PEGASYSTEMS INC
Form 10-K
May 03, 2007
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# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# FORM 10-K

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT of 1934**
**For the fiscal year ended December 31, 2006**

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT of 1934**
**Commission File No. 1-11859**

# PEGASYSTEMS INC.

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

**Massachusetts**

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

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

| | |
|---|---|
| **101 Main Street** | |
| **Cambridge, MA** | **02142-1590** |
| **(Address of principal executive offices)** | **(zip code)** |

**(617) 374-9600**

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

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**Securities registered pursuant to Section 12(b) of the Act:**

**None**

**Securities registered pursuant to Section 12(g) of the Act:**

**Common Stock, $.01 par value per share**

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Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act of 1933. Yes ¨ No x

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the Registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form10-K. x

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 x Non-accelerated filer ¨

Indicate by check mark whether the Registrant is a shell company, as defined in Rule 12b-2 of the Securities Exchange Act of 1934. Yes ¨ No x

The aggregate market value of the Registrant s common stock held by non-affiliates of the Registrant based on the closing price (as reported by NASDAQ) of such common stock on the last business day of the Registrant s most recently completed second fiscal quarter (June 30, 2006) was approximately $86 million.

There were 35,367,873 shares of the Registrant s common stock, $.01 par value per share, outstanding on April 23, 2007.

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# PART I

## ITEM 1 BUSINESS

Pegasystems was incorporated in Massachusetts in 1983. Our stock is traded on the NASDAQ Global Select Market under the symbol PEGA. Our website address is www.pega.com. We are not including the information contained on our website as part of, or incorporating it by reference into, this Annual Report on Form 10-K. Unless the context otherwise requires, references in this Annual Report on Form 10-K to the Company, we, us or our refer to Pegasystems Inc. and its subsidiaries.

### Forward-looking statements

This Annual Report on Form 10-K 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-looki 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 on this Annual Report on Form 10-K 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.

### SEC reports and our Code of Conduct

We make available free of charge through our website our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K, and amendments to these reports, as soon as reasonably practicable after we electronically file such material with, or furnish such material to, the Securities and Exchange Commission. We make available on our website reports filed by our executive officers and Directors on Forms 3, 4 and 5 regarding their ownership of our securities. Our Code of Conduct, and any amendments to our Code of Conduct, are also available on our website.

### Overview

We develop, market, license and support software to automate complex, changing business processes. Our business process management (BPM) software unifies business processes with business rules, giving business people and IT departments the ability to replace policy manuals, system specifications and lines of manual coding with dynamically responsive systems that intelligently guide, automate and optimize work. This patented technology enables organizations to build for change and ensure business systems keep pace with evolving business objectives.

Our SmartBPM Suite offers standards-based technology built in a rapid solution development environment. Our software combines the capability to solve a full range of business process challenges with the opportunity to leverage existing technology investments. By enabling business process responsiveness, Pegasystems enables more effective interaction between people and systems.

Pegasystems SmartBPM Suite is complemented with best-practice solution frameworks based on more than 20 years of experience helping Fortune 500 and other leading corporations in the financial services, insurance, healthcare, manufacturing and government markets.

We provide implementation, consulting, training and technical support services to help our customers maximize the business value from the use of our software. We also maintain alliances with systems integrators and technology consulting firms to support our customers.

### Business strategy

Our goal is to be the leader of the BPM software market by leveraging our patented technology that unifies business processes and business rules. To demonstrate the many business problems customers can address using our software, we have created industry-specific solution frameworks customers can use with our software. We focus our sales efforts on accounts within target customer organizations, which 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. We invest in professional services, customer support, and customer and partner enablement to help our customers achieve success.

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Strategic partnerships with consultants and systems integrators are important to our sales efforts because they influence buying decisions, help us to identify engagements and complement our software with their technology and domain expertise. These partners may deliver strategic business planning, consulting, project management and implementation services to our customers. Currently, our partners include Accenture Ltd., Booz Allen Hamilton Inc., Cognizant Technology Solutions, IBM Corp., Kanbay International, Inc., Satyam Computer Services Ltd., Steria Group and Virtusa Corporation.

**Pegasystems products**

We provide a comprehensive rules-based BPM suite intended to help our customers plan, build and manage business process management solutions.

***PegaRULES®***

Our PegaRULES rules engine is a key differentiator of our rules-based BPM software. Our rules management technology employs an inference engine that automatically analyzes our customer s data, determines which business rules apply to that data, initiates the appropriate business processes and prompts users for any additional inputs required. Our rules engine uses Change Aware declarative rules that automatically recognize changes in data, such as changes in age or account balance, and initiate the appropriate business processes for that change, such as a notification of eligibility for an account upgrade. This combination of rules and processes provides our customers the agility to better align their business processes with their business objectives.

***PegaRULES Process Commander®***

PegaRULES Process Commander provides additional capabilities designed to model, simulate, execute, monitor and analyze results. Built on the PegaRULES engine, PegaRULES Process Commander offers a browser-based development environment, execution engine and management dashboard built in a graphical, rapid solution development environment. This platform helps solve a wide range of business process management problems and allows our customers to leverage previous technology investments by integrating software applications across a common platform.

***Pegasystems SmartBPM Suite and Solution Frameworks***

Pegasystems SmartBPM Suite adds process analysis, process simulation, enterprise integration, portal integration, content management and/or case management to the PegaRULES Process Commander capabilities.

Pegasystems also offers purpose or industry specific solution frameworks built on the capabilities of our PegaRULES Process Commander software. Pega Customer Process Manager, PegaCARD Customer Process Manager, PegaHEALTH Customer Service Manager and Pega Product Configurator are solution frameworks that enable financial services, healthcare, insurance and other organizations to quickly implement new customer-facing practices and processes, bring new offerings to market, and provide specialized processing to meet the needs of different customers, departments or geographies. We offer frameworks that address exceptions management transactions that are not automatically processed by existing systems. By automating not only research and decision making, but also the business processes necessary to execute the decisions, our exceptions management frameworks can reduce the costs and risks associated with manual processing, while improving quality and efficiency. These frameworks include PegaCARD Smart Dispute, Smart Investigate for Payments, Smart Investigate for Securities, Smart Adjust, and PegaHEALTH Claims Automation Suite. We also offer industry frameworks for retail banking, insurance and healthcare, and cross industry frameworks that assist our customers in gaining value from the use of our software.

**Markets and representative customers**

The market for BPM software is driven by businesses that seek to close the execution gap that may exist between their business objectives and their existing business processes. Our target customers are large, industry-leading organizations faced with managing complex and changing processes that seek the agility needed for growth, productivity and compliance. Our traditional customers have been large companies in the financial services and healthcare markets. With PegaRULES Process Commander, we are also able to offer solutions to a broader range of companies as well as a broader range of industries.

***Financial services***

Financial services organizations continue to require software to improve the quality, accuracy and efficiency of customer interactions and transactions processing. Pegasystems customer process and exceptions management products provide flexibility and functionality to allow customers greater responsiveness to changing business requirements. Representative financial services customers of ours include: Bank of America Corporation, Barclays Bank PLC, Citigroup Inc., Credit Suisse Group, HSBC Holdings Plc, JPMorgan Chase & Co., National Australia Bank Limited, the Royal Bank of Scotland plc, Société Générale Group and TD Bank Financial Group.

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*Healthcare*

Healthcare organizations also continue to seek out products that integrate their front and back office initiatives and help drive customer service, efficiency and productivity. Representative healthcare customers of ours include: Aetna Inc., Blue Cross Blue Shield of Massachusetts, Blue Cross & Blue Shield of Minnesota, Computer Sciences Corporation, Group Health Cooperative, HealthNow New York Inc., Hospitals Contribution Fund of Australia Ltd. and Wellpoint Inc..

*Other industries*

PegaRULES Process Commander offers solutions to a broad range of companies and industries. We sell rules-based BPM technology outside our traditional markets to customers in insurance, telecommunications, government, pharmaceuticals, manufacturing and travel services. Customers include: American National Insurance Company, American International Group (AIG), Amgen, The Allstate Corporation, Advanced Micro Devices (AMD), General Electric Company, Novartis Pharmaceuticals Corp., Starwood Hotels & Resorts Worldwide Inc., The ServiceMaster Company and Vodafone Group, Plc.

**Sales and marketing**

We market our software and services primarily through a direct sales force. Strategic partnerships with consultants and systems integrators are important to our sales efforts because they influence buying decisions, help us to identify engagements, and complement our software with their technology and domain expertise. Our partners include Accenture Ltd., Booz Allen Hamilton Inc., Cognizant Technology Solutions, IBM Corp., Kanbay International, Inc., Satyam Computer Services Ltd., Steria Group and Virtusa Corporation.

To support our sales efforts, we conduct a broad range of marketing programs, including industry trade shows, industry seminars, meetings with industry analysts, and other direct and indirect marketing efforts. Our consulting staff, business partners, and other third parties also generate sales leads. As of December 31, 2006, our sales and marketing staff consisted of 138 people worldwide.

**Sales by geography**

In 2006, 2005, and 2004, sales to customers based outside of the United States represented 37%, 34% and 30%, respectively, of our total revenue. During 2006, 2005 and 2004, we derived our revenue from the following geographic areas:

| **(in thousands)** | **2006** | | **2005** | | **2004** | |
|---|---|---|---|---|---|---|
| United States | **$ 79,903** | **63%** | $ 66,459 | 66% | $ 72,689 | 70% |
| United Kingdom | **19,741** | **16%** | 18,161 | 18% | 11,930 | 12% |
| Europe, other | **11,606** | **9%** | 10,732 | 11% | 13,132 | 13% |
| Other | **14,773** | **12%** | 4,857 | 5% | 5,540 | 5% |
| | **$ 126,023** | **100%** | $ 100,209 | 100% | $ 103,291 | 100% |

In 2006 and 2005, no customer accounted for 10% or more of our total revenue. In 2004, one customer accounted for approximately 10% of our total revenue. 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.

**Services and support**

We offer services and support through three groups: our professional services group which provides market, business and technical knowledge to assist our customers throughout the sale and deployment of our products; our global customer support group which provides support and maintenance for our customers; and our education services group which offers training programs for our employees, customers and partners. As of December 31, 2006, our services and support groups consisted of 198 people located in our 10 offices. We also utilize third party subcontractors to assist us in providing services.

***Professional services***

Our professional services group helps companies and partners implement and optimize our software. These projects enable us to guide our customers through deployment of our software. Many of our customers choose to engage our professional services group to expand their use of our software to additional business or product lines or automate additional processes within existing solutions. In addition, systems integrators and consulting firms, with which we have alliances, help our customers deploy our products.

Our implementation procedures were developed through field experience and facilitate implementation of our software through

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project management that establishes standards for project activities and provides a basis for governance and accountability. By adopting a phased approach to deployment for non-essential services, our customers can engage in smaller, more easily managed projects that are more likely to result in a successful solution.

***Global customer support***

Our global customer support group is primarily responsible for support of our software deployed at customer sites. Support services include automated problem tracking, prioritization and escalation procedures, periodic preventive maintenance, documentation updates, new software releases and regularly scheduled meetings with our staff.

***Education services***

The success of our sales strategy for multiple follow-on sales to target customers depends on our ability to train a larger number of partners and customers to implement our technology. We offer training for our staff, customers and partners. Training is offered at our regional training facilities in Cambridge, Massachusetts, Reading, England, and Sydney, Australia, at third party facilities in numerous other locations, or may be specially arranged at customer sites. Courses are designed to meet the specific role requirements of process architects, system architects and system administrators. Our customers are also granted access to our web-based self service extranet. The password-protected site offers a portal for information important to the implementation and use of our products. Our extranet is available at any time of the day or night and users may access the site to interact with us at their convenience and to view product information, sales and marketing support materials, Pegasystems news and event information.

**Research and development**

Our product development priority is to continue expanding the capabilities of our rules-based BPM technology. We intend to maintain and extend the support of our existing solution frameworks, and we may choose to invest in additional frameworks which incorporate the latest business innovations. We also intend to maintain and extend the support of popular hardware platforms, operating systems, databases and connectivity options to facilitate easy and rapid deployment in diverse information technology infrastructures. Our goal with all of our products is to enhance product capabilities, ease of implementation, long-term flexibility and the ability to provide improved customer service.

We believe that the challenge of enhancing future performance and maintaining technology leadership will depend on our ability to anticipate changes, maintain and enhance our current products, develop new products and keep pace with the increasingly sophisticated requirements of our current and prospective customers. We must develop products that conform to our customers information technology standards, scale to meet the needs of large enterprises, operate globally and cost less than a comparable internal development effort. Our development organization is responsible for product architecture, core technology development, product testing and quality assurance.

As of December 31, 2006, our development group consisted of 108 people and has been significantly supplemented by the use of contracted resources. During 2006, 2005, and 2004, research and development expenses were approximately $22.7 million, $19.5 million, and $19.9 million, respectively. We expect that we will continue to commit significant resources to our product research and development in the future to maintain our leadership position.

**Competition**

The BPM software market is increasingly and intensely competitive, rapidly changing and highly fragmented, as current competitors expand their product offerings and new companies enter the market. Competitors vary in size and in the scope and breadth of the products and services offered. We encounter competition from:

- Enterprise content management-based vendors such as the FileNet division of International Business Machines Corporation;

- Enterprise application integration vendors such as TIBCO Software Inc. and webMethods Inc.;

Business process management vendors such as the Fuego division of BEA Systems, Inc. and Lombardi Software, Inc.;

Business rules engine vendors such as Fair Isaac Corporation and ILOG Inc.;

Companies that provide application specific business process management software for the financial services, healthcare, insurance and other specific markets such as Chordiant Software, Inc., DST Systems, Inc., Carreker Corporation, Oracle Corporation, SmartStream Technologies Ltd. and Trintech Group PLC;

Current customers information technology departments, which may seek to modify existing systems or develop proprietary systems.

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We are one of the leading companies in the overall BPM software market, and have a strong presence in exceptions management in the financial services and healthcare markets. We have been most successful competing for customers whose businesses are characterized by a high degree of change, complexity and size. We believe that the principal competitive factors within our market include:

- Product adaptability, scalability, functionality and performance;
- Proven success in delivering costs-savings and efficiency improvements;
- Ease-of-use for developers, business units and end-users;
- Timely development and introduction of new products and product enhancements;
- Establishment of a significant base of reference customers;
- Ability to integrate with other products and technologies;
- Customer service and support;
- Product price;
- Vendor reputation; and
- Relationships with systems integrators.

**Employees**

As of December 31, 2006, we had 547 employees, of whom 435 were based in the United States, 24 were based in Canada, 76 were based in Europe, 11 were based in Australia and 1 was based in Asia. Of the total, 138 were in sales and marketing, 198 performed consulting and customer support, 108 were in research and development, and 103 were in administration.

**Backlog of license, maintenance and consulting revenues**

As of December 31, 2006, we had software license and maintenance agreements and fixed fee professional services agreements with customers expected to result in approximately $49.3 million of revenue in 2007. As of December 31, 2005, we had software license and maintenance agreements and fixed fee professional services agreements with customers expected to result in approximately $47.5 million of revenue in 2006. Under such agreements, we must fulfill certain conditions prior to recognizing revenue, and there can be no assurance when, if ever, we will be able to satisfy all such conditions in each instance. We do not believe that backlog, as described above, is a meaningful indicator of future financial performance.

**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 Annual Report on Form 10-K 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 to new customers with a single license fee being payable at the commencement of the license. We continue to license our software under term licenses in certain instances, especially to existing customers. 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 signings, given the anticipated decline in the renewal revenue from term license arrangements, our license revenue and cash flow will likely decline in future periods.

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*The volume of our license signings began to increase in the second half of 2005 and in 2006, and we may not be able to sustain this increased volume of license signings 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 signings is likely to increase demand for professional services, training and maintenance relating to our products. Given that our volume of license signings began to increase in the second half of 2005 and in 2006, 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 future financial performance.

*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 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 Item 7, Critical Accounting Policies on page 26 of this Annual Report on Form 10-K. Beginning in 2006, we have increasingly entered 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. 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.

*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. 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 when paid in advance may adversely affect our profitability in any period due to sales commissions being paid at the time of signing and the corresponding revenue being recognized over time.

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*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 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 a continued increase in 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 during 2006, 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 increased demand for our products does not continue, we could experience decreased profitability or losses as a result of these increased fixed costs, and our financial performance could be adversely affected.

***Factors relating to our products and markets***

*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. Recently, larger companies such as IBM and BEA have begun to acquire companies that provide business process management software, and we expect competition from larger companies to increase. 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.

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*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 37% of total revenue in 2006, 34% in 2005 and 30% in 2004. We, in part through our wholly-owned subsidiaries based in the United Kingdom, 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 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 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.

*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 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.

*We have reported several material weaknesses in our internal control over financial reporting since the second quarter of 2005, and certain of these material weaknesses have not yet been effectively remediated. Investor confidence and share value may be adversely impacted if we are unable to promptly and effectively remediate these material weaknesses, or if we were to report additional material weaknesses in our internal control over financial reporting in the future.* 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 to report on a quarterly basis regarding the effectiveness of the company s disclosure controls and procedures. Beginning in the second quarter of 2005, we have reported several material weaknesses in our internal control over financial reporting. For the year ended December 31, 2006, management s assessment is included on page 33 of this Annual Report on Form 10-K and our independent registered public accounting firm s attestation is included on pages 34 and 35 of this Annual Report on Form 10-K. For 2006, management s assessment, and our registered public accounting firm s attestation, concluded that our internal control over financial reporting as of December 31, 2006 was not effective due to certain material weaknesses in our internal control over financial reporting as described in Item 9A, Controls and Procedures, of this Annual Report on Form 10-K. We may not be successful in promptly and effectively remediating these material weaknesses. In addition, our management may not be able to provide an unqualified assessment of our internal control over financial reporting for our 2007 fiscal year or beyond, or be able to provide quarterly certifications that our disclosure controls and procedures are effective, and our independent registered public accounting firm may not be able to provide unqualified opinions on management s assessment and on the effectiveness of the Company s internal control over financial reporting for any of these years. Any such event could result in an adverse reaction in the financial marketplace due to a loss of investor confidence in the reliability of our financial statements, which ultimately could negatively impact the market price of our shares.

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**ITEM 1B UNRESOLVED STAFF COMMENTS**

Not applicable.

**ITEM 2 PROPERTIES**

Our principal administrative, sales, marketing, support, and research and development operations are located in an 108,728 square foot leased facility in Cambridge, Massachusetts. The lease for this facility expires in 2013, subject to our option to extend for two additional five-year periods. We also lease space for our other offices in the United States, Canada, Australia, France, Spain, China and the United Kingdom. These leases expire at various dates through 2010. We believe that additional or alternative space will be available as needed in the future on commercially reasonable terms.

**ITEM 3 LEGAL PROCEEDINGS**

Not applicable.

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

During the fourth quarter of fiscal 2006, there were no matters submitted to a vote of security holders.

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## EXECUTIVE OFFICERS OF THE REGISTRANT

The names of our executive officers and certain information about them are set forth below as of February 1, 2007:

| Name | Age | Position(s) and Office(s) Held |
|---|---|---|
| Alan Trefler | 50 | Chief Executive Officer and Chairman |
| Craig A. Dynes | 51 | Chief Financial Officer and Senior Vice President |
| Edward L. Hughes | 55 | Senior Vice President, Global Sales |
| Douglas I. Kra | 44 | Vice President of Global Services |
| Michael Pyle | 52 | Senior Vice President of Product Development |
| James T. Reilly | 52 | Vice President Finance, Treasurer & Chief Accounting Officer |

There are no family relationships among any of our executive officers or directors.

*Alan Trefler,* a founder of Pegasystems, serves as Chief Executive Officer and Chairman and has been a Director since we organized in 1983. Prior to 1983, he managed an electronic funds transfer product for TMI Systems Corporation, a software and services company. Mr. Trefler holds a B.A. degree in economics and computer science from Dartmouth College.

*Craig A. Dynes* joined Pegasystems in September 2006 as Chief Financial Officer and Senior Vice President. From 2004 to 2006, Mr. Dynes served as Chief Financial Officer at Demandware, a venture-backed enterprise software firm. From 2003 to 2004, Mr. Dynes served as President and CEO of Narad Networks, a manufacturer of equipment for the cable television industry. From 1997 to 2002, Mr. Dynes served as Chief Financial Officer of SilverStream Software, Inc., an application development software company. Prior to SilverStream, Mr. Dynes held senior financial positions at Sybase Inc. and Powersoft Corp. Mr. Dynes is a graduate of the Richard Ivey School of Business Administration, the University of Western Ontario and is a Canadian Chartered Accountant.

*Edward L. Hughes* joined Pegasystems in February 2006 as Senior Vice President, Global Sales. From 2003 to 2005, Mr. Hughes served as Vice President of Sales in the Americas for the Software Development group of International Business Machines Corporation. From 2000 to 2003, Mr. Hughes served as Vice President of Sales for Rational Software, Inc. Prior to Rational, Mr. Hughes held senior management positions at Compuware Corporation. Mr. Hughes is a graduate of Catholic University and the Potomac School of Law.

*Douglas I. Kra* joined Pegasystems in November 2004 as Vice President of Global Services. From 2002 to 2004, Mr. Kra served as Vice President at eLoyalty Corp., a consulting company specializing in customer relationship management. From 2000 to 2001, Mr. Kra served as President of Zefer Corp., an internet consulting firm. Prior to Zefer, Mr. Kra spent ten years at Cambridge Technology Partners Inc. in a variety of senior roles. He holds a B.A. in Computer Science from Brandeis University and an M.B.A. in finance from New York University Stern School of Business.

*Michael Pyle* joined Pegasystems in 1985 and has served as Senior Vice President of Product Development since August 2000. Including his positions with Pegasystems, Mr. Pyle s professional background encompasses almost thirty years of software development and managerial experience throughout Europe and the United States. Mr. Pyle completed his B.C.S. specializing in Computer Science and Systems Programming at the Civil Service College in London.

*James T. Reilly* joined Pegasystems in 2000 as Corporate Controller. In 2002, Mr. Reilly was promoted to Vice President and in 2006 was named Treasurer and Chief Accounting Officer. Prior to joining Pegasystems, Mr. Reilly served as corporate controller for GSI Lumonics Inc., a manufacturer of laser systems and components, and as Corporate Budget Manager for Digital Equipment Corporation. While at Digital Equipment Corporation, Mr. Reilly also had assignments in Asia and manufacturing finance, and served as an industry marketing manager. Mr. Reilly earned his CPA while with Arthur Andersen in Chicago. Mr. Reilly holds a BSIE, Industrial Engineering, from Purdue University and an MBA from the Amos Tuck School of Business Administration at Dartmouth College.

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PART II

## ITEM 5 MARKET FOR REGISTRANT S COMMON STOCK, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

The following table sets forth the range of high and low sales prices of our common stock on the NASDAQ Global Market for 2006 and 2005. Our common stock is traded under the NASDAQ Symbol PEGA . As of March 1, 2007, we had approximately 67 stockholders of record and approximately 21,570 beneficial owners of our common stock. On March 1, 2007, the closing sale price of our common stock was $8.79. In July 2006, we began paying a quarterly cash dividend of $0.03 per share of common stock. Prior to July 2006, we had never declared or paid any cash dividends on our common stock. Quarterly cash dividends are expected to continue at $0.03 per share, subject to change by our Board of Directors, to stockholders of record as of the first trading day of each quarter.

| | High | Low |
|---|---|---|
| **2006** | | |
| First Quarter | **$ 8.37** | **$ 6.91** |
| Second Quarter | **$ 8.37** | **$ 6.19** |
| Third Quarter | **$ 8.88** | **$ 6.20** |
| Fourth Quarter | **$ 10.61** | **$ 8.52** |

| | High | Low |
|---|---|---|
| **2005** | | |
| First Quarter | $ 9.10 | $ 5.20 |
| Second Quarter | $ 6.11 | $ 4.85 |
| Third Quarter | $ 6.61 | $ 5.55 |
| Fourth Quarter | $ 7.59 | $ 5.89 |

**COMPARISON OF CUMULATIVE TOTAL STOCKHOLDER RETURN**

The following performance graph represents a comparison of the cumulative total return (assuming the reinvestment of dividends) for a $100 investment on December 31, 2001 in each of our common stock, the Total Return Index for the NASDAQ Stock Market (U.S.) ( NASDAQ Index ) (a broad market index) and the Goldman Sachs Technology Software Index ( GSTI Software ) (a published industry index). We paid dividends of $0.06 per share during the second half of 2006. The graph lines merely connect measurement dates and do not reflect fluctuations between those dates.

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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 ). During 2006, we repurchased 518,981 shares for $3.7 million under the Initial Program in open market purchases. That authorization was completed during the second quarter of 2006.

The following table sets forth information regarding Pegasystems repurchases of its common stock, under the Initial Program, during the year ended December 31, 2006.

| Period | Total Number of Shares Purchased | 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 Initial 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 |
| Total | 518,981 | $ 7.11 | | |

On May 30, 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. During 2006, we repurchased 443,439 shares for $3.1 million under the New Program in open market purchases. The New Program may be suspended or discontinued at any time without prior notice.

The following table sets forth information regarding Pegasystems repurchases of its common stock, under the New Program, during the year ended December 31, 2006.

| Period | Total Number of Shares Purchased | 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 New Program (in thousands) |
|---|---|---|---|---|
| July 2006 | 221,542 | $ 6.53 | 221,542 | $ 8,554 |
| August 2006 | 141,500 | 7.25 | 363,042 | 7,529 |
| September 2006 | 80,397 | 8.17 | 443,439 | 6,872 |
| Total | 443,439 | $ 7.05 | | |

In October 2006, we issued 2,586 shares of our common stock in connection with an exercise of warrants issued as part of the consideration for our acquisition of 1mind Corporation in 2002. These warrants were exercised by one former stockholder of 1mind. The consideration for this exercise was paid in the form of the surrender of 259 shares of our common stock under the warrants as a net exercise, which shares were valued at a total of approximately two thousand dollars based on the average closing price of our common stock over the ten consecutive trading days ending on the third trading day prior to the date of exercise.

In December 2005, we issued 27,766 shares of our common stock in connection with an exercise of warrants issued as part of the consideration for our acquisition of 1mind Corporation in 2002. These warrants were exercised by two former stockholders of 1mind. The consideration for this exercise was paid in the form of the surrender of 3,774 shares of our common stock under the warrants as a net exercise, which shares were valued at a total of $27 thousand, based on the average closing price of our common stock over the ten consecutive trading days ending on the third trading day prior to the date of exercise.

As of December 31, 2006, there were outstanding warrants to purchase 39,191 shares of our common stock with a weighted average fair value of $2.40 per share and a weighted average exercise price of $6.92 per share.

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**ITEM 6 SELECTED CONSOLIDATED FINANCIAL DATA**

The selected consolidated financial data presented below have been derived from our consolidated financial statements. This data may not be indicative of our future condition or results of operations and should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations and the consolidated financial statements and accompanying notes.

| | Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| | **2006** | **2005** | **2004** | **2003** | **2002** |
| | (in thousands, except per share data) | | | | |
| **Consolidated Statements of Operations Data:** | | | | | |
| Total revenue | **$ 126,023** | $ 100,209 | $ 103,291 | $ 95,030 | $ 97,508 |
| Income (loss) from operations | **(7,114)** | 1,218 | 5,771 | 14,735 | 13,421 |
| Income before provision for income taxes | **1,187** | 5,319 | 11,156 | 21,892 | 19,142 |
| Net income | **1,842** | 5,192 | 8,211 | 16,679 | 17,242 |
| Earnings per share: | | | | | |
| Basic | **$ 0.05** | $ 0.15 | $ 0.23 | $ 0.48 | $ 0.51 |
| Diluted | **$ 0.05** | $ 0.14 | $ 0.22 | $ 0.47 | $ 0.48 |
| Cash dividends declared per common shares | **$ 0.09** | $ | $ | $ | $ |
| Weighted average number of common shares outstanding: | | | | | |
| Basic | **35,229** | 35,774 | 35,691 | 34,518 | 33,835 |
| Diluted | **37,134** | 36,462 | 37,043 | 35,757 | 35,980 |

| | Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| | **2006** | **2005** | **2004** | **2003** | **2002** |
| | (in thousands) | | | | |
| **Consolidated Balance Sheet Data:** | | | | | |
| Total cash, cash equivalents and short-term investments | **$ 127,758** | $ 114,735 | $ 97,360 | $ 87,935 | $ 62,696 |
| Working capital | **147,229** | 133,440 | 121,273 | 98,056 | 77,253 |
| Long-term license installments, net of unearned interest income | **17,458** | 31,371 | 44,344 | 53,666 | 48,667 |
| Total assets | **214,008** | 209,654 | 195,878 | 191,959 | 160,144 |
| Capital lease obligation, including current portion | **63** | 166 | 263 | | |
| Stockholders equity | **166,158** | 167,682 | 166,607 | 153,922 | 132,679 |

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

### 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 required 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.

### Overview of Results of Operations

The dollar value of license signings in 2006 was significantly higher than the dollar value of license signings in 2005. The increase in the dollar value of license signings for 2006 was due to the increased success of our strategy of focusing on initial and follow-on sales to target accounts. We are investing in sales and marketing to drive continued growth in our license signings, however actual license signings are likely to fluctuate considerably quarter to quarter.

Total revenue in 2006 increased 26% to $126.0 million from $100.2 million in 2005. License revenue decreased $5.5 million and services revenue increased $31.3 million. Professional services and training revenue increased $26.3 million to $65.4 million in 2006 from $39.1 million in 2005, while maintenance revenue increased $5.0 million to $25.2 million in 2006 from $20.2 million in 2005. The $26.3 million increase in professional services and training revenue reflects increased demand from our customers for these services. The $5.0 million increase in maintenance revenue is associated with an expanded installed based of software and a higher proportion of perpetual licenses in the installed base which yield greater maintenance revenue than term licenses. Gross margin increased by $5.4 million from $66.9 million in 2005 to $72.3 million in 2006 primarily due to an increase of $10.5 million in services gross margin, partially offset by a $5.2 decrease in license gross margin.

Historically, our mix of license and services revenue has fluctuated from period to period, and we believe it will continue to do so.

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Income before provision for income taxes decreased to $1.2 million in 2006 from $5.3 million in 2005, primarily due to a $5.2 million decrease in license gross margin, a $13.7 million increase in operating expenses, partially offset by a $10.5 million increase in services gross margin, a $2.4 million increase in other income and expense related to foreign currency transactions and a $1.8 million improvement in interest income. Net income for 2006 decreased to $1.8 million from $5.2 million in 2005, due to the decrease in income before provision for income taxes partially offset by a lower effective tax rate in 2006.

We generated $19.8 million in cash flow from operations during 2006, and ended the period with $127.8 million in cash and short-term investments and $39.2 million in combined short and long-term license installment receivables.

Consistent with our strategy of developing multiple relationships within target customer organizations to identify opportunities for follow-on sales, a majority of our revenue in 2006 and 2005 was from existing customers who chose to add on to, renew or extend their use of our software. However, new customers (meaning companies or organizational divisions which were not current licensees of our software) accounted for $19.0 million, or 15%, of total 2006 revenue and $20.1 million, or 20%, of total 2005 revenue.

*Statements of Income Information*

The following shows certain items reflected in our Statements of Income as a percentage of total revenue:

| | Year ended December 31, | | |
|---|---|---|---|
| | **2006** | **2005** | **2004** |
| Software license revenue | **28.1%** | 40.8% | 40.2% |
| Services revenue | **71.9** | 59.2 | 59.8 |
| Total revenue | **100.0** | 100.0 | 100.0 |
| Cost of software license | **0.0** | 0.3 | 0.3 |
| Cost of services | **42.7** | 32.9 | 31.7 |
| Total cost of revenue | **42.7** | 33.2 | 32.0 |
| Gross profit | **57.3** | 66.8 | 68.0 |
| Research and development | **18.0** | 19.4 | 19.3 |
| Selling and marketing | **34.9** | 34.0 | 31.2 |
| General and administrative | **10.1** | 12.2 | 11.9 |
| Total operating expenses | **63.0** | 65.6 | 62.4 |
| Income from operations | **(5.7)** | 1.2 | 5.6 |
| Installment receivable interest income | **1.5** | 2.5 | 2.9 |
| Other interest income, net | **4.3** | 3.0 | 1.8 |
| Other income (expense), net | **0.8** | (1.4) | 0.5 |
| Income before provision (benefit) for income taxes | **0.9** | 5.3 | 10.8 |
| Provision (benefit) for income taxes | **(0.6)** | 0.1 | 2.9 |
| Net income | **1.5%** | 5.2% | 7.9% |

*International Revenue*

International revenue was 37%, 34% and 30% of total consolidated revenue in 2006, 2005 and 2004, respectively. Our international revenue may fluctuate in the future because such revenue is generally dependent upon a small number of product acceptances by our customers during a given period. Historically, most of our contracts have been denominated in U.S. dollars. We expect, however, that in the future more of our contracts may be denominated in foreign currencies which may expose us to increased currency exchange risk.

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**Year ended December 31, 2006 compared to year ended December 31, 2005**

*Revenue*

Our total revenue for 2006 increased 26% to $126.0 million from $100.2 million in 2005. This increase was primarily due to a $31.3 million increase in services revenue. The following table summarizes our revenue composition:

| *(in millions)* | Year ended December 31, | |
|---|---|---|
| | **2006** | **2005** |
| ***License revenue*** | | |
| Perpetual licenses | **$ 27.2** | $ 20.1 |
| Term licenses | **8.2** | 20.8 |
| Total license revenue | **35.4** | 40.9 |
| ***Services revenue*** | | |
| Professional services and training | **65.4** | 39.1 |
| Maintenance | **25.2** | 20.2 |
| Total services revenue | **90.6** | 59.3 |
| **Total revenue** | **$ 126.0** | $ 100.2 |

Total license revenue for 2006 decreased 13% to $35.4 million from $40.9 million in 2005. The decrease in total license revenue was the result of a $12.6 million decrease in term license revenue partially offset by a $7.1 million increase in perpetual license revenue. The decrease in term license revenue was primarily due to our decision to increasingly enter into term licenses with contract provisions that require the term license to be recognized over the license term as payments become due. A summary of expected payments for these term licenses is provided on page 25. These payments, which will be recognized as revenue in future periods, as they become due, have increased in total from $3.5 million at December 31, 2005 to $14.2 million at December 31, 2006.

Professional services and training revenue increased 67% to $65.4 million in 2006 from $39.1 million in 2005. The increase was primarily the result of an increase in demand from our customers for professional services. Other components of the increase in professional services and training revenue include $4.0 million in revenue from three large fixed fee contracts which were completed in 2006, a $2.9 million increase in billed expenses and $1.4 million increase in training revenue. Typically, we derive substantial revenue from services provided in connection with the implementation of software licensed by new customers. Maintenance revenue increased 25% to $25.2 million in 2006 from $20.2 million in 2005. The increase in maintenance revenue for 2006 was 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.

Deferred revenue at December 31, 2006 consisted primarily of amounts by which billed fees exceed revenue recognized on arrangements, and unearned portions of annual maintenance fees paid in advance. Deferred revenue decreased to $17.1 million as of December 31, 2006, from $20.5 million as of December 31, 2005. The $3.5 million decrease was due primarily to a $5.6 million decrease in the deferred revenue associated with agreements containing customer acceptances or completion of fixed-price services engagements, partially offset by a $2.0 million increase in the unearned portions of annual maintenance fees paid in advance.

International revenue increased to 37% of total revenue for 2006 from 34% for 2005. This increase was primarily related to one large international license transaction in the third quarter of 2006. 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.

*Cost of revenue*

The cost of maintenance, professional services and training increased 63% to $53.7 million from $33.0 million in 2005. Cost of services as a percentage of services revenue increased to 59% for 2006 from 56% for 2005. Such increases were due primarily to increases in compensation costs, contracted services and travel costs. 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 and in anticipation of increased demand resulting from new license signings. Services gross margin was $36.9 million for 2006 compared to $26.3 million for 2005. Services gross margin as a percentage of services revenue decreased to 41% for 2006 from 44% for 2005. The decrease in services gross margin percentage reflects the increase in services costs, partially offset by growth in maintenance revenue and its associated higher margin. Maintenance revenue increased 25% to $25.2 million in 2006 from $20.2 million in 2005 although it decreased as a percentage of services revenue to 28% in 2006 from 34% in 2005. Services headcount was 198 at the end of 2006 compared to 155 at the end of 2005. In addition, contracted services increased 82% from $6.2 million in 2005 to $11.3 million in 2006.

*Operating expenses*

Research and development expenses for 2006 increased to $22.7 million from $19.5 million for 2005 due to increased use of contractors and costs related to increased employee headcount. As a percentage of total revenue, research and development expenses decreased to 18% in 2006 from 19% in 2005, primarily due to increased revenue. Research and development headcount at the end of 2006 was 108 compared to 96 at the end of 2005.

Selling and marketing expenses for 2006 increased 29% to $43.9 million from $34.1 million for 2005. This increase was primarily due to a $2.5 million increase in sales commissions, increased compensation and benefits expenses of $4.5 million and increased travel expenses of $1.6 million due to higher headcount. As a percentage of total revenue, selling and marketing expenses increased to 35% in 2006 from 34% in 2005, primarily due to increased spending. Selling and marketing headcount at the end of 2006 was 138 compared to 112 at the end of 2005.

General and administrative expenses for 2006 increased 5% to $12.7 million from $12.1 million in 2005. The increase was primarily attributed to costs related to increased headcount. As a percentage of total revenue, general and administrative expenses decreased to 10% in 2006 from 12% in 2005, as revenue grew faster than general and administration spending. General and administrative headcount at the end of 2006 was 103 compared to 95 at the end of 2005.

*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 attributable to the time value of money, decreased to $1.9 million in 2006 from $2.5 million in 2005. The decrease was due primarily to a lower total value of that portfolio. A portion of the fee from each term license arrangement 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 6.9% during the past few years.

*Other interest income, net*

Other interest income increased to $5.4 million in 2006 from $3.0 million for 2005. The increase was primarily due to increased cash and investment balances and improved yields.

*Other income (expense), net*

Other income (expense), net, which consists primarily of currency exchange gains and losses, was $1.0 million income in 2006 compared to ($1.4) million expense in 2005. The favorable change in other income (expense), net, resulted primarily from the impact of foreign exchange rate changes on transactions recorded on our U.S. ledger valued in foreign currencies, consisting primarily of cash, investments, license installments, receivables, accounts payable and accruals.

*Income before provision for income taxes*

Income before provision for income taxes decreased to $1.2 million in 2006 from $5.3 million in 2005. This decrease was primarily due to a $5.2 million decrease in license gross margin, a $13.7 million increase in operating expenses primarily due to investments in sales and marketing, partially offset by a $10.5 million increase in services gross margin, a $1.8 million improvement in installment receivable interest income and other interest income, net, and a $2.4 million increase in other income and expense related to foreign currency transactions.

*Provision for income taxes*

The provision for income taxes was a benefit of \$0.7 million in 2006 compared to \$0.1 million provision in 2005. The effective tax rate was (55%) in 2006 compared to 2% in 2005.

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Our effective income tax rate for 2006 was below the statutory federal income tax rate primarily because we recorded $0.7 million of benefits related to current period extra-territorial income exclusions, $0.2 million of estimated federal income tax credits, a $0.3 million benefit from foreign activities, and $0.3 million of net benefit from state income taxes primarily due to state income tax credits. These factors were partially offset by $0.2 million of permanent differences primarily related to nondeductible meals and entertainment expenses and $0.2 million increase in reserve for tax uncertainties related to international activity.

We have provided reserves for certain tax matters, both domestic and foreign, which it believes could result in additional tax being due. Any additional assessment or reduction of these contingent liabilities will be reflected in the Company s effective tax rate in the period that additional facts become known. The reserve for tax uncertainties totaled approximately $2 million as of December 31, 2006, 2005, and 2004.

Judgment is required in determining our worldwide income tax expense provision. 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 transactions and arrangements made among related parties, transfer pricing for transactions with our subsidiaries, and potential challenges to nexus and 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 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 provision and operating results in the period in which such a determination is made.

**Year ended December 31, 2005 compared to year ended December 31, 2004**

*Revenue*

Our total revenue for 2005 decreased 3% to $100.2 million from $103.3 million in 2004. This decrease was primarily due to a $2.4 million decrease in services revenue. The following table summarizes our revenue composition:

| ***(in millions)*** | **Year ended December 31,** | |
|---|---|---|
| | **2005** | **2004** |
| ***License revenue*[1]** | | |
| Perpetual licenses | $ 20.1 | $ 22.9 |
| Term licenses | 20.8 | 18.7 |
| Total license revenue | 40.9 | 41.6 |
| ***Services revenue*** | | |
| Professional services and training | 39.1 | 45.6 |
| Maintenance | 20.2 | 16.1 |
| Total services revenue | 59.3 | 61.7 |
| **Total revenue** | $ 100.2 | $ 103.3 |

(1) License revenue composition amounts reported in a similar table in previous periods have been reformatted to the current presentation.

Total license revenue for 2005 decreased to $40.9 million from $41.6 million in 2004. The decrease in total license revenue was the result of a $2.8 million decrease in perpetual license revenue partially offset by a $2.1 million increase in term license revenue. The increase in term license revenue primarily reflected one large new term license transaction with an existing customer in the third quarter of 2005. The decrease in perpetual license revenue reflected our strategy of selling smaller initial perpetual licenses to our target accounts, with the potential of larger follow-on sales. Term license renewals scheduled for 2006 are modestly higher than actual term license renewals in 2005. While historically a majority of customers have renewed their term licenses, there can be no assurance that this will continue.

Maintenance revenue increased 26% to $20.2 million in 2005 from $16.1 million in 2004. The increase in maintenance revenue for 2005 was 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. The $6.5 million decrease in professional services and training revenue in 2005 reflects the fact that 2004 benefited from $9.6 million of revenue associated with the completion of several unusually large fixed-price contracts partially offset by an increased demand from our customers for these services in 2005. Typically, we derive substantial revenue from services provided in connection with the implementation of software licensed by new customers.

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At December 31, 2005, deferred revenue consisted primarily of amounts by which billed fees exceed revenue recognized on arrangements, and unearned portions of annual maintenance fees paid in advance. Deferred revenue balances increased to $20.5 million as of December 31, 2005, from $8.6 million as of December 31, 2004. The $11.9 million increase was due primarily to new license arrangements for which acceptance of the software or completion of services had not occurred and an increased value of unearned portions of annual maintenance fees paid in advance.

International revenue increased to 34% of total revenue for 2005 from 30% for 2004. This increase was primarily related to one large international license transaction in the third quarter of 2005. 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.

*Cost of revenue*

The cost of maintenance, professional services and training increased 1.0% to $33.0 million from $32.7 million in 2004. Cost of services as a percentage of services revenue increased to 56% for 2005 from 53% for 2004. Services gross margin was $26.3 million for 2005 compared to $29.0 million for 2004. The decrease in services gross margin reflects the increase in services costs, partially offset by growth in maintenance revenue and its associated higher margin. Such decrease also reflects the fact that 2004 benefited from $7.4 million of revenue and gross margin associated with several unusually large fixed-price contracts completed during that period. Services headcount was 155 at the end of 2005 compared to 123 at the end of 2004.

*Operating expenses*

Research and development expenses for 2005 decreased to $19.5 million from $19.9 million for 2004 due to reduced use of contractors partially offset by costs associated with increased employee headcount. As a percentage of total revenue, research and development expenses remained constant at 19% in 2005 and 2004. Research and development headcount at the end of 2005 was 96 compared to 90 at the end of 2004.

Selling and marketing expenses for 2005 increased 6% to $34.1 million from $32.2 million for 2004. This increase was primarily due to a $1.1 million increase in sales commissions, an increase in marketing program spending of $0.6 million, and increased wages and benefits expenses of $0.5 million due to higher headcount. As a percentage of total revenue, selling and marketing expenses increased to 34% in 2005 from 31% in 2004. Selling and marketing headcount at the end of 2005 was 112 compared to 108 at the end of 2004.

General and administrative expenses for 2005 decreased to $12.1 million from $12.3 million for 2004. As a percentage of total revenue, general and administrative expenses remained constant at 12% in 2005 and 2004. General and administrative headcount at the end of 2005 was 95 compared to 85 at the end of 2004. General and administrative expenses decreased in 2005 primarily due to reduced legal fees partially offset by costs associated with increased headcount.

*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 attributable to the time value of money, decreased to $2.5 million in 2005 from $3.0 million in 2004. The decrease was due primarily to a lower total value of that portfolio. A portion of the fee from each term license arrangement 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 5.8% during the past few years.

*Other interest income, net*

Other interest income increased to $3.0 million in 2005 from $1.8 million for 2004. The increase was primarily due to increased cash and investment balances and improved yields.

*Other income (expense), net*

Other income (expense), net, which consists primarily of currency exchange gains and losses, was ($1.4) million expense in 2005 compared to $0.5 million income in 2004. The unfavorable change in other income (expense), net, resulted primarily from the impact of foreign exchange rate changes on transactions recorded on our U.S. ledger valued 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 have unfavorably impacted foreign currency denominated assets.

*Income before provision for income taxes*

Income before provision for income taxes decreased to $5.3 million in 2005 from $11.2 million in 2004. This decrease was primarily due to a $2.7 million decrease in services gross margin, a $1.9 million decrease in other income and expense related to foreign currency transactions, a $1.2 million increase in operating expenses primarily due to investments in sales and marketing, and a $0.7 million decrease in license revenue, partially offset by a $1.2 million improvement in other interest income, net.

*Provision for income taxes*

The provision for income taxes in 2005 was $0.1 million compared to $2.9 million in 2004. The effective tax rate was 2% in 2005 compared to 26% in 2004.

During 2005, we engaged outside tax experts to review certain significant tax positions previously taken by the Company. In the fourth quarter of 2005, we completed a study of our extra-territorial income exclusions, which resulted in a decrease of our reserve for tax uncertainties related to this item. During the fourth quarter of 2005, we recorded a net income tax benefit of $1.3 million due primarily to changes in estimates upon completion of the study of benefits related to extra-territorial income exclusions, recording of tax refunds and overpayments, and changes in deferred tax items. These fourth quarter 2005 adjustments also significantly decreased the effective tax rate for 2005 compared to the statutory rate. Our effective income tax rate for 2005 was below the statutory federal income tax rate primarily because we recorded $1.0 million of benefits related to current period extra-territorial income exclusions, a $0.3 million reduction in reserve for tax uncertainties related to extra-territorial income exclusions, $0.2 million of estimated federal research and experimentation credit, a $0.2 million benefit from foreign activities, and $0.2 million of net benefit from state income taxes primarily due to state income tax credits. These factors were partially offset by $0.1 million of permanent differences primarily related to non-deductible meals and entertainment expenses.

Judgment is required in determining our worldwide income tax expense provision. 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 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 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 provision and operating results in the period in which such a determination is made. The reserve for tax uncertainties totaled approximately $2 million as of December 31, 2005 and 2004.

**Liquidity and capital resources**

We have funded our operations primarily from cash flow from operations. At December 31, 2006, we had cash and equivalents and short-term investments of $127.8 million, a $13.1 million increase from $114.7 million at December 31, 2005. This increase was primarily due to $19.8 million of cash flow from operations and $3.5 million from the exercise of stock options, partially offset by $6.8 million used to repurchase outstanding shares of our common stock and $2.4 million used for investments in equipment and software improvements.

Working capital was $147.2 million at December 31, 2006, a $13.8 million increase from $133.4 million at December 31, 2005. Working capital increased primarily due to a $13.1 million increase in cash and investments and a $5.0 million increase in trade accounts receivable, partially offset by a $7.3 million increase in accounts payable and accrued expenses. The $7.3 million increase in accounts payable and accrued expenses was primarily due to increases in commissions, vacation and other expenses. The increase in trade accounts receivable is a result of growth in our business. Despite the increase in trade accounts receivables our days billing outstanding has decreased from 73 days at December 31, 2005 to 70 days at December 31, 2006.

Cash flow from operating activities for 2006 decreased to $19.8 million from $25.3 million for 2005. During 2006, cash flow benefited from a $18.7 million reduction in license installments. 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).

Net cash flow from investing activities for 2006 was ($10.8) million, primarily due to net purchases of marketable debt securities. This compared with ($20.2) million used in investing activities during 2005, which was also primarily due to net purchases of marketable debt securities. Investments in equipment and software increased to $2.4 million in 2006 from $2.2 million in 2005.

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 ). During 2006, we repurchased 518,981 shares for $3.7 million under the initial program in open market purchases. That authorization was completed during the second quarter of 2006.

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The following table sets forth information regarding Pegasystems repurchases of its common stock, under the Initial Program, during the year ended December 31, 2006.

| Period | Total Number of Shares Purchased | 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 Initial 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 |
| Total | 518,981 | $ 7.11 | | |

On May 30, 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. During 2006, we repurchased 443,439 shares for $3.1 million under the New Program in open market purchases. The New Program may be suspended or discontinued at any time without prior notice.

The following table sets forth information regarding Pegasystems repurchases of its common stock, under the New Program, during the year ended December 31, 2006.

| Period | Total Number of Shares Purchased | 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 New Program (in thousands) |
|---|---|---|---|---|
| July 2006 | 221,542 | $ 6.53 | 221,542 | $ 8,554 |
| August 2006 | 141,500 | 7.25 | 363,042 | 7,529 |
| September 2006 | 80,397 | 8.17 | 443,439 | 6,872 |
| Total | 443,439 | $ 7.05 | | |

It is our current intention to pay a quarterly cash dividend of $0.03 per share to shareholders of record as of the first trading day of each quarter. On May 30, 2006, our Board of Directors approved an ongoing quarterly cash dividend of $0.03 per share, payable to stockholders of record as of July 2 and October 2, 2006 and January 2, 2007. Accordingly, the Company paid cash dividends in July and October 2006 and January 2007 of $1.1 million, $1.0 million and $1.1 million, respectively. The Board of Directors may terminate or modify this dividend program at any time without notice.

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 December 31, 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 a 108,728 square foot leased facility in Cambridge, Massachusetts. The lease for this facility expires in 2013, subject to our option to extend for two additional five-year periods. We also lease space for our other offices in the United States, Canada, Australia, France, Hong Kong 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.

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In July 2006, we entered into an agreement to lease additional space in our Cambridge Massachusetts facility. The agreement requires the landlord to reimburse us for up to approximately $864,000 in costs we incur with respect to improvements to the leased premises. As of December 31, 2006, we had incurred approximately $342,000 in improvement costs, which were recorded to leasehold improvements with a corresponding credit to deferred rent expense to be amortized to rent expense over the lease term, and had not yet been reimbursed. The lease for this additional space expires in 2013, subject to our option to extend for two additional five-year periods.

As of December 31, 2006, our known contractual obligations were as follows:

| | Payment due by period | | | | |
|---|---|---|---|---|---|
| **Contractual obligations: (in thousands)** | **Total** | **2007** | **2008 & 2009** | **2010 & 2011** | **2012 and after** |
| Purchase commitments | $ 2,880 | $ 2,190 | $ 690 | $ | $ |
| Capital lease obligations | 64 | 64 | | | |
| Operating lease obligations (1) | 25,911 | 4,104 | 8,233 | 7,942 | 5,632 |
| **Total** | $ 28,855 | $ 6,358 | $ 8,923 | $ 7,942 | $ 5,632 |

(1) Includes deferred rent of $1.8 million included in other long-term liabilities.

Net long-term deferred income tax liabilities as of December 31, 2006 were $2.3 million. This amount is not included in the contractual obligations table because the Company believes this presentation would not be meaningful. Deferred income tax liabilities are calculated based on temporary differences between the tax bases of assets and liabilities and their respective book bases, which will result in taxable amounts in future years when the liabilities are settled at their reported financial statement amounts. The results of these calculations do not have a direct connection with the amount of cash taxes to be paid in any future periods. As a result, scheduling deferred income tax liabilities as payments due by period could be misleading because this scheduling would not relate to liquidity needs.

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

| **Year ended December 31, (in thousands)** | **Installment payments for term licenses recorded on the balance sheet** | **Installment payments for ratable term licenses not on the balance sheet** |
|---|---|---|
| 2007 | $ 21,787 | $ 4,654 |
| 2008 | 10,623 | 4,156 |
| 2009 | 3,416 | 2,589 |
| 2010 | 2,707 | 1,784 |
| 2011 | 2,146 | 1,035 |
| 2012 and thereafter | 1,242 | |
| **Total** | **$ 41,921** | **$ 14,218** |

In a decreasing number of term license agreements, we recognize the present value of future term license payments upon customer acceptance, provided that no significant obligations or contingencies exist related to the software, other than maintenance support, and provided all other criteria for revenue recognition have been met.

Short-term license installments and Long-term license installments on the balance sheet represent unbilled term license installments that have been recognized as revenue, net of unearned interest income. Payments due for these installments, which include unearned interest income, decreased to $41.9 million at December 31, 2006 from $61.9 million at December 31, 2005, as license installment payments billed during 2006 exceeded the value of new term licenses where we recognized the present value of future license payments as revenue.

Increasingly, we enter into term licenses with contract provisions that require the term license to be recognized as revenue over the license term as payments become due. Installment payments for these ratable term licenses, which are not recorded on the balance sheet, increased to $14.2 million at December 31, 2006 from $3.5 million at December 31, 2005.

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**Critical accounting policies and estimates**

Management s discussion and analysis of the financial condition and results of operations is based upon the consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. 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.

***Revenue recognition***

Our revenue is derived from two primary sources: software license fees and service fees. 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 software maintenance services.

***Software License Revenues***

We license software under non-cancelable license agreements.

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

Term software license fees are generally payable on a monthly basis under license agreements that typically have a three to five-year term and may be renewed for additional terms at the customer s option.

We have a history of successfully collecting payments under our term license arrangements, which have extended payment terms spread over the term of the license. Therefore, in a decreasing number of term license agreements, we have recognized the present value of future term license payments upon customer acceptance, provided that no significant obligations or contingencies exist related to the software, other than maintenance support, and provided all other criteria for revenue recognition have been 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. 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 6.9% 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.

Increasingly, our term license agreements have contract provisions that require the 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.

***Service Revenues***

Our services revenue comprises fees for software maintenance, training and consulting services including software implementation. Consulting services may be provided on a stand-alone basis or bundled with a license and software maintenance services.

Software maintenance revenue is recognized over the term of the related maintenance agreement, which in most cases is one year.

Revenue from training services and consulting services under time and materials contracts is recognized as services are performed. We have vendor specific objective evidence of fair value for our software maintenance, training services, and consulting services under time and materials contracts.

Services may be provided on a fixed-price basis. We do not have vendor specific objective evidence of fair value for fixed-price services prior to completion of the services. When fixed-price services are part of a multiple element arrangement, and the services are not essential to the functionality of the other elements of the arrangement, and when services are the only undelivered element, we recognize the revenue from the total arrangement ratably over the longer of the software maintenance period or the service period. In a limited number of our arrangements, the fixed-price services are essential to the arrangement because we make significant alterations to the functionality of the software or build complex interfaces necessary for the software to be functional in the customer s environment. We have not been able to make reasonably dependable estimates for the purpose of determining our progress to completion, as we have limited experience with these types of complex arrangements. Accordingly, all revenue and costs are deferred until the completion of the fixed-price services. Revenue from fixed-price services that are not bundled with a software license is generally recognized as performed during the service period, which is typically less than four months.

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 December 31, 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.

***Deferred project costs***

We defer direct costs when a project is being accounted for under the completed contract method or when using the full deferral method, based on hours incurred on such projects at average costs per hour. We report these deferred project costs in other current assets.

***Deferred revenue***

Deferred revenue consists primarily of amounts of which billed fees exceed revenue recognized on arrangements, the unearned portion of services revenue and advance payment of maintenance fees. When the value of committed and undelivered services to be delivered after license implementation is known, we defer that amount along with the corresponding cost of services until the related elements of the agreement are completed and provided to the customer. The timing of revenue recognized under our arrangements with customers is impacted by these deferrals, but the total value of revenue recognized during the arrangements is not.

***Allowance for doubtful accounts and allowance for sales credit memos***

We maintain an allowance for doubtful accounts using estimates that we make based on factors we believe appropriate such as the composition of the accounts receivable aging, historical bad debts, changes in payment patterns, customer creditworthiness and current economic trends. If we used different assumptions, or if the financial condition of customers were to deteriorate, resulting in an impairment of their ability to make payments, additional provisions for doubtful accounts would be required and would increase bad debt expense.

We record allowances for estimates of potential sales credit memos when the related revenue is recorded and review them periodically. We base these estimates on historical analyses of sales credit memo data, current economic trends, assumptions about future events and experience with customer disputes. If we used different assumptions in calculating the allowance, adjustments would be reflected as changes to revenue. During the first quarter of 2005, we refined our estimate of allowances for sales credit memos which resulted in an increase in services revenue of $0.3 million.

***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 in accordance with APB 25, accounting for stock options. 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 income 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. Paragraph 81 of FASB Statement 123R provides that for the purposes of calculating the pool of excess tax benefits ( APIC pool ), the Company should include the net excess tax benefits that would have qualified had the Company adopted FASB 123R from inception. The FASB issued FSP 123(R)-3, which provides an alternative transition method to calculate beginning pool of excess tax benefits. The Company elected to adopt the alternative transition method ( short cut method ) in calculating its historical APIC pool of windfall tax benefits in regards to its share based compensation.

In 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 fair value of options and the amount of expense would be up to 5% higher or lower, respectively. If the assumed 73% volatility of our stock price was ten percentage points higher or lower, the fair value of options and the amount of expense would be up to 9% higher or lower, respectively. If the assumed 4.70% risk-free interest rate over the expected term of the options was up to two hundred basis points higher or lower, the fair value of options and the amount of expense would be up to 3% higher or lower, respectively. If the assumed 1.6% dividend yield was one percentage point higher or lower, the fair value of options and the amount of expense would be up to 8% higher or lower. Estimates of fair value are not intended to predict actual future events or the value ultimately realized by persons who receive awards.

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 trued up for actual forfeitures of options during vesting.

As of December 31, 2006, unrecognized compensation expense related to the unvested portion of our employee stock options was approximately $1.5 million and is expected to be recognized over a weighted-average period of approximately 1.7 years. During 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.

Cash received from option exercises under all share-based payment arrangements for the year ended December 31, 2006 was $3.5 million. The actual tax benefit for the tax deductions from option exercises for the year ended December 31, 2006 totaled $0.4 million.

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 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 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.

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 September 30, 2006. The weighted average grant date value per share of the award was $7.25.

***Accounting for Income Taxes***

Judgment is required in determining our worldwide income tax expense provision. 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 transactions and arrangements made among related parties, transfer pricing for transactions with our subsidiaries, and potential challenges to nexus and 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 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 provision and operating results in the period in which such a determination is made. Provisions have been made for such uncertainties, with reserves totaling approximately $2 million as of December 31, 2006.

We account for income taxes in accordance with Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes* ( SFAS 109 ), which requires that deferred tax assets and liabilities be recognized using enacted tax rates for the effect of temporary differences between the book and tax bases of recorded assets and liabilities. Principal differences between our book and tax accounts are related to the treatment of our license transactions. We use the operating lease method of recognizing license revenue for tax purposes, so that to the extent we continue to enter into term license contracts, we establish deferred tax liabilities for such future taxable income. In addition, because we defer recognition of this income into future periods for tax purposes, as of December 31, 2006, we had generated approximately $10 million in U.S. tax loss carry forwards which partially offset the related liabilities. We also earn tax credits in various jurisdictions for our ongoing investment in research and development activities. As of December 31, 2006, we had accumulated approximately $9 million of credits carried forward because they would generally be utilized after net operating losses have been consumed exposing us to uncertainties regarding our ability to realize these credits.

We have a valuation allowance related to tax benefits from stock option exercises which will increase equity, and loss carry forwards acquired in the 1mind acquisition, the recognition of which will generally reduce goodwill.

If we are late in filing income taxes for foreign subsidiaries, the taxing authorities in those jurisdictions may levy punitive or jeopardy assessments which can grow over time. The amounts billed during these periods may be much higher than what is ultimately owed. During the delinquent period, the differences between estimated taxes and actual taxes ultimately owed may result in a higher income tax provision. Upon filing of the foreign income tax returns and claims for refund of overpayment, the taxing jurisdiction provides a notice of overpayment, if any, which is then recorded as a reduction to our provision for income taxes.

***Contingencies***

From time to time, we are threatened with or become party to litigation. We periodically assess each matter to determine if a contingent liability in accordance with Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* ( SFAS 5 ), should be recorded. In making this determination, we may, depending on the nature of the matter, consult with internal and external legal counsel and technical experts. Based on the information we obtain, combined with our judgment regarding all the facts and circumstances of each matter, we determine whether it is probable that a contingent loss may be incurred and whether the amount of such loss can be estimated. Should a loss be probable and estimable, we record a contingent loss in accordance with SFAS 5. In determining the amount of a contingent loss, we consider advice received from experts in the specific matter, current status of legal proceedings, settlement negotiations that may be ongoing, prior case history and other factors. Should the judgments and estimates made by us be incorrect, we may need to record additional contingent losses that could materially adversely impact our results of operations.

**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**

No customer accounted for 10% or more of our total revenue in 2006 or 2005. In 2004, one customer accounted for approximately 10% of our total revenue.

**New Accounting Pronouncements**

In June 2006, the FASB issued Interpretation No. 48 ( FIN 48 ), Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 , which clarifies the accounting for uncertainty in income tax positions. FIN 48 requires a company to recognize in its financial statements the impact of a tax position, if that position is more likely than not of being sustained upon examination by the appropriate taxing authority, based on the technical merits of the position. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. We are currently evaluating the effect FIN 48 will have on our consolidated financial position and results of operations.

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In September 2006, the FASB issued SFAS 157, Fair Value Measurements. SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP) and expands disclosures about fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. We are currently evaluating the effect SFAS 157 will have on our consolidated financial position and results of operations.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin ( SAB ) 108 which provides interpretations regarding the process of quantifying prior year financial statement misstatements for the purposes of a materiality assessment. SAB 108 provides guidance that the following two methodologies should be used to quantify prior year income statement misstatements: (i) the error is quantified as the amount by which the current period income statement is misstated and (ii) the error is quantified as the cumulative amount by which the current year balance sheet is misstated. SAB 108 concludes that a company should evaluate whether a misstatement is material using both of these methodologies. The interpretation is effective for evaluations made on or after November 15, 2006. The adoption of SAB 108 will not have a material effect on us.

In February 2007, the FASB issued SFAS 159, The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of SFAS 115, which permits companies to choose to measure many financial instruments and certain other items at fair value. SFAS 159 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. We are currently evaluating the effect SFAS 159 will have on our consolidated financial position and results of operations.

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## ITEM 7A QUANTITATIVE AND QUALITATIVE DISCLOSURE 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 37% of our total revenue in 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 income 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 December 31, 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 December 31, 2006, with most of that change recognized in the statement of income 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 $39.2 million as of December 31, 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 200 basis point increase in market interest rates would have decreased the fair value of our license installments receivable by approximately $1 million as of December 31, 2006.

We have invested in fixed rate marketable debt securities. A 200 basis point increase in market interest rates would have reduced the fair value of our marketable debt securities by approximately $3 million as of December 31, 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.

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**ITEM 8 FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

**INDEX TO CONSOLIDATED FINANCIAL STATEMENTS**

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## MANAGEMENT REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act. Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission ( COSO ). As a result of this evaluation, our management concluded that our internal control over financial reporting was not effective as of December 31, 2006.

Our internal control over financial reporting includes policies and procedures that pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect transactions and dispositions of assets, provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with U.S. generally accepted accounting principles, and that receipts and expenditures are being made in accordance with authorizations of our management and directors; and provide reasonable assurance regarding prevention or timely detection of unauthorized acquisitions, use or disposition of our assets that could have a material effect on our financial statements.

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

As of December 31, 2006, management identified four deficiencies in the Company s internal control over financial reporting that each constituted a material weakness. These material weakness related to: (1) inadequate and ineffective controls over the accounting for certain complex software revenue recognition transactions; (2) inadequate and ineffective controls over the accounting for service revenue recognition transactions; (3) inadequate and ineffective controls over the accounting for income taxes; and (4) inadequate and ineffective controls over the periodic financial close process, as described in Item 9A, Controls and Procedures, of this Annual Report on Form 10-K.

Because of the material weaknesses listed above, management has concluded that we did not maintain effective internal control over financial reporting as of December 31, 2006, based on criteria in *Internal Control Integrated Framework* issued by the COSO.

Our management s assessment of the effectiveness of our internal control over financial reporting as of December 31, 2006 has been audited by Deloitte & Touche LLP, an independent registered public accounting firm, as stated in their report (which expressed an unqualified opinion on management s assessment and an adverse opinion on the effectiveness of our internal control over financial reporting as of December 31, 2006) which appears on pages 34 and 35 of this Annual Report on Form 10-K.

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholders of Pegasystems Inc.

Cambridge, Massachusetts

We have audited management s assessment, included in the accompanying *Management Report on Internal Control Over Financial Reporting,* that Pegasystems Inc. and subsidiaries (the Company ) did not maintain effective internal control over financial reporting as of December 31, 2006, because of the effect of the material weaknesses identified in management s assessment based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management s assessment and an opinion on the effectiveness of the Company s internal control over financial reporting based on our audit.

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

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

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The following material weaknesses have been identified and included in management s assessment:

1. ***Inadequate and ineffective controls over the accounting for certain complex software revenue recognition transactions.***
The Company did not have effective design or operational controls over the accounting for software revenue recognition, specifically, the Company s ability to apply generally accepted accounting principles as they relate to the recognition of revenue on transactions that contain complex and non-standard terms. This material weakness resulted in the misstatement of software license revenue which required the previously reported consolidated financial statements to be restated for the years ended December 31, 2003, 2004, and 2005.

2. ***Inadequate and ineffective controls over the accounting for service revenue recognition transactions.***
The Company s controls related to management s oversight and the determination of the appropriate accounting treatment for arrangements involving professional services revenue were inadequate and in effective. This material weakness resulted in a restatement of previously reported consolidated financial statements for the years ended December 31, 2003, 2004 and 2005.

3. ***Inadequate and ineffective controls over the accounting for income taxes.***
The Company did not have adequate design or operational controls over the accounting for income taxes to provide reasonable assurance that the relevant income tax accounts and related disclosures can be prepared in accordance with generally accepted accounting principles. As a result of these identified weaknesses, post-closing adjustments have been posted to the Company s books and records and its financial statements. These adjustments were not individually material, however the aggregation of

these matters coupled with continued post-closing adjustments recorded in the last three years, results in a material weakness in the design and operating effectiveness over the accounting for income taxes, as it could result in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

4. ***Inadequate and ineffective controls over the periodic financial close process.***

The Company did not have adequate design or operational controls and procedures that provided reasonable assurance that financial statements could be prepared in accordance with generally accepted accounting principles. Specifically, the Company did not have adequate controls and procedures with respect to (a) the timely disposition of required adjustments identified through the period-end account analysis and reconciliation process, (b) all required analyses were prepared accurately and consistently in accordance with the entity s defined closing process and in the appropriate accounting period, and (c) accounting for complex non-routine transactions. As a result of these identified weaknesses, material post closing adjustments were identified and recorded to the Company s books and records and financial statements. These adjustments, which are reflected in the Company s financial statements as of and for the year ended December 31, 2006, caused changes in assets, liabilities, stockholders equity, revenues and expenses. Such weaknesses could continue to impact the balances in all of the accounts previously mentioned.

These material weaknesses were considered in determining the nature, timing, and extent of audit tests applied in our audit of the consolidated financial statements as of and for the year ended December 31, 2006, of the Company and this report does not affect our report on such financial statements.

In our opinion, management s assessment that the Company did not maintain effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Also in our opinion, because of the effect of the material weaknesses described above on the achievement of the objectives of the control criteria, the Company has not maintained effective internal control over financial reporting as of December 31, 2006, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements as of and for the year ended December 31, 2006, of the Company and our report dated May 2, 2007 expressed an unqualified opinion, and included an explanatory paragraph regarding the Company s adoption of Statement of Financial Accounting Standard No. 123(R), *Share-Based Payment*, on those financial statements.

/s/ DELOITTE & TOUCHE LLP

Boston, Massachusetts

May 2, 2007

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholders of Pegasystems Inc.

Cambridge, Massachusetts

We have audited the accompanying consolidated balance sheets of Pegasystems Inc. and subsidiaries (the Company ) as of December 31, 2006 and 2005, and the related consolidated statements of income, stockholders' equity and comprehensive income, and cash flows for each of the three years in the period ended December 31, 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2006, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1 to the consolidated financial statements, the Company changed its method of accounting for stock-based compensation on January 1, 2006, as required by Statement of Financial Accounting Standards No. 123R, *Share-Based Payment*.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of December 31, 2006, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated May 2, 2007 expressed an unqualified opinion on management's assessment of the effectiveness of the Company's internal control over financial reporting and an adverse opinion on the effectiveness of the Company's internal control over financial reporting.

/s/ DELOITTE & TOUCHE LLP

Boston, Massachusetts

May 2, 2007

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**PEGASYSTEMS INC.**

**CONSOLIDATED BALANCE SHEETS**

**(in thousands, except share-related data)**

| | December 31, 2006 | December 31, 2005 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | **$ 26,008** | $ 21,314 |
| Short-term investments | **101,750** | 93,421 |
| Total cash and short-term investments | **127,758** | 114,735 |
| Trade accounts receivable, net of allowance for doubtful accounts of $365 in 2006 and 2005 | **31,985** | 26,978 |
| Short-term license installments | **21,790** | 26,537 |
| Other current assets | **9,065** | 4,752 |
| Total current assets | **190,598** | 173,002 |
| Long-term license installments, net of unearned interest income | **17,458** | 31,371 |
| Equipment and improvements, net of accumulated depreciation and amortization | **2,453** | 1,947 |
| Computer software for internal use, net of accumulated amortization | **1,054** | 845 |
| Other assets | **99** | 143 |
| Goodwill | **2,346** | 2,346 |
| Total assets | **$ 214,008** | $ 209,654 |
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | |
| Current liabilities: | | |
| Accrued payroll related expenses | **$ 11,770** | $ 8,162 |
| Accounts payable and accrued expenses | **14,474** | 10,769 |
| Deferred revenue | **17,062** | 20,528 |
| Current portion of capital lease obligation | **63** | 103 |
| Total current liabilities | **43,369** | 39,562 |
| Long-term deferred income taxes | **2,344** | 1,176 |
| Capital lease obligation, net of current portion | | 63 |
| Other long-term liabilities | **2,137** | 1,171 |
| Total liabilities | **47,850** | 41,972 |
| Commitments and contingencies (Note 5) | | |
| 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; 35,308,978 shares and 35,565,918 shares issued and outstanding at December 31, 2006 and 2005, respectively | **353** | 356 |
| Additional paid-in capital | **118,027** | 118,968 |
| Stock warrants | **94** | 107 |
| Retained earnings | **46,549** | 47,888 |
| Accumulated other comprehensive income: | | |
| Net unrealized loss on investments available-for-sale | **(343)** | (623) |

| | | |
|---|---|---|
| Foreign currency translation adjustments | **1,478** | 986 |
| Total stockholders equity | **166,158** | 167,682 |
| Total liabilities and stockholders equity | **$ 214,008** | $ 209,654 |

See notes to consolidated financial statements.

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**PEGASYSTEMS INC.**

**CONSOLIDATED STATEMENTS OF INCOME**

**(in thousands, except per share amounts)**

| | Year ended December 31, | | |
|---|---|---|---|
| | **2006** | **2005** | **2004** |
| Revenue: | | | |
| Software license | **$ 35,424** | $ 40,896 | $ 41,563 |
| Services | **90,599** | 59,313 | 61,728 |
| Total revenue | **126,023** | 100,209 | 103,291 |
| Cost of revenue: | | | |
| Cost of software license | **32** | 350 | 350 |
| Cost of services | **53,731** | 32,991 | 32,741 |
| Total cost of revenue | **53,763** | 33,341 | 33,091 |
| Gross profit | **72,260** | 66,868 | 70,200 |
| Operating expenses: | | | |
| Research and development | **22,707** | 19,457 | 19,936 |
| Selling and marketing | **43,938** | 34,093 | 32,170 |
| General and administrative | **12,729** | 12,100 | 12,323 |
| Total operating expenses | **79,374** | 65,650 | 64,429 |
| Income (loss) from operations | **(7,114)** | 1,218 | 5,771 |
| Installment receivable interest income | **1,899** | 2,471 | 3,026 |
| Other interest income, net | **5,360** | 3,010 | 1,842 |
| Other income (expense), net | **1,042** | (1,380) | 517 |
| Income before provision (benefit) for income taxes | **1,187** | 5,319 | 11,156 |
| Provision (benefit) for income taxes | **(655)** | 127 | 2,945 |
| Net income | **1,842** | $ 5,192 | $ 8,211 |
| Earnings per share, basic | **$ 0.05** | $ 0.15 | $ 0.23 |
| Earnings per share, diluted | **$ 0.05** | $ 0.14 | $ 0.22 |
| Weighted average number of common shares outstanding, basic | **35,229** | 35,774 | 35,691 |
| Weighted average number of common shares outstanding, diluted | **37,134** | 36,462 | 37,043 |

See notes to consolidated financial statements.

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**PEGASYSTEMS INC.**

**CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY AND COMPREHENSIVE INCOME**

**(in thousands)**

| | Common Stock | | Additional | | | Accumulated | Total | |
|---|---|---|---|---|---|---|---|---|
| | Number of Shares | Amount | Paid-In Capital | Stock Warrant | Retained Earnings | Other Comprehensive Income | Stock-holders Equity | Comprehensive Income |
| Balance at January 1, 2004 | 35,213 | $ 352 | $ 117,391 | $ 374 | $ 34,485 | $ 1,320 | $ 153,922 | |
| Exercise of stock options | 728 | 7 | 2,883 | | | | 2,890 | |
| Issuance of stock under Employee Stock Purchase Plan | 103 | 1 | 658 | | | | 659 | |
| Exercise of common stock warrants | 33 | 1 | 162 | (163) | | | | |
| Issuance of common stock warrants | | | | 38 | | | 38 | |
| Tax benefit from exercise of stock options | | | 1,058 | | | | 1,058 | |
| Foreign currency translation adjustments | | | | | | 87 | 87 | $ 87 |
| Net unrealized loss on investments available-for-sale | | | | | | (433) | (433) | (433) |
| Net deferred tax impact of unrealized loss on investments available-for-sale | | | | | | 175 | 175 | 175 |
| Net income | | | | | 8,211 | | 8,211 | 8,211 |
| Balance at December 31, 2004 | 36,077 | 361 | 122,152 | 249 | 42,696 | 1,149 | 166,607 | $ 8,040 |
| Repurchase of common stock | (957) | (9) | (5,867) | | | | (5,876) | |
| Exercise of stock options | 342 | 3 | 1,477 | | | | 1,480 | |
| Issuance of stock under Employee Stock Purchase Plan | 76 | 1 | 368 | | | | 369 | |
| Exercise of common stock warrants | 28 | | 142 | (142) | | | | |
| Tax benefit from exercise of stock options | | | 696 | | | | 696 | |
| Foreign currency translation adjustments | | | | | | (430) | (430) | $ (430) |
| Net unrealized loss on investments available-for-sale | | | | | | (586) | (586) | (586) |
| Net deferred tax impact of unrealized loss on investments available-for-sale | | | | | | 230 | 230 | 230 |
| Net income | | | | | 5,192 | | 5,192 | 5,192 |
| Balance at December 31, 2005 | 35,566 | $ 356 | $ 118,968 | $ 107 | $ 47,888 | $ 363 | $ 167,682 | $ 4,406 |
| Repurchase of common stock | (962) | (10) | (6,809) | | | | (6,819) | |
| Exercise of stock options | 640 | 6 | 3,490 | | | | 3,496 | |
| Issuance of stock under Employee Stock Purchase Plan | 25 | 1 | 203 | | | | 204 | |
| Issuance of stock awards | 37 | | 274 | | | | 274 | |
| Exercise of common stock warrants | 3 | | 13 | (13) | | | | |
| Stock-based compensation expense | | | 1,194 | | | | 1,194 | |
| Tax benefit from exercise of stock options | | | 694 | | | | 694 | |
| Declaration of dividends | | | | | (3,181) | | (3,181) | |

| | | | | |
|---|---|---|---|---|
| Foreign currency translation adjustments | | 492 | 492 | 492 |
| Net unrealized loss on investments available-for-sale | | 462 | 462 | 462 |
| Net deferred tax impact of unrealized loss on investments available-for-sale | | (182) | (182) | (182) |
| Net income | 1,842 | | 1,842 | $ 1,842 |