

PEGASYSTEMS INC
Form 10-Q
August 09, 2011
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(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, 2011

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

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)

(617) 374-9600

(Registrant's telephone number including area code)

04-2787865
(IRS Employer

Identification No.)

02142-1590
(Zip Code)

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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company
(Do not check if smaller reporting company)

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 37,540,861 shares of the Registrant's common stock, \$.01 par value per share, outstanding on July 28, 2011.

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Table of Contents**PEGASYSTEMS INC.****UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS**

(in thousands)

	As of June 30, 2011	As of December 31, 2010
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 66,983	\$ 71,127
Marketable securities	32,634	16,124
Total cash, cash equivalents, and marketable securities	99,617	87,251
Trade accounts receivable, net of allowance of \$1,357 and \$1,159	96,499	79,896
Deferred income taxes	4,811	4,770
Income taxes receivable	12,969	9,266
Other current assets	6,302	7,473
Total current assets	220,198	188,656
Property and equipment, net	11,845	11,010
Long-term deferred income taxes	33,868	33,769
Long-term other assets	2,850	2,905
Intangible assets, net	74,985	80,684
Goodwill	20,451	20,451
Total assets	\$ 364,197	\$ 337,475
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 5,953	6,286
Accrued expenses	23,750	24,736
Accrued compensation and related expenses	25,742	27,125
Deferred revenue	76,028	56,903
Total current liabilities	131,473	115,050
Income taxes payable	6,023	5,783
Long-term deferred revenue	17,407	17,751
Other long-term liabilities	2,625	3,221
Total liabilities	157,528	141,805
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, 1,000 shares authorized; no shares issued and outstanding		
Common stock, 70,000 shares authorized; 37,535 shares and 37,250 shares issued and outstanding	375	372
Additional paid-in capital	127,056	122,607
Retained earnings	76,188	71,431
Accumulated other comprehensive income	3,050	1,260

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Total stockholders' equity		206,669		195,670
Total liabilities and stockholders' equity		\$ 364,197	\$	337,475

See notes to unaudited condensed consolidated financial statements.

Table of Contents**PEGASYSTEMS INC.****UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(in thousands, except per share amounts)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Revenue:				
Software license	\$ 34,645	\$ 28,200	\$ 68,107	\$ 58,543
Maintenance	28,294	20,388	55,742	35,474
Professional services	40,579	33,658	82,029	63,313
Total revenue	103,518	82,246	205,878	157,330
Cost of revenue:				
Cost of software license	1,631	1,109	3,305	1,140
Cost of maintenance	3,260	2,715	6,634	4,652
Cost of professional services	35,506	27,436	70,474	51,904
Total cost of revenue	40,397	31,260	80,413	57,696
Gross profit	63,121	50,986	125,465	99,634
Operating expenses:				
Selling and marketing	37,208	29,896	71,244	51,789
Research and development	15,696	14,010	30,829	25,636
General and administrative	6,839	6,745	13,971	11,804
Acquisition-related costs	144	3,395	482	4,903
Restructuring costs	-	6,080	141	6,080
Total operating expenses	59,887	60,126	116,667	100,212
Income (loss) from operations	3,234	(9,140)	8,798	(578)
Foreign currency transaction gain (loss)	173	(2,542)	1,189	(5,616)
Interest income, net	91	171	177	736
Other (expense) income, net	(167)	1	(139)	242
Income (loss) before provision (benefit) for income taxes	3,331	(11,510)	10,025	(5,216)
Provision (benefit) for income taxes	1,058	(3,322)	3,021	(879)
Net income (loss)	\$ 2,273	\$ (8,188)	\$ 7,004	\$ (4,337)
Net earnings (loss) per share:				
Basic	\$ 0.06	\$ (0.22)	\$ 0.19	\$ (0.12)
Diluted	\$ 0.06	\$ (0.22)	\$ 0.18	\$ (0.12)

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Weighted-average number of common shares outstanding					
Basic	37,405	37,054	37,341	36,966	
Diluted	38,851	37,054	38,828	36,966	
Cash dividends declared per share	\$ 0.03	\$ 0.03	\$ 0.06	\$ 0.06	

See notes to unaudited condensed consolidated financial statements.

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(in thousands)

	Six Months Ended June 30,	
	2011	2010
Operating activities:		
Net income (loss)	\$ 7,004	\$ (4,337)
Adjustment to reconcile net income (loss) to cash provided by (used in) operating activities:		
Excess tax benefits from exercise or vesting of equity awards	(4,011)	(5,529)
Deferred income taxes	(83)	(321)
Depreciation and amortization	8,228	3,686
Stock-based compensation expense	4,400	3,632
Foreign currency transaction (gain) loss	377	4,011
Other	414	707
Change in operating assets and liabilities:		
Trade accounts receivable	(15,790)	(11,756)
Income taxes receivable	(3,703)	(6,651)
Other current assets	5,250	7,046
Accounts payable and accrued expenses	(2,761)	2,970
Deferred revenue	18,395	6,025
Other long-term assets and liabilities	(500)	(5,801)
Cash provided by (used in) operating activities	17,220	(6,318)
Investing activities:		
Purchase of marketable securities	(25,361)	(61,156)
Matured and called marketable securities	7,738	26,280
Sale of marketable securities	1,047	162,242
Payments for 2010 acquisition, net of cash acquired	-	(108,991)
Contingent consideration paid for an acquisition in 2008	-	(250)
Investment in property and equipment	(3,563)	(3,497)
Cash (used in) provided by investing activities	(20,139)	14,628
Financing activities:		
Issuance of common stock for share-based compensation plans	1,707	1,198
Excess tax benefits from exercise or vesting of equity awards	4,011	5,529
Dividend payments to shareholders	(2,238)	(2,216)
Common stock repurchases for tax withholdings for net settlement of equity awards	(3,569)	(4,212)
Common stock repurchases under share repurchase programs	(2,084)	(3,330)
Cash used in financing activities	(2,173)	(3,031)
Effect of exchange rate changes on cash and cash equivalents	948	(6,103)
Net decrease in cash and cash equivalents	(4,144)	(824)

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Cash and cash equivalents, beginning of period	71,127	63,857
Cash and cash equivalents, end of period	\$ 66,983	\$ 63,033

See notes to unaudited condensed consolidated financial statements.

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PEGASYSTEMS INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. ACCOUNTING POLICIES

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 (U.S.) 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, 2010.

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 2011.

During the first quarter of 2011, the Company recorded adjustments to the purchase price allocation of its acquisition of Chordiant. As required by applicable business combination accounting rules, these adjustments were applied retrospectively. Therefore, other current assets, long-term other assets, goodwill, accrued expenses, and deferred tax assets have been revised as of December 31, 2010 to reflect these adjustments. These revisions did not have any impact on the Company s previously reported results of operations or cash flows. See Note 6 Acquisition, Goodwill, and Other Intangible Assets for further discussion of these adjustments.

On June 29, 2011, the Company entered into a lease arrangement for its new office headquarters in Cambridge, Massachusetts. The Company expects to cease the use of its current offices in Cambridge, Massachusetts, by the second quarter of 2012 and abandon certain leasehold improvements and furniture and fixtures. Accordingly, in June 2011 the Company revised the remaining useful lives of these fixed assets and recorded an incremental \$0.2 million of depreciation expense during the second quarter of 2011 as a result of this change in estimate. The Company expects to record approximately \$0.5 million of additional depreciation expense per quarter through the second quarter of 2012. See Note 10 Commitments and Contingencies for further discussion of the new lease terms.

Accounting Standards Not Yet Effective

Presentation of Comprehensive Income: In June 2011, the Financial Accounting Standards Board FASB issued Accounting Standards Update (ASU) No. 2011-05, *Comprehensive Income (Topic 220)* (ASU 2011-05), which (1) eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders equity; (2) requires the consecutive presentation of the statement of net income and other comprehensive income; and (3) requires an entity to present reclassification adjustments on the face of the financial statements from other comprehensive income to net income. The amendments in this ASU do not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income nor do the amendments affect how earnings per share is calculated or presented. This ASU is required to be applied retrospectively and is effective for fiscal years and interim periods within those years beginning after December 15, 2011, which for the Company means fiscal year 2012. The adoption of this standard will not impact the Company s financial position or results of operations as this accounting standard only requires enhanced disclosure.

Disclosure of Supplementary Pro Forma Information for Business Combinations: In December 2010, the FASB issued ASU No. 2010-29, *Disclosure of Supplementary Pro Forma Information for Business Combinations (Topic 805) Business Combinations* (ASU 2010-29), to improve consistency in how the pro forma disclosures are calculated. Additionally, ASU 2010-29 enhances the disclosure requirements and requires description of the nature and amount of any material, nonrecurring pro forma adjustments directly attributable to a business combination. ASU 2010-29 is effective for the Company in fiscal year 2012 and should be applied prospectively to business combinations for which the acquisition date is after the effective date. Early adoption is permitted. The adoption of this standard will not impact the Company s financial position or results of operations as this accounting standard only requires enhanced disclosure.

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Performing Step 2 of the Goodwill Impairment Test: In December 2010, the FASB issued ASU No. 2010-28, *When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts (Topic 350) Intangibles Goodwill and Other* (ASU 2010-28). ASU 2010-28 amends the criteria for performing Step 2 of the goodwill impairment test for reporting units with zero or negative carrying amounts and requires performing Step 2 if qualitative factors indicate that it is more likely than not that a goodwill impairment exists. The Company will adopt ASU 2010-28 in fiscal year 2012 and any impairment to be recorded upon adoption will be recognized as an adjustment to its beginning retained earnings. The Company does not expect the adoption of ASU 2010-28 will have a significant impact on its consolidated financial statements.

2. MARKETABLE SECURITIES

(in thousands)	June 30, 2011			Fair Value
	Amortized Cost	Unrealized Gains	Unrealized Losses	
Marketable securities:				
Municipal bonds	\$ 16,784	31	(13)	\$ 16,802
Government sponsored enterprise bonds	10,003	1	(2)	10,002
Corporate bonds	4,814	17		4,831
Commercial paper	998	1		999
Marketable securities	\$ 32,599	50	(15)	\$ 32,634

(in thousands)	December 31, 2010			Fair Value
	Amortized Cost	Unrealized Gains	Unrealized Losses	
Marketable securities:				
Government sponsored enterprise bonds	\$ 5,601	1	(9)	\$ 5,593
Corporate bonds	5,468		(49)	5,419
Commercial paper	2,999		(1)	2,998
Municipal bonds	2,114			2,114
Marketable securities	\$ 16,182	1	(59)	\$ 16,124

All of the Company's investments are classified as available-for-sale and are carried at fair value with unrealized gains and losses recorded as a component of accumulated other comprehensive income. As of June 30, 2011, remaining maturities of marketable debt securities ranged from July 26, 2011 to November 26, 2014 with a weighted-average remaining maturity of approximately 19 months.

3. DERIVATIVE INSTRUMENTS

During the second quarter of 2011, the Company entered into forward foreign currency contracts to manage its exposure to changes in foreign currency exchange rates associated with its foreign currency denominated accounts receivable and cash. The U.S. operating company invoices most of its foreign customers in foreign currencies, which results in cash and receivables held at the end of the period to be valued in these foreign currencies. Since the U.S. operating company's functional currency is the U.S. dollar, the Company recognizes a foreign currency transaction gain or (loss) on the foreign currency denominated accounts receivable held by the U.S. operating company in its consolidated statements of operations when there are changes in the foreign currency exchange rates versus the U.S. dollar. The Company is primarily exposed to changes in the value of the Euro and British pound relative to the U.S. dollar. The forward foreign currency contracts utilized by the Company are not designated as hedging instruments and as a result, the Company records the fair value of these contracts at the end of each reporting period in its consolidated balance sheet as other current assets for unrealized gains and accrued expenses for unrealized losses, with any fluctuations in the value of these contracts recognized in other income (expense), net, in its consolidated statement of income. However, the fluctuations in the value of these forward foreign currency contracts largely offset the gains and losses from the remeasurement or settlement of the foreign currency denominated accounts receivable and cash held by the U.S. operating company, thus mitigating the volatility. Generally, the Company enters into forward foreign currency contracts with terms of 60 days or less.

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As of June 30, 2011, the Company had forward foreign currency contracts outstanding to sell 6 million British pounds and 7 million Euros and receive \$19.6 million. The fair value of these outstanding forward foreign currency contracts as of June 30, 2011 totaled \$0.1 million, which was recorded in accrued expenses. During the second quarter and first six months of 2011, the change in the fair value of these forward foreign currency contracts recorded in other (expense) income, net, was a loss of \$0.2 million.

The net impact of the losses recorded on the forward foreign currency contracts and the foreign currency transaction gains recorded on the remeasurement and settlement of the foreign currency denominated assets was nearly zero for the second quarter of 2011.

4. FAIR VALUE MEASUREMENTS*Assets Measured at Fair Value on a Recurring Basis*

The Company's assets and liabilities measured at fair value on a recurring basis are classified within the fair value hierarchy as follows:

Level 1 - Quoted prices in active markets for identical assets or liabilities.

Level 2 - Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

The Company's cash equivalents and marketable securities are classified within Level 1 or Level 2 of the fair value hierarchy because they are valued using quoted market prices, or broker dealer quotations and matrix pricing compiled by third party pricing vendors, respectively. The Company's marketable securities and forward foreign currency contracts are valued based on a market approach in which all significant inputs are observable or can be derived from or corroborated by observable market data such as interest rates, yield curves, and credit risk.

Assets and liabilities measured at fair value on a recurring basis were as follows:

(in thousands)	June 30, 2011	Fair Value Measurements at Reporting Date Using	
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
ASSETS			
Money market funds	\$ 8,227	\$ 8,227	\$
Marketable securities:			
Municipal bonds	\$ 16,802	\$ 7,528	\$ 9,274
Government sponsored enterprise bonds	10,002		10,002
Corporate bonds	4,831	4,831	
Commercial paper	999		999
Total marketable securities	\$ 32,634	\$ 12,359	\$ 20,275
LIABILITIES			
Forward foreign currency contracts	\$ 120	\$	\$ 120

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(in thousands)	December 31, 2010	Fair Value Measurements at Reporting Date Using	
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Money market funds	\$ 14,342	\$ 14,342	\$
Marketable securities:			
Government sponsored enterprise bonds	\$ 5,593	\$ -	\$ 5,593
Corporate bonds	5,419	5,419	
Commercial paper	2,998		2,998
Municipal bonds	2,114		2,114
Total marketable securities	\$ 16,124	\$ 5,419	\$ 10,705

Assets Measured at Fair Value on a Nonrecurring Basis

Assets not recorded at fair value on a recurring basis, such as property and equipment and intangible assets, are recognized at fair value when they are impaired. During the first six months of 2011 and 2010, the Company did not recognize any nonrecurring fair value measurements from impairments. The Company recorded assets acquired and liabilities assumed related to its acquisition of Chordiant at fair value as described in Note 6 Acquisition, Goodwill, and Other Intangible Assets.

5. TRADE ACCOUNTS RECEIVABLE, NET OF ALLOWANCES

(in thousands)	June 30, 2011	December 31, 2010
Trade accounts receivable	\$ 75,742	\$ 65,373
Unbilled accounts receivable	22,114	15,682
Total accounts receivable	97,856	81,055
Allowance for doubtful accounts	(136)	(132)
Allowance for sales credit memos	(1,221)	(1,027)
Total allowance	(1,357)	(1,159)
	\$ 96,499	\$ 79,896

Unbilled trade accounts receivable relate to services earned under time and material arrangements and maintenance and license arrangements that had not been invoiced as of June 30, 2011 and December 31, 2010, respectively.

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On April 21, 2010, the Company acquired all of the outstanding shares of common stock of Chordiant, a leading provider of customer relationship management (CRM) software and services with a focus on improving customer experiences through decision technology for approximately \$160.3 million in cash and the issuance of stock options.

The operations of Chordiant were included in the Company's operating results from the date of acquisition. Due to the rapid integration of the products, sales force, and operations of Chordiant, it is no longer feasible for the Company to identify revenue from new arrangements attributable to Chordiant.

During the first quarter of 2011, the Company recorded adjustments to the purchase price allocation to reflect the Company's final determination of other accrued liabilities, acquired tax assets and uncertain tax liabilities. As a result of this determination, the Company recorded a \$1.8 million decrease to other accrued liabilities, a \$0.4 million increase to net deferred tax assets, and a corresponding \$2.2 million decrease to goodwill. These purchase price adjustments were also reflected retrospectively as of December 31, 2010 in the accompanying condensed consolidated balance sheet as required by the business combination accounting rules.

Pro forma Information

The following pro forma financial information presents the combined results of operations of the Company and Chordiant as if the acquisition had occurred on January 1, 2009 after giving effect to certain pro forma adjustments. The pro forma adjustments reflected herein include only those adjustments that are directly attributable to the Chordiant acquisition, factually determinable, and expected to have a continuing impact on the Company. These pro forma adjustments include a reduction of historical Chordiant revenue for fair value adjustments related to acquired deferred revenue and elimination of deferred costs associated with revenue, a net increase in amortization expense to eliminate historical amortization of Chordiant intangible assets and to record amortization expense for the \$88 million of acquired identifiable intangibles. The pro forma financial information does not reflect any adjustments for anticipated synergies resulting from the acquisition and is not necessarily indicative of the operating results that would have actually occurred had the transaction been consummated as of January 1, 2009.

	Pro Forma Three Months Ended June 30,	Pro Forma Six Months Ended June 30,
	2010	2010
Revenue	\$ 85,524	\$ 176,164
Net loss	(16,858)	(20,336)
Net loss per basic and diluted share	\$ (0.45)	\$ (0.55)

Goodwill and Intangibles

The Company operates in one operating segment, business process solutions, for which discrete financial information is available and its performance is evaluated regularly by the Company's CEO, who is the Company's chief operating decision maker, or CODM. The Company has one reporting unit, the fair value of which is evaluated annually to determine whether goodwill is impaired.

The purchase price adjustments related to the Chordiant acquisition identified during the first quarter of 2011 were retrospectively applied as of December 31, 2010. There were no other changes in the carrying amount of goodwill during the first or second quarter of 2011.

(in thousands)	2011
Balance as of January 1,	\$ 22,618

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Purchase price adjustments to goodwill retrospectively applied	(2,167)
Revised balance as of January 1, and June 30,	\$ 20,451

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Intangible assets are recorded at cost and are amortized using the straight-line method over their estimated useful life, which range from one to nine years.

(Dollars in thousands)	Amortization		Accumulated		Net Book Value
	Period (Years)	Cost	Amortization		
As of June 30, 2011					
Customer related intangibles	9	\$ 44,355	\$ (5,750)	\$ 38,605	
Technology	8	43,446	(7,189)	36,257	
Trade name	1	248	(248)		
Technology designs	4	490	(402)	88	
Non-compete agreements	5	100	(65)	35	
Intellectual property	4	1,400	(1,400)		
Total		\$ 90,039	\$ (15,054)	\$ 74,985	

(Dollars in thousands)	Amortization		Accumulated		Net Book Value
	Period (Years)	Cost	Amortization		
As of December 31, 2010					
Customer related intangibles	9	\$ 44,355	\$ (3,286)	\$ 41,069	
Technology	8	43,446	(4,108)	39,338	
Trade name	1	248	(165)	83	
Technology designs	4	490	(340)	150	
Non-compete agreements	5	100	(56)	44	
Intellectual property	4	1,400	(1,400)		
Total		\$ 90,039	\$ (9,355)	\$ 80,684	

For the second quarter and first six months of 2011 and 2010, amortization of intangibles was reflected in the Company's unaudited condensed consolidated statements of operations as follows:

(in thousands)	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2011	2010	2011	2010
Cost of software license	\$1,571	\$ 1,079	\$3,142	\$ 1,110
Selling and marketing	1,232	847	2,464	847
General and administrative	26	46	93	51
Total amortization expense	\$2,829	\$1,972	\$5,699	\$2,008

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(in thousands)	Future estimated amortization expense
As of June 30,	
Remainder of 2011	\$ 5,616
2012	11,137
2013	11,095
2014	9,489
2015	8,688
2016 and thereafter	28,960
	\$ 74,985

7. ACCRUED EXPENSES

(in thousands)	June 30, 2011	December 31, 2010
Other taxes	\$ 3,650	\$ 2,971
Restructuring	1,548	3,671
Professional fees	1,048	1,615
Income taxes	2,590	1,201
Professional services partners fees	1,421	1,498
Short-term deferred rent	1,405	1,272
Self-insurance health and dental claims	991	1,635
Dividends payable	1,127	1,118
Employee reimbursable expenses	921	575
Other	9,049	9,180
	\$ 23,750	\$ 24,736

8. DEFERRED REVENUE

(in thousands)	June 30, 2011	December 31, 2010
Software license	\$ 14,113	\$ 7,617
Maintenance	55,884	43,594
Professional services and other	6,031	5,692
Current deferred revenue	76,028	56,903
Software license	16,820	15,833
Maintenance and professional services	587	1,918
Long-term deferred revenue	17,407	17,751
	\$ 93,435	\$ 74,654

9. ACCRUED RESTRUCTURING COSTS

During 2010, in connection with the Company's integration plan of Chordiant, the Company recorded \$6.5 million of severance and related benefit costs for the reduction of approximately 50 personnel in redundant roles. These personnel were primarily in general and administrative functions and their employment ended by the third quarter of 2010. The severance and related benefit costs will be paid by the end of the second quarter of 2012.

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In connection with the Company's evaluation of its combined facilities, the Company approved a plan to exit space within one facility. The Company ceased use of this space during the fourth quarter of 2010 and recognized \$1.6 million of restructuring expenses, representing future lease payments and demising costs, net of estimated sublease income for this space. The lease expires at the end of 2013. During the first quarter of 2011, the Company incurred an additional \$0.1 million of exit costs related to the elimination of this space.

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A summary of the restructuring activity during the first six months of 2011 is as follows:

(in thousands)	Personnel	Facilities	Total
Balance as of December 31, 2010	\$ 2,752	\$ 2,117	\$ 4,869
Restructuring costs	-	141	141
Cash payments	(1,769)	(980)	(2,749)
Balance as of June 30, 2011	\$ 983	\$ 1,278	\$ 2,261

(in thousands)	June 30, 2011	December 31, 2010
Reported as:		
Accrued expenses	\$ 1,548	\$ 3,671
Other long-term liabilities	713	1,198
	\$ 2,261	\$ 4,869

10. COMMITMENTS AND CONTINGENCIES*Yue vs. Chordiant Software, Inc.*

On January 2, 2008, Chordiant and certain of its officers and one other employee were named in a complaint filed in the United States District Court for the Northern District of California (the Court) by Dongxiao Yue under the caption Dongxiao Yue (Plaintiff) v. Chordiant Software, Inc. et al. Case No. CV 08-0019 (N.D. Cal.). The complaint alleged that Chordiant's Marketing Director (CMD) software product infringed copyrights in certain software marketed by Netbula LLC.

On August 17, 2010, the Plaintiff filed an additional complaint with the Court against a number of Chordiant customers and partners, alleging that their use of CMD infringed the same copyrights at issue in the complaint filed against Chordiant. In accordance with the terms of Chordiant's contracts with these customers and partners, the Company agreed to indemnify and defend these customers and partners in this matter.

On April 8, 2011, the Company and the Plaintiff agreed to a settlement and mutual release of all claims against Chordiant and its customers and partners that existed at the date of acquisition. The Company recorded its best estimate, and subsequent settlement, of this assumed liability as part of the purchase price allocation. In April 2011, the Company paid the settlement amount.

The Company is a party in various other contractual disputes, litigation and potential claims arising in the ordinary course of business. Currently, the Company does not believe that the resolution of these matters will have a material adverse effect on its financial position or results of operations.

Operating Leases

On June 29, 2011, the Company entered into a lease arrangement for the Company's new office headquarters in Cambridge, Massachusetts. The lease arrangement commences on July 1, 2011 and terminates on December 31, 2023, subject to two 5-year extension options. The Company's lease for its current offices in Cambridge, Massachusetts is scheduled to expire on May 31, 2013. The Company will continue to pay its monthly rent through the remaining term of the current lease. The new lease arrangement provides the Company with a rent-free period for the remaining term of the current lease, for the same amount of space covered by the current lease. The future rental payments due under the new lease total \$75.8 million.

Table of Contents**11. COMPREHENSIVE INCOME**

Comprehensive income includes the Company's net income plus the results of certain stockholders' equity changes not reflected in the unaudited condensed consolidated statements of income. The components of comprehensive income are as follows:

(in thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Net income (loss)	\$ 2,273	\$ (8,188)	\$ 7,004	\$ (4,337)
Other comprehensive income (loss):				
Unrealized gain (loss) on securities, net of tax	42	(3)	26	(541)
Foreign currency translation adjustments	476	(1,114)	1,764	(1,447)
Comprehensive income (loss)	\$ 2,791	\$ (9,305)	\$ 8,794	\$ (6,325)

12. STOCK-BASED COMPENSATION

For the second quarter and first six months of 2011 and 2010, stock-based compensation expense was reflected in the Company's unaudited condensed consolidated statements of income as follows:

(in thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Cost of services	\$ 553	\$ 483	\$ 1,350	\$ 881
Operating expenses	1,312	1,703	3,050	2,751
Total stock-based compensation before tax	\$ 1,865	\$ 2,186	\$ 4,400	\$ 3,632
Income tax benefit	(613)	(578)	(1,499)	(1,091)

During the first six months of 2011, the Company issued approximately 332,000 shares to its employees under the Company's share-based compensation plans.

During the first six months of 2011, the Company granted approximately 107,000 restricted stock units (RSUs) with a total fair value of \$3.6 million. Approximately 52,000 of these RSUs were granted in connection with the election by employees to receive 50% of their 2011 target incentive compensation under the Company's Corporate Incentive Compensation Plan (the CICP) in the form of RSUs instead of cash. The total stock-based compensation of approximately \$1.6 million associated with these RSUs will be recognized over one year.

As of June 30, 2011, the Company had approximately \$9.1 million of unrecognized stock-based compensation expense, net of estimated forfeitures, related to all unvested RSUs and unvested stock options that is expected to be recognized over a weighted-average period of 2.1 years.

Table of Contents**13. NET EARNINGS (LOSS) PER SHARE**

Basic earnings per share is computed using the weighted-average number of common shares outstanding during the period. Diluted earnings per share is computed using the weighted-average number of common shares outstanding during the period, plus the dilutive effect of outstanding options, RSUs, and warrants, using the treasury stock method and the average market price of our common stock during the applicable period. Certain shares related to some of our outstanding stock options and RSUs were excluded from the computation of diluted earnings per share because they were antidilutive in the periods presented, but could be dilutive in the future.

<i>(in thousands, except per share amounts)</i>	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Basic				
Net income (loss)	\$ 2,273	\$ (8,188)	\$ 7,004	\$ (4,337)
Weighted-average common shares outstanding	37,405	37,054	37,341	36,966
Net earnings (loss) per share, basic	\$ 0.06	\$ (0.22)	\$ 0.19	\$ (0.12)
Diluted				
Net income (loss)	\$ 2,273	\$ (8,188)	\$ 7,004	\$ (4,337)
Weighted-average common shares outstanding, basic	37,405	37,054	37,341	36,966
Weighted-average effect of dilutive securities:				
Stock options	1,201	-	1,241	-
RSUs	242	-	242	-
Warrants	3	-	4	-
Effect of assumed exercise of stock options, warrants and				
RSUs	1,446	-	1,487	-
Weighted-average common shares outstanding, diluted	38,851	37,054	38,828	36,966
Net earnings (loss) per share, diluted	\$ 0.06	\$ (0.22)	\$ 0.18	\$ (0.12)
Outstanding options and RSUs excluded as impact would be antidilutive	31	2,960	27	3,041

14. GEOGRAPHIC INFORMATION AND MAJOR CUSTOMERS

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the CODM in deciding how to allocate resources and in assessing performance.

The Company develops and licenses its rules-based software solutions and provides professional services, maintenance, and training related to its software. The Company derives substantially all of its revenue from the sale and support of one group of similar products and services

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software that provides business process solutions in the enterprise applications market. To assess performance, the Company's CODM primarily reviews financial information on a consolidated basis. Therefore, the Company has determined it operates in one segment - business process solutions.

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The Company's international revenue is from sales to customers based outside of the U.S. The Company derived its revenue from the following geographic areas:

<i>(Dollars in thousands)</i>	Three Months Ended				Six Months Ended			
	June 30,		June 30,		June 30,		June 30,	
	2011	2010	2011	2010	2011	2010	2011	2010
U.S.	\$ 59,411	57%	\$ 48,205	59%	\$ 111,323	54%	\$ 96,282	61%
United Kingdom	22,738	22%	12,156	15%	42,633	21%	22,811	15%
Europe, other	10,956	11%	9,246	11%	31,453	15%	22,289	14%
Other	10,413	10%	12,639	15%	20,469	10%	15,948	10%
	\$ 103,518	100%	\$ 82,246	100%	\$ 205,878	100%	\$ 157,330	100%

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," "could," "estimate," "may," "target," "project," 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 encourage you to carefully review the risk factors we have identified in Item 1A of Part I of our Annual Report on Form 10-K for the year ended December 31, 2010. We believe these risk factors, among other factors, 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, market, license, and support software to automate complex, changing business processes. Our software enables organizations to build, deploy, and change enterprise applications easily and quickly by directly capturing business objectives, automating programming, and automating work. Our software is used to build a wide range of business process solutions including customer on-boarding and account opening, customer relationship management (CRM), exception and case management, and risk/fraud and compliance management. We also provide professional services, maintenance, and training related to our software.

We focus our sales efforts on target accounts, which are large companies or divisions within companies, and typically leaders in their industry. Our strategy is to sell initial licenses that are focused on a specific purpose or area of operations, rather than selling large enterprise licenses. Once a customer has realized the value of our software, we work with the customer to identify opportunities for follow-on sales.

Our license revenue is primarily derived from sales of our PegaRULES Process Commander (PRPC) software and related solution frameworks. PRPC is a comprehensive platform for building and managing BPM applications that unifies business rules and business processes. Our solution frameworks, built on the capabilities of PRPC, are purpose or industry-specific collections of best practice functionality, which allow organizations to quickly implement new customer-facing practices and processes, bring new offerings to market, and provide customized or specialized processing. These products often result in shorter implementation periods than competitive enterprise software products. PRPC and related solution frameworks can be used by a broad range of customers within financial services, insurance and healthcare markets, as well as other markets, such as communications and government.

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As a result of our acquisition of Chordiant in April 2010, we expanded our ability to develop and license CRM software. We acquired several additional products including Chordiant Decision Management that allow customers to maximize lifetime value through improving customer experiences, providing better cross-sell/up-sell abilities, and aiding customer retention. We intend to remain a leader in the use of decision management.

We also offer Pega Cloud, which is our cloud computing service offering that allows customers to create and run PRPC applications using an internet-based infrastructure. This offering enables our customers to immediately build, test, and deploy their applications in a secure cloud environment while minimizing their infrastructure and hardware costs. Revenue from our Pega Cloud offering is included in consulting services revenue.

Our revenue increased 26% during the second quarter of 2011 compared to the second quarter of 2010 and reflects significant growth in each of software license, maintenance and professional services revenue. Our revenue increased 31% during the first six months of 2011 compared to the first six months of 2010 primarily because of the increase in maintenance revenues and professional services revenues. Maintenance revenue increased 39% during the second quarter of 2011 and 57% during the first six months of 2011 due to the increase in the aggregate value of the installed base of our software and license arrangements executed by Chordiant prior to the acquisition. Due to the rapid integration of the products, sales force, and operations of Chordiant, it is no longer feasible to separately identify revenue from new arrangements as being attributable to either Chordiant or Pegasystems. We generated approximately \$17.2 million in cash from operations in the first six months of 2011 and ended the quarter with approximately \$99.6 million in cash, cash equivalents, and marketable securities.

We believe our growth in the first six months of 2011 was primarily due to:

Increased demand for our industry leading software solutions and services;

Expansion of our solutions frameworks offerings; and

Expansion of our customer base through sales to new customers.

We believe that the ongoing challenges for our business include our ability to drive revenue growth, expand our expertise in new and existing industries, remain a leader in the decision management market, and maintain our leadership position in the BPM market.

Critical accounting policies

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 of America (U.S. GAAP) and the rules and regulations of the SEC for interim financial reporting. 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.

There have been no changes in our critical accounting policies as disclosed in our Annual Report on Form 10-K for the year ended December 31, 2010. For more information regarding our critical accounting policies, we encourage you to read the discussion contained in Item 7 under the heading Critical Accounting Policies and Estimates and Note 2. Significant Accounting Policies included in the notes to the Consolidated Financial Statements contained in our Annual Report on Form 10-K for the year ended December 31, 2010.

Table of Contents**Results of Operations**

<i>(Dollars in thousands)</i>	Three Months Ended June 30,		Increase (Decrease)		Six Months Ended June 30,		Increase (Decrease)	
	2011	2010			2011	2010		
Total revenue	\$103,518	\$82,246	\$21,272	26%	\$205,878	\$157,330	\$48,548	31%
Gross profit	\$63,121	\$50,986	\$12,135	24%	\$125,465	\$99,634	\$25,831	26%
Acquisition-related costs	\$144	\$3,395	\$(3,251)	(96)%	\$482	\$4,903	\$(4,421)	(90)%
Restructuring costs	-	\$6,080	\$(6,080)	(100)%	\$141	\$6,080	\$(5,939)	(98)%
Other operating expenses	\$59,743	\$50,651	\$9,092	18%	\$116,044	\$89,229	\$26,815	30%
Total operating expenses	\$59,887	\$60,126	\$(239)	-%	\$116,667	\$100,212	\$16,455	16%
Income (loss) from operations	\$3,234	\$(9,140)	\$12,374	135%	\$8,798	\$(578)	\$9,376	n/m
Income (loss) before provision for income taxes	\$3,331	\$(11,510)	\$14,841	129%	\$10,025	\$(5,216)	\$15,241	292%

n/m-not meaningful

We continue to experience an increase in demand for our software products and related services, which we believe is due to the strong value proposition, short implementation period, and variety of licensing models we offer our customers. During the first half of 2011, we executed a significantly higher value of license arrangements compared to the same period in 2010.

The increases in gross profit were primarily due to the increases in maintenance and license revenues.

During the second quarter of 2011, our operating expenses were approximately the same in total compared to the second quarter of 2010, as the increases in selling and marketing expenses and research and development expenses were offset by the decreases in acquisition-related and restructuring costs incurred in 2010. The increase in total operating expenses during the first six months of 2011 compared to the first six months of 2010 was primarily due to the increases in selling and marketing expenses associated with higher headcount and higher sales commissions due to the significant increase in the value of license arrangements executed.

The increases in income from operations were primarily due to the increases in gross profit.

The increases in income before provision for income taxes were primarily due to the increases in gross profit and foreign currency transaction gains recorded in 2011 compared to foreign currency transaction losses recorded in 2010.

Revenue

<i>(Dollars in thousands)</i>	Three Months Ended June 30,		Increase (Decrease)		Six Months Ended June 30,		Increase (Decrease)					
	2011	2010			2011	2010						
License revenue												
Perpetual licenses	\$20,710	60%	\$16,104	57%	\$4,606	29%	\$44,281	65%	\$33,108	56%	\$11,173	34%
Term licenses	6,927	20%	7,641	27%	(714)	(9)%	16,818	25%	18,561	32%	(1,743)	(9)%
Subscription	7,008	20%	4,455	16%	2,553	57%	7,008	10%	6,874	12%	134	2%
Total license revenue	\$34,645	100%	\$28,200	100%	\$6,445	23%	\$68,107	100%	\$58,543	100%	\$9,564	16%