PEGASYSTEMS INC
Form 10-Q
November 09, 2011
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x **Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended September 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)

Massachusetts	**04-2787865**
(State or other jurisdiction of	***(IRS Employer***
incorporation or organization)	***Identification No.)***
101 Main Street Cambridge, MA	**02142-1590**
(Address of principal executive offices)	***(Zip Code)***

(617) 374-9600

(Registrant s telephone number including area 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 x 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 x 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 x	Non-accelerated filer ¨ (Do not check if smaller reporting company)	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 x

There were 37,688,744 shares of the Registrant s common stock, $.01 par value per share, outstanding on October 27, 2011.

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PEGASYSTEMS INC.

UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands)

	As of September 30, 2011	As of December 31, 2010
ASSETS		
Current assets:		
Cash and cash equivalents	$ 51,603	$ 71,127
Marketable securities	46,671	16,124
Total cash, cash equivalents, and marketable securities	98,274	87,251
Trade accounts receivable, net of allowance of $1,153 and $1,159	79,121	79,896
Deferred income taxes	4,820	4,770
Income taxes receivable	21,272	9,266
Other current assets	7,680	7,473
Total current assets	211,167	188,656
Property and equipment, net	11,601	11,010
Long-term deferred income taxes	32,673	33,769
Long-term other assets	1,991	2,905
Intangible assets, net	72,177	80,684
Goodwill	20,451	20,451
Total assets	$ 350,060	$ 337,475
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 6,001	6,286
Accrued expenses	19,959	24,736
Accrued compensation and related expenses	23,243	27,125
Deferred revenue	67,316	56,903
Total current liabilities	116,519	115,050
Income taxes payable	2,380	5,783
Long-term deferred revenue	15,722	17,751
Other long-term liabilities	3,674	3,221
Total liabilities	138,295	141,805
Commitments and contingencies		
Stockholders equity:		
Preferred stock, 1,000 shares authorized; no shares issued and outstanding		
Common stock, 70,000 shares authorized; 37,681 shares and 37,250 shares issued and outstanding	377	372
Additional paid-in capital	129,050	122,607
Retained earnings	80,016	71,431
Accumulated other comprehensive income	2,322	1,260

Total stockholders equity		211,765		195,670
Total liabilities and stockholders equity	$	350,060	$	337,475

See notes to unaudited condensed consolidated financial statements.

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PEGASYSTEMS INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share amounts)

	Three Months Ended September 30, 2011	Three Months Ended September 30, 2010	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
Revenue:				
Software license	$ 25,346	$ 33,889	$ 93,453	$ 92,432
Maintenance	29,971	23,418	85,713	58,892
Professional services	40,186	32,709	122,215	96,022
Total revenue	95,503	90,016	301,381	247,346
Cost of revenue:				
Cost of software license	1,637	1,571	4,942	2,711
Cost of maintenance	2,980	3,187	9,614	7,839
Cost of professional services	37,194	30,232	107,668	82,136
Total cost of revenue	41,811	34,990	122,224	92,686
Gross profit	53,692	55,026	179,157	154,660
Operating expenses:				
Selling and marketing	32,463	31,199	103,707	82,988
Research and development	16,218	14,924	47,047	40,560
General and administrative	7,222	6,442	21,193	18,246
Acquisition-related costs	-	111	482	5,014
Restructuring costs	(203)	407	(62)	6,487
Total operating expenses	55,700	53,083	172,367	153,295
(Loss) income from operations	(2,008)	1,943	6,790	1,365
Foreign currency transaction (loss) gain	(1,049)	1,513	140	(4,103)
Interest income, net	102	180	279	916
Other income, net	504	572	365	814
(Loss) income before (benefit) provision for income taxes	(2,451)	4,208	7,574	(1,008)
(Benefit) provision for income taxes	(7,410)	1,069	(4,389)	190
Net income (loss)	$ 4,959	$ 3,139	$ 11,963	$ (1,198)
Earnings (loss) per share:				
Basic	$ 0.13	$ 0.08	$ 0.32	$ (0.03)
Diluted	$ 0.13	$ 0.08	$ 0.31	$ (0.03)

Weighted-average number of common shares outstanding								
Basic		37,588		36,996		37,425		37,008
Diluted		38,930		38,534		38,864		37,008
Cash dividends declared per share	$	0.03	$	0.03	$	0.09	$	0.09

See notes to unaudited condensed consolidated financial statements.

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PEGASYSTEMS INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
Operating activities:		
Net income (loss)	$ 11,963	$ (1,198)
Adjustment to reconcile net income (loss) to cash provided by (used in) operating activities:		
Excess tax benefits from exercise or vesting of equity awards	(6,628)	(5,456)
Deferred income taxes	1,092	(2,088)
Depreciation and amortization	12,648	6,968
Stock-based compensation expense	6,722	5,213
Foreign currency transaction loss	624	3,775
Other	528	716
Change in operating assets and liabilities:		
Trade accounts receivable	2,264	(20,076)
Income taxes receivable	(12,006)	(6,772)
Other current assets	7,103	4,750
Accounts payable and accrued expenses	(8,983)	4,971
Deferred revenue	8,250	(281)
Other long-term assets and liabilities	(3,930)	(28)
Cash provided by (used in) operating activities	19,647	(9,506)
Investing activities:		
Purchase of marketable securities	(49,689)	(67,228)
Matured and called marketable securities	14,738	27,280
Sale of marketable securities	4,048	162,226
Payments for 2010 acquisition, net of cash acquired	-	(109,228)
Contingent consideration paid for an acquisition in 2008	-	(250)
Investment in property and equipment	(5,108)	(4,075)
Cash (used in) provided by investing activities	(36,011)	8,725
Financing activities:		
Issuance of common stock for share-based compensation plans	2,164	1,546
Excess tax benefits from exercise or vesting of equity awards	6,628	5,456
Dividend payments to shareholders	(3,365)	(3,330)
Common stock repurchases for tax withholdings for net settlement of equity awards	(5,488)	(4,493)
Common stock repurchases under share repurchase programs	(3,460)	(6,098)
Cash used in financing activities	(3,521)	(6,919)
Effect of exchange rate changes on cash and cash equivalents	361	(3,380)

Net decrease in cash and cash equivalents		(19,524)		(11,080)
Cash and cash equivalents, beginning of period		71,127		63,857
Cash and cash equivalents, end of period	$	51,603	$	52,777

See notes to unaudited condensed consolidated financial statements.

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 incremental depreciation expense of $0.4 million and $0.6 million during the third quarter and first nine months of 2011, respectively, as a result of this change in estimate. The Company expects to record approximately $0.4 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

Testing Goodwill for Impairment: In September 2011, the Financial Accounting Standards Board FASB issued Accounting Standards Update (ASU) No. 2011-08, *Intangibles-Goodwill and Other (Topic 350) (ASU 2011-08)*, which allows an entity to first assess qualitative factors to determine whether it is necessary to perform the two-step quantitative goodwill impairment test. Previous guidance under Topic 350 required an entity to test goodwill for impairment, on at least an annual basis, by comparing the fair value of a reporting unit with its carrying amount, including goodwill (step one). If the fair value of a reporting unit is less than its carrying amount, then the second step of the test must be performed to measure the amount of the impairment loss, if any. Under the amendments in ASU 2011-08, an entity is not required to calculate the fair value of a reporting unit unless the entity determines, based on a qualitative assessment, that it is more likely than not that its fair value is less than its carrying amount. The amendments are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption is permitted, including for annual and interim goodwill impairment tests performed as of a date before September 15, 2011, if an entity s financial statements for the most recent annual or interim period have not yet been issued or, for nonpublic entities, have not yet been made available for issuance. ASU 2011-08 is effective for the Company in fiscal year 2012. The Company does not expect the adoption of this standard will have a significant impact on its consolidated financial statements.

Presentation of Comprehensive Income: In June 2011, the FASB issued 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.

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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.

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

	$46,696	$46,696	$46,696	$46,696
(in thousands)	**September 30, 2011**			
	Amortized Cost	**Unrealized Gains**	**Unrealized Losses**	**Fair Value**
Marketable securities:				
Municipal bonds	$ 24,166	55	(5)	$ 24,216
Corporate bonds	15,132	7	(71)	15,068
Government sponsored enterprise bonds	6,097		(11)	6,086
Commercial paper	1,000			1,000
Certificates of deposit	301			301
Marketable securities	$ 46,696	62	(87)	$ 46,671

(in thousands)	**December 31, 2010**			
	Amortized Cost	**Unrealized Gains**	**Unrealized Losses**	**Fair Value**
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, net of tax. As of September 30, 2011, remaining maturities of marketable debt securities ranged from October 14, 2011 to November 14, 2014 with a weighted-average remaining maturity of approximately 17 months.

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3. DERIVATIVE INSTRUMENTS

Beginning in the second quarter of 2011, the Company enters 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 reporting period denominated 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 cash and 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, net, in its consolidated statement of operations. However, the fluctuations in the value of these forward foreign currency contracts partially 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.

During the third quarter of 2011, the Company entered into and settled forward foreign currency contracts to sell 5.5 million Euros and 4.5 million British pounds and received $15.1 million. The Company also settled the forward foreign currency contracts outstanding as of June 30, 2011 to sell 6 million British pounds and 7 million Euros and received $19.6 million. As of September 30, 2011, the Company did not have any forward foreign currency contracts outstanding. During the third quarter and first nine months of 2011, the change in the fair value of the Company s forward foreign currency contracts recorded in other income, net, was a gain of $0.5 million and $0.3 million, respectively.

The net impact on net income of the gains recorded on the forward foreign currency contracts, which is included in other income, net, in the accompanying consolidated statements of operations, and the foreign currency transaction losses recorded on the remeasurement and settlement of the foreign currency denominated assets, which is included in foreign currency transaction (loss) gain in the accompanying consolidated statements of operations, was a net loss of approximately $0.5 million for both the third quarter of 2011 and six months ended September 30, 2011. This net loss was primarily due to the change in the value of the Company s Australian dollar denominated accounts receivable during the third quarter of 2011, for which the Company did not have an Australian forward currency contract. The Company did not enter into any forward foreign currency contracts in the first 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.

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

(in thousands)	September 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)
Cash equivalents	$ 12,345	$ 10,845	$ 1,500
Marketable securities:			
Municipal bonds	$ 24,216	$ 8,618	$ 15,598
Corporate bonds	15,068	15,068	
Government sponsored enterprise bonds	6,086	4,090	1,996
Commercial paper	1,000		1,000
Certificates of deposit	301		301
Total marketable securities	$ 46,671	$ 27,776	$ 18,895

(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 nine 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.

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5. TRADE ACCOUNTS RECEIVABLE, NET OF ALLOWANCES

(in thousands)	September 30, 2011	December 31, 2010
Trade accounts receivable	$ 60,332	$ 65,373
Unbilled accounts receivable	19,942	15,682
Total accounts receivable	80,274	81,055
Allowance for doubtful accounts	(101)	(132)
Allowance for sales credit memos	(1,052)	(1,027)
Total allowance	(1,153)	(1,159)
	$ 79,121	$ 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 September 30, 2011 and December 31, 2010, respectively.

6. ACQUISITION, GOODWILL, AND OTHER INTANGIBLE ASSETS

Chordiant Acquisition

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.

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.

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	Pro Forma Nine Months Ended September 30, 2010
Revenue	$ 266,180
Net loss	$ (17,197)
Net loss per basic and diluted share	$ (0.46)

Goodwill and Intangibles

As discussed in Note 15   Geographic Information and Major Customers , the Company operates in one operating segment, business process solutions. 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 nine months of 2011.

(in thousands)	2011
Balance as of January 1,	$ 22,618
Purchase price adjustments to goodwill retrospectively applied	(2,167)
Revised balance as of January 1, and September 30,	$ 20,451

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 Period (Years)	Cost	Accumulated Amortization	Net Book Value
As of September 30, 2011				
Customer related intangibles	9	$ 44,355	$ (6,982)	$ 37,373
Technology	8	43,446	(8,729)	34,717
Trade name	1	248	(248)	
Technology designs	4	490	(433)	57
Non-compete agreements	5	100	(70)	30
Intellectual property	4	1,400	(1,400)	
Total		$ 90,039	$ (17,862)	$ 72,177

	Amortization Period (Years)	Cost	Accumulated Amortization	Net Book Value
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

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For the third quarter and first nine 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 September 30, 2011	Three Months Ended September 30, 2010	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
Cost of software license	$ 1,571	$ 1,550	$ 4,713	$ 2,660
Selling and marketing	1,232	1,206	3,696	2,053
General and administrative	5	67	98	118
Total amortization expense	$ 2,808	$ 2,823	$ 8,507	$ 4,831

(in thousands) As of September 30,	Future estimated amortization expense
Remainder of 2011	$ 2,808
2012	11,137
2013	11,095
2014	9,489
2015	8,688
2016 and thereafter	28,960
	$ 72,177

7. ACCRUED EXPENSES

(in thousands)	September 30, 2011	December 31, 2010
Other taxes	$ 2,392	$ 2,971
Restructuring	940	3,671
Professional fees	1,021	1,615
Income taxes	2,597	1,201
Professional services partners fees	1,164	1,498
Short-term deferred rent	1,366	1,272
Self-insurance health and dental claims	1,360	1,635
Dividends payable	1,131	1,118
Employee reimbursable expenses	1,439	575
Other	6,549	9,180
	$ 19,959	$ 24,736

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8. DEFERRED REVENUE

(in thousands)	September 30, 2011	December 31, 2010
Software license	$ 14,134	$ 7,617
Maintenance	46,765	43,594
Professional services and other	6,417	5,692
Current deferred revenue	67,316	56,903
Software license	15,342	15,833
Maintenance and professional services	380	1,918
Long-term deferred revenue	15,722	17,751
	$ 83,038	$ 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 that will be paid by the end of the second quarter of 2012.

In connection with the Company s evaluation of its combined facilities, the Company approved a plan to exit a portion of its office space within one of its facilities. 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 third quarter of 2011, as a result of signing a sublease for the vacated space, the Company revised its estimate of exit costs and recorded a $0.2 million reduction of expense.

A summary of the restructuring activity during the first nine 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	-	(62)	(62)
Cash payments	(2,243)	(1,111)	(3,354)
Balance as of September 30, 2011	$ 509	$ 944	$ 1,453

(in thousands)	September 30, 2011	December 31, 2010
Reported as:		
Accrued expenses	$ 940	$ 3,671
Other long-term liabilities	513	1,198
	$ 1,453	$ 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 commenced on July 1, 2011 and terminates on December 31, 2023, subject to the Company s option to extend for two additional five-year periods. 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.

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 operations. The components of comprehensive income are as follows:

(in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Net income (loss)	$ 4,959	$ 3,139	$ 11,963	$ (1,198)
Other comprehensive income (loss):				
Unrealized gain (loss) on securities, net of tax	13	26	39	(515)
Foreign currency translation adjustments	(741)	1,749	1,023	302
Comprehensive income (loss)	$ 4,231	$ 4,914	$ 13,025	$ (1,411)

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12. STOCK-BASED COMPENSATION

For the third quarter and first nine months of 2011 and 2010, stock-based compensation expense was reflected in the Company s unaudited condensed consolidated statements of operations as follows:

(in thousands)	Three Months Ended September 30, 2011	Three Months Ended September 30, 2010	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
Cost of services	$ 659	$ 447	$ 2,009	$ 1,328
Operating expenses	1,663	1,134	4,713	3,885
Total stock-based compensation before tax	$ 2,322	$ 1,581	$ 6,722	$ 5,213
Income tax benefit	(676)	(555)	(2,175)	(1,646)

During the first nine months of 2011, the Company issued approximately 518,000 shares to its employees under the Company s share-based compensation plans and approximately 8,000 shares to the non-employee members of its Board of Directors.

During the first nine months of 2011, the Company granted approximately 134,000 restricted stock units (RSUs) with a total fair value of $4.7 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 September 30, 2011, the Company had approximately $7.9 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 two years.

13. INCOME TAXES

The provision for income taxes represents current and future amounts owed for federal, state, and foreign taxes. The Company accounts for income taxes at each interim period using its estimated annual effective tax rate. The Company expects it will have an overall tax benefit for 2011. During the third quarter of 2011, the Company recorded a $2.4 million reduction in unrecognized tax benefits and a corresponding reduction in income tax expense related to uncertain tax positions of prior years for which the statute of limitations has expired. As a result of its estimated annual effective tax rate benefit and the $2.4 million of discrete items recorded as a reduction of tax expense in the quarter, the Company recorded a net tax benefit of approximately $7.4 million during the third quarter of 2011. As of September 30, 2011, the amount of unrecognized tax benefits totaled approximately $18.5 million.

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14. 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.

	Three Months Ended September 30,		Nine Months Ended September 30,	
(in thousands, except per share amounts)	**2011**	**2010**	**2011**	**2010**
Basic				
Net income (loss)	$ 4,959	$ 3,139	$ 11,963	$ (1,198)
Weighted-average common shares outstanding	37,588	36,996	37,425	37,008
Earnings (loss) per share, basic	$ 0.13	$ 0.08	$ 0.32	$ (0.03)
Diluted				
Net income (loss)	$ 4,959	$ 3,139	$ 11,963	$ (1,198)
Weighted-average common shares outstanding, basic	37,588	36,996	37,425	37,008
Weighted-average effect of dilutive securities:				
Stock options	1,078	1,343	1,187	-
RSUs	261	192	249	-
Warrants	3	3	3	-
Effect of assumed exercise of stock options, warrants and RSUs	1,342	1,538	1,439	-
Weighted-average common shares outstanding, diluted	38,930	38,534	38,864	37,008
Earnings (loss) per share, diluted	$ 0.13	$ 0.08	$ 0.31	$ (0.03)
Outstanding options and RSUs excluded as impact would be antidilutive	27	102	27	2,752

15. 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 chief operating decision maker, (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 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 derived its revenue from the following geographic areas:

	Three Months Ended September 30,				Nine Months Ended September 30,			
(Dollars in thousands)	2011		2010		2011		2010	
U.S.	$ 49,166	51 %	$ 54,338	61 %	$ 160,489	53 %	$ 150,620	61 %
United Kingdom	17,822	19 %	18,413	20 %	60,455	20 %	41,224	17 %
Europe, other	16,697	18 %	9,926	11 %	48,150	16 %	32,215	13 %
Other	11,818	12 %	7,339	8 %	32,287	11 %	23,287	9 %
	$ 95,503	100 %	$ 90,016	100 %	$ 301,381	100 %	$ 247,346	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 inte 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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We develop and license CRM software, which includes our Decision Management product that allows customers to maximize lifetime value through improving customer experiences, providing better cross-sell/up-sell abilities, and aiding customer retention. We continue to invest in the development of new products and intend to remain a leader in decision management.

We also offer Pega Cloud, a 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 6% during the third quarter of 2011 compared to the third quarter of 2010 due to an increase in maintenance and professional services revenue partially offset by a decrease in license revenue. Our revenue increased 22% during the first nine months of 2011 compared to the first nine months of 2010 because of the increases in maintenance and professional services revenues. Maintenance revenue increased 28% during the third quarter of 2011 and 46% during the first nine 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. We generated approximately $19.6 million in cash from operations in the first nine months of 2011 and ended the quarter with approximately $98.3 million in cash, cash equivalents, and marketable securities.

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

- Demand for our industry leading software solutions and services;
- Expansion of our solutions frameworks offerings;
- Development of our partner alliances; 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 in a persisting weak global economy, 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.

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Results of Operations

(Dollars in thousands)	Three Months Ended September 30, 2011	2010	Increase (Decrease)		Nine Months Ended September 30, 2011	2010	Increase (Decrease)	
Total revenue	$95,503	$ 90,016	$5,487	6%	$301,381	$ 247,346	$54,035	22%
Gross profit	$53,692	$55,026	$(1,334)	(2)%	$179,157	$154,660	$24,497	16%
Acquisition-related costs	-	$111	$(111)	(100)%	$482	$5,014	$(4,532)	(90)%
Restructuring costs	$(203)	$407	$(610)	n/m	$(62)	$6,487	$(6,549)	n/m
Other operating expenses	$55,903	$52,565	$3,338	6%	$171,947	$141,794	$30,153	21%
Total operating expenses	$55,700	$53,083	$2,617	5%	$172,367	$153,295	$19,072	12%
(Loss) income from operations	$(2,008)	$1,943	$(3,951)	n/m	$6,790	$1,365	$5,425	397%
(Loss) income before (benefit) provision for income taxes	$(2,451)	$4,208	$(6,659)	n/m	$7,574	$(1,008)	$8,582	n/m

n/m-not meaningful

We believe the continued demand for our software products and related services is due to the strong value proposition, short implementation period, and variety of licensing models we offer our customers. The value of license arrangements executed decreased in the third quarter of 2011 compared to the same period in 2010, however, in the first nine months of 2011, we executed a higher value of license arrangements compared to the same period in 2010.

The decrease in gross profit during the third quarter of 2011 was primarily due to the decrease in license revenue. The increase in gross profit during the first nine months of 2011 was primarily due to the increase in maintenance revenue.

During the third quarter of 2011, the increase in total operating expenses was primarily due to an increase in research and development expenses associated with higher headcount. The increase in total operating expenses during the first nine months of 2011 was primarily due to the increase in selling and marketing expenses associated with higher headcount and higher sales commissions related to the increase in the value of license arrangements executed.

The decrease in income from operations during the third quarter of 2011 was primarily due to the decrease in license gross profit. The increase in income from operations during the first nine months of 2011 was primarily due to the increase in maintenance gross profit.

The decrease in income before provision for income taxes during the third quarter of 2011 was primarily due to decrease in license gross profit and foreign currency transaction gains recorded in the third quarter of 2010 compared to foreign currency transaction losses recorded in the third quarter of 2011. The increase in income before provision for income taxes for the first nine months of 2011 was primarily due to the increase in maintenance gross profit and foreign currency transaction gains recorded in the first nine months of 2011 compared to foreign currency transaction losses recorded in the first nine months of 2010.

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Revenue

(Dollars in thousands)	**Three Months Ended September 30, 2011**	**2010**	**Increase (Decrease)**		**Nine Months Ended September 30, 2011**	**2010**	**Increase (Decrease)**	
License revenue								