerings is increasingly and intensely competitive, rapidly changing, and highly fragmented.* The market for business process management software and related implementation, consulting and training services is intensely competitive and highly fragmented. We currently encounter significant competition from internal information systems departments of potential or existing customers that develop custom software. We also compete with companies that target the customer interaction and workflow markets, companies focused on business rules engines or enterprise application integration, pure play business process management companies and professional service organizations that develop custom software in conjunction with rendering consulting services. Competition for market share and pressure to reduce prices and make sales concessions are likely to increase. Many competitors have far greater resources and may be able to respond more quickly and efficiently to new or emerging technologies, programming languages or standards or to changes in customer requirements or preferences. Competitors may also be able to devote greater managerial and financial resources to develop, promote and distribute products and provide related consulting and training services. There can be no assurance that we will be able to compete successfully against current or future competitors or that the competitive pressures faced by us will not materially adversely affect our business, operating results, and financial condition.

*We have historically sold to the financial services and healthcare markets, and rapid changes or consolidation in these markets could affect the level of demand for our products.* We have historically derived a significant portion of our revenue from customers in the financial services and healthcare markets, and sales to these markets are important for our future growth, although we have been increasing our sales to other markets. Competitive pressures, industry consolidation, decreasing operating margins, regulatory changes and privacy concerns affect the financial condition of our customers and their willingness to buy. In addition, customers' purchasing patterns in these industries for large technology projects are somewhat discretionary. The financial services market is undergoing intense domestic and international consolidation, and consolidation has been increasing in the healthcare market. Consolidation may interrupt normal buying behaviors and increase the volatility of our operating results. In recent years, several of our customers have been merged or consolidated. Future mergers or consolidations may cause a decline in revenues and adversely affect our future financial performance. All of these factors affect the level of demand for our products from customers in these industries, and could adversely affect our business, operating results and financial condition.

*We rely on certain third-party relationships.* We have a number of relationships with third parties that are significant to sales, marketing and support activities, and product development efforts. We rely on relational database management system applications and development tool vendors, software and hardware vendors, large system integrators and technology consulting firms to provide marketing and sales opportunities for the direct sales force and to strengthen our products through the use of industry-standard tools and utilities. We also have relationships with third parties that distribute our products. There can be no assurance that these companies, most of which have significantly greater financial and marketing resources, will not develop or market products that compete with ours in the future or will not otherwise end or limit their relationships with us.

*We face risks from operations and customers based outside of the U.S.* Sales to customers headquartered outside of the United States represented approximately 35% of total revenue in the first six months of 2006, 35% in 2005, 32% in 2004, and 20% in 2003. We, in part through our wholly-owned subsidiaries based in the United Kingdom, Singapore, Canada, and Australia, market products and render consulting and training services to customers based in Canada, the United Kingdom, France, Germany, the Netherlands, Belgium, Switzerland, Austria, Ireland, Sweden, South Africa, Mexico, Australia, Hong Kong, and Singapore. We have established offices in Europe and Australia. We believe that growth will necessitate expanded international operations, requiring a diversion of managerial attention and increased costs. We anticipate hiring additional personnel to accommodate international growth, and we may also enter into agreements with local distributors, representatives, or resellers. If we are unable to do one or more of these things in a timely manner, our growth, if any, in our foreign operations may be restricted, and our business, operating results, and financial condition could be materially and adversely affected.

In addition, there can be no assurance that we will be able to maintain or increase international market demand for our products. Many of our international sales are denominated in U.S. dollars. Accordingly, any appreciation of the value of the U.S. dollar relative to the currencies of

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those countries in which we sell our products may place us at a competitive disadvantage by effectively making our products more expensive as compared to those of our competitors. Additional risks inherent in our international business activities generally include unexpected changes in regulatory requirements, increased tariffs and other trade barriers, the costs of localizing

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products for local markets and complying with local business customs, longer accounts receivable patterns and difficulties in collecting foreign accounts receivable, difficulties in enforcing contractual and intellectual property rights, heightened risks of political and economic instability, the possibility of nationalization or expropriation of industries or properties, difficulties in managing international operations, potentially adverse tax consequences (including restrictions on repatriating earnings and the threat of double taxation), increased accounting and internal control expenses, and the burden of complying with a wide variety of foreign laws. There can be no assurance that one or more of these factors will not have a material adverse effect on our foreign operations, and, consequentially, our business, operating results, and financial condition.

Furthermore, we conduct a portion of our business in currencies other than the United States dollar. Our revenues and operating results are adversely affected when the dollar strengthens relative to other currencies and are positively affected when the dollar weakens. Changes in the value of major foreign currencies, particularly the British Pound and the Euro relative to the United States dollar, could adversely affect our revenues and operating results.

***Factors relating to our internal operations and potential liabilities***

*We depend on certain key personnel, and must be able to attract and retain qualified personnel in the future.* The business is dependent on a number of key, highly skilled technical, managerial, consulting, sales, and marketing personnel, including Alan Trefler, our Chief Executive Officer. The loss of key personnel could adversely affect financial performance. We do not have any significant key-man life insurance on any officers or employees and do not plan to obtain any. Our success will depend in large part on the ability to hire and retain qualified personnel. The number of potential employees who have the extensive knowledge of computer hardware and operating systems needed to develop, sell and maintain our products is limited, and competition for their services is intense, and there can be no assurance that we will be able to attract and retain such personnel. If we are unable to do so, our business, operating results and financial condition could be materially adversely affected.

In addition, Christopher Sullivan resigned as our Chief Financial Officer in May 2006, and we have not yet hired a permanent replacement for the CFO position. In the interim, Shawn Hoyt, our Vice President and General Counsel, has assumed the role of Interim CFO and James Reilly, our Vice President, Finance and Treasurer, has been promoted to Chief Accounting Officer. If we are not able to hire a permanent and qualified replacement for the CFO position in a timely manner, our Finance and Legal operations may become overly strained, the quality of work may suffer, and our investors may react negatively, which could cause our stock price to decline.

*We may experience significant errors or security flaws in our product and services, and could face product liability and warranty claims as a result.* Despite testing prior to their release, software products frequently contain errors or security flaws, especially when first introduced or when new versions are released. Errors in our software products could affect the ability of our products to work with other hardware or software products, or could delay the development or release of new products or new versions of products. The detection and correction of any security flaws can be time consuming and costly. Software product errors and security flaws in our products or services could expose us to product liability or warranty claims as well as harm our reputation, which could impact our future sales of products and services. Our license agreements typically contain provisions intended to limit the nature and extent of our risk of product liability and warranty claims. There is a risk that a court might interpret these terms in a limited way or could hold part or all of these terms to be unenforceable. Also, there is a risk that these contract terms might not bind a party other than the direct customer. Furthermore, some of our licenses with our customers are governed by non-U.S. law, and there is a risk that foreign law might give us less or different protection. Although we have not experienced any material product liability claims to date, a product liability suit or action claiming a breach of warranty, whether or not meritorious, could result in substantial costs and a diversion of management's attention and our resources.

*We face risks related to intellectual property claims or appropriation of our intellectual property rights.* We rely primarily on a combination of copyright, trademark and trade secrets laws, as well as confidentiality agreements to protect our proprietary rights. We have obtained patents from the United States Patent and Trademark Office relating to the architecture of our systems. We cannot assure that such patents will not be invalidated or circumvented or that rights granted thereunder or the claims contained therein will provide us with competitive advantages. Moreover, despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or to obtain the use of information that we regard as proprietary. In addition, the laws of some foreign countries do not protect our proprietary rights to as great an extent as do the laws of the United States. There can be no assurance that our means of protecting our proprietary rights will be adequate or that our competitors will not independently develop similar technology.

We are not aware that any of our products infringe the proprietary rights of third parties. There can be no assurance, however, that third parties will not claim infringement by us with respect to current or future products. Although we attempt to limit the amount and type of our contractual liability for infringement of the proprietary rights of third parties, these limitations often contain certain exclusions, and we cannot be assured that these limitations will be applicable and enforceable in all cases. Even if these limitations are found to be applicable and enforceable, our liability to our customers for these types of claims could be material in amount given the size of certain of our transactions. We expect that software product developers will increasingly be subject to infringement claims as the number of products and competitors in our industry segment grows and the functionality of products in different industry segments overlaps. Any such claims, with or without merit, could be

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time-consuming, result in costly litigation, cause product shipment delays, or require us to enter into royalty or licensing agreements. Such royalty or licensing agreements, if required, may not be available on terms acceptable to us or at all, which could have a material adverse effect upon our business, operating results, and financial condition.



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*Investor confidence and our stock price may be adversely impacted if we are unable to effectively remediate in a timely manner the two existing material weaknesses in our internal control over financial reporting, or if in future periods our management is unable to provide an unqualified assessment regarding the effectiveness of our internal control over financial reporting, or if our independent registered public accounting firm is unable to provide an unqualified attestation regarding management's assessment, for our 2006 fiscal year or beyond, in each case as required by Section 404 of the Sarbanes-Oxley Act of 2002.* The Securities and Exchange Commission, as directed by Section 404 of the Sarbanes-Oxley Act of 2002, adopted rules requiring public companies to include a report of management on the company's internal control over financial reporting in its annual reports on Form 10-K that contains an assessment by management of the effectiveness of the company's internal control over financial reporting, and requiring the company's independent registered public accounting firm to report on management's assessment. For the year ended December 31, 2005, management's assessment is included on page 37 of our Annual Report on Form 10-K for such year and our independent registered public accounting firm's attestation is included on page 38 of our Annual Report on Form 10-K for such year. For 2005, management's assessment, and our registered public accounting firm's attestation, concluded that our internal control over financial reporting as of December 31, 2005 was not effective due to a material weakness in our ability to properly apply generally accepted accounting principles as they relate to the recognition of revenue on transactions that contain complex and non-standard terms and a material weakness relating to our ability to make accurate estimates impacting our tax provision. For the second quarter of 2006, management's assessment is that these material weaknesses have not yet been effectively remediated, as discussed on page 23 of this Quarterly Report on Form 10-Q. For future periods, although we intend to diligently and regularly review and update our internal control over financial reporting in order to improve controls and ensure compliance with the Section 404 requirements, our management may not be able to provide an unqualified assessment for our 2006 fiscal year or beyond, and our independent registered public accounting firm may not be able to provide unqualified opinions on management's assessment. Any inability to effectively remediate in a timely manner the two existing material weaknesses, or any inability in the future to provide an unqualified assessment regarding our internal control over financial reporting or to obtain an unqualified opinion from our independent registered public accounting firm, could result in a loss of investor confidence in the reliability of our financial statements, which ultimately could negatively impact the market price of our shares.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

At the end of 2004, our Board of Directors authorized the repurchase of up to \$10 million of our outstanding common stock (the "Initial Program"). That authorization expired June 30, 2006. On June 1, 2006, we announced that our Board of Directors approved a new \$10 million stock repurchase program beginning July 1, 2006 and ending June 30, 2007 (the "New Program"). Under the New Program, shares may be purchased in such amounts as market conditions warrant, subject to regulatory and other considerations. Purchases under the New Program may be made from time to time on the open market or in privately negotiated transactions. The New Program may be suspended or discontinued at any time without prior notice. Our repurchase activity in each of the first six months of 2006 under the Initial Program was as follows:

| Period        | Total Number<br>of Shares<br>Purchased <sup>(1)</sup> | Average Price<br>Paid per<br>Share | Total Number<br>of Shares<br>Purchased as Part<br>of Publicly<br>Announced Share<br>Repurchase<br>Program |  | Approximate Dollar<br>Value Of Shares That<br>May Yet Be Purchased<br>Under The Initial<br>Program<br>(in thousands) |
|---------------|---|------------------------------------|---|--|--|
|               |   |                                    |   |  |  |
| January 2006  |   | \$                                 |   |  | \$ 4,123   |
| February 2006 |   |                                    |   |  | 4,123  |
| March 2006    | 41,994  | 7.42                               | 999,106   |  | 3,812  |
| April 2006    |   |                                    |   |  | 3,812  |
| May 2006      | 224,092   | 7.15                               | 1,223,198   |  | 2,210  |
| June 2006     | 252,895   | 7.03                               | 1,476,093   |  | Program Completed  |
| <b>Total</b>  | <b>518,981</b>  | <b>7.11</b>                        | <b>1,476,093</b>  |  |  |

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(1) All shares were purchased pursuant to the Initial Program.

**Item 3. Defaults upon Senior Securities**

Not applicable.

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

Our annual meeting of stockholders was held on May 30, 2006. The following matters were voted upon:

Alexander V. d Arbeloff, Richard H. Jones, Steven F. Kaplan, James P. O Halloran, Alan Trefler and William W. Wyman were elected to serve as Directors of the Company until the 2007 Annual Meeting of Stockholders and until their successors are duly elected and qualified.

Mr. d Arbeloff was elected with 34,855,942 votes FOR and 165,660 votes WITHHELD , Mr. Jones was elected with 34,840,818 votes FOR and 180,784 votes WITHHELD , Mr. Kaplan was elected with 34,599,886 votes FOR and 421,716 votes WITHHELD , Mr. O Halloran was elected with 34,069,873 votes FOR and 951,729 votes WITHHELD , Mr. Trefler was elected with with 34,843,917 votes FOR and 177,685 votes WITHHELD , and Mr. Wyman was elected with 31,513,194 votes FOR and 3,508,408 votes WITHHELD .

The stockholders approved the Pegasystems Inc. 2006 Employee Stock Purchase Plan, as further described in note 2(f) of the notes to unaudited condensed consolidated financial statements appearing elsewhere in this Report on Form 10-Q, with 28,837,366 votes FOR , 822,169 votes AGAINST, 404,910 votes ABSTAINING and 4,957,157 NON-VOTES .

The stockholders approved the ratification of the Audit Committee s selection of Deloitte & Touche LLP as our independent registered public accounting firm for the year ending December 31, 2006, with 34,948,438 votes FOR , 62,685 votes AGAINST and 10,479 votes ABSTAINING and 0 NON-VOTES .

**Item 5. Other Information**

None.

**Item 6. Exhibits**

The exhibits listed in the Exhibit Index immediately preceding such exhibits are filed as part of this report and such Exhibit Index is incorporated herein by reference.

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**Pegasystems Inc.**

Date: August 7, 2006

By: /s/ Alan Trefler  
Alan Trefler  
Chairman and Chief Executive Officer  
(principal executive officer)

Date: August 7, 2006

By: /s/ Shawn Hoyt  
Shawn Hoyt  
Interim Chief Financial Officer, General Counsel and Secretary  
  
(principal financial officer)

Date: August 7, 2006

By: /s/ James Reilly  
James Reilly  
Vice President, Finance, Treasurer and Chief Accounting Officer  
(principal accounting officer)

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**PEGASYSTEMS INC.**

Exhibit Index

**Exhibit**

| <b>No.</b> | <b>Description</b>   |
|------------|--|
| 31.1       | Certification pursuant to Exchange Act Rules 13a-14 and 15d-14 of the Chief Executive Officer. |
| 31.2       | Certification pursuant to Exchange Act Rules 13a-14 and 15d-14 of the Chief Financial Officer. |
| 32.1       | Certification pursuant to 18 U.S.C. Section 1350 of the Chief Executive Officer.               |
| 32.2       | Certification pursuant to 18 U.S.C. Section 1350 of the Chief Financial Officer.               |