

PEGASYSTEMS INC
Form 10-Q
November 08, 2012
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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 September 30, 2012

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 <i>(State or other jurisdiction of incorporation or organization)</i> | 04-2787865 <i>(IRS Employer Identification No.)</i> |
| One Rogers Street Cambridge, MA <i>(Address of principal executive offices)</i> | 02142-1209 <i>(Zip Code)</i> |
| 101 Main Street Cambridge, MA <i>(Former address of principal executive offices)</i> | 02142-1590 <i>(Zip Code)</i> |
| (617) 374-9600 <i>(Registrant's telephone number including area code)</i> | |

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 37,887,686 shares of the Registrant's common stock, \$.01 par value per share, outstanding on October 29, 2012.

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(in thousands)

| | As of September 30, 2012 | As of December 31, 2011 |
|---|--------------------------------|-------------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 66,237 | \$ 60,353 |
| Marketable securities | 45,092 | 51,079 |
| Total cash, cash equivalents, and marketable securities | 111,329 | 111,432 |
| Trade accounts receivable, net of allowance of \$1,274 and \$926 | 80,849 | 98,293 |
| Deferred income taxes | 9,823 | 9,826 |
| Income taxes receivable | 10,776 | 7,545 |
| Other current assets | 6,276 | 4,865 |
| Total current assets | 219,053 | 231,961 |
| Property and equipment, net | 31,285 | 14,458 |
| Long-term deferred income taxes | 43,835 | 43,286 |
| Long-term other assets | 1,767 | 2,186 |
| Intangible assets, net | 61,009 | 69,369 |
| Goodwill | 20,451 | 20,451 |
| Total assets | \$ 377,400 | \$ 381,711 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 4,548 | 10,899 |
| Accrued expenses | 17,311 | 18,336 |
| Accrued compensation and related expenses | 26,779 | 39,170 |
| Deferred revenue | 74,784 | 73,840 |
| Total current liabilities | 123,422 | 142,245 |
| Income taxes payable | 9,113 | 9,547 |
| Long-term deferred revenue | 17,423 | 15,367 |
| Other long-term liabilities | 14,394 | 5,796 |
| Total liabilities | 164,352 | 172,955 |
| Commitments and contingencies | | |
| Stockholders' equity: | | |
| Preferred stock, 1,000 shares authorized; no shares issued and outstanding | | |
| Common stock, 100,000 shares and 70,000 shares authorized; 37,900 shares and 37,712 shares issued and outstanding | 379 | 377 |
| Additional paid-in capital | 134,614 | 129,701 |
| Retained earnings | 75,078 | 77,029 |
| Accumulated other comprehensive income | 2,977 | 1,649 |
| Total stockholders' equity | 213,048 | 208,756 |

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| | | |
|--|------------|------------|
| Total liabilities and stockholders' equity | \$ 377,400 | \$ 381,711 |
|--|------------|------------|

See notes to unaudited condensed consolidated financial statements.

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

(in thousands, except per share amounts)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|-----------------|------------------------------------|------------------|
| | 2012 | 2011 | 2012 | 2011 |
| Revenue: | | | | |
| Software license | \$ 28,575 | \$ 25,346 | \$ 95,517 | \$ 93,453 |
| Maintenance | 32,317 | 29,971 | 97,657 | 85,713 |
| Professional services | 40,765 | 40,186 | 124,706 | 122,215 |
| Total revenue | 101,657 | 95,503 | 317,880 | 301,381 |
| Cost of revenue: | | | | |
| Cost of software license | 1,585 | 1,637 | 4,763 | 4,942 |
| Cost of maintenance | 3,745 | 2,980 | 11,072 | 9,614 |
| Cost of professional services | 32,335 | 37,194 | 103,351 | 107,668 |
| Total cost of revenue | 37,665 | 41,811 | 119,186 | 122,224 |
| Gross profit | 63,992 | 53,692 | 198,694 | 179,157 |
| Operating expenses: | | | | |
| Selling and marketing | 36,893 | 32,463 | 116,476 | 103,707 |
| Research and development | 19,506 | 16,218 | 57,411 | 47,047 |
| General and administrative | 7,192 | 7,222 | 21,171 | 21,193 |
| Acquisition-related costs | | | | 482 |
| Restructuring costs | | (203) | | (62) |
| Total operating expenses | 63,591 | 55,700 | 195,058 | 172,367 |
| Income (loss) from operations | 401 | (2,008) | 3,636 | 6,790 |
| Foreign currency transaction gain (loss) | 438 | (1,049) | 337 | 140 |
| Interest income, net | 113 | 102 | 318 | 279 |
| Other (expense) income, net | (920) | 504 | (1,496) | 365 |
| Income (loss) before provision (benefit) for income taxes | 32 | (2,451) | 2,795 | 7,574 |
| Provision (benefit) for income taxes | 363 | (7,410) | 1,336 | (4,389) |
| Net (loss) income | \$ (331) | \$ 4,959 | \$ 1,459 | \$ 11,963 |
| (Loss) earnings per share: | | | | |
| Basic | \$ (0.01) | \$ 0.13 | \$ 0.04 | \$ 0.32 |
| Diluted | \$ (0.01) | \$ 0.13 | \$ 0.04 | \$ 0.31 |
| Weighted-average number of common shares outstanding | | | | |
| Basic | 37,881 | 37,588 | 37,834 | 37,425 |
| Diluted | 37,881 | 38,930 | 38,897 | 38,864 |
| Cash dividends declared per share | \$ 0.03 | \$ 0.03 | \$ 0.09 | \$ 0.09 |

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See notes to unaudited condensed consolidated financial statements.

Table of Contents**PEGASYSTEMS INC.****UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME****(in thousands)**

| | Three Months Ended | | Nine Months Ended | |
|--|---------------------------|--------------|--------------------------|--------------|
| | September 30, | | September 30, | |
| | 2012 | 2011 | 2012 | 2011 |
| <i>(in thousands)</i> | | | | |
| Net (loss) income | \$ (331) | \$ 4,959 | \$ 1,459 | \$ 11,963 |
| Other comprehensive income (loss), net of tax: | | | | |
| Unrealized gain on securities, net of tax | 33 | 13 | 80 | 39 |
| Foreign currency translation adjustments | 1,315 | (741) | 1,248 | 1,023 |
| Total other comprehensive income (loss) | 1,348 | (728) | 1,328 | 1,062 |
| Comprehensive income | \$ 1,017 | \$ 4,231 | \$ 2,787 | \$ 13,025 |

See notes to unaudited condensed consolidated financial statements.

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

| | Nine Months Ended September 30, | |
|---|--|------------------|
| | 2012 | 2011 |
| Operating activities: | | |
| Net income | \$ 1,459 | \$ 11,963 |
| Adjustment to reconcile net income to cash provided by operating activities: | | |
| Excess tax benefits from exercise or vesting of equity awards | (3,161) | (6,628) |
| Deferred income taxes | (511) | 1,092 |
| Depreciation and amortization | 13,986 | 12,648 |
| Stock-based compensation expense | 8,622 | 6,722 |
| Foreign currency transaction loss | 785 | 624 |
| Other non-cash items | 4,604 | 528 |
| Change in operating assets and liabilities: | | |
| Trade accounts receivable | 17,769 | 2,264 |
| Income taxes receivable and other current assets | (1,471) | (4,903) |
| Accounts payable and accrued expenses | (20,976) | (8,983) |
| Deferred revenue | 2,747 | 8,250 |
| Other long-term assets and liabilities | 5,231 | (3,930) |
| Cash provided by operating activities | 29,084 | 19,647 |
| Investing activities: | | |
| Purchase of marketable securities | (13,336) | (49,689) |
| Matured and called marketable securities | 18,465 | 14,738 |
| Sale of marketable securities | | 4,048 |
| Investment in property and equipment | (21,875) | (5,108) |
| Cash used in investing activities | (16,746) | (36,011) |
| Financing activities: | | |
| Issuance of common stock for share-based compensation plans | 753 | 2,164 |
| Excess tax benefits from exercise or vesting of equity awards | 3,161 | 6,628 |
| Dividend payments to shareholders | (3,404) | (3,365) |
| Common stock repurchases for tax withholdings for net settlement of equity awards | (3,650) | (5,488) |
| Common stock repurchases under share repurchase programs | (3,910) | (3,460) |
| Cash used in financing activities | (7,050) | (3,521) |
| Effect of exchange rate on cash and cash equivalents | 596 | 361 |
| Net increase (decrease) in cash and cash equivalents | 5,884 | (19,524) |
| Cash and cash equivalents, beginning of period | 60,353 | 71,127 |
| Cash and cash equivalents, end of period | \$ 66,237 | \$ 51,603 |

See notes to unaudited condensed consolidated financial statements.

Table of Contents**PEGASYSTEMS INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****1. ACCOUNTING POLICIES*****Basis of Presentation***

Pegasystems Inc. (together with its subsidiaries, the Company) has prepared the accompanying unaudited condensed consolidated financial statements pursuant to the rules and regulations of the U.S. 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, 2011.

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 2012.

2. NEW ACCOUNTING PRONOUNCEMENTS

Disclosures About Offsetting Assets and Liabilities: In December 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2011-11, *Balance Sheet (Topic 210): Disclosures About Offsetting Assets and Liabilities*, which creates new disclosure requirements regarding the nature of an entity's rights of setoff and related arrangements associated with its financial instruments and derivative instruments. Certain disclosures of the amounts of certain instruments subject to enforceable master netting arrangements or similar agreements would be required, irrespective of whether the entity has elected to offset those instruments in the statement of financial position. This ASU is effective for the Company on January 1, 2013 with retrospective application required. 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.

3. MARKETABLE SECURITIES

(in thousands)

| | September 30, 2012 | | | |
|---------------------------------------|--------------------|---------------------|----------------------|------------|
| | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value |
| Municipal bonds | \$ 28,700 | 79 | (4) | \$ 28,775 |
| Corporate bonds | 14,212 | 105 | | 14,317 |
| Government sponsored enterprise bonds | 2,000 | | | 2,000 |
| | \$ 44,912 | 184 | (4) | \$ 45,092 |

(in thousands)

| | December 31, 2011 | | | |
|-----------------|-------------------|---------------------|----------------------|------------|
| | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value |
| Municipal bonds | \$ 27,968 | 74 | (2) | \$ 28,040 |
| Corporate bonds | 15,058 | 16 | (34) | 15,040 |

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| | | | | |
|---------------------------------------|-----------|----|------|-----------|
| Government sponsored enterprise bonds | 8,001 | 2 | (4) | 7,999 |
| | \$ 51,027 | 92 | (40) | \$ 51,079 |

The Company considers debt securities with maturities of three months or less from the purchase date to be cash equivalents. Interest is recorded when earned. 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 related income taxes.

As of September 30, 2012, remaining maturities of marketable debt securities ranged from November 2012 to December 2014, with a weighted-average remaining maturity of approximately 11 months.

Table of Contents**4. DERIVATIVE INSTRUMENTS**

The Company uses 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 income 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 (expense) income, net, in its consolidated statement of income. 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 partly mitigating the volatility. Generally, the Company enters into forward foreign currency contracts with terms not greater than 90 days.

During the first nine months of 2012, the Company entered into and settled forward foreign currency contracts to sell 48.9 million and £39 million and receive in exchange \$123.6 million. During the first nine months of 2011, the Company entered into and settled forward foreign currency contracts to sell 22.5 million and £16.5 million and receive in exchange \$58.6 million. As of September 30, 2012 and December 31, 2011, the Company did not have any forward foreign currency contracts outstanding. During the third quarter and first nine months of 2012, the change in the fair value of the Company's forward foreign currency contracts recorded in other (expense) income, net, was a loss of \$0.9 million and \$1.5 million, respectively. 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 (expense) income, net, was a gain of \$0.5 million and \$0.3 million, respectively.

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

Fair value is an exit price, representing the amount that would be received from the sale of an asset or paid to transfer a liability in an orderly transaction between market participants based on assumptions that market participants would use in pricing an asset or liability. As a basis for classifying the fair value measurements, a three-tier fair value hierarchy, which classifies the fair value measurements based on the inputs used in measuring fair value, was established as follows: (Level 1) observable inputs such as quoted prices in active markets for identical assets or liabilities; (Level 2) significant other observable inputs that are observable either directly or indirectly; and (Level 3) significant unobservable inputs in which there is little or no market data, which requires the Company to develop its own assumptions. This hierarchy requires the Company to use observable market data, when available, and to minimize the use of unobservable inputs when determining fair value. On a recurring basis, the Company records its marketable securities at fair value.

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The fair value hierarchy of the Company's cash equivalents and marketable securities at fair value is as follows:

| (in thousands) | Fair Value Measurements at Reporting Date Using | | |
|---------------------------------------|---|--|---|
| | September 30, 2012 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) |
| Money market funds | \$ 3,270 | \$ 3,270 | \$ |
| Marketable securities: | | | |
| Government sponsored enterprise bonds | \$ 2,000 | \$ | \$ 2,000 |
| Corporate bonds | 14,317 | 14,317 | |
| Municipal bonds | 28,775 | 13,575 | 15,200 |
| Total marketable securities | \$ 45,092 | \$ 27,892 | \$ 17,200 |

| (in thousands) | Fair Value Measurements at Reporting Date Using | | |
|---------------------------------------|---|--|---|
| | December 31, 2011 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) |
| Money market funds | \$ 3,067 | \$ 3,067 | \$ |
| Marketable securities: | | | |
| Municipal bonds | \$ 28,040 | \$ 6,110 | \$ 21,930 |
| Corporate bonds | 15,040 | 15,040 | 0 |
| Government sponsored enterprise bonds | 7,999 | 2,001 | 5,998 |
| Total marketable securities | \$ 51,079 | \$ 23,151 | \$ 27,928 |

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 2012 and 2011, the Company did not recognize any nonrecurring fair value measurements from impairments.

6. TRADE ACCOUNTS RECEIVABLE, NET OF ALLOWANCES

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| (in thousands) | September 30, 2012 | December 31, 2011 |
|------------------------------------|-----------------------|----------------------|
| Trade accounts receivable | \$ 63,370 | \$ 77,123 |
| Unbilled trade accounts receivable | 18,753 | 22,096 |
| Total accounts receivable | 82,123 | 99,219 |
| Allowance for doubtful accounts | | (31) |
| Allowance for sales credit memos | (1,274) | (895) |
| Total allowance | (1,274) | (926) |
| | \$ 80,849 | \$ 98,293 |

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, 2012 and December 31, 2011, respectively.

Table of Contents**7. GOODWILL AND OTHER INTANGIBLE ASSETS**

There were no changes in the carrying amount of goodwill during the first nine months of 2012.

Intangible assets are recorded at cost and are amortized using the straight-line method over their estimated useful life, which range from 5 to 9 years.

| (in thousands) | Cost | Accumulated Amortization | Net Book Value |
|---------------------------------|-----------|-----------------------------|-------------------|
| As of September 30, 2012 | | | |
| Customer related intangibles | \$ 44,355 | \$ (11,910) | \$ 32,445 |
| Technology | 43,446 | (14,891) | 28,555 |
| Trade name | 248 | (248) | |
| Technology designs | 490 | (490) | |
| Non-compete agreements | 100 | (91) | 9 |
| Intellectual property | 1,400 | (1,400) | |
| Total | \$ 90,039 | \$ (29,030) | \$ 61,009 |

| (in thousands) | Cost | Accumulated Amortization | Net Book Value |
|--------------------------------|-----------|-----------------------------|-------------------|
| As of December 31, 2011 | | | |
| Customer related intangibles | \$ 44,355 | \$ (8,214) | \$ 36,141 |
| Technology | 43,446 | (10,269) | 33,177 |
| Trade name | 248 | (248) | |
| Technology designs | 490 | (463) | 27 |
| Non-compete agreements | 100 | (76) | 24 |
| Intellectual property | 1,400 | (1,400) | |
| Total | \$ 90,039 | \$ (20,670) | \$ 69,369 |

For the third quarter and first nine months of 2012 and 2011, amortization of intangibles was reflected in the Company's unaudited condensed consolidated statements of income as follows:

| (in thousands) | Three Months Ended September 30, 2012 | | Nine Months Ended September 30, 2011 | |
|----------------------------|---|----------|--|----------|
| Cost of software license | \$ 1,541 | \$ 1,571 | \$ 4,649 | \$ 4,713 |
| Selling and marketing | 1,232 | 1,232 | 3,696 | 3,696 |
| General and administrative | 5 | 5 | 15 | 98 |
| Total amortization expense | \$ 2,778 | \$ 2,808 | \$ 8,360 | \$ 8,507 |

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Amortization of intangibles is estimated to be recorded over their remaining useful lives as follows:

| | Future estimated amortization expense |
|---|--|
| (in thousands) As of September 30, 2012 | |
| Remainder of 2012 | \$ 2,777 |
| 2013 | 11,095 |
| 2014 | 9,489 |
| 2015 | 8,688 |
| 2016 | 8,688 |
| 2017 | 8,688 |
| Thereafter | 11,584 |
| | \$ 61,009 |

8. ACCRUED EXPENSES

| (in thousands) | September 30, 2012 | December 31, 2011 |
|---|-------------------------------|------------------------------|
| Other taxes | \$ 2,351 | \$ 2,759 |
| Restructuring | 429 | 626 |
| Professional fees | 1,191 | 1,146 |
| Income taxes | 670 | 1,954 |
| Professional services partners fees | 725 | 120 |
| Short-term deferred rent | 1,671 | 1,428 |
| Self-insurance health and dental claims | 1,709 | 1,931 |
| Dividends payable | 1,138 | 1,132 |
| Employee reimbursable expenses | 1,785 | 897 |
| Construction in process | 627 | |
| Other | 5,015 | 6,343 |
| | \$ 17,311 | \$ 18,336 |

9. DEFERRED REVENUE

| (in thousands) | September 30, 2012 | December 31, 2011 |
|---------------------------------------|-------------------------------|------------------------------|
| Software license | \$ 13,686 | \$ 15,005 |
| Maintenance | 52,761 | 50,916 |
| Professional services and other | 8,337 | 7,919 |
| Current deferred revenue | 74,784 | 73,840 |
| Software license | 17,312 | 13,532 |
| Maintenance and professional services | 111 | 1,835 |
| Long-term deferred revenue | 17,423 | 15,367 |

\$ 92,207 \$ 89,207

Table of Contents**10. 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, which were paid by the end of the first quarter of 2012. Also, in connection with the Company's evaluation of its combined facilities, the Company eliminated space within one facility 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.

A summary of the restructuring activity during the first nine months of 2012 is as follows:

| (in thousands) | Personnel | Facilities | Total |
|----------------------------------|-----------|------------|----------|
| Balance as of December 31, 2011 | \$ 243 | \$ 800 | \$ 1,043 |
| Cash payments | (243) | (258) | (501) |
| Balance as of September 30, 2012 | \$ | \$ 542 | \$ 542 |

| (in thousands) | September 30, 2012 | December 31, 2011 |
|-----------------------------|-----------------------|----------------------|
| Reported as: | | |
| Accrued expenses | \$ 429 | \$ 626 |
| Other long-term liabilities | 113 | 417 |
| | \$ 542 | \$ 1,043 |

11. STOCK-BASED COMPENSATION

For the third quarter and first nine months of 2012 and 2011, stock-based compensation expense was reflected in the Company's unaudited condensed consolidated statements of income as follows:

| (in thousands) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|----------|------------------------------------|----------|
| | 2012 | 2011 | 2012 | 2011 |
| Cost of services | \$ 849 | \$ 659 | \$ 2,710 | \$ 2,009 |
| Operating expenses | 1,935 | 1,663 | 5,912 | 4,713 |
| Total stock-based compensation before tax | \$ 2,784 | \$ 2,322 | \$ 8,622 | \$ 6,722 |
| Income tax benefit | (915) | (676) | (2,781) | (2,175) |

During the first nine months of 2012, the Company issued approximately 296,000 shares to its employees under the Company's share-based compensation plans.

During the first nine months of 2012, the Company granted approximately 156,000 restricted stock units (RSUs) with a total fair value of \$5.2 million. Approximately 52,000 RSUs were issued in connection with the election by employees to receive 50% of their 2012 target incentive compensation under the Company's Corporate Incentive Compensation Plan (the CICP) in the form of RSUs instead of cash. Stock-based compensation of approximately \$1.9 million associated with this RSU grant will be recognized over one year.

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As of September 30, 2012, the Company had approximately \$10.4 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**12. EARNINGS 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 | | Nine Months Ended | |
|---|-----------------------|-----------------------|-----------------------|-----------------------|
| | September 30, 2012 | September 30, 2011 | September 30, 2012 | September 30, 2011 |
| <i>(in thousands, except per share amounts)</i> | | | | |
| Basic | | | | |
| Net (loss) income | \$ (331) | \$ 4,959 | \$ 1,459 | \$ 11,963 |
| Weighted-average common shares outstanding | 37,881 | 37,588 | 37,834 | 37,425 |
| (Loss) earnings per share, basic | \$ (0.01) | \$ 0.13 | \$ 0.04 | \$ 0.32 |
| Diluted | | | | |
| Net (loss) income | \$ (331) | \$ 4,959 | \$ 1,459 | \$ 11,963 |
| Weighted-average common shares outstanding, basic | 37,881 | 37,588 | 37,834 | 37,425 |
| Weighted-average effect of dilutive securities: | | | | |
| Stock options | | 1,078 | 817 | 1,187 |
| RSUs | | 261 | 246 | 249 |
| Warrants | | 3 | | 3 |
| Effect of assumed exercise of stock options, warrants and RSUs | | 1,342 | 1,063 | 1,439 |
| Weighted-average common shares outstanding, diluted | 37,881 | 38,930 | 38,897 | 38,864 |
| (Loss) earnings per share, diluted | \$ (0.01) | \$ 0.13 | \$ 0.04 | \$ 0.31 |
| Outstanding options and RSUs excluded as impact would be antidilutive | 1,865 | 27 | 55 | 27 |

Table of Contents**13. GEOGRAPHIC INFORMATION AND MAJOR CUSTOMERS**

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 chief operating decision maker primarily reviews financial information on a consolidated basis. Therefore, the Company has determined it operates in one segment Business Process Solutions.

| <i>(Dollars in thousands)</i> | Three Months Ended September 30, | | | | Nine Months Ended September 30, | | | |
|-------------------------------|-------------------------------------|------|-----------|------|------------------------------------|------|------------|------|
| | 2012 | | 2011 | | 2012 | | 2011 | |
| U.S. | \$ 56,475 | 56% | \$ 49,166 | 51% | \$ 173,406 | 55% | \$ 160,489 | 53% |
| United Kingdom | 18,862 | 18% | 17,822 | 19% | 55,329 | 17% | 60,455 | 20% |
| Europe, other | 12,836 | 13% | 19,515 | 21% | 45,051 | 14% | 52,884 | 18% |
| Other | 13,484 | 13% | 9,000 | 9% | 44,094 | 14% | 27,553 | 9% |
| | \$ 101,657 | 100% | \$ 95,503 | 100% | \$ 317,880 | 100% | \$ 301,381 | 100% |

There were no customers accounting for 10% or more of the Company's total revenue during the third quarter and first nine months of 2012 and 2011. There was one customer that accounted for 10% or more of the Company's outstanding trade receivables, net, as of December 31, 2011, as listed below.

| <i>(Dollars in thousands)</i> | As of September 30, 2012 | As of December 31, 2011 |
|---|--------------------------------|-------------------------------|
| Trade receivables, net of allowances | \$ 80,849 | \$ 98,293 |
| Customer A | | 14% |

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

Forward-Looking Statements

This Quarterly Report on Form 10-Q contains or incorporates forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements include, but are not limited to, statements about our future financial performance and business plans, the adequacy of our liquidity and capital resources, the continued payment of quarterly dividends by the Company, and the timing of recognizing revenue under existing term license agreements. 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. Important factors that could cause actual future activities and results to differ include, among others, variation in demand for our products and services and the difficulty in predicting the completion of product acceptance and other factors affecting the timing of license revenue recognition, the ongoing uncertainty and volatility in the global financial markets related to the European sovereign debt crisis and the so-called fiscal cliff in the U.S., the ongoing consolidation in the financial services and healthcare markets, reliance on third party relationships, the potential loss of vendor specific objective evidence for our professional services, and management of the Company's growth. These risks are described more completely in Item 1A of Part I of our Annual Report on Form 10-K for the year ended December 31, 2011 and in Item 1A of Part II of this Quarterly Report on Form 10-Q. 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, which allows organizations to build, deploy, and change enterprise applications easily and quickly. Our unified software platform includes all the necessary elements and technologies to build enterprise applications in a fraction of the time it would take with competitive disjointed architectures, by directly capturing business objectives, automating programming, and automating work. Our customers use our software to improve their customer service and customer experience, generate new business, and enhance productivity and profitability. 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 a series of smaller licenses that are focused on specific purposes or areas of operations, rather than sell large enterprise licenses.

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 business process management (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. Our products are simpler, easier to use and 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, healthcare, communications, energy, and government markets.

Our solution frameworks products include customer relationship management (CRM) software, which enables unified predictive decisioning and analytics and optimizes the overall customer experience. Our decision management products and capabilities are designed to manage processes so that all actions optimize the outcome based on business objectives. We continue to invest in the development of new products and intend to remain a leader in BPM, CRM, and decision management.

We also license Pega Cloud, a service offering that allows customers to create and/or run Pega 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 professional services revenue.

We offer training for our customers and partners at our regional training facilities, at numerous third party facilities, and at customer sites. In 2012, we began offering training online through Pega Academy, which provides an alternative way to learn our software in a virtual environment quickly and easily. We expect that this online training will help expand the number of trained experts at a faster pace, but at a lower average price per student per class.

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Our total revenue during the third quarter and first nine months of 2012 increased 6% and 5%, respectively, compared to the same periods in 2011. License revenue increased 13% and 2% during the third quarter and first nine months of 2012, respectively, compared to the same periods in 2011. The slower growth in our license revenue for the first nine months of 2012 was mainly due to a higher proportion of term than perpetual license arrangements executed. It was also due to customer delays in signing arrangements due to uncertain U.S. economic conditions and the weak European economy. Maintenance revenue increased 8% during the third quarter of 2012 and 14% during the first nine months of 2012 compared to the same periods in 2011 primarily due to the growth in the aggregate value of the installed base of our software and continued strong renewal rates. The professional services gross margins increased to 21% in the third quarter of 2012 largely due to lower on-boarding time and expenses associated with reduced hiring as more of our customers became enabled and more implementation projects were led by our partners. During the first nine months of 2012, we generated approximately \$29.1 million in cash from operations due to our strong collections and ended the quarter with \$111.3 million in cash, cash equivalents, and marketable securities.

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, 2011. 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, 2011.

Results of Operations

| <i>(Dollars in thousands)</i> | Increase (Decrease) | | | | Increase (Decrease) | | | |
|---|-----------------------|------------|-----------|--------|-----------------------|------------|------------|-------|
| | Three Months Ended | | | | Nine Months Ended | | | |
| | September 30, 2012 | 2011 | | | September 30, 2012 | 2011 | | |
| Total revenue | \$ 101,657 | \$ 95,503 | \$ 6,154 | 6% | \$ 317,880 | \$ 301,381 | \$ 16,499 | 5% |
| Gross profit | \$ 63,992 | \$ 53,692 | \$ 10,300 | 19% | \$ 198,694 | \$ 179,157 | \$ 19,537 | 11% |
| Total operating expenses | \$ 63,591 | \$ 55,700 | \$ 7,891 | 14% | \$ 195,058 | \$ 172,367 | \$ 22,691 | 13% |
| Income (loss) from operations | \$ 401 | \$ (2,008) | \$ 2,409 | (120)% | \$ 3,636 | \$ 6,790 | \$ (3,154) | (46)% |
| Income (loss) before provision (benefit) for income taxes | \$ 32 | \$ (2,451) | \$ 2,483 | (101)% | \$ 2,795 | \$ 7,574 | \$ (4,779) | (63)% |

The aggregate value of license arrangements executed during the third quarter of 2012 was significantly higher than in the third quarter of 2011. However, for the first nine months of 2012, the aggregate value of license arrangements executed were lower compared to the same period in 2011 due to the continued weak global economic conditions, especially in Europe, where the value of new license arrangements executed was almost 50% lower. The aggregate value of license arrangements executed fluctuates quarter to quarter. During the first nine months of 2012 and 2011, approximately 69% and 55%, respectively, of license arrangements were executed with existing customers.

The increase in gross profit during the third quarter of 2012 compared to the same period in 2011 was primarily due to an increase in license revenue and lower consulting services expenses. The increase in gross profit during the first nine months of 2012 compared to the same period in 2011 was primarily due to the increase in maintenance revenue and lower consulting services expenses.

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The increases in operating expenses were primarily due to the increases in selling and marketing and research and development expenses associated with higher headcount.

While income before provision for income taxes increased during the third quarter of 2012 compared to the same period in 2011, it decreased during the first nine months of 2012 compared to the same period in 2011. The decrease was primarily due to our operating expenses, associated with increased hiring, growing faster than our revenue. The decrease was also due to a \$1.5 million loss on our forward foreign currency contracts recorded in the first nine months of 2012 compared to a gain of \$0.3 million recorded in the first nine months of 2011. See Note 4 Derivative Instruments in the notes to the accompanying unaudited condensed consolidated financial statements for further discussion.

Revenue

| | Three Months Ended | | | | Nine Months Ended | | | | | | | |
|-----------------------------|--------------------|------|-----------|------|-------------------|------|---------------------|------|-----------|------|------------|-------|
| | September 30, | | Increase | | September 30, | | Increase (Decrease) | | | | | |
| | 2012 | 2011 | | | 2012 | 2011 | | | | | | |
| <i>Dollars in thousands</i> | | | | | | | | | | | | |
| License revenue | | | | | | | | | | | | |
| Perpetual licenses | \$ 16,999 | 60% | \$ 15,527 | 61% | \$ 1,472 | 9% | \$ 50,448 | 53% | \$ 59,808 | 64% | \$ (9,360) | (16)% |
| Term licenses | 9,742 | 34% | 9,034 | 36% | 708 | 8% | 32,650 | 34% | 25,852 | 28% | 6,798 | 26% |
| Subscription | 1,834 | 6% | 785 | 3% | 1,049 | 134% | 12,419 | 13% | 7,793 | 8% | 4,626 | 59% |
| Total license revenue | \$ 28,575 | 100% | \$ 25,346 | 100% | \$ 3,229 | 13% | \$ 95,517 | 100% | \$ 93,453 | 100% | \$ 2,064 | 2% |

The mix between perpetual and term license arrangements executed in a particular period varies based on customer needs. A change in the mix between perpetual and term license arrangements executed over time may cause our revenues to vary materially as a higher proportion of term license arrangements would result in license revenue to be recognized over longer periods as payments become due or earlier if prepaid. Since the fourth quarter of 2011, the mix has moved toward term licenses resulting in higher term and lower perpetual license revenue during the first nine months of 2012 compared to the same period in 2011. In addition, some of our perpetual license arrangements include extended payment terms and some others include additional rights of use that also delay the recognition of revenue over longer periods.

The aggregate value of payments due under noncancellable term licenses grew to \$155.9 million as of September 30, 2012 compared to \$84.5 million as of September 30, 2011. We expect to recognize \$8.6 million of the \$155.9 million as revenue during the fourth quarter of 2012 in addition to new term license agreements we may complete or prepayments we may receive for existing term license agreements in the fourth quarter of 2012. The aggregate value of payments due under perpetual license arrangements was \$39.4 million as of September 30, 2012 compared to \$36 million as of September 30, 2011. See the table of future cash receipts on page 23.

Subscription revenue primarily consists of the ratable recognition of license, maintenance and bundled services revenue on perpetual license arrangements that include a right to unspecified future products. Subscription revenue does not include revenue from our Pega Cloud offerings. The timing of scheduled payments under customer arrangements may limit the amount of revenue that can be recognized in a reporting period. Consequently, our subscription revenue may vary quarter to quarter. The increases in subscription revenue were primarily due to the revenue recognized in the third quarter and first nine months of 2012 on some arrangements for which revenue recognition criteria had not been met for the same periods in 2011.

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| <i>(Dollars in thousands)</i> | Three Months Ended | | Increase | | Nine Months Ended | | Increase | |
|-------------------------------|--------------------|-----------|----------|----|-------------------|-----------|-----------|-----|
| | September 30, | | | | September 30, | | | |
| | 2012 | 2011 | | | 2012 | 2011 | | |
| Maintenance revenue | | | | | | | | |
| Maintenance | \$ 32,317 | \$ 29,971 | \$ 2,346 | 8% | \$ 97,657 | \$ 85,713 | \$ 11,944 | 14% |

The increases in maintenance revenue were primarily due to the growth in the aggregate value of the installed base of our software and continued strong renewal rates. For the first nine months of 2012, the increase was also due to the revenue recognition of a \$2 million one-time fee associated with a customer maintenance agreement during the second quarter of 2012.

| <i>(Dollars in thousands)</i> | Three Months Ended | | | | Increase (Decrease) | | | | Nine Months Ended | | | |
|--------------------------------------|--------------------|------|---------------------|------|---------------------|-------|---------------------|------|-------------------|------|---------------------|------|
| | September 30, | | Increase (Decrease) | | September 30, | | Increase (Decrease) | | September 30, | | Increase (Decrease) | |
| | 2012 | 2011 | | | 2012 | 2011 | | | 2012 | 2011 | | |
| Professional services revenue | | | | | | | | | | | | |
| Consulting Services | \$ 39,549 | 97% | \$ 38,436 | 96% | \$ 1,113 | 3% | \$ 119,825 | 96% | \$ 117,003 | 96% | \$ 2,822 | 2% |
| Training | 1,216 | 3% | 1,750 | 4% | (534) | (31)% | 4,881 | 4% | 5,212 | 4% | (331) | (6)% |
| Total Professional services | \$ 40,765 | 100% | \$ 40,186 | 100% | \$ 579 | 1% | \$ 124,706 | 100% | \$ 122,215 | 100% | \$ 2,491 | 2% |

Professional services are primarily consulting services related to new license implementations. Our consulting services revenue may fluctuate quarter to quarter based on customer requirements and budget availability, the number of license arrangements executed, and the mix of services performed by us or our enabled partners. The slight increases in our consulting services revenue were as a result of more customers becoming enabled and our partners leading more implementation projects.

| <i>(Dollars in thousands)</i> | Three Months Ended | | Increase | | Nine Months Ended | | Increase | |
|---------------------------------|--------------------|-----------|-----------|------|-------------------|------------|-----------|-----|
| | September 30, | | | | September 30, | | | |
| | 2012 | 2011 | | | 2012 | 2011 | | |
| Gross Profit | | | | | | | | |
| Software license | \$ 26,990 | \$ 23,709 | \$ 3,281 | 14% | \$ 90,754 | \$ 88,511 | \$ 2,243 | 3% |
| Maintenance | 28,572 | 26,991 | 1,581 | 6% | 86,585 | 76,099 | 10,486 | 14% |
| Professional services | 8,430 | 2,992 | 5,438 | 182% | 21,355 | 14,547 | 6,808 | 47% |
| Total gross profit | \$ 63,992 | \$ 53,692 | \$ 10,300 | 19% | \$ 198,694 | \$ 179,157 | \$ 19,537 | 11% |
| Total gross profit % | 63% | 56% | | | 63% | 59% | | |
| Software license gross profit % | 94% | 94% | | | 95% | 95% | | |

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| | | | | |
|--------------------------------------|-----|-----|-----|-----|
| Maintenance gross profit % | 88% | 90% | 89% | 89% |
| Professional services gross profit % | 21% | 7% | 17% | 12% |

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As a result of the increased number of customer and partner led implementations, we have slowed the hiring of professional services personnel, reducing non-billable on-boarding time and increasing utilization rates of our staff, resulting in higher gross profit percentages. If we increase our hiring pace in future periods, we may incur enablement costs that may result in lower professional services gross profit percentages.

| <i>(Dollars in thousands)</i> | Three Months Ended September 30, | | (Decrease) | | Nine Months Ended September 30, | | (Decrease) | |
|-------------------------------------|-------------------------------------|-----------------|----------------|-------------|------------------------------------|-----------------|-----------------|-------------|
| | 2012 | 2011 | | | 2012 | 2011 | | |
| Amortization of intangibles: | | | | | | | | |
| Cost of software license | \$ 1,541 | \$ 1,571 | \$ (30) | (2)% | \$ 4,649 | \$ 4,713 | \$ (64) | (1)% |
| Selling and marketing | 1,232 | 1,232 | | | 3,696 | 3,696 | | |
| General and Administrative | 5 | 5 | | | 15 | 98 | (83) | (85)% |
| Total amortization expense | \$ 2,778 | \$ 2,808 | \$ (30) | (1)% | \$ 8,360 | \$ 8,507 | \$ (147) | (2)% |

The decreases in amortization expense were due to the amortization in full of the trade name intangible asset in 2011 and the technology designs intangible asset in the first quarter of 2012.

Operating expenses

| <i>(Dollars in thousands)</i> | Three Months Ended September 30, | | Increase | | Nine Months Ended September 30, | | Increase | |
|---|-------------------------------------|-----------|----------|-----|------------------------------------|------------|-----------|-----|
| | 2012 | 2011 | | | 2012 | 2011 | | |
| Selling and marketing | | | | | | | | |
| Selling and marketing | \$ 36,893 | \$ 32,463 | \$ 4,430 | 14% | \$ 116,476 | \$ 103,707 | \$ 12,769 | 12% |
| As a percent of total revenue | 36% | 34% | | | 37% | 34% | | |
| Selling and marketing headcount at September 30 | | | | | 524 | 430 | 94 | 22% |

Selling and marketing expenses include compensation, benefits, and other headcount-related expenses associated with our selling and marketing personnel as well as advertising, promotions, trade shows, seminars, and other programs. Selling and marketing expenses also include the amortization of customer related intangibles.

We continue to create additional sales capacity by increasing sales headcount to target new accounts in existing industries, as well as to expand coverage in new industries and geographies. The increase in selling and marketing expenses during the third quarter of 2012 compared to the same period in 2011 was primarily due to a \$4.3 million increase in compensation and benefit expenses associated with higher headcount. The increase in selling and marketing expenses during the first nine months of 2012 compared to the same period in 2011 was primarily due to a \$14.4 million increase in compensation and benefit expenses associated with higher headcount, partially offset by a \$2.2 million decrease in commission expense associated with the lower value of license arrangements executed during the first nine months of 2012 compared to the same period in 2011.

| <i>(Dollars in thousands)</i> | Three Months Ended September 30, | | Increase | | Nine Months Ended September 30, | | Increase | |
|---|-------------------------------------|-----------|----------|-----|------------------------------------|-----------|-----------|-----|
| | 2012 | 2011 | | | 2012 | 2011 | | |
| Research and development | | | | | | | | |
| Research and development | \$ 19,506 | \$ 16,218 | \$ 3,288 | 20% | \$ 57,411 | \$ 47,047 | \$ 10,364 | 22% |
| As a percent of total revenue | 19% | 17% | | | 18% | 16% | | |
| Research and development headcount at September 30, | | | | | 713 | 467 | 246 | 53% |

Research and development expenses include compensation, benefits, contracted services, and other headcount-related expenses associated with research and development. The increase in headcount reflects the growth in our Indian research facility.

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The increases in research and development expenses during the third quarter and first nine months of 2012 compared to the same periods in 2011 were primarily due to increases in compensation and benefit expenses associated with higher headcount of

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approximately \$3.2 million and \$7.5 million, respectively, and increases in rent and facilities related expenses associated with the build-out of our U.S. and India facilities of \$0.9 million and \$3 million, respectively.

| <i>(Dollars in thousands)</i> | Three Months Ended | | (Decrease) | | Nine Months Ended | | (Decrease) | |
|--|--------------------|----------|------------|--|-------------------|-----------|------------|-----|
| | September 30, | | | | September 30, | | | |
| | 2012 | 2011 | | | 2012 | 2011 | | |
| General and administrative | | | | | | | | |
| General and administrative | \$ 7,192 | \$ 7,222 | \$ (30) | | \$ 21,171 | \$ 21,193 | \$ (22) | |
| As a percent of total revenue | 7% | 8% | | | 6% | 7% | | |
| General and administrative headcount at September 30 | | | | | 243 | 206 | 37 | 18% |

General and administrative expenses include compensation, benefits, and other headcount-related expenses associated with finance, legal, corporate governance, and other administrative headcount. It also includes accounting, legal, and other administrative fees. The general and administrative headcount includes employees in human resources, information technology and corporate services departments whose costs are allocated to the rest of the Company's functional departments.

We completed the move to our new office headquarters in the third quarter of 2012. We recorded approximately \$1.4 million and \$4.4 million of rent expense under the new lease arrangement during the third quarter and first nine months of 2012, respectively, and approximately \$0.4 million during each of the third quarter and first nine months of 2011. We will continue to incur duplicate rent and rent related expenses until the earlier of when the lease for our old headquarters expires in May 2013 or we are able to return the property to the landlord without further obligation.

Stock-based compensation

The following table summarizes stock-based compensation expense included in our unaudited condensed consolidated statements of income:

| <i>(Dollars in thousands)</i> | Three Months Ended | | Increase | | Nine Months Ended | | Increase | |
|---|--------------------|--------|----------|-----|-------------------|----------|----------|-----|
| | September 30, | | | | September 30, | | | |
| | 2012 | 2011 | | | 2012 | 2011 | | |
| Cost of services | \$ 849 | \$ 659 | \$ 190 | 29% | \$ 2,710 | \$ 2,009 | \$ 701 | 35% |
| Operating expenses | 1,935 | 1,663 | 272 | 16% | 5,912 | 4,713 | 1,199 | 25% |
| Total stock-based compensation before tax | 2,784 | 2,322 | 462 | 20% | 8,622 | 6,722 | 1,900 | 28% |
| Income tax benefit | (915) | (676) | | | (2,781) | (2,175) | | |

The increases in stock-based compensation expense during the third quarter and first nine months of 2012 compared to the same periods in 2011 were primarily due to the higher value of the annual periodic equity grant, the annual executive grant and new hire grants.

Table of Contents**Non-operating income and expenses, net**

| <i>(Dollars in thousands)</i> | Three Months Ended September 30, | | Change | | Nine Months Ended September 30, | | Change | |
|---|-------------------------------------|------------|----------|--------|------------------------------------|--------|------------|--------|
| | 2012 | 2011 | | | 2012 | 2011 | | |
| Foreign currency transaction gain (loss) | \$ 438 | \$ (1,049) | \$ 1,487 | (142)% | \$ 337 | \$ 140 | \$ 197 | 141% |
| Interest income, net | 113 | 102 | 11 | 11% | 318 | 279 | 39 | 14% |
| Other (expense) income, net | (920) | 504 | (1,424) | (283)% | (1,496) | 365 | (1,861) | (510)% |
| Non-operating income (loss) and expenses, net | \$ (369) | \$ (443) | \$ 74 | (17)% | \$ (841) | \$ 784 | \$ (1,625) | (207)% |

We hold foreign currency denominated accounts receivable and cash in our U.S. operating company where the functional currency is the U.S. dollar. As a result, these receivables and cash are subject to foreign currency transaction gains and losses when there are changes in exchange rates between the U.S. dollar and the foreign currencies. The fluctuations in foreign currency transaction gains and losses were primarily due to the changes in the value of the British pound and Euro relative to the U.S. dollar during the third quarter and first nine months of 2012 and 2011.

Beginning in the second quarter of 2011, we enter into forward foreign currency contracts to manage our exposure to changes in foreign currency exchange rates affecting the foreign currency denominated accounts receivable and cash held by our U.S. operating company. We have not designated these forward foreign currency contracts as hedging instruments and as a result, we record the fair value of the outstanding contracts at the end of the reporting period in our consolidated balance sheet, with any fluctuations in the value of these contracts recognized in other (expense) income, net. The fluctuations in the value of these forward foreign currency contracts recorded in other (expense) income, net, partially offset in net income 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 recorded in foreign currency transaction gain.

The total change in the fair value of our forward foreign currency contracts recorded in other (expense) income, net, during the third quarter and first nine months of 2012 was a loss of \$0.9 million and \$1.5 million, respectively. During the third quarter and first nine months of 2011, the total change in the fair value of the Company's forward foreign currency contracts recorded in other (expense) income, net, was a gain of \$0.5 million and \$0.3 million, respectively.

Provision for income taxes

The Company accounts for income taxes at each interim period using its estimated annual effective tax rate. The provision for income taxes represents current and future amounts owed for federal, state, and foreign taxes. For the first nine months of 2012, our annual effective tax rate was 47.8%. During the third quarter and first nine months of 2012, we recorded provisions of \$0.4 million and \$1.3 million, respectively. 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 had 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 third quarter of 2011, the Company recorded a net tax benefit of approximately \$7.4 million in the third quarter of 2011 and a benefit of \$4.4 million for the first nine months of 2011.

Table of Contents**Liquidity and capital resources**

| | Nine Months Ended September 30, | |
|--|--|-------------|
| | 2012 | 2011 |
| <i>(in thousands)</i> | | |
| Cash provided by (used in) | | |
| Operating activities | \$ 29,084 | \$ 19,647 |
| Investing activities | (16,746) | (36,011) |
| Financing activities | (7,050) | (3,521) |
| Effect of exchange rate on cash | 596 | 361 |
| Net increase (decrease) in cash and cash equivalents | \$ 5,884 | \$ (19,524) |

| | As of September 30, 2012 | As of December 31, 2011 |
|--|--|------------------------------------|
| | Total cash, cash equivalents, and marketable securities | \$ 111,329 |

We believe that our current cash, cash equivalents, and cash flow from operations will be sufficient to fund our operations and our share repurchase program for at least the next 12 months.

In June 2011, we entered into a lease arrangement for our new office headquarters in Cambridge, Massachusetts commencing on July 1, 2011 and terminating on December 31, 2023, subject to our option to extend for two additional five-year periods. As mentioned above, we completed the move to our new office headquarters in the third quarter of 2012. We will continue to pay our monthly rent under the lease for our old office headquarters in Cambridge, Massachusetts, through the remaining term of that lease, which is scheduled to expire on May 31, 2013. We invested approximately \$11.2 million in the first nine months of 2012, net of our landlord tenant improvement allowance, and we expect to invest approximately \$0.8 million in the remainder of 2012, net of our landlord tenant improvement allowance, for furniture, fixtures, IT equipment, and leasehold improvements for our new office headquarters.

We evaluate acquisition opportunities from time to time, which if pursued, could require use of our funds. Approximately \$44.6 million of our cash and cash equivalents is held in our foreign subsidiaries. If it became necessary to repatriate these funds, we may be required to pay U.S. tax, net of any applicable foreign tax credits, upon repatriation. We consider the earnings of our foreign subsidiaries to be permanently reinvested and, as a result, U.S. taxes on such earnings are not provided. It is impractical to estimate the amount of U.S. tax we could have to pay upon repatriation due to the complexity of the foreign tax credit calculations and because we consider our earnings permanently reinvested. There can be no assurance that changes in our plans or other events affecting our operations will not result in materially accelerated or unexpected expenditures.

Cash provided by operating activities

The primary driver of cash provided by operating activities during the first nine months of 2012 was a \$17.8 million decrease in accounts receivable due to our strong collections.

The primary drivers of cash provided by operating activities during the first nine months of 2011 were \$12 million of net income and an \$8.3 million increase in deferred revenue primarily resulting from the difference in timing of billings and revenue recognition for annual maintenance.

Table of Contents**Future Cash Receipts from License Arrangements**

Total contractual future cash receipts due from our existing license agreements was approximately \$195.2 million as of September 30, 2012 compared to \$120.6 million as of September 30, 2011. The future cash receipts due as of September 30, 2012 are summarized as follows:

| <i>As of September 30, (in thousands)</i> | Contractual payments for term licenses not recorded on the balance sheet (1) | Other contractual license payments not recorded on the balance sheet (2) | Total |
|---|---|---|--------------|
| Remainder of 2012 | \$ 8,566 | \$ 9,467 | \$ 18,033 |
| 2013 | 42,837 | 10,430 | 53,267 |
| 2014 | 40,393 | 4,280 | 44,673 |
| 2015 | 34,504 | 5,793 | 40,297 |
| 2016 and thereafter | 29,554 | 9,384 | 38,938 |
| Total | \$ 155,854 | \$ 39,354 | \$ 195,208 |

- (1) These amounts will be recognized as revenue in the future over the term of the agreement as payments become due or earlier if prepaid.
- (2) These amounts will be recognized as revenue in future periods and relate to perpetual and subscription licenses with extended payment terms and/or additional rights of use.

Cash used in investing activities

During the first nine months of 2012, we invested \$21.9 million primarily in leasehold improvements, furniture and fixtures and equipment for the build-out of our U.S. and India offices.

During the first nine months of 2011, cash used in investing activities was primarily for purchases of marketable debt securities of \$49.7 million, partially offset by the proceeds received from the sales and maturities of marketable debt securities of \$18.8 million.

Cash used in financing activities

Cash used in financing activities during the first nine months of 2012 and 2011 was primarily for repurchases of our common stock and the payment of our quarterly dividend. Since 2004, our Board of Directors has approved annual stock repurchase programs that have authorized the repurchase in the aggregate of up to \$86.3 million of our common stock. Purchases under these programs have been made on the open market.

The following table is a summary of our repurchase activity under all of our repurchase programs during the first nine months of 2012 and 2011:

| <i>(Dollars in thousands)</i> | Nine Months Ended September 30, | | | |
|-------------------------------|--|--------|-------------|--------|
| | 2012 | | 2011 | |
| | Shares | Amount | Shares | Amount |

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| | | | | |
|---|---------|-----------|--------|-----------|
| Prior year authorization as of January 1, | | \$ 13,963 | | \$ 13,237 |
| Repurchases paid | 125,891 | (3,861) | 92,158 | (3,439) |
| Repurchases unsettled | 1,692 | (48) | 3,026 | (102) |
| Authorization remaining as of September 30, | | \$ 10,054 | | \$ 9,696 |

In addition to the share repurchases made under our repurchase programs, we net settled the majority of our employee stock option exercises and RSU vesting, which resulted in the withholding of shares to cover the option exercise price and the minimum statutory tax withholding obligations.

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During the first nine months of 2012 and 2011, option and RSU holders net settled stock options and vested RSUs representing the right to purchase a total of 424,000 shares and 620,000 shares, respectively, of which only 243,000 shares and 375,000 shares, respectively, were issued to the option and RSU holders and the balance of the shares were surrendered to us to pay for the exercise price and the applicable taxes. During the first nine months of 2012 and 2011, instead of receiving cash from the equity holders, we withheld shares with a value of \$3.6 million and \$5.5 million, respectively, for withholding taxes and \$2.4 million and \$4.2 million, respectively, for the exercise price. The value of share repurchases and shares withheld for net settlement of our employee stock option exercises and vesting of RSUs offset the proceeds received under our various share-based compensation plans during the first nine months of 2012 and 2011.

Dividends

The Company declared a cash dividend of \$0.03 per share for each quarter in the first nine months of 2012 and 2011, and paid cash dividends of \$3.4 million in both the first nine months of 2012 and 2011. It is our current intention to pay a quarterly cash dividend of \$0.03 per share to shareholders of record as of each quarter, however, the Board of Directors may terminate or modify this dividend program at any time without notice.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Market risk represents the risk of loss that may affect us due to adverse changes in financial market prices and rates. Our market risk exposure is primarily related to fluctuations in foreign exchange rates. We enter into forward foreign currency contracts to partially mitigate our exposure to the fluctuations in foreign exchange rates. See Note 4 *Derivative Instruments* in the notes to the accompanying unaudited condensed consolidated financial statements for further discussion.

There were no significant changes to our quantitative and qualitative disclosures about market risk during the first nine months of 2012. Please refer to Part II, Item 7A. *Quantitative and Qualitative Disclosures about Market Risk* included in our Annual Report on Form 10-K for the year ended December 31, 2011 for a more complete discussion of our market risk exposure.

Item 4. Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures.

Our management, with the participation of our Chief Executive Officer, or CEO, and Chief Financial Officer, or CFO, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act) as of September 30, 2012. In designing and evaluating our disclosure controls and procedures, our management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives, and our management necessarily applied its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on this evaluation, our CEO and CFO concluded that our disclosure controls and procedures were effective as of September 30, 2012.

(b) Changes in Internal Control over Financial Reporting.

There have been no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act) during the quarter ended September 30, 2012 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents**Part II Other Information:****Item 1A. Risk Factors**

We encourage you to carefully consider the risk factors identified in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2011. These risk factors could materially affect our business, financial condition and future results and could cause our actual business and financial results to differ materially from those contained in forward-looking statements made in this Quarterly Report on Form 10-Q or elsewhere by management from time to time. Except as described below, there have been no material changes during the first nine months of 2012 to the risk factors disclosed in our Annual Report on Form 10-K for the year ended December 31, 2011.

The ongoing uncertainty and volatility in the global financial markets related to the European sovereign debt crisis and the so-called fiscal cliff in the U.S. may adversely affect the Company's operating results.

Global financial markets continue to experience disruptions, including increased volatility, and diminished liquidity and credit availability. In particular, developments in Europe have created uncertainty with respect to the ability of certain European countries to continue to service their sovereign debt obligations. This debt crisis and related European financial restructuring efforts may cause the value of the Euro to deteriorate, reducing the purchasing power of our European customers and reducing the translation of Euro based revenues into U.S. dollars. For the first nine months of 2012, approximately 11% of our revenues were derived from countries which use the Euro as their primary currency. In the event that one or more countries were to replace the Euro with their legacy currency, then the Company's sales in and to such countries, or Europe generally, would likely be adversely affected until stable exchange rates were established. In addition, the European crisis is contributing to instability in global credit markets. Finally, global credit markets and the condition of the U.S. domestic and global economy could be further affected by the fiscal cliff tax increases and spending cuts that will go into effect automatically on January 1, 2013 in the absence of prior Congressional action. If these austerity measures are allowed to go into effect, economic growth in the United States could stall or go into recession which, among other things, could decrease demand for our products and services and adversely affect our cash flows and results of operations. If global economic and market conditions, or economic and financial market conditions in Europe, the United States or other key markets, remain uncertain, persist, or deteriorate further, our customers may respond by suspending, delaying or reducing their expenditures, which may adversely affect our cash flows and results of operations.

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

The following table sets forth information regarding our repurchases of our common stock during the third quarter of 2012:

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Approximate Dollar Value | |
|----------------|--|------------------------------------|---|---|
| | | | Total Number of Shares Purchased as Part of Publicly Announced Share Repurchase Programs (1) | of Shares That May Yet Be Purchased Under Publicly Announced Share Repurchase Programs (in thousands) (1) |
| 7/1/12-7/31/12 | 18,432 | \$ 28.85 | 18,432 | \$ 10,908 |
| 8/1/12-8/31/12 | 23,748 | 26.89 | 23,748 | 10,269 |
| 9/1/12-9/30/12 | 7,480 | 28.83 | 7,480 | 10,054 |
| Total | 49,660 | \$ 27.91 | | |

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- (1) Since 2004, our Board of Directors has approved stock repurchase programs that have authorized the repurchase of \$86.3 million of our common stock. On November 9, 2011, we announced that our Board of Directors approved a \$5.6 million increase in the remaining funds available under the program expiring on December 31, 2011, and an extension of the expiration date to December 31, 2012. Under this program, the Current Program, purchases may be made from time to time on the open market or in privately negotiated transactions. Shares may be repurchased in such amounts as market conditions warrant, subject to regulatory and other considerations. We have established a pre-arranged stock repurchase plan, which is intended to comply with the requirements of Rule 10b5-1 under the Securities Exchange Act of 1934, as amended, and of Rule 10b-18 of the Exchange Act (the 10b5-1 Plan). All share repurchases under the Current Program during closed trading window periods will be made pursuant to the 10b5-1 Plan.

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Item 6. Exhibits

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

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SIGNATURES

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

Pegasystems Inc.

By:

Date: November 8, 2012

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

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PEGASYSTEMS INC.

Exhibit Index

Exhibit

No. Description

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

- 101 The following materials from Pegasystems Inc.'s Quarterly Report on Form 10-Q for the quarter ended September 30, 2012, formatted in XBRL (Extensible Business Reporting Language): (i) the Unaudited Condensed Consolidated Balance Sheets (ii) the Unaudited Condensed Consolidated Statements of Income, (iii) the Unaudited Condensed Consolidated Statements of Comprehensive Income (iv) the Unaudited Condensed Consolidated Statements of Cash Flows, and (v) Notes to the Unaudited Condensed Consolidated Financial Statements. *

*Pursuant to Rule 406T of Regulation S-T, these interactive data files shall not be deemed filed for purpose of Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to liability under that section, and shall not be incorporated by reference into any registration statement or other document filed under the Securities Act of 1933, as amended, except as expressly set forth by specific reference in such filing.