

PEGASYSTEMS INC  
Form 10-Q  
August 07, 2007  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

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(Mark One)

**Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the quarterly period ended June 30, 2007

or

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

Commission File Number: 1-11859

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**PEGASYSTEMS INC.**

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

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

**101 Main Street Cambridge, MA**  
*(Address of principal executive offices)*

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

**02142-1590**  
*(Zip Code)*

**(617) 374-9600**

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

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

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

There were 36,259,305 shares of the Registrant's common stock, \$.01 par value per share, outstanding on August 3, 2007.

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**PEGASYSTEMS INC.**

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**Table of Contents****PEGASYSTEMS INC.****CONDENSED CONSOLIDATED BALANCE SHEETS (unaudited)**

(in thousands, except share-related data)

	June 30, 2007	December 31, 2006
<b><u>ASSETS</u></b>		
Current assets:		
Cash and cash equivalents	\$ 14,731	\$ 26,008
Short-term investments	126,400	101,750
Total cash and short-term investments	141,131	127,758
Trade accounts receivable, net of allowance for doubtful accounts of \$365 in 2007 and 2006	35,125	31,985
Short-term license installments	15,205	21,790
Other current assets	8,361	9,065
Total current assets	199,822	190,598
Long-term license installments, net of unearned interest income	12,029	17,458
Equipment and improvements, net of accumulated depreciation and amortization	3,238	2,453
Computer software for internal use, net of accumulated amortization	823	1,054
Long-term deferred tax assets and other assets	6,155	99
Goodwill	2,346	2,346
Total assets	\$ 224,413	\$ 214,008
<b><u>LIABILITIES AND STOCKHOLDERS' EQUITY</u></b>		
Current liabilities:		
Accrued payroll related expenses	\$ 7,841	\$ 11,770
Accounts payable and accrued expenses	11,660	14,474
Deferred revenue	21,942	17,062
Current portion of capital lease obligation	9	63
Total current liabilities	41,452	43,369
Long-term deferred income taxes		2,344
Income taxes payable and other long-term liabilities	11,432	2,137
Total liabilities	52,884	47,850
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, \$.01 par value, 1,000,000 shares authorized; no shares issued and outstanding		
Common stock, \$.01 par value, 70,000,000 shares authorized; 36,171,921 and 35,308,978 shares issued and outstanding at June 30, 2007 and December 31, 2006, respectively	362	353
Additional paid-in capital	125,074	118,027
Stock warrants	94	94
Retained earnings, including the cumulative effect of (\$1,490) for the adoption of a new accounting pronouncement at January 1, 2007 (see footnote 4)	44,577	46,549
Accumulated other comprehensive income (loss):		
Net unrealized loss on investments available-for-sale	(319)	(343)
Foreign currency translation adjustments	1,741	1,478

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Total stockholders' equity	171,529	166,158
Total liabilities and stockholders' equity	\$ 224,413	\$ 214,008

See notes to unaudited condensed consolidated financial statements.

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

(in thousands, except per share amounts)

	Three months ended June 30,		Six months ended June 30,	
	2007	2006	2007	2006
<b>Revenue:</b>				
Software license	\$ 10,344	\$ 6,801	\$ 22,428	\$ 13,799
Services	25,319	20,530	50,724	42,731
<b>Total revenue</b>	<b>35,663</b>	<b>27,331</b>	<b>73,152</b>	<b>56,530</b>
<b>Cost of revenue:</b>				
Cost of software license		1		32
Cost of services	14,320	11,048	29,884	25,135
<b>Total cost of revenue</b>	<b>14,320</b>	<b>11,049</b>	<b>29,884</b>	<b>25,167</b>
<b>Gross profit</b>	<b>21,343</b>	<b>16,282</b>	<b>43,268</b>	<b>31,363</b>
<b>Operating expenses:</b>				
Research and development	6,380	5,681	12,565	11,083
Selling and marketing	11,647	10,174	23,416	19,984
General and administrative	4,255	3,385	8,470	6,022
<b>Total operating expenses</b>	<b>22,282</b>	<b>19,240</b>	<b>44,451</b>	<b>37,089</b>
<b>Loss from operations</b>	<b>(939)</b>	<b>(2,958)</b>	<b>(1,183)</b>	<b>(5,726)</b>
Installment receivable interest income	282	454	558	901
Other interest income, net	1,639	1,483	3,184	2,598
Other income, net	98	403	78	648
<b>Income (loss) before provision (benefit) for income taxes</b>	<b>1,080</b>	<b>(618)</b>	<b>2,637</b>	<b>(1,579)</b>
Provision (benefit) for income taxes	433	(359)	970	(409)
<b>Net income (loss)</b>	<b>\$ 647</b>	<b>\$ (259)</b>	<b>\$ 1,667</b>	<b>\$ (1,170)</b>
Earnings (loss) per share, basic	\$ 0.02	\$ (0.01)	\$ 0.05	\$ (0.03)
Earnings (loss) per share, diluted	\$ 0.02	\$ (0.01)	\$ 0.04	\$ (0.03)
Weighted average number of common shares outstanding, basic	35,670	35,561	35,510	35,567
Weighted average number of common shares outstanding, diluted	38,017	35,561	37,822	35,567
Dividends per share	\$ 0.03	\$ 0.03	\$ 0.06	\$ 0.03

See notes to unaudited condensed consolidated financial statements.

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

(in thousands)

	Six months ended	
	June 30,	
	2007	2006
Cash flows from operating activities:		
Net income (loss)	\$ 1,667	\$ (1,170)
Adjustment to reconcile net income (loss) to cash flows from operating activities:		
Stock option income tax benefits	(1,180)	(213)
Deferred income taxes	808	(878)
Depreciation, amortization, and other non-cash items	1,192	1,073
Stock-based compensation expense	696	835
Change in operating assets and liabilities:		
Trade accounts receivable and license installments	8,875	11,556
Other current assets	783	(1,128)
Accounts payable and accrued expenses	(7,285)	174
Deferred revenue	4,880	4,077
Other long-term assets and liabilities	883	557
<b>Cash flows from operating activities</b>	<b>11,319</b>	<b>14,883</b>
Cash flows from investing activities:		
Purchase of investments	(53,480)	(34,534)
Maturing and called investments	27,900	29,375
Investment in software, equipment and improvements	(1,504)	(1,297)
<b>Cash flows from investing activities</b>	<b>(27,084)</b>	<b>(6,456)</b>
Cash flows from financing activities:		
Payments under capital lease obligation	(54)	(51)
Exercise of stock options	6,011	1,173
Tax benefit from vested stock options	1,180	213
Proceeds from the sale of stock under Employee Stock Purchase Plan	82	102
Dividend payments to shareholders	(2,120)	
Repurchase of common stock	(914)	(3,481)
<b>Cash flows from financing activities</b>	<b>4,185</b>	<b>(2,044)</b>
Effect of exchange rate on cash and cash equivalents	303	165
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>(11,277)</b>	<b>6,548</b>
Cash and cash equivalents, beginning of period	26,008	21,314
<b>Cash and cash equivalents, end of period</b>	<b>\$ 14,731</b>	<b>\$ 27,862</b>
Supplemental disclosures of cash flow information:		
Cash paid during the year-to-date period for:		
Interest	\$ 1	\$ 10

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Income taxes	\$ 1,053	\$ 303
Non-cash financing activity:		
Dividends payable	\$ 1,088	\$ 1,067

See notes to unaudited condensed consolidated financial statements.

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

The Company has prepared the accompanying unaudited condensed consolidated financial statements pursuant to the rules and regulations of the Securities and Exchange Commission (SEC) regarding interim financial reporting. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements and should be read in conjunction with the Company's audited financial statements included in the Annual Report on Form 10-K for the year ended December 31, 2006.

In the opinion of management, the Company has prepared the accompanying unaudited condensed consolidated financial statements on the same basis as its audited financial statements, and these financial statements include all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the results of the interim periods presented. The operating results for the interim periods presented are not necessarily indicative of the results expected for the full year 2007.

**2. SIGNIFICANT ACCOUNTING POLICIES***(a) Trade accounts receivable*

Trade accounts receivable balances, which consist of billed and unbilled amounts, were \$35.1 million and \$32.0 million at June 30, 2007 and December 31, 2006, respectively. Trade accounts receivable includes \$4.1 million and \$2.5 million at June 30, 2007 and December 31, 2006, respectively, for services earned under time and material arrangements that had not been invoiced at the end of the respective period.

*(b) Other current assets*

Other current assets consist of the following:

<b>(in thousands)</b>	<b>June 30, 2007</b>	<b>December 31, 2006</b>
Deferred tax assets	\$ 3,000	\$ 2,962
Deferred cost of services	754	1,593
Interest receivable	2,090	1,776
Income tax receivable	1,362	1,331
Prepaid expense	778	842
Reimbursable expense	244	349
Sales tax receivable	133	212
Balance at the end of the period	\$ 8,361	\$ 9,065

*(c) Stockholders' equity*

On June 1, 2006, the Company's Board of Directors declared an ongoing quarterly cash dividend of \$.03 per share. The dividend declared during the second quarter of 2007 was paid on July 16, 2007 to stockholders of record as of July 2, 2007. The Company paid in the aggregate approximately \$1.1 million in connection with this dividend. The accrued liability for this dividend is included in Accounts payable and accrued expenses on the Company's condensed consolidated balance sheet at June 30, 2007. The Company currently expects to continue to pay a quarterly cash dividend of \$.03 per share to stockholders of record as of the first trading day of each quarter, subject to change in the discretion of the Company's Board of Directors.

On June 1, 2006, the Company publicly announced that the Company's Board of Directors had approved a \$10 million stock repurchase program beginning July 1, 2006 and ending June 30, 2007 (the "Second Program").



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

The following table sets forth information regarding the Company's repurchases of its common stock under the Second Program during the second quarter of 2007.

Period	Total Number of Shares Purchased	Average Price	Total Number	Approximate Dollar Value of Shares That May Yet Be Purchased Under The Second Program  (in thousands)
		Paid per Share	of Shares Purchased as Part of Publicly Announced Share Repurchase Program	
April 2007		\$	443,439	\$ 6,872
May 2007	10,540	10.09	453,979	6,766
June 2007	77,705	10.40	531,684	Program Ended
Total	88,245	\$ 10.36		

On June 4, 2007, the Company announced that its Board of Directors approved a new \$10 million stock repurchase program beginning July 1, 2007 and ending June 30, 2008 (the Third Program). Under the Third Program, shares may be purchased in such amounts as market conditions warrant, subject to regulatory and other considerations. Purchases under the Third Program may be made from time to time on the open market or in privately negotiated transactions.

**(d) Earnings per share**

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

(in thousands, except per share amounts)	Three months ended June 30,		Six months ended June 30,	
	2007	2006	2007	2006
<b>Basic</b>				
Net income (loss)	\$ 647	\$ (259)	\$ 1,667	\$ (1,170)
Weighted average common shares outstanding	35,670	35,561	35,510	35,567
Earnings (loss) per share, basic	\$ 0.02	\$ (0.01)	\$ 0.05	\$ (0.03)
<b>Diluted</b>				
Net income (loss)	\$ 647	\$ (259)	\$ 1,667	\$ (1,170)
Weighted average common shares outstanding	35,670	35,561	35,510	35,567
Effect of assumed exercise of stock options and warrants	2,347		2,312	
Weighted average common shares outstanding, assuming dilution	38,017	35,561	37,822	35,567
Earnings (loss) per share, diluted	\$ 0.02	\$ (0.01)	\$ 0.04	\$ (0.03)

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Outstanding options and warrants excluded as impact would be anti-dilutive	1,192	4,664	1,229	8,886
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**(e) Segment reporting**

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

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

(\$ in thousands)	Three months ended				Six months ended			
	June 30,		June 30,		June 30,		June 30,	
	2007	2006	2007	2006	2007	2006	2007	2006
United States	\$ 24,861	70%	\$ 19,045	70%	\$ 52,531	72%	\$ 38,374	68%
United Kingdom	6,392	18%	3,634	13%	11,682	16%	7,261	13%
Other Europe	1,539	4%	2,572	9%	3,032	4%	7,929	14%
Other	2,871	8%	2,080	8%	5,907	8%	2,966	5%
	\$ 35,663	100%	\$ 27,331	100%	\$ 73,152	100%	\$ 56,530	100%

In the second quarter of 2007, no single customer accounted for ten percent or more of the Company's total revenue. In the second quarter of 2006, one customer accounted for 11% of the Company's total revenue. In the first six months of 2007 and 2006, no single customer accounted for ten percent or more of the Company's total revenue.

**(f) Share Based-Compensation**

The Company accounts for stock-based compensation expense in accordance with Statement of Financial Accounting Standards (SFAS) No. 123(R), Share-Based Payment (SFAS 123R). Under SFAS 123R, stock-based compensation expense reflects the fair value of stock-based awards measured at the grant date, is recognized over the relevant service period, and is adjusted each period for anticipated forfeitures. The Company estimates the fair value of each stock-based award on the date of grant using the Black-Scholes option valuation model. The Black-Scholes option valuation model incorporates assumptions as to stock price volatility, the expected post-vesting life of the options, a risk-free interest rate and dividend yield. Estimates of fair value are not intended to predict actual future events or the value ultimately realized by persons who receive equity awards.

The following table provides the classification of stock-based compensation as reflected in the Company's unaudited condensed consolidated statements of operations:

(in thousands, except per share amounts)	Three months ended June 30, 2007	Three months ended June 30, 2006	Six months ended June 30, 2007	Six months ended June 30, 2006
Stock-based compensation expense:				
Cost of services	\$ 107	\$ 68	\$ 269	\$ 137
Research and development	30	35	71	75
Selling and marketing	108	151	210	261
General and administrative	55	318	146	362
Total stock-based compensation before tax	300	572	696	835
Income tax benefit	(95)	(213)	(199)	(308)
Net stock-based compensation expense	\$ 205	\$ 359	\$ 497	\$ 527
Effect on earnings (loss) per share:				
Basic	\$ (.01)	\$ (.01)	\$ (.01)	\$ (.01)
Diluted	\$ (.01)	\$ (.01)	\$ (.01)	\$ (.01)

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

The fair value of stock options was estimated on the date of grant using a Black-Scholes option valuation model with the following weighted average assumptions:

	Three months ended	
	June 30, 2007	June 30, 2006
Expected volatility <sup>(1)</sup>	58%	76%
Expected post-vesting option life <sup>(2)</sup>	3.4 years	3.6 years
Interest rate (risk free) <sup>(3)</sup>	4.96%	5.11%
Expected annual dividend yield <sup>(4)</sup>	1.43%	0.91%

  

	Six months ended	
	June 30, 2007	June 30, 2006
Expected volatility <sup>(1)</sup>	62%	77%
Expected post-vesting option life <sup>(2)</sup>	3.4 years	3.6 years
Interest rate (risk free) <sup>(3)</sup>	4.71%	4.95%
Expected annual dividend yield <sup>(4)</sup>	1.47%	0.38%

- (1) The expected volatility for each grant is determined based on the average of historical weekly price changes of the Company's common stock over a period of time which approximates the expected option term.
- (2) The expected post-vesting option life for each grant is determined based on the historical exercise behavior of employees and post-vesting employment termination.
- (3) The risk-free interest rate for the expected term of the stock option is based on the U.S. Treasury yield at the time of grant.
- (4) The expected annual dividend yield as shown in the table above is based on the weighted average of the dividend yield assumption used for options granted during the period. As the Company had not declared dividends prior to the quarter ended June 30, 2006, options granted prior to the initial dividend were valued using a dividend yield of zero. Options granted after the initial dividend were valued using the expected annual dividend yield, calculated based on the expected dividend of \$0.12 per share, per year (\$0.03 per share, per quarter times 4 quarters) divided by the average stock price.

As of June 30, 2007, awards representing 4.1 million shares were reserved for future issuance under the Company's stock plans, consisting of 0.2 million shares under the 1996 Non-Employee Director Stock Option Plan, 3.4 million shares under the 2004 Long-Term Incentive Plan, 0.5 million shares under the 2006 Employee Stock Purchase Plan. No further awards may be issued under the 1994 Long-Term Incentive Plan and the 1996 Employee Stock Purchase Plan.

The following table presents the combined stock option activity for the 1994 Long-Term Incentive Plan, the 2004 Long-Term Incentive Plan and the 1996 Non-Employee Director Stock Option Plan for the three months ended June 30, 2007:

	Shares (in thousands)	Weighted Average Exercise Price per share	Weighted Average	
			Contractual Term (in years)	Aggregate Intrinsic Value (in thousands)
Outstanding as of January 1, 2007	8,436	\$ 7.94	5.63	

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Granted	159		9.26		
Exercised	(942)		6.38		
Cancelled	(147)		9.88		
Outstanding as of June 30, 2007	7,506	\$	8.13	5.20	\$ 28,407
Ending vested and expected to vest	7,294	\$	8.13	5.10	\$ 27,739
Ending exercisable	6,677	\$	8.24	4.83	\$ 25,252

The Company received \$6.0 million from options exercised during the six months ended June 30, 2007: their intrinsic value was \$3.6 million.

**Table of Contents****PEGASYSTEMS INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)****(g) Recently Issued Accounting Pronouncements**

In September 2006, the Financial Accounting Standard Board ( FASB ) issued SFAS No. 157, Fair Value Measurements ( SFAS No. 157 ). SFAS No. 157 defines fair values, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS No. 157 is effective for the Company beginning on January 1, 2008. The Company does not expect that adoption of this new standard will have a material effect on our financial position or results of operations.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115. This Standard allows entities to voluntarily choose, at specified election dates, to measure many financial assets and financial liabilities (as well as certain nonfinancial instruments that are similar to financial instruments) at fair value. The election is made on an instrument-by-instrument basis and is irrevocable. If the fair value option is elected for an instrument, the Statement specifies that all subsequent changes in fair value for that instrument shall be reported in earnings. SFAS No. 159 is effective for the Company beginning on January 1, 2008. The Company does not expect that adoption of this new standard will have a material effect on our financial position or results of operations.

In June 2007, the FASB Emerging Issues Task Force ( EITF ) published Issue No. 07-3, Accounting for Nonrefundable Advance Payments for Goods or Services to Be Used in Future Research and Development Activities. The EITF reached a consensus that these payments made by an entity to third parties should be deferred and capitalized. Such amounts should be recognized as an expense as the related goods are delivered or the related services are performed. Entities should report the effects of applying this Issue as a change in accounting principle through a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption. EITF Issue No. 07-3 is effective for the Company beginning on January 1, 2008. Earlier application is not permitted. The Company does not expect that adoption of this new pronouncement will have a material effect on our financial position or results of operations.

**3. COMPREHENSIVE INCOME (LOSS)**

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

(in thousands)	Three months ended		Six months ended	
	June 30, 2007	June 30, 2006	June 30, 2007	June 30, 2006
Comprehensive income (loss):				
Net income (loss)	\$ 647	\$ (259)	\$ 1,667	\$ (1,170)
Other comprehensive income (loss):				
Unrealized gain (loss) on securities (net of tax)	(105)	(70)	24	(99)
Foreign currency translation adjustments	227	107	263	140
Comprehensive income (loss)	\$ 769	\$ (222)	\$ 1,954	\$ (1,129)

**4. INCOME TAXES**

The Company adopted the provisions of Financial Accounting Standards Board (FASB) Interpretation No. 48, Accounting for Uncertainty in Income Taxes ( FIN 48 ), an interpretation of FASB Statement No. 109 ( SFAS 109 ) on January 1, 2007. As a result of the implementation of FIN 48, the Company recorded a \$1.5 million reduction to January 1, 2007 retained earnings. At the adoption date of January 1, 2007, the Company had \$9.7 million of unrecognized tax benefits, \$3.7 million of which would affect the Company's effective tax rate if recognized. There were no material changes to the amount of unrecognized tax benefits during the first six months of 2007. The Company expects that the changes in the unrecognized tax benefits within the next twelve months would not be material.



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**PEGASYSTEMS INC.**

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

The Company recognizes interest and penalties related to uncertain tax positions in income tax expense. As of January 1, 2007, the Company had approximately \$1.3 million of accrued interest and \$0.1 million of accrued penalties related to uncertain tax positions.

The Company files income tax returns in the U.S. federal jurisdiction, and various states and foreign jurisdictions. Generally, the Company is no longer subject to U.S. federal, state or local, or foreign, income tax examinations by tax authorities for the years before 2001. Currently, the Company is under examination in the United Kingdom for the tax years 2001 through 2004. With few exceptions, the statute of limitations remains open in all other jurisdictions for the tax years 2002 to the present.

**Table of Contents****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**  
**Forward-Looking Statements**

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

**Business Overview**

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

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.

Our revenue historically has fluctuated quarter to quarter and has generally been higher in the second half of the year.

**Results of Operations**

(In millions, except percentages)	Three months ended			Six months ended		
	June 30,		Percentage Change	June 30,		Percentage Change
	2007	2006		2007	2006	
Total revenue	\$ 35.7	\$ 27.3	30%	\$ 73.2	\$ 56.5	29%
Gross profit	21.3	16.3	31%	43.3	31.4	38%
Total operating expense	22.3	19.2	16%	44.5	37.1	20%
Income (loss) before provision (benefit) for income taxes	1.1	(0.6)	275%	2.6	(1.6)	267%

Total revenue in the first six months of 2007 increased by 29% compared to the first six months of 2006 as a result of an \$8.6 million increase in license revenue, a \$5.2 million increase in professional services revenue related to license implementations and a \$2.8 million increase in maintenance revenue.

Gross profit increased in the first six months of 2007 compared to the first six months of 2006 primarily due to the increase in license revenue.

Total operating expenses in the first six months of 2007 increased by 20% compared to the first six months of 2006 primarily due to our continued investment in expanding the number of sales and professional services personnel, increased spending in research and development and higher accounting and legal fees as a result of restating our previously issued financial statements.

As a result of the increase in revenue and gross profit, income (loss) before provision for income taxes and net income (loss) changed from a loss in the first six months of 2006 to a profit in the first six months of 2007.

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We generated \$11.3 million in cash flow from operations during the first six months of 2007, and ended the period with \$141.1 million in cash and short-term investments and \$27.2 million in combined short and long-term license installment receivables.

**Revenue****License revenue**

(In millions, except percentages)	Three months ended			Six months ended		
	June 30, 2007	2006	Percentage Change	June 30, 2007	2006	Percentage Change
Perpetual licenses	\$ 7.4	\$ 3.3	124%	\$ 16.8	\$ 8.4	100%
Term licenses	2.9	3.5	17%	5.6	5.4	4%
<b>Total license revenue</b>	<b>\$ 10.3</b>	<b>\$ 6.8</b>	<b>52%</b>	<b>\$ 22.4</b>	<b>\$ 13.8</b>	<b>63%</b>

For both the three months and six months ended June 30, 2007, license revenue growth was driven primarily by perpetual license arrangements. Consistent with our strategy of selling limited size initial licenses in order for customers to more quickly realize business value from our software, the number of license signings has increased while the average value has slightly decreased. The limited size licenses have resulted in faster customer acceptance, more rapid revenue recognition and a decrease in deferred license revenue for the first six months of 2007 compared to the first six months of 2006.

These trends can serve to increase the extent to which license revenue fluctuates quarterly, due to both arrangements with shorter lead-time between license signing and recognition and to a limited number of larger arrangements where complex terms may result in deferred revenue recognition. As a result, while the value of license signings during the second quarter of 2007 was about the same as the first quarter of 2007, perpetual license revenue decreased in the second quarter of 2007 compared to the first quarter of 2007, while deferred revenue and backlog increased.

License revenue from term licenses increased only slightly for the first six months of 2007 compared to the same period in 2006. However, in the first six months of 2006, the majority of term license arrangements included contract terms for which we recognized the present value of committed future term license payments as term license revenue. Our current term license arrangements are presently structured to require revenue to be recognized over the license term as payments become due. Payments for these term licenses, which will be recognized in future periods, totaled \$29.4 million as of June 30, 2007. See the table of expected cash receipts from term licenses on page 17.

**Services revenue**

(In millions, except percentages)	Three months ended			Six months ended		
	June 30, 2007	2006	Percentage Change	June 30, 2007	2006	Percentage Change
Professional services and training	\$ 17.9	\$ 14.8	21%	\$ 36.3	\$ 31.1	17%
Maintenance	7.4	5.7	30%	14.4	11.6	24%
<b>Total services revenue</b>	<b>\$ 25.3</b>	<b>\$ 20.5</b>	<b>23%</b>	<b>\$ 50.7</b>	<b>\$ 42.7</b>	<b>19%</b>

The increase in services revenue for the three and six months ended June 30, 2007 was primarily a result of increased demand from our customers for professional services related to new license implementations. These increases were driven by the large increase in license signings that occurred in the second half of 2006. To meet the demand, we have increased employee headcount in the services organization to 216 at June 30, 2007 from 180 at June 30, 2006 while contracted services are approximately \$5.4 million for the six months of 2007 and 2006.

Maintenance revenue increases for the three and six months ended June 30, 2007 reflect the continued increase in the installed base of our software.

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We record allowances for estimates of potential sales credit memos when the related revenue is recorded and we review these allowances periodically. We base these estimates on historical analyses of credit memo data, current economic trends, assumptions about future events and our experience with customer disputes. The following table summarizes the activity of the allowance for credit memos:

(in thousands)	Six months ended	
	June 30, 2007	June 30, 2006
Balance at beginning of period	\$ 1,238	\$ 470
Revenue deferred (recognized)	498	1,966
Credit memos issued that impact revenue	(384)	(1,031)
Balance at end of period	\$ 1,352	\$ 1,405

Deferred revenue at June 30, 2007 consisted primarily of billed fees which exceed revenue recognized on arrangements and unearned portions of annual maintenance fees paid in advance. Deferred revenue balances increased to \$21.9 million at June 30, 2007, from \$17.1 million at December 31, 2006 primarily due to an increase in pre-paid annual maintenance fees. International revenue was 30% of total revenue for both the second quarter of 2007 and the second quarter of 2006. International revenue decreased to 28% of total revenue for the first six months of 2007 from 32% for the first six months of 2006.

**Gross profit**

(In millions, except percentages)	Three months ended			Six months ended		
	June 30, 2007	June 30, 2006	Percentage Change	June 30, 2007	June 30, 2006	Percentage Change
License gross profit	\$ 10.3	\$ 6.8	51%	\$ 22.4	\$ 13.8	62%
Services gross profit in dollars	\$ 11.0	\$ 9.5	16%	\$ 20.8	\$ 17.6	18%
Services gross margin	43%	46%		41%	41%	

There are no significant direct costs associated with license revenue. Increases in license gross profit are therefore due to increases in license revenue.

Services gross profit margin remained constant at 41% for the first six months of 2007 and 2006. Increases in services gross profit are therefore directly attributable to the increase in services revenue. Our costs of service are primarily the personnel costs associated with the delivery of consulting services and the costs of subcontractors to meet the demand for professional services. We expect to continue to increase the number of professional service employees to meet future demand. In addition, we will continue to utilize subcontractors while we recruit, hire and train new professional service employees.

**Operating expenses****Research and development**

(In millions, except percentages)	Three months ended			Six months ended		
	June 30, 2007	June 30, 2006	Percentage Change	June 30, 2007	June 30, 2006	Percentage Change
Research and development	\$ 6.4	\$ 5.7	12%	\$ 12.6	\$ 11.1	13%
As a percent of total revenue	18%	21%		17%	20%	

Research and development expenses include payroll, employee benefits, stock-based compensation expense, contracted services, and other labor-related costs associated with research and development. Research and development costs increased during the three and six months ended June 30, 2007 due to increased headcount-related costs. Employee headcount increased to 116 on June 30, 2007 from 110 on June 30, 2006. We supplement our local research and development activities by using offshore contractors. Contracted services for the first six months of 2007 increased to \$3.0 million from \$2.8 million for the first six months of 2006. We are planning to expand our use of offshore resources for research

and development by hiring our own offshore employees to supplement our use of offshore contractors.

**Table of Contents****Selling and marketing**

(In millions, except percentages)	Three months ended			Six months ended		
	June 30, 2007	June 30, 2006	Percentage Change	June 30, 2007	June 30, 2006	Percentage Change
Selling and marketing	\$ 11.6	\$ 10.2	14%	\$ 23.4	\$ 20.0	17%
As a percent of total revenue	33%	37%		32%	35%	

Selling and marketing expenses include payroll, employee benefits, stock-based compensation expense, and other headcount-related costs associated with selling and marketing personnel as well as advertising, promotions, trade shows, seminars, and other programs. The increases in selling and marketing expenses were primarily due to a \$1.0 million increase in employee related costs associated with increased staff in both sales and marketing. Our selling and marketing employee headcount increased by 16% from 126 at the end of the second quarter 2006 to 146 at the end of the second quarter 2007.

**General and administrative**

(In millions, except percentages)	Three months ended			Six months ended		
	June 30, 2007	June 30, 2006	Percentage Change	June 30, 2007	June 30, 2006	Percentage Change
General administrative	\$ 4.3	\$ 3.4	26%	\$ 8.5	\$ 6.0	41%
As a percent of total revenue	12%	12%		12%	11%	

General and administrative costs include payroll, employee benefits, stock-based compensation expense and other headcount-related costs associated with finance, legal, corporate governance, other administrative headcount, and accounting, legal and other administrative fees. General and administrative costs increased during the three and six months ended June 30, 2007, primarily reflecting increased costs for accounting and legal fees associated with the restatement of our previously issued financial statements and increased compensation costs relating to increased headcount. For the second quarter of 2007, accounting and legal fees increased to \$1.4 million from \$0.5 million for the second quarter of 2006. Audit and legal fees related to the restatement totaled \$0.8 million in the second quarter of 2007. For the first six months of 2007, accounting and legal fees increased to \$2.6 million from \$1.0 million for the first six months of 2006. Audit and legal fees related to the restatement totaled \$1.5 million in the first six months of 2007. Our general and administrative employee headcount increased to 108 employees at the end of the second quarter of 2007 from 99 employees at the end of the second quarter of 2006.

**Investment income, other income and Income Taxes**

(In millions)	Three months ended			Six months ended		
	June 30, 2007	June 30, 2006	Change	June 30, 2007	June 30, 2006	Change
Installment receivable interest income and other interest income, net	\$ 1.9	\$ 1.9	\$	\$ 3.7	\$ 3.5	\$ 0.2
Other income (expense), net	0.1	0.4	(0.3)	0.1	0.6	(0.5)
Investment income and other	\$ 2.0	\$ 2.3	\$ (0.3)	\$ 3.8	\$ 4.1	\$ (0.3)

**Interest Income**

Interest income increased primarily due to larger balances of cash and investments, partially offset by an expected reduction in interest income from installment receivables reflecting the declining balance of term licenses on which revenue had been recognized in advance of payments.

**Other income (expense), net**

Other income (expense), net, consists primarily of currency exchange gains and losses. The six month period ended June 30, 2006 had benefited from increases of approximately 6% in the value of British pounds and Euro currencies versus the U.S. dollar, while the benefit in the six month period ended June 30, 2007 was from increases of approximately 2% in the value of British pounds and Euro currencies versus the U.S. dollar,

partially offset by recognized losses on called investments in marketable debt securities.

**Table of Contents****Provision for income taxes**

The provision for income taxes for the first six months of 2007 was \$1.0 million, compared to a tax benefit of \$0.4 million for the first six months of 2006. The \$1.0 million provision represents a 37% effective tax rate on the income before provision for income taxes. The increase in the provision for income taxes was due primarily to improved profitability. The Company adopted the provisions of FIN 48 on January 1, 2007. See additional disclosure in the Notes to Unaudited Condensed Consolidated Financial Statements for additional information.

**Liquidity and capital resources**

We have funded our operations primarily from cash flow from operations. At June 30, 2007, we had cash and cash equivalents and short-term investments of \$141.1 million, a \$13.3 million increase from \$127.8 million at December 31, 2006. This increase was primarily due to \$11.3 million of cash flow from operations and \$6.0 million from the exercise of stock options, partially offset by \$2.1 million used for dividend payments to stockholders and \$1.5 million used for investments in software, equipment and improvements.

Working capital was \$158.4 million at June 30, 2007, a \$11.2 million increase from the \$147.2 million at December 31, 2006. Working capital increased primarily due to a \$13.3 million increase in cash and cash equivalents and short term investments and a \$3.9 million decrease in accrued payroll related expenses partially offset by a \$6.6 million decrease in short-term license installments.

Cash flow from operating activities for the first six months of 2007 decreased to \$11.3 million from \$14.9 million for the first six months of 2006. During the first six months of 2007, cash flow was lower due to a \$7.5 million decrease in accounts payable and accrued expenses and a \$2.7 million increase in accounts receivable and license installments, offset by \$2.9 million increase in net income, \$1.7 million from deferred taxes and a \$1.9 million decrease in other assets.

Net cash used in investing activities for the first six months of 2007 was \$27.1 million, primarily due to net purchases of marketable debt securities, compared to \$6.5 million for the first six months of 2006.

On June 1, 2006, we publicly announced that our Board of Directors had approved a \$10 million stock repurchase program beginning July 1, 2006 and ending June 30, 2007 (the **Second Program**). The following table sets forth information regarding our repurchases of our common stock under the Second Program during the second quarter of 2007.

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number	Approximate Dollar
			of Shares Purchased as Part of Publicly Announced Share Repurchase Program	Value of Shares That May Yet Be Purchased Under The Second Program (in thousands)
April 2007		\$	443,439	\$ 6,872
May 2007	10,540	10.09	453,979	6,766
June 2007	77,705	10.40	531,684	Program Ended
Total	88,245	\$ 10.36		

On June 4, 2007, we publicly announced that our Board of Directors approved a new \$10 million stock repurchase program beginning July 1, 2007 and ending June 30, 2008 (the **Third Program**). Under the Third Program, shares may be purchased in such amounts as market conditions warrant, subject to regulatory and other considerations. Purchases under the Third Program may be made from time to time on the open market or in privately negotiated transactions.

In 2006, we commenced a quarterly dividend program, pursuant to which we pay a cash dividend of \$0.03 per share to our stockholders of record on the first trading day of each quarter. As part of this program, our Board of Directors declared a dividend of \$0.03 per share to the stockholders of record as of July 2, 2007, resulting in a total dividend payment on July 16, 2007 of approximately \$1.1 million. The Board of Directors may terminate or modify this dividend program at any time without notice.



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

As of June 30, 2007, we did not have material commitments for capital or operating expenditures other than purchase commitments for customer support and consulting services and 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 and tenant improvement incentives. The excess of expense over current payments is recorded as deferred rent and included in other long-term liabilities. As of June 30, 2007, our known contractual obligations were as follows:

(in millions)	Total	Payment due by period			
		Remainder of 2007	2008 & 2009	2010 & 2011	2012 and after
<b>Contractual obligations:</b>					
Purchase commitments	\$ 1.8	\$ 1.1	\$ 0.7	\$	\$
Operating lease obligations	23.9	2.1	8.3	7.9	5.6
<b>Total</b>	<b>\$ 25.7</b>	<b>\$ 3.2</b>	<b>\$ 9.0</b>	<b>\$ 7.9</b>	<b>\$ 5.6</b>

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

Years ending December 31,	Installment payments for term licenses recorded on the balance sheet	Installment payments for ratable term licenses not recorded on the balance sheet (in millions)
Remainder of 2007	\$ 9.1	\$ 3.0
2008	10.7	7.3
2009	3.4	6.6
2010	2.7	5.8
2011	2.2	3.6
2012 and thereafter	1.3	
<b>Total</b>	<b>\$ 29.4</b>	<b>\$ 26.3</b>

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 \$29.4 million at June 30, 2007 from \$41.9 million at December 31, 2006.

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Our current term license arrangements are presently structured to require revenue to be recognized over the license term as payments become due. Installment payments for these ratable term licenses, which have not yet been recorded as revenue and are not recorded on the balance sheet, increased to \$26.3 million at June 30, 2007 from \$14.2 million at December 31, 2006.

### ***Recently issued accounting pronouncements***

In September 2006, the Financial Accounting Standard Board ( FASB ) issued SFAS No. 157, Fair Value Measurements ( SFAS No. 157 ). SFAS No. 157 defines fair values, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS No. 157 is effective for us beginning on January 1, 2008. We do not expect that adoption of this new standard will have a material effect on our financial position or results of operations.

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In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115*. This Standard allows entities to voluntarily choose, at specified election dates, to measure many financial assets and financial liabilities (as well as certain nonfinancial instruments that are similar to financial instruments) at fair value. The election is made on an instrument-by-instrument basis and is irrevocable. If the fair value option is elected for an instrument, the Statement specifies that all subsequent changes in fair value for that instrument shall be reported in earnings. SFAS No. 159 is effective for us beginning on January 1, 2008. We do not expect that adoption of this new standard will have a material effect on our financial position or results of operations.

In June 2007, the FASB Emerging Issues Task Force ( EITF ) published Issue No. 07-3, *Accounting for Nonrefundable Advance Payments for Goods or Services to Be Used in Future Research and Development Activities*. The EITF reached a consensus that these payments made by an entity to third parties should be deferred and capitalized. Such amounts should be recognized as an expense as the related goods are delivered or the related services are performed. Entities should report the effects of applying this Issue as a change in accounting principle through a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption. EITF Issue No. 07-3 is effective for us beginning on January 1, 2008. Earlier application is not permitted. We do not expect that adoption of this new pronouncement will have a material effect on our financial position or results of operations.

### **Critical accounting policies and estimates**

Management's Discussion and Analysis of Financial Condition and Results of Operations is based upon the condensed consolidated financial statements, 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. The significant accounting policies that we believe are the most critical to aid in fully understanding and evaluating our reported financial results include the following:

Revenue recognition,

Deferred revenue,

Allowance for doubtful accounts and allowance for credit memos,

Stock-based compensation,

Accounting for income taxes, and

Contingencies.

There have been no changes in our critical accounting policies or significant accounting estimates as disclosed in our 2006 Annual Report on Form 10-K other than the implementation of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, (see Note 4 in the Notes to the Unaudited Condensed Consolidated Financial Statements included elsewhere in this Quarterly Report on Form 10-Q). For more information regarding the Company's critical accounting policies, the Company refers the reader to the discussion contained in Item 7 under the heading *Critical Accounting Policies and Estimates* of the Company's Annual Report on Form 10-K for the year ended December 31, 2006, and to Note 6 to the Consolidated Financial Statements for the year ended December 31, 2006, contained within the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

### **Inflation**

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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.

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**Significant customers**

During the second quarter of 2007, no single customer accounted for ten percent or more of our total revenue. During the second quarter of 2006, one customer accounted for 11% of our total revenue. During the first six months of 2007 and 2006, no single customer accounted for ten percent or more of our total revenue.

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

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

*Foreign currency exposure*

We derived approximately 30% of our total revenue in the first six months of 2007 from sales to customers based outside of the United States. Some of our international sales are denominated in foreign currencies, such as the British pound and Euro. The price in United States dollars of products and services sold outside the United States in foreign currencies will vary as the value of the United States dollar fluctuates against those foreign currencies. There can be no assurance that sales denominated in foreign currencies will not be material in the future and that there will not be increases in the value of the United States dollar against such currencies that will reduce the dollar return to us on the sale of our products and services in such foreign currencies. The foreign currency exposure related to revenue is largely offset by the expenses we incur in foreign currencies.

Because most of our transactions with customers are invoiced from our offices in the U.S., and some of those transactions are denominated in currencies other than the U.S. dollar, we have receivables and license installments that are valued in other currencies. In addition, our U.S. operating company holds some cash and investments in currencies other than the U.S. dollar in order to support operations in other countries. When there are changes in the exchange rates for those other currencies versus the U.S. dollar functional currency we recognize a currency gain or (loss) in the statement of operations as other income (expense) related to foreign currency transactions. We had net assets valued in foreign currencies, consisting primarily of cash, investments, license installments, and receivables, partially offset by accounts payable and accruals, with a carrying value of \$25 million as of June 30, 2007. A ten percent change in currency exchange rates would change by approximately \$2 million the carrying value of those net assets as reported on our balance sheet as of June 30, 2007, with most of that change recognized in the statement of operations as other income (expense).

*Interest rate exposure*

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

License installments receivable bear interest at the rate in effect when the license revenue was recognized, which does not vary throughout the life of the contractual cash flow stream. We believe that at current market interest rates, the fair value of license installments receivable approximates the carrying value as reported on our balance sheets. However, there can be no assurance that the fair market value will approximate the carrying value in the future. Factors such as increasing interest rates can reduce the fair market value of the license installments receivable. Changes in market rates do not affect net earnings, as the license installments receivable are carried at cost and, since they are not financial instruments and are held until maturity, are not marked to market to reflect changes in the fair value of the portfolio. The carrying value of \$27 million as of June 30, 2007 reflects the weighted average of historic discount rates used to record each term license arrangement. A two hundred basis point increase in market interest rates would have decreased the fair value of our license installments receivable by approximately \$1 million as of June 30, 2007.

We have invested in fixed rate marketable debt securities. A two hundred basis point increase in market interest rates would have reduced the fair value of our marketable debt securities by approximately \$2 million as of June 30, 2007. 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 4. Controls and Procedures**

(a) *Evaluation of Disclosure Controls and Procedures.* Our management, with the participation of our Chief Executive Officer, or CEO, and Chief Financial Officer, or CFO, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act) as of June 30, 2007. In designing and evaluating our disclosure controls and procedures, our management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives, and our management necessarily applied its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on this evaluation, our CEO and CFO concluded that, as of June 30, 2007, our disclosure controls and procedures were not effective as of that date, due to the material weaknesses in our internal control over financial reporting described below.

The Public Company Accounting Oversight Board defines a material weakness as a significant deficiency, or a combination of significant deficiencies, that results in there being a more than remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

(i) *Accounting for Certain Complex Software Revenue Recognition Transactions.* Management identified a material weakness as of December 31, 2005 related to the ability of the Company's revenue accounting staff to interpret the accounting literature as it related to transactions containing complex and non-standard terms.

(ii) *Accounting for Income Taxes.* Management identified a significant deficiency as of December 31, 2004 related to insufficient technical review and supervision of tax decisions, including various estimates. This significant deficiency had not been remediated as of December 31, 2005, and management therefore declared this deficiency to be a material weakness as of that date and as of December 31, 2006.

(iii) *Accounting for Service Revenue Recognition Transactions.* In September 2005, as part of the normal periodic review by the Securities and Exchange Commission (the "SEC") of public company filings, we began a series of communications with the SEC regarding, among other things, our method of accounting for certain multiple element arrangements that include software, fixed-price services that are not considered essential to the functionality of the other elements of those arrangements, and software maintenance services. As a result of these communications, we concluded that we should revise our method of accounting for these arrangements and for certain other arrangements involving fixed-price services. We also reviewed our accounting for time and materials fees for professional services engagements. We determined that we had not properly recognized revenue earned at the end of each quarter for time and materials services provided but not yet invoiced. We have revised our accounting procedures to correctly record revenue on these services.

As a result of these revisions, we restated our previously issued financial statements and other financial information for the years 2005, 2004 and 2003, financial information for the years 2002 and 2001 and for each of the quarters in the years 2005 and 2004. We also restated our previously issued financial statements and other financial information for the first and second quarters of 2006. In connection with these restatements, management determined that our controls with respect to accounting for arrangements involving professional services were inadequate and ineffective, and, as a result, a material weakness existed.

(iv) *Periodic Financial Close Process.* Management has determined that the Company's controls and procedures relating to the periodic financial close process were inadequate and ineffective as of June 30, 2007. Specifically, management determined that a material weakness existed in the Company's controls and procedures with respect to (a) the timely disposition of required adjustments identified through the period-end account analysis and reconciliation process, (b) the accurate and consistent preparation of all required analyses in accordance with the Company's defined closing process in the appropriate accounting period, and (c) accounting for complex non-routine transactions.

We have been diligently working to remediate these material weaknesses. To address the material weakness described in clause (i) above, we have further improved our protocols for the review of complex transactions and conducted additional training of our revenue recognition staff. To address the material weakness described in clause (ii) above, we have further evaluated and improved our procedures for the review and calculation of our tax provisions. To address the material weakness described in clause (iii) above, we have changed the methods by which we account for such arrangements, and applied these changes retroactively to our previously issued financial statements for the years 2005, 2004 and 2003, and to financial information for the years 2002 and 2001, and to our previously issued financial statements for the first and second quarters of 2006. Our revised methods of accounting for such arrangements are described under *Revenue Recognition in Critical Accounting Policies* in our Annual Report on Form 10-K for 2006. We have also improved the expertise of our staff responsible for revenue recognition with respect to the proper method of accounting for arrangements involving professional services. To address the material weakness described in clause (iv) above, we have reviewed and improved our controls and procedures relating to the periodic financial close process. We believe that the actions described in this paragraph will be effective in remediating the material weaknesses. However, we have not had sufficient time to observe the effectiveness of these actions in operation, and therefore are not yet in a position to conclude that the material weaknesses have been effectively remediated.



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(b) *Changes in Internal Control over Financial Reporting.* No change in internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act) occurred during the fiscal quarter ended June 30, 2007 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**Part II Other Information:**

**Item 1. Legal Proceedings**

Not applicable.

**Item 1A. Risk Factors**

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

***Factors relating to our revenues***

*In recent years, we have typically licensed our software to new customers pursuant to perpetual licenses rather than term licenses, which has the effect of decreasing the amount of future term license renewal revenue and cash flow, and could reduce our overall future license revenue and cash flow if we are unable to increase the future volume of license transactions.* In prior years, we typically licensed our software under term licenses requiring the customer to make monthly payments over the license term. More recently, we have typically been selling perpetual licenses to our software 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.

*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 overall profitability and financial results.

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



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

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

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

*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 and results of operations could be adversely affected.*

**Table of Contents*****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.

*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

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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 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.

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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 our Annual Report on Form 10-K for such year and our independent registered public accounting firm's attestation is included on pages 34 and 35 of our Annual Report on Form 10-K for such year. For the second quarter of 2007, management's assessment concluded that our internal control over financial reporting as of June 30, 2007 was not effective due to certain specified material weaknesses in our internal control over financial reporting, as discussed in Item 4, Controls and Procedures, of this Quarterly Report on Form 10-Q. 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.

**Item 2. Unregistered Sale of Equity Securities and Use of Proceeds**  
None.

**Item 3. Defaults upon Senior Securities**  
Not applicable.

**Item 4. Submission of Matters to a Vote of Security Holders**  
Not applicable.

**Item 5. Other Information**  
None.

**Item 6. Exhibits**

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

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**SIGNATURES**

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

**Pegasystems Inc.**

Date: August 7, 2007

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

Date: August 7, 2007

By: /s/ Craig Dynes  
Craig Dynes  
Senior Vice President, Chief Financial Officer  
(principal financial officer)

Date: August 7, 2007

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

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**PEGASYSTEMS INC.**

Exhibit Index

**Exhibit No. Description**

31.1	Certification pursuant to Exchange Act Rules 13a-14 and 15d-14 of the Chief Executive Officer.
31.2	Certification pursuant to Exchange Act Rules 13a-14 and 15d-14 of the Chief Financial Officer.
32.1	Certification pursuant to 18 U.S.C. Section 1350 of the Chief Executive Officer.
32.2	Certification pursuant to 18 U.S.C. Section 1350 of the Chief Financial Officer.