

PEGASYSTEMS INC  
Form 10-K  
February 25, 2014  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-K**

X **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT  
of 1934**

For the fiscal year ended December 31, 2013

.. **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE  
ACT of 1934**

Commission File No. 1-11859

**PEGASYSTEMS INC.**

(Exact name of Registrant as specified in its charter)

Massachusetts

(State or other jurisdiction of incorporation or organization)

(IRS Employer Identification No. 04-2787865)

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One Rogers Street

Cambridge, MA  
(Address of principal executive offices)

02142-1209  
(zip code)

(617) 374-9600

(Registrant's telephone number, including area code)

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

| <u>Title of Each Class</u>               | <u>Name of Each Exchange on Which Registered</u> |
|--|--|
| Common Stock, \$0.01 par value per share | NASDAQ Global Select Market                      |

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

None

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

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

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

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. (Check one):

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

The aggregate market value of the Registrant's common stock held by non-affiliates of the Registrant based on the closing price (as reported by NASDAQ) of such common stock on the last business day of the Registrant's most recently completed second fiscal quarter (June 30, 2013) was approximately \$576 million.

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There were 38,135,303 shares of the Registrant's common stock, \$0.01 par value per share, outstanding on February 5, 2014.

### **DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Registrant's definitive proxy statement related to its 2014 annual meeting of stockholders to be filed subsequently are incorporated by reference into Part III of this report.

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**PART I**

**Forward-looking statements**

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

**ITEM 1. Business**

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

**Our business: Better Business Software**

We believe that business success requires that organizations become digital enterprises in order to serve today's empowered customers, and that software either accelerates or impedes that transformation. Pega powers the digital enterprise with Better Business Software that replaces archaic programming or multiple software packages with a comprehensive model built on visual metaphors that businesspeople can understand and drive. The resulting digital enterprise engages customers, simplifies processes, and turns the power to change into a competitive advantage.

We develop, market, and license software solutions that help clients improve their business results by giving them the power to engage customers, simplify their operations, and adapt to change. Pegasystems' software allows clients to build and change enterprise software applications much more rapidly than they can with traditional programming, while engaging the collaborative efforts of both businesspeople and technologists.

Pegasystems unified platform intersects with several traditional software markets, including: Customer Relationship Management ( CRM ), Business Process Management ( BPM ), Business Rules Management Systems ( BRMS ) Dynamic Case Management ( DCM ), Decision Management, including predictive and adaptive analytics, and the Vertical Specific Software ( VSS ) market of vertical industry solutions and packaged applications. Pegasystems unified and highly scalable platform provides superior capability and agility to its clients.

Pegasystems also provides consulting services and implementation support, training, and technical support services to help clients maximize the business value from our software. We focus our sales efforts primarily on target accounts, which are large companies or divisions within companies, and typically leaders in their industries. Our strategy is to sell a client a series of licenses, each focused on a specific purpose or area of operations. As we have found meaningful interest from smaller companies, we are working to invest in expanding our sales force to extend coverage beyond our traditional Fortune 500 focus.

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### **Our partners**

We maintain alliances with global systems integrators and technology consulting firms that provide consulting services to our clients. Strategic partnerships with technology consulting firms and systems integrators are important to our sales efforts because they influence buying decisions, help us to identify sales opportunities, and complement our software with their domain expertise and services capabilities. These partners may deliver strategic business planning, consulting, project management, and implementation services to our clients. Currently, our partners include well respected, major firms such as Accenture Ltd., Capgemini SA, Cognizant Technology Solutions Inc., Infosys Technologies Limited, Mahindra Satyam, Tata Consultancy Services Limited, PricewaterhouseCoopers LLP, Virtusa Corporation, and Wipro Ltd.

### **Our products**

#### ***Pega Build for Change® Platform***

The Pega Build for Change® platform (PegaRULES Process Commander®) is a unified platform that enables clients to build enterprise applications in a fraction of the time it would take using traditional programming technologies. Business and IT personnel collaborate, using a visual language that models the requirements and design of the application in a readily understandable manner. This agile approach facilitates continuous improvement methodologies, such as BPM or Lean Six Sigma, to effectively manage individual projects or drive a complete enterprise transformation. All aspects of the application are defined in the model: business strategy mapping, business processes, data models, case definitions, rules, decisions, reporting, interfaces, intelligent work management capabilities, business activity monitoring, and the user experience across both web and mobile devices.

Once defined this way, the finished application and its documentation are generated and immediately ready for use. Our approach bypasses the error-prone and time-consuming process of manually translating requirements into code. The software application is automatically created directly from the model, closing the costly gap between vision and execution. The Pega Build for Change® platform is standards-based and can leverage a client's existing technology to create new business applications that cross technology silos and bridge front and back-office.

#### ***Business Process Solutions***

Pegasystems also offers purpose or industry-specific solutions built on its platform. These solutions provide a best-practice starting point for key industry processes, yet maintain a flexibility not delivered by traditional commercial off the shelf products. This allows organizations to quickly implement new processes, refine customer experiences, bring new offerings to market, and provide customized or specialized processing to meet the needs of different customers, departments, geographies or regulatory requirements.

#### ***Pega Customer Engagement Solutions***

Pega Customer Engagement Solutions offer a process-driven, customer-centric CRM solution to maximize the lifetime value of customers and reduce the costs of serving customers. We provide marketing, sales, and service solutions to optimize sales processes and customer service interactions. Our case management and business process solutions facilitate the fulfillment of customer requests, while our Next-Best-Action analytics predict and adapt to customer behavior to improve both business outcomes and the customer experience.

Decision management is incorporated into these solutions to guide actions and optimize process outcomes based on business objectives. Solutions, including cross-sell/up-sell, retention, service recommendations, and collections help businesses deploy automated decision making quickly. The predictive and adaptive analytics incorporated into these solutions support the creation and improvement of decision models to improve outcomes.

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### ***Pega Application Mobility Platform***

Our acquisition of Antenna Software, Inc. ( Antenna ) expanded our Pega Application Mobility Platform, which enables clients to build, manage, and deploy mobile applications. Our mobile application development platform permits clients to manage the complex elements of the mobile application lifecycle including security, integration, testing, and management of mobile applications and devices. It also helps businesses significantly reduce their development time, deployment cost, and the complexity associated with run-the-business mobile applications.

### ***Pega Cloud®***

Pega Cloud® is Pegasystems service offering that allows clients to create and deploy our software applications using an Internet-based infrastructure. This offering enables our clients to rapidly build, test, and deploy their applications in a secure cloud environment, while minimizing their infrastructure and hardware costs.

### **Our services and support**

We offer services and support through our Pega consulting group, our global client support group, and our training services group. We also utilize third party contractors to assist us in providing these services.

### ***Pega Consulting***

Our Pega consulting group provides guidance and implementation services to our clients and partners on how to best apply our technology and develop strong implementation expertise.

### ***Global Client support***

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

### ***Training Services***

The success of our sales strategy for multiple follow-on sales to target clients depends on our ability to train a large number of partners and clients to implement our technology. We offer training for our staff, clients, and partners. Training is offered at our regional training facilities in Cambridge, Massachusetts, Bedford, New Hampshire, Reading, England, Hyderabad, India, Sydney, Australia, at third party facilities in numerous other locations, and at client sites. We also offer training online through PegaACADEMY, which offers an alternative way to learn our software quickly, easily, and cost effectively. We expect that the online training will help expand the number of trained experts at a faster pace. Our courses are designed to meet the specific requirements of process architects, system architects, and system administrators.

### **Our markets**

Our target clients are primarily large, industry-leading organizations faced with managing changes to their complex business processes in order to increase business agility, drive growth, improve productivity, retain customers, and help ensure compliance. Our clients have typically been large companies in the financial services, healthcare, insurance, government, communications and media, manufacturing and high tech, and life sciences markets. We are expanding our client base to a broader range of companies within those markets as well as to additional industries, such as energy, travel and entertainment.

### ***Financial Services***

Financial services organizations rely on software to improve the quality, accuracy, and efficiency of customer interactions and transactions processing. Pegasystems customer service process, marketing, and exceptions management products allow clients to be responsive to changing business requirements.

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### ***Healthcare***

Healthcare organizations seek products that integrate their front and back office initiatives and help drive customer service, efficiency, and productivity. Our claims products allow healthcare clients to address financial, administrative and coverage requirements of healthcare consumerism and reform.

### ***Insurance***

Insurance companies, whether competing globally or nationally for customers and channels, need software to automate the key activities of distribution management, quoting, underwriting, claims, and policy servicing as well as products that improve customer service and the overall customer experience. Pega's solutions for insurance carriers increase business value by delivering customer-focused experiences that drive higher sales, lower expense ratios, and improve risk mitigation.

### ***Communications and Media***

Communications and media organizations need to address high levels of customer churn, growing pressure to increase revenue and an ability to respond quickly to changing market conditions. Our solutions enable organizations to reshape the way they interact with customers, streamline operations and bring new services and products to market.

### ***Government***

Government agencies need to modernize legacy systems and processes to meet the growing demands for improved constituent service, lower costs and greater levels of transparency. Pegasystems offers a proven, economical and highly effective solution that delivers advanced capabilities to streamline application development and delivery via an agile, multi-channel environment.

### ***Life Sciences***

Life sciences organizations are looking for solutions to increase efficiencies and transparency across the product development lifecycle by automating and streamlining business processes across people, applications, business rules and enterprise systems. Our solutions for life sciences focus on product development, safety and risk management, CRM, and regulatory transparency delivering advanced capabilities to streamline development and bring to market industry leading solutions quickly.

### ***Manufacturing and High Technology***

Manufacturers world-wide are transforming their businesses to better engage customers and suppliers, as well as directly manage the performance of their products from the earliest designs to beyond the manufacturing stage and throughout the product life-cycle. Our manufacturing solutions address supplier risk, manage warranties, recalls, repairs, and returns, as well as extend ERP system capabilities.

### ***Other Industries***

We offer solutions to a broad range of other types of companies and industries. For example, we sell our BPM technology to clients in energy, transportation, retail, travel, and other services.



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### **Competition**

We compete in the BPM, Case Management, CRM, Business Rules, Decision Management, and mobile application development platform software markets. These markets are intensely competitive, rapidly changing, and highly fragmented, as current competitors expand their product offerings and new companies enter the market. Competitors vary in size and in the scope and breadth of the products and services offered. We encounter competition from:

BPM vendors, including Service-Oriented Architecture ( SOA ) middleware vendors such as IBM, Oracle Corporation, Software AG, and Tibco Software Inc., and other BPM vendors such as Appian Corporation and the Cordys division of Open Text;

Case Management vendors such as the Documentum division of EMC Corporation, the FileNet division of IBM s Information Management Group, and the BPM/Case Management division of Open Text;

CRM application vendors such as Salesforce.com, the Siebel division of Oracle, and the Microsoft Dynamics CRM division of Microsoft;

Decision Management vendors including Business Rules Engine vendors such as the ILOG and SPSS divisions of IBM, and the Blaze division of FICO, and vendors of solutions that leverage predictive analytics in managing customer relationships including the Unica Division of IBM;

Companies that provide application specific software for the financial services, healthcare, insurance and other specific markets such as Guidewire Software, Inc., the Detica NetReveal Division of BAE, SmartStream Technologies Ltd., SunGard, SAP, and The TriZetto Group, Inc.;

Mobile application development platform vendors, including IBM and SAP, as well as open source mobile technologies, including the jQuery Mobile platform from the jQuery Foundation;

Professional service organizations that develop custom software in conjunction with rendering consulting services; and

Clients current information technology departments, which may seek to modify their existing systems or develop their own proprietary systems.

We have been most successful competing for clients whose businesses are characterized by a high degree of change, complexity, and regulation. We believe that the principal competitive factors within our market include:

Product adaptability, scalability, functionality, and performance;

Proven success in delivering cost-savings and efficiency improvements;

Ease-of-use for developers, business units, and end-users;

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Timely development and introduction of new products and product enhancements;

Establishment of a significant base of reference clients;

Ability to integrate with other products and technologies;

Customer service and support;

Product price;

Vendor reputation; and

Relationships with systems integrators.

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We believe we are competitively differentiated as our unified Build for Change® technology allows both client business and IT staff, using a single, intuitive user interface, to build enterprise applications in a fraction of the time it would take with the types of disjointed architectures and tools offered by our competitors. We believe we compete favorably due to our expertise in our target industries and our long-standing client relationships. We believe we compete less favorably on the basis of some of these factors with respect to our larger competitors, many of which have greater sales, marketing and financial resources, more extensive geographical presence and greater name recognition than we do. In addition, we may be at a disadvantage with respect to our ability to provide expertise outside our target industries. See Risk Factors The market for our offerings is intensely and increasingly competitive, rapidly changing and highly fragmented in Item 1A of this Annual Report on Form 10-K.

### **Sales and marketing**

We market our software and services primarily through a direct sales force. Strategic partnerships with consultants and systems integrators are important to our sales efforts because they influence buying decisions, help us to identify sales opportunities, and complement our software and services with their domain expertise and professional services capabilities.

To support our sales efforts, we conduct a broad range of marketing programs, including client and industry targeted solution campaigns, trade shows, including our PegaWORLD user conference, solution seminars and Webinars, industry analyst and press relations, Web and digital marketing, community development, social media, and other direct and indirect marketing efforts. Our consulting staff, business partners, and other third parties also conduct joint and separate marketing campaigns that generate sales leads.

### **Sales by geography**

In 2013, 2012, and 2011, sales to clients based outside of the United States of America ( U.S. ) represented approximately 45%, 46%, and 48%, respectively, of our total revenue. We currently operate in one reportable segment business process solutions. We derive substantially all of our operating revenue from the sale and support of one group of similar products and services. The majority of our assets are located within the U.S. See Note 18 Geographic Information and Major Clients included in the notes to the accompanying audited consolidated financial statements for further detail. See Risk Factors We face risks from operations and clients based outside of the U.S. in Item 1A of this Annual Report on Form 10-K.

### **Research and development**

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

During 2013, 2012, and 2011, research and development expenses were approximately \$79.7 million, \$76.7 million, and \$65.3 million, respectively. We expect that we will continue to commit significant resources to our product research and development in the future to maintain our leadership position.

### **Employees**

As of January 31, 2014, we had 2,627 employees worldwide, of which 1,219 were based in North America, 548 were based in Europe, and 860 were based in Asia Pacific.

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**Backlog of license, maintenance, and services**

As of December 31, 2013, we had software license, maintenance, and services agreements with clients expected to result in approximately \$506.1 million of future revenue, of which we expect approximately \$279.7 million to be recognized in 2014. As of December 31, 2012, we had backlog of software license, maintenance, and services agreements with clients of approximately \$438 million. Under some of these agreements, we must fulfill certain conditions prior to recognizing revenue, and there can be no assurance when, if ever, we will be able to satisfy all such conditions in each instance. Business conditions could change and, therefore, backlog may not be a reliable indicator of future financial performance.

**Available Information**

We make available free of charge through our Website [www.pegacom/about-us/investors/sec](http://www.pegacom/about-us/investors/sec) filings our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K, and amendments to these reports, as soon as reasonably practicable after we electronically file such material with, or furnish such material to, the Securities and Exchange Commission ( SEC ). The SEC maintains a Website that contains reports, proxy, and information statements and other information regarding issuers that file electronically with the SEC at [www.sec.gov](http://www.sec.gov). We make available on our Website reports filed by our executive officers and Directors on Forms 3, 4, and 5 regarding their ownership of our securities. Our Code of Conduct, and any amendments to our Code of Conduct, is also available on our Website.

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**ITEM 1A. Risk Factors**

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

**Factors relating to our financial results**

*The timing of our license revenue is difficult to predict accurately, which may cause our quarterly operating results to vary considerably.* A change in the number or size of high value license arrangements, or a change in the mix between perpetual licenses, term licenses, and Pega Cloud® subscriptions can cause our revenues to fluctuate materially from quarter to quarter. Our decision to enter into term licenses and Pega Cloud® subscriptions that require the revenue to be recognized over the license term may adversely affect our profitability in any period due to sales commissions being paid at the time of signing and the corresponding revenue being recognized over time. We budget for our selling and marketing, product development, and other expenses based on anticipated future revenue. If the timing or amount of revenue fails to meet our expectations in any given quarter, our financial performance is likely to be adversely affected because only small portions of expenses vary with revenue. As a result, period-to-period comparisons of our operating results are not necessarily meaningful and should not be relied upon to predict future performance.

*The number of our license arrangements has been increasing, and we may not be able to sustain this growth unless we and our partners can provide sufficient high quality consulting services, training, and maintenance resources to enable our clients to realize significant business value from our software.* Our clients typically request consulting services and training to assist them in implementing our products. Our clients also purchase maintenance on our products in almost all cases. As a result, an increase in the number of license arrangements is likely to increase demand for consulting services, training, and maintenance relating to our products. Given that the number of our license arrangements has been increasing, we will need to provide our clients with more consulting services, training, and maintenance to enable our clients to realize significant business value from our software. We have been increasingly enabling our partners and clients through training to create an expanded universe of people that are skilled in the implementation of our products. However, if we and our partners are unable to provide sufficient high quality consulting services, training, or maintenance resources to our clients, our clients may not realize sufficient business value from our products to justify follow-on sales, which could impact our future financial performance. In addition, the growth required to meet the increased demand for our consulting services could strain our ability to deliver our services engagements at desired levels of profitability, thereby impacting our overall profitability and financial results.

*We frequently enter into a series of licenses that are focused on a specific purpose or area of operations. If we are not successful in obtaining follow-on business from these clients, our financial performance could be adversely affected.* We frequently enter into a series of licenses with our new clients that are focused on a specific purpose or area of operations. Once a client has realized the value of our software, we work with the client to identify opportunities for follow-on sales. However, we may not be successful in demonstrating this value to some clients, for reasons relating to the performance of our products, the quality of the services and support we provide for our products, or external reasons. For these clients, we may not obtain follow-on sales or the follow-on sales may be delayed, and our license revenue could be limited. This could lower the total value of all transactions and adversely affect our financial performance.

*Our consulting services revenue is dependent to a significant extent on closing new license transactions with clients.* We derive a substantial portion of our consulting services revenue from implementation of new software licenses with our clients, both from implementations that are led by our consulting services staff and from implementations where we provide consulting to our partners and clients to support their implementations. Accordingly, it is imperative that we close more license transactions with our clients if we are to maintain or grow our services revenue.

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*If we are unable to maintain vendor specific objective evidence ( VSOE ) of fair value of our consulting services arrangements, we may be required to delay the recognition of a portion of our revenue to future periods.* We have established VSOE of fair value of our consulting services in North America, Australia, and Europe, based on the price charged when these services are sold separately. The weakened economy and significant competition within our industry have created pricing pressure on consulting services provided by technology companies. If we elect to discount our consulting services pricing or otherwise introduce variability in our consulting services arrangements to attract or retain clients, this could lead to an insufficient number of consistently priced consulting services arrangements for us to maintain VSOE. If we do not have VSOE of fair value of our consulting services, we may be required to recognize all revenue for these consulting services arrangements, including any related license, maintenance, and other services revenue if the consulting services are bundled in an arrangement, ratably over the longer of the software maintenance period or the service period.

*Our financial results may be adversely affected if we are required to change certain estimates, judgments, and positions relative to our income taxes.* In the ordinary course of conducting a global business enterprise, there are many transactions and calculations undertaken whose ultimate tax outcome cannot be certain. Some of these uncertainties arise as a consequence of positions we have taken regarding valuation of deferred tax assets, transfer pricing for transactions with our subsidiaries, and potential challenges to nexus and tax credit estimates. We estimate our exposure to unfavorable outcomes related to these uncertainties and estimate the probability of such outcomes. Future realization of our deferred tax assets ultimately depends on the existence of sufficient taxable income within the available carryback or carryforward periods. We record a valuation allowance to reduce our deferred tax assets to an amount we believe is more likely than not to be realized. If our taxable income is not consistent with our expectations or the timing of income is not within the applicable carryforward period, we may be required to establish a valuation allowance on all or a portion of these deferred tax assets. Changes in our valuation allowance impact income tax expense in the period of adjustment. Although we believe our estimates are reasonable, no assurance can be given that the final tax outcome of these matters or our current estimates regarding these matters will not be different from what is reflected in our historical income tax provisions, returns, and accruals. Such differences, or changes in estimates relating to potential differences, could have a material impact, unfavorable or favorable, on our income tax provisions, require us to change the recorded value of deferred tax assets, and adversely affect our financial results.

*We are investing heavily in sales and marketing and support in anticipation of a continued increase in license arrangements, and we may experience decreased profitability or losses if we are unsuccessful in increasing the value of our license arrangements in the future.* We have been increasing our investment in sales and marketing to meet increasing demand for our software by hiring additional sales and marketing personnel. We anticipate that we will need to provide our clients with more maintenance support as a result of this increase in demand, and have been hiring additional personnel in this area. These investments have resulted in increased fixed costs that do not vary with the level of revenue. If the increased demand for our products does not continue, we could experience decreased profitability or losses as a result of these increased fixed costs.

**Factors relating to our products and markets**

*We will need to acquire or develop new products, evolve existing ones, and adapt to technology change.* Technical developments, client requirements, programming languages, and industry standards change frequently in our markets. As a result, success in current markets and new markets will depend upon our ability to enhance current products, to acquire or develop and introduce new products that meet client needs, keep pace with technology changes, respond to competitive products, and achieve market acceptance. Product development requires substantial investments for research, refinement, and testing. There can be no assurance that we will have sufficient resources to make necessary product development investments. We may experience difficulties that will delay or prevent the successful development, introduction, or implementation of new or enhanced products. Inability to introduce or implement new or enhanced products in a timely manner would adversely affect future financial performance.

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***The market for our offerings is intensely and increasingly competitive, rapidly changing, and highly fragmented.*** We compete in the BPM, Case Management, CRM, Decision Management, and mobile application development platform software markets. The markets for our software and related implementation, consulting, and training services are intensely competitive, rapidly changing and highly fragmented. We currently encounter significant competition from internal information systems departments of potential or existing clients that develop custom software. We also compete with companies that target the BPM, Case Management, Decision Management, and mobile application development platform markets as well as professional service organizations that develop custom software in conjunction with rendering consulting services. Competition for market share and pressure to reduce prices and make sales concessions are likely to increase. Many of our competitors, such as IBM, Oracle and SAP, are large and have far greater resources and may be able to respond more quickly and efficiently to new or emerging technologies, programming languages or standards or to changes in client requirements or preferences. Competitors may also be able to devote greater managerial and financial resources to develop, promote, and distribute products and provide related consulting and training services. There can be no assurance that we will be able to compete successfully against current or future competitors or that the competitive pressures faced by us will not materially adversely affect our business, operating results, and financial condition.

***The continued weakness in the U.S and international economies may negatively impact our sales to, and the collection of receivables from, our financial services and insurance clients and possibly our clients in other industries.*** Our sales to, and our collection of receivables from, our clients may be impacted by adverse changes in global economic conditions, especially in the U.S., Europe and Asia Pacific. In the past few years, these regions have experienced instability in financial markets, tightening credit, and weak overall economic conditions, which has impacted the financial services and insurance industries in particular. These trends could impact the ability and willingness of our financial services and insurance clients, and possibly our clients in other industries, to make investments in technology, which may delay or reduce the amount of purchases of our software and services. These factors could also impact the ability and willingness of these clients to pay their trade obligations and honor their contractual commitments under their noncancellable term licenses. These clients may also become subject to increasingly restrictive regulatory requirements, which could limit or delay their ability to proceed with new technology purchases. Our financial services and insurance clients as a group represent a significant amount of our revenues and receivables. Accordingly, their potential financial instability could negatively impact our business, operating results, and financial condition.

***We have historically sold to the financial services, insurance and healthcare markets, and rapid changes or consolidation in these markets could affect the level of demand for our products.*** We have historically derived a significant portion of our revenue from clients in the financial services, insurance, and healthcare markets, and sales to these markets are important for our future growth. Competitive pressures, industry consolidation, decreasing operating margins, regulatory changes, and privacy concerns affect the financial condition of our clients and their willingness to buy. In addition, clients' purchasing patterns in these industries for large technology projects are somewhat discretionary. The financial services and insurance markets are undergoing intense domestic and international consolidation and financial turmoil, and consolidation has been occurring in the healthcare market. Consolidation may interrupt normal buying behaviors and increase the volatility of our operating results. In recent years, several of our clients have been merged or consolidated, and we expect this to continue in the near future. Future mergers or consolidations may cause a decline in revenues and adversely affect our future financial performance. All of these factors affect the level of demand for our products from clients in these industries, and could adversely affect our business, operating results and financial condition.

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***We rely on certain third-party relationships.*** We have a number of relationships with third parties that are significant to sales, marketing and support activities, and product development efforts. We rely on software and hardware vendors, large system integrators, and technology consulting firms to provide marketing and sales opportunities for the direct sales force and to strengthen our products through the use of industry-standard tools and utilities. We also have relationships with third parties that distribute our products. There can be no assurance that these companies, most of which have significantly greater financial and marketing resources, will not develop or market products that compete with ours in the future or will not otherwise end or limit their relationships with us.

***We face risks from operations and clients based outside of the U.S.*** Sales to clients located outside of the U.S. represented approximately 45% of our total revenue in 2013, approximately 46% of our total revenue in 2012, and approximately 48% of our total revenue in 2011. We, in part through our wholly owned subsidiaries, market products and render consulting and training services to clients based outside of the U.S. including clients based in Canada, Europe, Asia and Australia. We have established offices in North America, Europe, Asia, including India, and Australia. We believe that growth will necessitate expanded international operations, requiring a diversion of managerial attention and increased costs. We anticipate hiring additional personnel to accommodate international growth, and we may also enter into agreements with local distributors, representatives, or resellers. If we are unable to do one or more of these things in a timely manner, our growth, if any, in our foreign operations may be restricted, and our business, operating results, and financial condition could be materially and adversely affected.

In addition, there can be no assurance that we will be able to maintain or increase international market demand for our products. Additional risks inherent in our international business activities generally include laws and business practices favoring local competitors, compliance with multiple, conflicting and changing governmental laws and regulations, including employment, tax, privacy and data protection laws and regulations, increased tariffs and other trade barriers, the costs of localizing products for local markets, including translation into foreign languages and associated expenses and complying with local business customs, longer accounts receivable patterns and difficulties in collecting foreign accounts receivable, difficulties in enforcing contractual and intellectual property rights and pressure on the creditworthiness of sovereign nations, particularly in Europe. Liquidity issues or political actions by sovereign nations could result in decreased values of any cash balances held in our European entities. Other inherent risks include complying with regional data privacy laws, treatment of revenue from international sources and changes to tax codes, including being subject to foreign tax laws and being liable for paying withholding income or other taxes in foreign jurisdictions, potentially adverse tax consequences (including restrictions on repatriating earnings and the threat of double taxation), increased accounting and internal control expenses, and the burden of complying with a wide variety of foreign laws, heightened risks of political and economic instability, foreign currency fluctuations and controls, different pricing environments, difficulties in staffing and managing foreign operations, natural disasters, acts of war, terrorism, pandemics or security breaches, and regional economic and political conditions.

There can be no assurance that one or more of these factors will not have a material adverse effect on our foreign operations, and, consequentially, our business, operating results, and financial condition.



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***We are exposed to fluctuations in currency exchange rates that could negatively impact our financial results and cash flows.*** Because a significant portion of our business is conducted outside the U.S., we face exposure to adverse movements in foreign currency exchange rates. These exposures may change over time as business practices evolve, and they could have a material adverse impact on our financial results and cash flows. Our international sales are usually denominated in foreign currencies. The operating expenses of our foreign operations are primarily denominated in foreign currencies, which partially offset our foreign currency exposure on our international sales. Our U.S. operating company invoices most of our foreign clients in foreign currencies, so it holds cash and accounts receivable denominated in these foreign currencies, which are subject to foreign currency transaction gains or losses. Beginning in the second quarter of 2011, we have entered into foreign currency forward contracts to manage our exposure to changes in foreign currency exchange rates affecting foreign currency denominated accounts receivable and cash held by our U.S. operating company. The use of these foreign currency forward contracts partially mitigates the exposure to the foreign currency transaction gains and losses. If we were to cease or reduce our use of foreign currency forward contracts or similar hedging arrangements, a decrease in the value of foreign currencies, particularly the British pound and the Euro relative to the U.S. dollar, could adversely impact our financial results and cash flows.

## **Factors relating to our internal operations and potential liabilities**

***We depend on certain key personnel, and must be able to attract and retain qualified personnel in the future.*** The business is dependent on a number of key, highly skilled technical, managerial, consulting, sales, and marketing personnel, including our Chief Executive Officer. The loss of key personnel could adversely affect financial performance. We do not have any significant key-man life insurance on any officers or employees and do not plan to obtain any. Our success will depend in large part on the ability to hire and retain qualified personnel. The number of potential employees who have the extensive knowledge of computer hardware and operating systems needed to develop, sell, and maintain our products is limited, and competition for their services is intense, and there can be no assurance that we will be able to attract and retain such personnel. If we are unable to do so, our business, operating results, and financial condition could be materially adversely affected.

***We may experience significant errors or security flaws in our product and services, and could face privacy, product liability and warranty claims as a result.*** Despite testing prior to their release, software products frequently contain errors or security flaws, especially when first introduced or when new versions are released. Errors in our software products could affect the ability of our products to work with other hardware or software products, or could delay the development or release of new products or new versions of products. The detection and correction of any security flaws can be time consuming and costly. Errors or security flaws in our software could result in the inadvertent disclosure of confidential information or personal data relating to our clients, employees, or third parties. Software product errors and security flaws in our products or services could expose us to privacy, product liability and warranty claims as well as harm our reputation, which could impact our future sales of products and services. Our license agreements typically contain provisions intended to limit the nature and extent of our risk of product liability and warranty claims. There is a risk that a court might interpret these terms in a limited way or could hold part or all of these terms to be unenforceable. Also, there is a risk that these contract terms might not bind a party other than the direct client. Furthermore, some of our licenses with our clients are governed by non-U.S. law, and there is a risk that foreign law might give us less or different protection. Although we have not experienced any material product liability claims to date, a product liability suit or action claiming a breach of warranty, whether or not meritorious, could result in substantial costs and a diversion of management's attention and our resources.

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***We face risks related to intellectual property claims or appropriation of our intellectual property rights.*** We rely primarily on a combination of copyright, trademark and trade secrets laws, as well as confidentiality agreements to protect our proprietary rights. We have obtained patents worldwide relating to the architecture of our systems. We cannot assure that such patents will not be invalidated or circumvented or that rights granted thereunder or the claims contained therein will provide us with competitive advantages. Moreover, despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or to obtain the use of information that we regard as proprietary. In addition, the laws of some foreign countries do not protect our proprietary rights to as great an extent as do the laws of the U.S. There can be no assurance that our means of protecting our proprietary rights will be adequate or that our competitors will not independently develop similar technology.

There can be no assurance that third parties will not claim infringement by us with respect to current or future products. Although we attempt to limit the amount and type of our contractual liability for infringement of the proprietary rights of third parties, these limitations often contain certain exclusions, and we cannot be assured that these limitations will be applicable and enforceable in all cases. Even if these limitations are found to be applicable and enforceable, our liability to our clients for these types of claims could be material in amount given the size of certain of our transactions. We expect that software product developers will increasingly be subject to infringement claims as the number of products and competitors in our industry segment grows and the functionality of products in different industry segments overlaps. Any such claims, with or without merit, could be time-consuming, result in costly litigation, cause product shipment delays, or require us to enter into royalty or licensing agreements. Such royalty or licensing agreements, if required, may not be available on terms acceptable to us or at all, which could have a material adverse effect upon our business, operating results, and financial condition.

***We are subject to increasingly complex and burdensome U.S. and foreign laws and regulations, and any failure to comply with these laws and regulations could subject us to, among other things, penalties and legal expenses that could harm our reputation or have a material adverse effect on our business, financial condition and results of operations.*** We are subject to extensive federal, state and foreign laws and regulations including but not limited to the U.S. Foreign Corrupt Practices Act, the U.K. Bribery Act, data privacy, protection and security laws, and similar laws and regulations. The Foreign Corrupt Practices Act, the U.K. Bribery Act and similar foreign anti-bribery laws generally prohibit companies and their intermediaries from making improper payments to non-U.S. persons for the purpose of obtaining or retaining business. Similar laws and regulations exist in many other countries throughout the world in which we do or intend to do business. We have developed and implemented a compliance program based on what we believe are current best practices, but we cannot guarantee that we, our employees, our consultants or our contractors are or will be in compliance with all federal, state and foreign regulations, particularly as we expand our operations outside of the U.S. If we or our representatives fail to comply with any of these laws or regulations, a range of fines, penalties and/or other sanctions could be imposed on us, which could have a material adverse effect on our business, financial condition and results of operations. Even if we are not determined to have violated these laws, government investigations into these issues typically require the expenditure of significant resources and generate negative publicity, which could also have an adverse effect on our business, financial condition and results of operations. In addition, regulation of data privacy, protection and security laws is increasing worldwide, including various restrictions on cross-border access or transfer of data including personal data of our employees, clients and customers of our clients. Compliance with such regulations may increase our costs and there is a risk of enforcement of such laws resulting in damage to our brand as well as financial penalties.

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*If our security measures are breached and/or unauthorized access is obtained to confidential information from our cloud computing service offering or other offerings, we may be exposed to significant legal and financial liabilities.* Our cloud computing service offering allows clients to create and deploy PRPC-based applications using an internet-based infrastructure. This offering involves the hosting of clients applications which may contain confidential information, including personal and financial data regarding their end customers on the servers of a third-party technology provider. We also rely on third-party systems including encryption, virtualized infrastructure and support. Because we do not control the transmissions between our clients and our third-party infrastructure providers, the processing of data on the servers of the third-party technology providers, or the internal controls maintained by the third-party technology providers that could prevent unauthorized access and provide appropriate data encryption, we cannot ensure the complete integrity or security of such transmissions, data or processing. Our security measures may be breached as a result of third-party action, including intentional misconduct by computer hackers, system error, human error or otherwise. Because the techniques used to obtain unauthorized access or to sabotage systems change frequently and generally are not recognized until launched against a target, we may be unable to anticipate these techniques or to implement adequate preventative measures. While we have invested in the protection of our data and our client's data to reduce these risks, there can be no assurance that our efforts will prevent breaches in our systems. Security breaches could expose us and our clients to a risk of loss or misuse of this information. Any security breach could result in a loss of confidence in the security of our service, damage our reputation, disrupt our business, lead to legal liability and negatively impact our future sales. We carry data breach insurance coverage to potentially mitigate the financial impact of such potential legal liability. In addition, privacy and security concerns in some parts of the world may inhibit demand for our cloud offering or lead to requirements to provide our products or services in configurations that may increase the cost of serving such markets.

*The acquisition of other businesses and technologies may present new risks.* We have recently undertaken an acquisition and we continue to evaluate and consider other potential strategic transactions, including acquisitions of businesses, technologies, services, products and other assets. These acquisitions, if undertaken, may involve significant new risks and uncertainties, including distraction of management attention away from our current business operations, insufficient new revenue to offset expenses, inadequate return on capital, integration challenges, new regulatory requirements, new third-party intellectual property infringement claims related to the acquired technology and/or services, and issues not discovered in our due diligence process. No assurance can be given that such acquisitions will be successful and will not adversely affect our profitability or operations.

### **ITEM 1B. Unresolved Staff Comments**

None.

### **ITEM 2. Properties**

Our principal administrative, sales, marketing, support, and research and development operations are located at One Rogers Street, Cambridge, Massachusetts in an approximately 163,000 square foot leased facility. Our lease expires in 2023, subject to our option to extend for two additional five-year periods. We also lease space for our other offices in North America, Europe and the Asia Pacific under leases that expire at various dates through 2021. We periodically evaluate the adequacy of existing facilities and additional facilities in new cities, and we believe that additional or alternative space will be available as needed in the future on commercially reasonable terms.

### **ITEM 3. Legal Proceedings**

None.

### **ITEM 4. Mine Safety Disclosures**

Not applicable.

**Table of Contents****PART II****ITEM 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities**  
**Market Information**

Our common stock is quoted on the NASDAQ Global Select Market (NASDAQ) under the symbol PEGA. The following table sets forth the range of high and low sales prices of our common stock on NASDAQ for each quarter in the years ended December 31:

|                | Common Stock Price |          |          |          |
|----------------|--------------------|----------|----------|----------|
|                | 2013               |          | 2012     |          |
|                | High               | Low      | High     | Low      |
| First Quarter  | \$ 30.35           | \$ 22.77 | \$ 39.09 | \$ 25.81 |
| Second Quarter | \$ 33.56           | \$ 24.46 | \$ 39.97 | \$ 29.76 |
| Third Quarter  | \$ 40.55           | \$ 32.57 | \$ 33.36 | \$ 22.51 |
| Fourth Quarter | \$ 51.53           | \$ 36.79 | \$ 29.19 | \$ 19.00 |

**Holder**

As of February 5, 2014, we had approximately 28 stockholders of record and approximately 33,000 beneficial owners of our common stock.

**Dividends**

In July 2006, we began paying a quarterly cash dividend of \$0.03 per share of common stock. Quarterly cash dividends are expected to continue at \$0.03 per share, subject to change or elimination at any time by our Board of Directors.

**Issuer Purchases of Equity Securities**

The following table sets forth information regarding our repurchases of our common stock during the fourth quarter of 2013.

| Period                 | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Share Repurchase Program (1) | Approximate Dollar Value of Shares That May Yet Be Purchased Under Publicly Announced Share Repurchased Programs (1) (in thousands) |
|------------------------|----------------------------------|------------------------------|---|---|
| 10/1/2013 - 10/31/2013 | 35,540                           | \$ 38.10                     | 35,540  | \$ 4,207  |
| 11/1/2013 - 11/30/2013 | 17,592                           | \$ 44.62                     | 17,592  | \$ 3,422  |
| 12/1/2013 - 12/31/2013 | 23,633                           | \$ 48.81                     | 23,633  | \$ 14,433   |
| Total                  | 76,765                           | \$ 42.89                     |   |   |

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- (1) Since 2004, our Board of Directors has approved stock repurchase programs that have authorized the repurchase, in the aggregate, of up to \$104.5 million of our common stock. On December 16, 2013, we announced that our Board of Directors extended the expiration date of the current stock repurchase program (the Current Program ) to December 31, 2014 and authorized the Company to repurchase up to \$15 million of our stock between December 11, 2013 and December 31, 2014. Under 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, intended to comply with the requirements of Rule 10b5-1 under the Securities Exchange Act of 1934, as amended, and 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.

For the restricted stock units granted to employees, the number of shares otherwise issuable on the vesting date is reduced by a number of shares having a value equal to the minimum statutory income withholding tax that we are required pay in cash to the applicable taxing authorities on behalf of our employees. We do not consider these transactions to be common stock repurchases.

**Table of Contents****Stock Performance Graph and Cumulative Total Stockholder Return**

The following performance graph represents a comparison of the cumulative total stockholder return (assuming the reinvestment of dividends) for a \$100 investment on December 31, 2008 in our common stock, the Total Return Index for the NASDAQ Composite ( NASDAQ Composite ), a broad market index, and the Standard & Poors ( S&P ) North Software-Software Index ( S&P NSSI ), a published industry index. We paid dividends of \$.09 per share during 2013, \$0.15 per share during 2012 and \$0.12 per share during 2011, 2010, and 2009, respectively. The graph lines merely connect measurement dates and do not reflect fluctuations between those dates.

|                  | <b>12/31/2008</b> | <b>12/31/2009</b> | <b>12/31/2010</b> | <b>12/31/2011</b> | <b>12/31/2012</b> | <b>12/31/2013</b> |
|------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| Pegasystems Inc. | \$100.00          | \$276.32          | \$298.75          | \$240.61          | \$186.39          | \$405.52          |
| NASDAQ Composite | \$100.00          | \$145.34          | \$171.70          | \$170.34          | \$200.57          | \$281.14          |
| S&P NSSI         | \$100.00          | \$147.90          | \$185.10          | \$172.42          | \$202.46          | \$265.43          |

**Table of Contents****ITEM 6. Selected Financial Data**

The selected financial data presented below has been derived from our audited consolidated financial statements. This data should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations, the consolidated financial statements and accompanying notes.

|   | Year Ended December 31, |            |            |            |            |
|---|-------------------------|------------|------------|------------|------------|
|   | 2013                    | 2012       | 2011       | 2010       | 2009       |
| (in thousands, except per share amounts)                  |                         |            |            |            |            |
| <b>Consolidated Statements of Operations Data:</b>        |                         |            |            |            |            |
| Total revenue   | \$ 508,954              | \$ 461,710 | \$ 416,675 | \$ 336,599 | \$ 264,013 |
| Income (loss) from operations                             | 58,097                  | 31,426     | 10,494     | (2,580)    | 41,819     |
| Income (loss) before provision (benefit) for income taxes | 56,393                  | 30,945     | 10,813     | (6,197)    | 47,415     |
| Net income (loss)   | 38,043                  | 21,868     | 10,108     | (5,891)    | 32,212     |
| Earnings (loss) per share:                                |                         |            |            |            |            |
| Basic   | \$ 1.00                 | \$ 0.58    | \$ 0.27    | \$ (0.16)  | \$ 0.89    |
| Diluted   | \$ 0.98                 | \$ 0.56    | \$ 0.26    | \$ (0.16)  | \$ 0.85    |
| Cash dividends declared per common share                  | \$ 0.12                 | \$ 0.12    | \$ 0.12    | \$ 0.12    | \$ 0.12    |

|   | Year Ended December 31, |            |            |           |            |
|---|-------------------------|------------|------------|-----------|------------|
|   | 2013                    | 2012       | 2011       | 2010      | 2009       |
| (in thousands)  |                         |            |            |           |            |
| <b>Consolidated Balance Sheet Data:</b>                 |                         |            |            |           |            |
| Total cash, cash equivalents, and marketable securities | \$ 156,692              | \$ 122,985 | \$ 111,432 | \$ 87,251 | \$ 202,653 |
| Working capital   | 159,772                 | 123,885    | 89,716     | 73,606    | 188,552    |
| Intangible assets, net of accumulated amortization      | 56,574                  | 58,232     | 69,369     | 80,684    | 336        |
| Goodwill  | 37,463                  | 20,451     | 20,451     | 20,451    | 2,391      |
| Total assets  | 533,662                 | 439,492    | 381,711    | 337,475   | 279,585    |
| Total stockholders' equity                              | 271,788                 | 236,479    | 208,756    | 195,670   | 205,219    |

The following items impact the comparability of our consolidated financial data:

Our acquisition of Antenna in October 2013 and our acquisition of Chordiant in April 2010.

Foreign currency transaction (losses) gains of \$(1.6) million, \$0.8 million, \$(0.9) million, \$(5.6) million and \$2.1 million, during the years ended December 31, 2013, 2012, 2011, 2010, and 2009, respectively. See Item 7A. Quantitative and Qualitative Disclosure about Market Risk for further discussion of our foreign currency exchange risk.

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### **ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations**

#### **Business overview**

We develop, market, license, and support software solutions that help clients improve their business results by giving them the power to engage customers, simplify their operations, and adapt to change. Our unified software platform enables our clients to build, deploy, and change enterprise applications easily and quickly, by directly capturing business objectives, automating programming, and automating work. We also provide consulting services, maintenance, and training related to our software.

We focus our sales efforts primarily 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 licenses that are focused on a specific purpose or area of operations.

Our license revenue is primarily derived from sales of our PRPC software and related business solutions. PRPC is a comprehensive platform for building and managing BPM applications that unifies business rules and business processes. Our solutions, 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 business solutions can be used by a broad range of clients across markets including financial services, insurance, healthcare, communications and media, life sciences, manufacturing and high technology, and government markets.

Our business solution products include 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 actions optimize the process outcomes 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 offer Pega Cloud®, a service offering that allows our clients 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 acquisition of Antenna expands Pega's Application Mobility Platform, which provides clients with a mobile application development platform to build, manage, and deploy mobile applications as part of a seamless omnichannel experience. Enterprises can manage the complex elements of the mobile application lifecycle including security, integration, testing, and management of mobile applications and devices. Pega's mobile application development solutions help businesses to significantly reduce their development time, deployment costs, and the complexity associated with run-the-business mobile applications. The operations of Antenna are included in our operating results from the date of acquisition. Total revenue attributable to Antenna included in our consolidated statements of operations in 2013 was \$3.9 million. Due to the rapid integration of the products, sales force, and operations of Antenna, other than the maintenance and hosting revenue attributable to the recognition of the fair value of acquired deferred maintenance and hosting revenue, it may not be feasible for us to identify revenue from new arrangements attributable to Antenna.

We offer training for our staff, clients, and partners at our regional training facilities, at third party facilities, and at client sites. In 2012, we began offering training online through PegaACADEMY, which provides an alternative way to learn our software in a virtual environment quickly and easily. We believe that this online training will continue to expand the number of trained experts at a faster pace.



**Table of Contents****RESULTS OF OPERATIONS****2013 Compared to 2012***(Dollars in thousands)*

|  | Year Ended December 31, |            | Increase  |     |
|--|-------------------------|------------|-----------|-----|
|  | 2013                    | 2012       |           |     |
| Total revenue                            | \$ 508,954              | \$ 461,710 | \$ 47,244 | 10% |
| Gross profit                             | 351,548                 | 304,330    | 47,218    | 16% |
| Acquisition-related costs                | 1,306                   |            | 1,306     | n/m |
| Restructuring costs                      | 1,731                   |            | 1,731     | n/m |
| Other operating expenses                 | 290,414                 | 272,904    | 17,510    | 6%  |
| Total operating expenses                 | 293,451                 | 272,904    | 20,547    | 8%  |
| Income from operations                   | 58,097                  | 31,426     | 26,671    | 85% |
| Income before provision for income taxes | 56,393                  | 30,945     | 25,448    | 82% |

**n/m not meaningful****Revenue***(Dollars in thousands)*

|                                 | Year Ended December 31, |      |            |      | Increase  |     |
|---------------------------------|-------------------------|------|------------|------|-----------|-----|
|                                 | 2013                    |      | 2012       |      |           |     |
| <b>Software license revenue</b> |                         |      |            |      |           |     |
| Perpetual licenses              | \$ 122,644              | 64%  | \$ 102,438 | 63%  | \$ 20,206 |     |
| Term licenses                   | 62,711                  | 33%  | 46,638     | 28%  | 16,073    |     |
| Subscription                    | 6,521                   | 3%   | 14,830     | 9%   | (8,309)   |     |
| Total software license revenue  | \$ 191,876              | 100% | \$ 163,906 | 100% | \$ 27,970 | 17% |

The aggregate value of new license arrangements executed in 2013 was higher than in 2012. The aggregate value of new license arrangements executed in the fourth quarter of 2013 was down slightly as compared to the fourth quarter of 2012. The aggregate value of new license arrangements executed fluctuates quarter to quarter. During 2013 and 2012, approximately 80% and 74%, respectively, of the value of new license arrangements were executed with existing clients.

The mix between perpetual and term license arrangements executed in a particular period varies based on client needs. A change in the mix between perpetual and term license arrangements executed may cause our revenues to vary materially from period to period. A higher proportion of term license arrangements executed would result in more license revenue being recognized over longer periods as payments become due or earlier if prepaid. However, some of our perpetual license arrangements include extended payment terms or additional rights of use, which also result in the recognition of revenue over longer periods.

The increase in perpetual license revenue was primarily due to higher value perpetual arrangements executed during 2013 and the fourth quarter of 2012 than during 2012 and the fourth quarter of 2011.

The increase in term license revenue was primarily due to revenue recognized on term license arrangements executed in 2012 and 2011. The aggregate value of payments due under noncancellable term licenses increased to \$233.6 million as of December 31, 2013 compared to \$211.5 million as of December 31, 2012. See the table of future cash receipts from these term licenses on page 31.

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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, which is included in consulting services revenue. The timing of scheduled payments under client arrangements may limit the amount of revenue recognized in a reporting period. Consequently, our subscription revenue may vary quarter to quarter. The decrease in subscription revenue in 2013 was primarily due to revenue recognized in the second quarter of 2012 for a large payment that became due.

| <i>(Dollars in thousands)</i> | <b>Year Ended December 31,</b> |             | <b>Increase</b> |     |
|-------------------------------|--------------------------------|-------------|-----------------|-----|
|                               | <b>2013</b>                    | <b>2012</b> |                 |     |
| <b>Maintenance revenue</b>    |                                |             |                 |     |
| Maintenance                   | \$ 157,309                     | \$ 133,527  | \$ 23,782       | 18% |

The increase in maintenance revenue was primarily due to the growth in the aggregate value of the installed base of our software and continued strong renewal rates. Maintenance revenue primarily attributable to recognition of the fair value of the acquired Antenna deferred maintenance revenue was \$0.8 million in 2013.

| <i>(Dollars in thousands)</i> | <b>Year Ended December 31,</b> |      |             |      | <b>(Decrease)</b> |       |
|-------------------------------|--------------------------------|------|-------------|------|-------------------|-------|
|                               | <b>2013</b>                    |      | <b>2012</b> |      |                   |       |
| <b>Services revenue</b>       |                                |      |             |      |                   |       |
| Consulting services           | \$ 154,500                     | 97%  | \$ 157,792  | 96%  | \$ (3,292)        | (2)%  |
| Training                      | 5,269                          | 3%   | 6,485       | 4%   | (1,216)           | (19)% |
| Total Services                | \$ 159,769                     | 100% | \$ 164,277  | 100% | \$ (4,508)        | (3)%  |

Consulting services revenue includes revenue from our Pega Cloud® service offerings. Consulting services revenue decreased, partially offset by a \$4.4 million revenue increase from our Pega Cloud® service offerings, of which \$1.1 million was attributable to the acquired Antenna business. The decrease was primarily the result of more clients becoming enabled and our partners leading more implementation projects. If this trend continues, our consulting services revenue may continue to decrease in future periods. The decrease in our training revenue was primarily due to the increased adoption of our PegaACADEMY self-service online training by our partners, which has a significantly lower average price per student as compared to our traditional instructor-led training.

| <i>(Dollars in thousands)</i>   | <b>Year Ended December 31,</b> |             | <b>Increase (Decrease)</b> |       |
|---------------------------------|--------------------------------|-------------|----------------------------|-------|
|                                 | <b>2013</b>                    | <b>2012</b> |                            |       |
| <b>Gross Profit</b>             |                                |             |                            |       |
| Software license                | \$ 185,595                     | \$ 157,567  | \$ 28,028                  | 18%   |
| Maintenance                     | 142,037                        | 118,740     | 23,297                     | 20%   |
| Services                        | 23,916                         | 28,023      | (4,107)                    | (15)% |
| Total gross profit              | \$ 351,548                     | \$ 304,330  | \$ 47,218                  | 16%   |
| Total gross profit %            | 69%                            | 66%         |                            |       |
| Software license gross profit % | 97%                            | 96%         |                            |       |
| Maintenance gross profit %      | 90%                            | 89%         |                            |       |
| Services gross profit %         | 15%                            | 17%         |                            |       |

The increase in total gross profit was due to increases in license and maintenance revenue.

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The decrease in services gross profit percent was primarily due to lower consulting revenues, costs incurred on several projects for which the corresponding revenue will be recognized in future periods as revenue recognition criteria had not been met, and increased employee incentive expenses.

| <i>(Dollars in thousands)</i>       | Year Ended December 31, |           | Increase |        |
|-------------------------------------|-------------------------|-----------|----------|--------|
|                                     | 2013                    | 2012      |          |        |
| <b>Amortization of intangibles:</b> |                         |           |          |        |
| Cost of revenue                     | \$ 6,443                | \$ 6,189  | \$ 254   | 4%     |
| Selling and marketing               | 5,174                   | 4,928     | 246      | 5%     |
| General and administrative          | 396                     | 20        | 376      | 1,880% |
|                                     | \$ 12,013               | \$ 11,137 | \$ 876   | 8%     |

The increase in amortization expense was due to the amortization associated with \$10.4 million of intangibles acquired from Antenna.

**Operating expenses**

| <i>(Dollars in thousands)</i>  | Year Ended December 31, |            | Increase  |     |
|--|-------------------------|------------|-----------|-----|
|  | 2013                    | 2012       |           |     |
| <b>Selling and marketing</b>   |                         |            |           |     |
| Selling and marketing  | \$ 181,094              | \$ 167,263 | \$ 13,831 | 8%  |
| As a percent of total revenue  | 36%                     | 36%        |           |     |
| Selling and marketing headcount  | 598                     | 520        | 78        | 15% |
| 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. |                         |            |           |     |

The increase in selling and marketing expenses was primarily due to a \$9.9 million increase in compensation and benefit expenses associated with higher headcount, a \$1.7 million increase in marketing programs, a \$1.2 million increase in commission expense, and a \$1.3 million increase in partner commission expense.

| <i>(Dollars in thousands)</i>  | Year Ended December 31, |           | Increase |     |
|--|-------------------------|-----------|----------|-----|
|  | 2013                    | 2012      |          |     |
| <b>Research and development</b>  |                         |           |          |     |
| Research and development   | \$ 79,726               | \$ 76,726 | \$ 3,000 | 4%  |
| As a percent of total revenue  | 16%                     | 17%       |          |     |
| Research and development headcount   | 913                     | 727       | 186      | 26% |
| Research and development expenses include compensation, benefits, contracted services, and other headcount-related expenses associated with research and development. The increase in headcount reflects growth in our India research facility as we have been replacing contractors with employees. The increase in offshore headcount lowered our average compensation expense per employee. |                         |           |          |     |

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The increase in research and development expenses was primarily due to a \$7.4 million increase in compensation and benefit expenses associated with higher headcount, partially offset by a \$2.3 million decrease in engineering contractor expenses and a decrease in rent and equipment-related expenses.

| <i>(Dollars in thousands)</i>        | Year Ended December 31, |           | Increase |    |
|--------------------------------------|-------------------------|-----------|----------|----|
|                                      | 2013                    | 2012      |          |    |
| <b>General and administrative</b>    |                         |           |          |    |
| General and administrative           | \$ 29,594               | \$ 28,915 | \$ 679   | 2% |
| As a percent of total revenue        | 6%                      | 6%        |          |    |
| General and administrative headcount | 271                     | 251       | 20       | 8% |

General and administrative expenses include compensation, benefits, and other headcount-related expenses associated with the finance, legal, corporate governance, and other administrative headcount. It also includes accounting, legal, and other professional consulting, and 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 our functional departments.

The increase in general and administrative expenses was primarily due to increase in compensation and benefits associated with higher headcount.

**Acquisition-related costs**

Acquisition-related costs are expensed as incurred and include direct and incremental costs associated with an impending or completed acquisition. During 2013, the \$1.3 million of acquisition-related costs were primarily professional fees associated with our acquisition of Antenna.

**Restructuring costs**

In 2013, restructuring costs include future lease payments and demising costs, net of estimated sublease income, for the elimination of space within one facility related to the integration of Antenna. See Note 12 Accrued Restructuring Costs in the notes to the accompanying consolidated financial statements for further detail.

**Stock-based compensation**

We recognize stock-based compensation expense associated with equity awards in our consolidated statements of operations based on the fair value of these awards at the date of grant.

| <i>(Dollars in thousands)</i>             | Year Ended December 31, |          | Increase |     |
|---|-------------------------|----------|----------|-----|
|   | 2013                    | 2012     |          |     |
| <b>Stock-based compensation:</b>          |                         |          |          |     |
| Cost of services                          | \$ 4,085                | \$ 3,655 | \$ 430   | 12% |
| Operating expenses                        | 8,784                   | 7,851    | 933      | 12% |
| Total stock-based compensation before tax | 12,869                  | 11,506   | \$ 1,363 | 12% |
| Income tax benefit                        | (3,918)                 | (3,699)  |          |     |

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The increase in stock-based compensation expense was primarily due to a full year of expense on the December 2012 annual employee equity grants. See Note 15 *Stock-Based Compensation* in the notes to the accompanying audited consolidated financial statements for further information on our stock-based awards.

***Non-operating income and (expenses), net***

| <i>(Dollars in thousands)</i>            | Year Ended December 31, |          | Change     |        |
|--|-------------------------|----------|------------|--------|
|  | 2013                    | 2012     |            |        |
| Foreign currency transaction (loss) gain | \$ (1,593)              | \$ 780   | \$ (2,373) | (304)% |
| Interest income, net                     | 524                     | 419      | 105        | 25%    |
| Other (expense) income, net              | (635)                   | (1,680)  | 1,045      | (62)%  |
|  | \$ (1,704)              | \$ (481) | \$ (1,223) | 254%   |

We use foreign currency forward contracts ( *forward contracts* ) to manage our exposure to changes in foreign currency denominated accounts receivable, intercompany payables, and cash primarily held by our U.S. operating company. We have not designated these forward 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 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, intercompany payables, and cash held by the U.S. operating company recorded in foreign currency transaction loss.

We have been primarily exposed to the fluctuation in the British pound and Euro relative to the U.S. dollar. More recently, we have experienced increased levels of exposure to the Australian dollar and Indian rupee. See Note 4 *Derivative Instruments* in the notes to the accompanying consolidated financial statements for discussion on our use of forward contracts.

The total change in the fair value of our foreign currency forward contracts recorded in other (expense) income, net, during 2013 and 2012 was a loss of \$0.7 million and \$1.7 million, respectively.

***Provision for income taxes***

The provision for income taxes represents current and future amounts owed for federal, state, and foreign taxes. During 2013 and 2012, we recorded an \$18.4 million provision and a \$9.1 million provision, respectively, which resulted in an effective tax rate of 32.5% and 29.3%, respectively

Our effective income tax rate for 2013 was below the statutory federal income tax rate due to a \$2.1 million benefit related to the current period domestic production activities deduction, a \$1.2 million benefit related to income generated in foreign jurisdictions that is subject to tax at a rate lower than the U.S. statutory tax rate, and a \$1.6 million benefit related to the 2012 and 2013 federal research and experimentation ( *R&E* ) credit. These benefits were partially offset by \$1.4 million of permanent differences related to nondeductible meals and entertainment expenses, foreign stock compensation, and transaction costs.

Our effective income tax rate for 2012 was below the statutory federal income tax rate due to a \$1.2 million benefit related to the domestic production activities deduction and a \$1.2 million benefit related to income generated in foreign jurisdictions that is subject to tax at a rate lower than the U.S. statutory rate. These benefits were partially offset by \$1 million of permanent differences related to nondeductible meals and entertainment expenses and nondeductible foreign stock compensation.

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The American Taxpayer Relief Act of 2012 (the Act) was signed into law by President Obama on January 2, 2013. Among other things, the Act retroactively extended the R&E credit through the end of 2013. Under ASC 740, *Income Taxes*, the effects of new legislation are recognized upon enactment, which means that both the retroactive tax effects for the 2012 R&E credit and the tax effects for the 2013 R&E are recognized in the 2013 financial statements. If we had recognized the effects of the 2012 R&E credit in the 2012 financial statements, the effective tax rate in 2012 would have been lowered by approximately 2.6%.

As of December 31, 2013, we had approximately \$40.9 million of total unrecognized tax benefits, of which \$25.2 million would decrease our effective tax rate if recognized. The remaining \$15.7 million of unrecognized tax benefits relate to acquired net operating losses (NOLs) and R&E credits that are subject to limitations on their use. We expect that the changes in the unrecognized benefits within the next twelve months will be approximately \$0.1 million, all of which would reduce our effective tax rate if realized.

**2012 Compared to 2011**

(Dollars in thousands)

|  | Year Ended December 31, |            | Increase  |      |
|--|-------------------------|------------|-----------|------|
|  | 2012                    | 2011       |           |      |
| Total revenue                            | \$ 461,710              | \$ 416,675 | \$ 45,035 | 11%  |
| Gross profit                             | 304,330                 | 251,877    | 52,453    | 21%  |
| Total operating expenses                 | 272,904                 | 241,383    | 31,521    | 13%  |
| Income from operations                   | 31,426                  | 10,494     | 20,932    | 199% |
| Income before provision for income taxes | 30,945                  | 10,813     | 20,132    | 186% |

The aggregate value of new license arrangements executed in 2012 was slightly higher than in 2011. The aggregate value of new license arrangements executed fluctuates quarter to quarter. During 2012 and 2011, approximately 74% and 58%, respectively, of new license arrangements were executed with existing clients. 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 clients.

The increase in gross profit was primarily due to the increase in license revenue and to a lesser extent the increase in maintenance revenue.

The increase in operating expenses was primarily due to the increase in selling and marketing expenses and to a lesser extent the increase in research and development expenses, associated with higher headcount.

The increase in income from operations and income before provision for income taxes was primarily due to the higher increases in license and maintenance gross profit compared to the increase in operating expenses.

**Revenue**

(Dollars in thousands)

|                        | Year Ended December 31, |      |            |      | Increase  |     |
|------------------------|-------------------------|------|------------|------|-----------|-----|
|                        | 2012                    |      | 2011       |      |           |     |
| <b>License revenue</b> |                         |      |            |      |           |     |
| Perpetual licenses     | \$ 102,438              | 63%  | \$ 94,129  | 68%  | \$ 8,309  | 9%  |
| Term licenses          | 46,638                  | 28%  | 34,453     | 25%  | 12,185    | 35% |
| Subscription           | 14,830                  | 9%   | 10,225     | 7%   | 4,605     | 45% |
| Total license revenue  | \$ 163,906              | 100% | \$ 138,807 | 100% | \$ 25,099 | 18% |

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In both 2011 and 2012, more than 50% of the aggregate value of new license arrangements for the fiscal year was executed in our fourth quarter. A large proportion of the value of these arrangements was term licenses that contributed very little to the increase in our term license revenue in 2012, but will be recognized as revenue in future periods. As a result, the aggregate value of future payments due under noncancellable term licenses increased significantly in both 2011 and 2012 from \$90.9 million as of December 31, 2010 to \$161.4 million as of December 31, 2011 and to \$211.5 million as of December 31, 2012. The increase in term license revenue for 2012 is a result of the increase in the aggregate value of future payments due under noncancellable term licenses arrangements from prior years.

The increases in the aggregate value of term license arrangements executed in a certain period is not necessarily indicative of the volume level in future periods.

The mix between perpetual and term license arrangements executed in a particular period varies based on client needs. A change in the mix between perpetual and term license arrangements executed over time may cause our revenues to vary materially from period to period. The increase in perpetual license revenue was primarily due to the increase in the aggregate value of new perpetual license arrangements executed during the fourth quarter of 2012.

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 client 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 increase in subscription revenue was primarily due to the full year of revenue recognized in 2012 on some arrangements for which we began recognizing revenue in the fourth quarter of 2011.

(Dollars in thousands)

|                            | Year Ended December 31, |            | Increase  |     |
|----------------------------|-------------------------|------------|-----------|-----|
|                            | 2012                    | 2011       |           |     |
| <b>Maintenance revenue</b> |                         |            |           |     |
| Maintenance                | \$ 133,527              | \$ 117,110 | \$ 16,417 | 14% |

The increase in maintenance revenue was primarily due to the growth in the aggregate value of the installed base of our software and continued strong renewal rates.

(Dollars in thousands)

|                         | Year Ended December 31, |      |            |      | Increase (Decrease) |      |
|-------------------------|-------------------------|------|------------|------|---------------------|------|
|                         | 2012                    |      | 2011       |      |                     |      |
| <b>Services revenue</b> |                         |      |            |      |                     |      |
| Consulting services     | \$ 157,792              | 96%  | \$ 153,919 | 96%  | \$ 3,873            | 3%   |
| Training                | 6,485                   | 4%   | 6,839      | 4%   | (354)               | (5)% |
| Total Services          | \$ 164,277              | 100% | \$ 160,758 | 100% | \$ 3,519            | 2%   |

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Revenue from our Pega Cloud® offerings is included in consulting services revenue and was the primary driver for the increase in services revenue in 2012. In addition, our consulting services revenue increased due to higher realization rates in 2012 compared to 2011. As more of our clients are becoming enabled and our partners are leading the majority of implementation projects, our consulting services revenue may be lower in future periods.

| <i>(Dollars in thousands)</i>         | <b>Year Ended December 31,</b> |                   | <b>Increase</b>  |            |
|---------------------------------------|--------------------------------|-------------------|------------------|------------|
|                                       | <b>2012</b>                    | <b>2011</b>       |                  |            |
| <b>Gross Profit</b>                   |                                |                   |                  |            |
| Software license                      | \$ 157,567                     | \$ 132,114        | \$ 25,453        | 19%        |
| Maintenance                           | 118,740                        | 104,033           | 14,707           | 14%        |
| Services                              | 28,023                         | 15,730            | 12,293           | 78%        |
| <b>Total gross profit</b>             | <b>\$ 304,330</b>              | <b>\$ 251,877</b> | <b>\$ 52,453</b> | <b>21%</b> |
| Total gross profit percent            | 66%                            | 60%               |                  |            |
| Software license gross profit percent | 96%                            | 95%               |                  |            |
| Maintenance gross profit percent      | 89%                            | 89%               |                  |            |
| Services gross profit percent         | 17%                            | 10%               |                  |            |

As a result of the increased number of client and partner led implementations, we have slowed the hiring of consulting 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 again incur on-boarding and enablement costs that may result in lower services gross profit percentages.

| <i>(Dollars in thousands)</i>       | <b>Year Ended December 31,</b> |                  | <b>Increase (Decrease)</b> |             |
|-------------------------------------|--------------------------------|------------------|----------------------------|-------------|
|                                     | <b>2012</b>                    | <b>2011</b>      |                            |             |
| <b>Amortization of intangibles:</b> |                                |                  |                            |             |
| Cost of software license            | \$ 6,189                       | \$ 6,284         | \$ (95)                    | (2)%        |
| Selling and marketing               | 4,928                          | 4,928            |                            | %           |
| General and administrative          | 20                             | 103              | (83)                       | (81)%       |
|                                     | <b>\$ 11,137</b>               | <b>\$ 11,315</b> | <b>\$ (178)</b>            | <b>(2)%</b> |

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

**Operating expenses**

| <i>(Dollars in thousands)</i>   | <b>Year Ended December 31,</b> |             | <b>Increase</b> |     |
|---------------------------------|--------------------------------|-------------|-----------------|-----|
|                                 | <b>2012</b>                    | <b>2011</b> |                 |     |
| <b>Selling and marketing</b>    |                                |             |                 |     |
| Selling and marketing           | \$ 167,263                     | \$ 147,457  | \$ 19,806       | 13% |
| As a percent of total revenue   | 36%                            | 35%         |                 |     |
| Selling and marketing headcount | 520                            | 464         | 56              | 12% |



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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 was primarily due to a \$19.3 million increase in compensation and benefit expenses associated with higher headcount, partially offset by a \$1.1 million decrease in commission expense.

|                                    | Year Ended December 31, |           | Increase  |     |
|------------------------------------|-------------------------|-----------|-----------|-----|
|                                    | 2012                    | 2011      |           |     |
| <i>(Dollars in thousands)</i>      |                         |           |           |     |
| <b>Research and development</b>    |                         |           |           |     |
| Research and development           | \$ 76,726               | \$ 65,308 | \$ 11,418 | 17% |
| As a percent of total revenue      | 17%                     | 16%       |           |     |
| Research and development headcount | 727                     | 523       | 204       | 39% |

The increase in headcount reflects growth in our India research facility as we have been replacing contractors with employees. The increase in offshore headcount lowered our average compensation expense per employee.

The increase in research and development expenses was primarily due to a \$9.9 million increase in compensation and benefit expenses associated with higher headcount and a \$3.3 million increase in rent and facilities related expenses associated with the build-out of our U.S. and India facilities, partially offset by a \$2.3 million decrease in engineering contractor expenses.

|                                      | Year Ended December 31, |           | Increase |     |
|--------------------------------------|-------------------------|-----------|----------|-----|
|                                      | 2012                    | 2011      |          |     |
| <i>(Dollars in thousands)</i>        |                         |           |          |     |
| <b>General and administrative</b>    |                         |           |          |     |
| General and administrative           | \$ 28,915               | \$ 28,198 | \$ 717   | 3%  |
| As a percent of total revenue        | 6%                      | 7%        |          |     |
| General and administrative headcount | 251                     | 216       | 35       | 16% |

We completed the move to our new office headquarters in the third quarter of 2012 and ceased use of the former office space in the fourth quarter of 2012, resulting in approximately \$0.2 million in lease exit costs. We recorded approximately \$5.7 million and \$1.9 million of rent expense under the new lease arrangement during 2012 and 2011, respectively.

**Stock-based compensation**

We recognize stock-based compensation expense associated with equity awards in our consolidated statements of operations based on the fair value of these awards at the date of grant.

|   | Year Ended December 31, |          | Increase |     |
|---|-------------------------|----------|----------|-----|
|   | 2012                    | 2011     |          |     |
| <i>(Dollars in thousands)</i>             |                         |          |          |     |
| <b>Stock-based compensation:</b>          |                         |          |          |     |
| Cost of services                          | \$ 3,655                | \$ 2,737 | \$ 918   | 34% |
| Operating expenses                        | 7,851                   | 6,291    | 1,560    | 25% |
| Total stock-based compensation before tax | 11,506                  | 9,028    | \$ 2,478 | 27% |
| Income tax benefit                        | (3,699)                 | (2,854)  |          |     |

The increase in stock-based compensation expense was primarily due to the higher value of the annual periodic equity grant, the annual executive grant and new hire grants. See Note 15 Stock-Based Compensation in the notes to the accompanying audited consolidated financial statements for further information on our stock-based awards.



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

| (Dollars in thousands)                   | Year Ended December 31, |          | Change   |     |
|--|-------------------------|----------|----------|-----|
|  | 2012                    | 2011     |          |     |
| Foreign currency transaction gain (loss) | \$ 780                  | \$ (935) | \$ 1,715 | n/m |
| Interest income, net                     | 419                     | 398      | 21       | 5%  |
| Other income, net                        | (1,680)                 | 856      | (2,536)  | n/m |
|  | \$ (481)                | \$ 319   | \$ (800) | n/m |

n/m not meaningful

We hold foreign currency denominated accounts receivable, intercompany payables, and cash in our U.S. operating company where the functional currency is the U.S. dollar. As a result, these receivables, intercompany payables, 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 2012 and 2011.

Beginning in the second quarter of 2011, we entered into foreign currency forward contracts to manage our exposure to changes in foreign currency exchange rates affecting the foreign currency denominated accounts receivable, intercompany payables, and cash held by our U.S. operating company. We have not designated these foreign currency forward 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 foreign currency forward 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, intercompany payables, and cash held by the U.S. operating company recorded in foreign currency transaction gain (loss).

The total change in the fair value of our foreign currency forward contracts recorded in other (expense) income, net, during 2012 and 2011 was a loss of \$1.7 million and a gain of \$0.8 million, respectively.

**Provision (benefit) for income taxes**

The provision for income taxes represents current and future amounts owed for federal, state, and foreign taxes. During 2012 and 2011, we recorded a \$9.1 million provision and a \$0.7 million provision, respectively, which resulted in an effective tax rate of 29.3% and 6.5%, respectively

Our effective income tax rate for 2012 was below the statutory federal income tax rate due to a \$1.2 million benefit related to the current period domestic production activities and a \$1.2 million benefit related to lower foreign income tax rates. These benefits were partially offset by \$1 million of permanent differences related to nondeductible meals and foreign stock compensation.

Our effective income tax rate for 2011 was below the statutory federal income tax rate due to a \$2.5 million reduction in liabilities established for 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 expired, a \$1.5 million benefit related to the current period domestic production activities and a \$0.6 million benefit related to tax credits from our continued investment in research and development activities. These benefits were partially offset by a \$0.3 million increase in our valuation allowances and \$0.6 million of permanent differences related to nondeductible meals.

As of December 31, 2012, the Company had approximately \$26.3 million of total unrecognized tax benefits, of which \$16 million would decrease the Company's effective tax rate if recognized. However, approximately \$9.2 million of these unrecognized tax benefits relate to acquired NOLs and research tax credits, which are subject to limitations on use.

**Table of Contents****LIQUIDITY AND CAPITAL RESOURCES**

(in thousands)

|  | Year Ended December 31, |           |             |
|--|-------------------------|-----------|-------------|
|  | 2013                    | 2012      | 2011        |
| Cash provided by (used in):                          |                         |           |             |
| Operating activities                                 | \$ 80,703               | \$ 43,579 | \$ 39,815   |
| Investing activities                                 | (63,997)                | (19,238)  | (45,388)    |
| Financing activities                                 | (14,567)                | (8,091)   | (6,312)     |
| Effect of exchange rate on cash                      | 567                     | 922       | 1,111       |
| Net increase (decrease) in cash and cash equivalents | \$ 2,706                | \$ 17,172 | \$ (10,774) |

  

|   | As of December 31, |            |            |
|---|--------------------|------------|------------|
|   | 2013               | 2012       | 2011       |
| Total cash, cash equivalents, and marketable securities | \$ 156,692         | \$ 122,985 | \$ 111,432 |

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. There can be no assurance that changes in our plans or other events affecting our operations will not result in materially accelerated or unexpected cash requirements.

We evaluate acquisition opportunities from time to time, which if pursued, could require use of our funds. On October 9, 2013, we acquired Antenna for \$27.7 million in cash, inclusive of cash acquired and a preliminary working capital adjustment. During 2013, we incurred \$1.3 million, primarily in professional fees to affect this acquisition and expect to incur an additional estimated \$0.4 million in such fees.

As of December 31, 2013, approximately \$43.3 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.

**Cash provided by operating activities**

The primary drivers of cash provided by operating activities during 2013 were net income of \$38.0 million and a \$26.4 million increase in deferred revenue primarily resulting from the difference in timing of billings and revenue recognition for annual maintenance.

The primary drivers of cash provided by operating activities during 2012 were \$21.9 million of net income and a \$24.8 million increase in deferred revenue primarily resulting from the difference in timing of billings and revenue recognition for annual maintenance.

Cash used in operating activities during 2011 was primarily due to our net income of \$10.1 million and an \$18.5 million increase in accounts receivable.

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

Total contractual future cash receipts due from our existing license agreements was approximately \$264.3 million as of December 31, 2013 compared to \$255 million as of December 31, 2012. The future cash receipts due as of December 31, 2013 are summarized as follows:

| <b>As of December 31, (in thousands)</b> | <b>Contractual<br/>payments for term<br/>licenses not recorded on<br/>the balance sheet (1)</b> | <b>Other contractual<br/>license payments not<br/>recorded on the<br/>balance sheet (2)</b> | <b>Total</b>      |
|--|---|---|-------------------|
| 2014                                     | \$ 69,287   | \$ 22,947   | \$ 92,234         |
| 2015                                     | 62,978  | 4,652   | 67,630            |
| 2016                                     | 50,037  | 3,128   | 53,165            |
| 2017                                     | 28,459  |   | 28,459            |
| 2018 and thereafter                      | 22,829  |   | 22,829            |
| <b>Total</b>                             | <b>\$ 233,590</b>   | <b>\$ 30,727</b>  | <b>\$ 264,317</b> |

(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 2013, cash used in investing activities was primarily for purchases of marketable debt securities for \$60.6 million, partially offset by the proceeds received from the maturities and called marketable debt securities of \$27.8 million. We paid \$25.6 million to acquire Antenna, net of cash acquired and a preliminary working capital adjustment. We also invested \$5.6 million primarily in leasehold improvements and computer equipment for the build-out of our U.S. and India offices.

During 2012, we invested \$23.6 million primarily in leasehold improvements, furniture and fixtures and equipment for the build-out of our U.S. and India offices.

During 2011, cash used in investing activities was primarily for purchases of marketable debt securities for \$57.2 million, partially offset by the proceeds received from the sales, maturities and called marketable debt securities of \$21.7 million. We also invested \$9.8 million in property and equipment, primarily leasehold improvements, computer equipment and furniture and fixtures for our U.S. and UK offices.

**Cash used in financing activities**

Net cash used in financing activities during 2013, 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 up to \$104.5 million of our common stock. As of December 31, 2013, approximately \$83.7 million has been repurchased, approximately \$14.4 million remains available for repurchase and approximately \$6.4 million expired. Purchases under these programs have been made on the open market.

**Table of Contents****Common stock repurchases**

The following table is a summary of our repurchase activity under all of our stock repurchase programs:

| <i>(Dollars in thousands)</i>                      | 2013    |           | Year ended December 31,<br>2012 |           | 2011    |           |
|--|---------|-----------|---------------------------------|-----------|---------|-----------|
|  | Shares  | Amount    | Shares                          | Amount    | Shares  | Amount    |
| Prior year authorizations at January 1,            |         | \$ 14,793 |                                 | \$ 13,963 |         | \$ 13,237 |
| Authorizations                                     |         | 12,164    |                                 | 6,036     |         | 5,590     |
| Repurchases paid                                   | 386,629 | (12,370)  | 181,803                         | (5,130)   | 137,429 | (4,815)   |
| Repurchases unsettled                              | 3,141   | (154)     | 3,399                           | (76)      | 1,688   | (49)      |
| Authorized dollars remaining as of<br>December 31, |         | \$ 14,433 |                                 | \$ 14,793 |         | \$ 13,963 |

In addition to the share repurchases made under our repurchase programs, we net settled the majority of our employee stock options exercised and RSUs vested. During 2013 and 2012, option and RSU holders net settled stock options and vested RSUs representing the right to purchase a total of 861,000 shares and 548,000 shares, respectively, of which only 432,000 shares and 319,000 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 with respect to stock options and the applicable taxes for both options and RSUs. During 2013 and 2012, instead of receiving cash from the equity holders, we withheld shares with a value of \$7.4 million and \$4.4 million, respectively, for withholding taxes, and \$9.0 million and \$2.7 million, respectively, for the exercise price.

**Dividends**

We declared quarterly dividends totaling \$0.12 per share for each of the years ended December 31, 2013, 2012, and 2011. Our Board of Directors authorized us to accelerate the payment of the fourth quarter 2012 dividend otherwise payable in January 2013 to December 2012. Therefore, we paid \$5.7 million in dividends in 2012. For the years ended December 31, 2013 and 2011, we paid cash dividends of \$3.4 million, and \$4.5 million, respectively. It is our current intention to pay a quarterly cash dividend of \$0.03 per share, however, the Board of Directors may terminate or modify this dividend program at any time without notice.

**Contractual obligations**

As of December 31, 2013, we had purchase obligations for customer support and marketing programs and payments under operating leases. Our lease arrangement for our new office headquarters expires in 2023, subject to our option to extend for two additional five-year periods. We also lease space for our other offices under noncancellable operating leases that expire at various dates through 2021.

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As of December 31, 2013, our known contractual obligations, including future minimum rental payments required under operating leases with noncancellable terms in excess of one year were as follows:

| (in thousands)                            | Payment due by period |           |             |             |                   |           |
|---|-----------------------|-----------|-------------|-------------|-------------------|-----------|
|   | Total                 | 2014      | 2015 & 2016 | 2017 & 2018 | 2019 & Thereafter | Other     |
| Purchase obligations (1)                  | \$ 1,114              | \$ 1,114  | \$          | \$          | \$                | \$        |
| Liability for uncertain tax positions (2) | 19,154                |           |             |             |                   | 19,154    |
| Operating lease obligations (3)           | 95,429                | 11,947    | 22,625      | 19,427      | 41,430            |           |
| Total                                     | \$ 115,697            | \$ 13,061 | \$ 22,625   | \$ 19,427   | \$ 41,430         | \$ 19,154 |

- (1) Represents the fixed or minimum amounts due under purchase obligations for customer support and marketing programs.
- (2) As of December 31, 2013, our recorded liability for uncertain tax positions was approximately \$19.2 million. We are unable to reasonably estimate the timing of the cash outflow due to uncertainties in the timing of the effective settlement of tax positions.
- (3) Includes deferred rent of approximately \$0.7 million included in accrued expenses and approximately \$11.1 million in other long-term liabilities in the accompanying audited consolidated balance sheet as of December 31, 2013.

**CRITICAL ACCOUNTING POLICIES, SIGNIFICANT JUDGMENTS AND ESTIMATES**

Management's discussion and analysis of the financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the U.S. and the rules and regulations of the SEC for annual 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. We consider the following accounting policies to be both those most important to the portrayal of our financial condition and those that require the most subjective judgment. If actual results differ significantly from management's estimates and projections, there could be a material effect on our financial statements.

**Revenue recognition**

Our revenue is derived primarily from software licenses, maintenance fees related to our software licenses, and consulting services. Our license arrangements, whether involving a perpetual license or a term license, generally contain multiple elements, including consulting services, training, and software maintenance services.

Software revenue recognition requires judgment, including whether a software arrangement includes multiple elements, and if so, whether vendor-specific objective evidence (VSOE) of fair value exists for those elements. The amount of arrangement consideration allocated to undelivered elements is based on the VSOE of fair value for those elements and recognized as those elements are delivered. Any remaining portion of the total arrangement fee is allocated to the software license, the first delivered element. Revenue is recognized for each element when all of the revenue recognition criteria have been met.

Changes in the mix of the elements in a software arrangement, the ability to identify VSOE for those elements, the fair value of the respective elements, and changes to a product's estimated life cycle could materially impact the amount of earned and unearned revenue.

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Before we can recognize revenue, the following four basic criteria must be met:

*Persuasive evidence of an arrangement* As evidence of the existence of an arrangement, we use a contract or purchase order signed by the client for software and maintenance and a statement of work for consulting services. In the event the client is a reseller we ensure a binding agreement exists between the reseller and end user of the software.

*Delivery of product* Software is delivered electronically or shipped via disk media. Services, including maintenance, are considered delivered as the work is performed or, in the case of maintenance, over the contractual service period.

*Fee is fixed or determinable* We assess whether a fee is fixed or determinable at the outset of the arrangement. In addition, we assess whether contract modifications to an existing term arrangement constitute a concession. Our agreements do not include a right of return.

*Collection of fee is probable* We assess the probability of collecting from each client at the outset of the arrangement based on a number of factors, including the client's payment history, its current creditworthiness, economic conditions in the client's industry and geographic location, and general economic conditions. If in our judgment collection of a fee is not probable, revenue is recognized as cash is collected, provided all other conditions for revenue recognition have been met.

### ***Software license revenues***

Perpetual software license fees are recognized as revenue when the software is delivered, any acceptance required by contract that is not perfunctory is obtained, no significant obligations or contingencies exist related to the software, other than maintenance, and all other revenue recognition criteria are met.

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

As a result of our focus on frequent sales to our targeted clients, our strategy to sell initial term licensing agreements to those clients with the goal to generate follow-on sales, and as a result of extended payment terms and other factors, such as the risk of concessions, we recognize term license revenue over the term of the agreement as payments become due or earlier if prepaid, provided all other criteria for revenue recognition have been met.

Subscription revenue primarily consists of license, maintenance and bundled services revenue recognized on our license arrangements that include a right to unspecified future products, which is recognized ratably over the term of the subscription period.

### ***Maintenance revenues***

First-year maintenance typically is sold with the related software license and renewed on an annual basis thereafter. Maintenance revenue is deferred and recognized ratably over the term of the support period, which is generally one year and subject to annual renewals. Perpetual license maintenance obligations are based on separately stated renewal rates in the arrangement that are substantive and therefore represent VSOE of fair value. Term license arrangements include separately stated maintenance fees and we use separate sales to determine VSOE of fair value.

### ***Services revenues***

Our services revenue is comprised of fees for consulting services, including software implementation, training, reimbursable expenses and sales of our Pega Cloud® offering ( Pega Clou® ). Consulting services may be provided on a stand-alone basis or bundled with a license and software maintenance services.



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Revenue from training services and consulting services under time and materials contracts is recognized as services are performed. We have VSOE of fair value for our training services and consulting services under time and materials contracts in North America, Australia, and Europe.

Consulting services may occasionally be provided on a fixed-price basis. We do not have VSOE of fair value for fixed-price services or time and materials services in certain geographical regions. When these services are part of a multiple element arrangement, and the services are not essential to the functionality of the software, and when services, including maintenance, are the only undelivered element, we recognize the revenue from the total arrangement ratably over the longer of the software maintenance period or the service period. Revenue from fixed-price services that are not bundled with a software license is generally recognized ratably during the service period, which is typically less than four months.

Revenue from stand-alone sales of Pega Cloud® is recognized ratably over the term of the service. When implementation services are sold together with our Pega Cloud® offering and these services have stand-alone value to the client, we account for these services separately from our Pega Cloud® offering as described earlier. Stand-alone value is established through the client's ability to buy these services from many trained partner system integrators and from transactions sold independently from the sale of Pega Cloud®. Since these multiple-element arrangements are not software license sales, we apply a selling price hierarchy. Under the selling price hierarchy, third-party evidence of selling price ( TPE ) will be considered if VSOE does not exist, and estimated selling price ( ESP ) will be used if neither VSOE nor TPE is available. Generally, we are not able to determine TPE as our sales strategy is customized to the needs of our clients and our products or services are dissimilar to comparable products or services in the marketplace. In determining ESP, we apply significant judgment as we weigh a variety of factors, based on the facts and circumstances of the arrangement. We typically arrive at an ESP for a service that is not sold separately by considering company-specific factors such as geographies, competitive landscape, and pricing practices used to establish bundled pricing and discounting.

### ***Warranties and Indemnification***

We warrant to our clients that our software products will conform to documented specifications for a limited period. We have not experienced significant claims related to software warranties beyond the scope of maintenance support, which we are already obligated to provide, and consequently we have not established reserves for warranty obligations.

Our agreements with clients generally require us to indemnify the client against claims that our software infringes third party patent, copyright, trademark or other proprietary rights. Such indemnification obligations are generally limited in a variety of industry-standard respects, including our right to replace an infringing product. As of December 31, 2013, we had not experienced any losses related to these indemnification obligations and no claims were outstanding.

### ***Deferred revenue***

Deferred software license revenue typically results from client billings for which all of the criteria to recognize revenue have not been met. Deferred maintenance revenue represents software license updates and product support contracts that are typically billed in advance and are recognized ratably over the support periods. Deferred services revenue represents advanced billings for consulting, hosting, and training services that are recognized as the services are performed.

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### ***Goodwill and Intangible Assets Impairment***

Our goodwill and intangibles assets result from our business acquisitions. Goodwill and intangible assets with indefinite useful lives are not amortized, but are tested for impairment at least annually or as circumstances indicate their value may no longer be recoverable. We do not carry any intangible assets with indefinite useful lives other than goodwill. We perform our annual goodwill impairment during the fourth quarter of the fiscal year. With the acquisition of Antenna, we have determined our business has two operating segments, which are our two reporting units. To assess if goodwill is impaired, we first perform a qualitative assessment to determine whether further impairment testing is necessary. If, as a result of the qualitative assessment, we consider it more-likely-than-not that the fair value of a reporting unit is less than its carrying amount, we perform a quantitative impairment test in a two-step process. For the first step, we screen for impairment, and if any possible impairment exists, we undertake a second step of measuring such impairment by performing discounted cash flow analyses. These analyses are based on cash flow assumptions that are consistent with the plans and estimates being used to manage our business. In the first step, we review the carrying amount of our reporting unit compared to the fair value of the reporting unit. An excess carrying value to fair value would indicate that goodwill may be impaired. If we determined that goodwill may be impaired, then we would compare the implied fair value to the carrying value of the goodwill. We periodically re-evaluate our business and have determined that we have two operating segments, which are our two reporting units. If our assumptions change in the future, we may be required to record impairment charges to reduce the carrying value of our goodwill. Changes in the valuation of goodwill could materially impact our operating results and financial position.

We evaluate our intangible assets for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. In evaluating potential impairment of these assets, we specifically consider whether any indicators of impairment are present, including, but not limited to:

whether there has been a significant adverse change in the business climate that affects the value of an asset;

whether there has been a significant change in the extent or manner in which an asset is used; and

whether there is an expectation that the asset will be sold or disposed of before the end of its originally estimated useful life.

If indicators of impairment are present, we compare the estimated undiscounted cash flows that the specific asset is expected to generate to its carrying value. These estimates involve significant subjectivity. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the asset exceeds its fair value.

As of December 31, 2013, we had \$37.5 million of goodwill and \$56.6 million of acquired intangible assets. If our estimates or the related assumptions change in the future, we may be required to record impairment charges to reduce the carrying value of these assets. Changes in the valuation of long-lived assets could materially impact our operating results and financial position. To date, there have been no impairments of goodwill or intangibles assets.

### ***Accounting for Income Taxes***

We use the asset and liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are determined based on temporary differences between the financial statement and tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse.

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We regularly assess the need for a valuation allowance against our deferred tax assets. Future realization of our deferred tax assets ultimately depends on the existence of sufficient taxable income within the available carryback or carryforward periods. Sources of taxable income include taxable income in prior carryback years, future reversals of existing taxable temporary differences, tax planning strategies, and future taxable income. We record a valuation allowance to reduce our deferred tax assets to an amount we believe is more likely than not to be realized. Changes in our valuation allowance impact income tax expense in the period of adjustment. Our deferred tax valuation allowances require significant judgment and uncertainties, including assumptions about future taxable income that are based on historical and projected information.

As of December 31, 2013, we had approximately \$127.5 million of acquired Chordiant federal NOLs that are subject to annual use limitations under section 382 of the Internal Revenue Code. Based on those limitations we anticipate using \$101.7 million of the remaining NOLs by 2029. In addition, we had \$0.9 million of deferred tax assets related to state NOLs as of December 31, 2013.

We acquired approximately \$52 million and \$58.1 million of federal and foreign NOLs, respectively, in the Antenna transaction. We have preliminarily determined that we may utilize \$18.4 million of the acquired Antenna federal NOLs under the applicable section 382 limitation, and these losses are scheduled to expire in 2032. A valuation allowance is recorded on the deferred tax assets in excess of the federal NOLs that are deemed recoverable under the preliminary limitation. With regard to the acquired foreign NOLs, a full valuation allowance has been recorded as of December 31, 2013 due to uncertainty regarding the availability of these NOLs to offset future income generated by the related foreign businesses due to limitations under local country change in control provisions.

We assess our income tax positions and record tax benefits based upon management's evaluation of the facts, circumstances, and information available at the reporting date. For those tax positions where it is more-likely-than-not that a tax benefit will be sustained, we record the largest amount of tax benefit with a greater than 50 percent likelihood of being realized upon ultimate settlement with a taxing authority having full knowledge of all relevant information. For those income tax positions where it is not more-likely-than-not that a tax benefit will be sustained, no tax benefit is recognized in the financial statements. We classify liabilities for uncertain tax positions as non-current liabilities unless the uncertainty is expected to be resolved within one year. We classify interest and penalties on uncertain tax positions as income tax expense.

As a global company, we use significant judgment to calculate and provide for income taxes in each of the tax jurisdictions in which we operate. In the ordinary course of our business, there are transactions and calculations undertaken whose ultimate tax outcome cannot be certain. Some of these uncertainties arise as a consequence of transfer pricing for transactions with our subsidiaries and nexus and tax credit estimates. In addition, the calculation of acquired tax attributes and the associated limitations are complex. We estimate our exposure to unfavorable outcomes related to these uncertainties and estimate the probability of such outcomes.

Although we believe our estimates are reasonable, no assurance can be given that the final tax outcome will not be different from what is reflected in our historical income tax provisions, returns, and accruals. Such differences, or changes in estimates relating to potential differences, could have a material impact on our income tax provision and operating results in the period in which such a determination is made.

See Note 16 Income Taxes in the notes to the accompanying audited consolidated financial statements for further information.

**ITEM 7A. Quantitative and Qualitative Disclosure about Market Risk**

Market risk represents the risk of loss that may affect us due to adverse changes in financial market prices and rates. Our market risk exposure is primarily related to fluctuations in foreign exchange rates and interest rates.

**Table of Contents***Foreign currency exposure*

We derived approximately 45%, 46%, and 48%, of our total revenue from sales to clients based outside of the U.S. in 2013, 2012 and 2011, respectively. Our international sales are usually denominated in foreign currencies. However, the operating expenses of our foreign operations are also primarily denominated in foreign currencies, which partially offset our foreign currency exposure. A decrease in the value of foreign currencies, particularly the British pound and the Euro relative to the U.S. dollar, could adversely impact our revenues and operating results.

Since the second quarter of 2011, we have used forward contracts to manage our exposure to changes in foreign currency exchange rates affecting foreign currency denominated accounts receivable, intercompany payables, and cash primarily held by our U.S. operating company.

Our U.S. operating company invoices most of our foreign clients in foreign currencies, so it holds cash and receivables denominated in these foreign currencies. Our U.S. operating company's functional currency is the U.S. dollar. Therefore, when there are changes in the foreign currency exchange rates versus the U.S. dollar, we recognize a foreign currency transaction gain or (loss) in our consolidated statements of operations. In addition, we have intercompany accounts that are eliminated in consolidation, but that expose us to foreign currency exchange rate fluctuation, which are recorded as foreign currency transaction gains or (losses) in our consolidated statements of operations.

We have been primarily exposed to changes in the value of the Euro and British pound relative to the U.S. dollar. More recently, we have experienced increased levels of exposure to the Australian dollar and Indian rupee. We have not designated the forward contracts as hedging instruments and as a result, we record their fair value at the end of each reporting period in our 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 our consolidated statements of operations. Generally, we enter into contracts with terms of 90 days or less.

The fluctuations in the value of these forward contracts partially offset the gains and losses from the remeasurement or settlement of the foreign currency denominated accounts receivable, intercompany payables, and cash held by the U.S. operating company recorded in foreign currency transaction (loss) gain, thus partially mitigating the volatility.

We entered into forward contracts with notional values as follows:

| <b>Foreign currency (in thousands)</b> | <b>Year Ended December 31,</b> |             |             |
|--|--------------------------------|-------------|-------------|
|  | <b>2013</b>                    | <b>2012</b> | <b>2011</b> |
| Euro                                   | 102,300                        | 49,700      | 28,500      |
| British pound                          | £ 85,400                       | £ 52,000    | £ 19,500    |
| Australian dollar                      | A\$ 26,300                     | A\$         | A\$         |
| Indian rupee                           | Rs 690,000                     | Rs          | Rs          |

The total change in the fair value of our forward contracts recorded in other (expense) income, net, was as follows:

| <i>(in thousands)</i>                               | <b>Change in Fair Value in USD</b> |             |             |
|---|------------------------------------|-------------|-------------|
|   | <b>Year Ended</b>                  |             |             |
|   | <b>December 31,</b>                |             |             |
|   | <b>2013</b>                        | <b>2012</b> | <b>2011</b> |
| (Loss) gain included in other (expense) income, net | \$ (747)                           | \$ (1,738)  | \$ 764      |

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The impact on net income of the gains and losses recorded on the foreign currency forward contracts, which is included in other (expense) income, net, in the accompanying consolidated statements of operations, and the foreign currency transaction gains and losses recorded on the remeasurement and settlement of the foreign currency denominated assets, which is included in foreign currency transaction gain (loss) in the accompanying consolidated statements of operations, was a net loss of approximately \$2.3 million, \$1 million and \$0.2 million for the years ended December 31, 2013, 2012 and 2011, respectively.

*Interest rate exposure*

As of December 31, 2013, we had \$76.5 million of marketable debt securities, which consisted primarily of corporate and municipal bonds, with a weighted-average remaining maturity of 12 months. Due to the overall short-term remaining maturities of our marketable debt securities, our interest rate exposure is not significant. As of December 31, 2013, a 200 basis point increase in market interest rates would have reduced the fair value of our fixed rate marketable debt securities by approximately \$1.6 million.

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**ITEM 8. Financial Statements and Supplementary Data**

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholders of Pegasystems Inc.

Cambridge, Massachusetts

We have audited the accompanying consolidated balance sheets of Pegasystems Inc. and subsidiaries (the Company) as of December 31, 2013 and 2012, and the related consolidated statements of operations, comprehensive income (loss), stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2013. We also have audited the Company's internal control over financial reporting as of December 31, 2013, based on criteria established in *Internal Control - Integrated Framework* (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on these financial statements and an opinion on the Company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

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

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Pegasystems Inc. and subsidiaries as of December 31, 2013 and 2012, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2013, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2013, based on the criteria established in *Internal Control - Integrated Framework* (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission.

/s/ DELOITTE & TOUCHE LLP

Boston, Massachusetts

February 25, 2014





**Table of Contents****PEGASYSTEMS INC.****CONSOLIDATED BALANCE SHEETS****(in thousands, except per share amounts)**

|   | As of December 31, |            |
|---|--------------------|------------|
|   | 2013               | 2012       |
| <b>ASSETS</b>   |                    |            |
| Current assets:   |                    |            |
| Cash and cash equivalents   | \$ 80,231          | \$ 77,525  |
| Marketable securities   | 76,461             | 45,460     |
| Total cash, cash equivalents, and marketable securities   | 156,692            | 122,985    |
| Trade accounts receivable, net of allowance of \$1,997 and \$963  | 165,594            | 134,066    |
| Deferred income taxes   | 11,106             | 10,202     |
| Income taxes receivable   | 4,708              | 6,261      |
| Other current assets  | 9,117              | 5,496      |
| Total current assets  | 347,217            | 279,010    |
| Property and equipment, net   | 28,957             | 30,827     |
| Long-term deferred income taxes   | 60,925             | 49,292     |
| Long-term other assets  | 2,526              | 1,680      |
| Intangible assets, net  | 56,574             | 58,232     |
| Goodwill  | 37,463             | 20,451     |
| Total assets  | \$ 533,662         | \$ 439,492 |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>   |                    |            |
| Current liabilities:  |                    |            |
| Accounts payable  | \$ 3,745           | \$ 3,330   |
| Accrued expenses  | 28,419             | 15,534     |
| Accrued compensation and related expenses   | 44,399             | 40,715     |
| Deferred revenue  | 110,882            | 95,546     |
| Total current liabilities   | 187,445            | 155,125    |
| Income taxes payable  | 21,392             | 13,551     |
| Long-term deferred revenue  | 34,196             | 18,719     |
| Other long-term liabilities   | 18,841             | 15,618     |
| Total liabilities   | 261,874            | 203,013    |
| Commitments and contingencies (Note 13)   |                    |            |
| Stockholders' equity:   |                    |            |
| Preferred stock, \$0.01 par value, 1,000 shares authorized; no shares issued and outstanding                      |                    |            |
| Common stock, \$0.01 par value, 100,000 shares authorized; 38,162 shares and 37,945 shares issued and outstanding | 382                | 379        |
| Additional paid-in capital  | 139,947            | 138,576    |
| Retained earnings   | 127,826            | 94,349     |
| Accumulated other comprehensive income:   |                    |            |
| Net unrealized gain on available-for-sale marketable securities   | 77                 | 88         |
| Foreign currency translation adjustments  | 3,556              | 3,087      |
| Total stockholders' equity  | 271,788            | 236,479    |

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|  |            |            |
|--|------------|------------|
| Total liabilities and stockholders' equity | \$ 533,662 | \$ 439,492 |
|--|------------|------------|

See notes to consolidated financial statements.

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

(in thousands, except per share amounts)

|   | Year ended December 31, |                  |                  |
|---|-------------------------|------------------|------------------|
|   | 2013                    | 2012             | 2011             |
| <b>Revenue:</b>   |                         |                  |                  |
| Software license  | \$ 191,876              | \$ 163,906       | \$ 138,807       |
| Maintenance   | 157,309                 | 133,527          | 117,110          |
| Services  | 159,769                 | 164,277          | 160,758          |
| <b>Total revenue</b>  | <b>508,954</b>          | <b>461,710</b>   | <b>416,675</b>   |
| <b>Cost of revenue:</b>                                     |                         |                  |                  |
| Software license  | 6,281                   | 6,339            | 6,693            |
| Maintenance   | 15,272                  | 14,787           | 13,077           |
| Services  | 135,853                 | 136,254          | 145,028          |
| <b>Total cost of revenue</b>                                | <b>157,406</b>          | <b>157,380</b>   | <b>164,798</b>   |
| <b>Gross profit</b>   | <b>351,548</b>          | <b>304,330</b>   | <b>251,877</b>   |
| Selling and marketing                                       | 181,094                 | 167,263          | 147,457          |
| Research and development                                    | 79,726                  | 76,726           | 65,308           |
| General and administrative                                  | 29,594                  | 28,915           | 28,198           |
| Acquisition-related costs                                   | 1,306                   |                  | 482              |
| Restructuring costs   | 1,731                   |                  | (62)             |
| <b>Total operating expenses</b>                             | <b>293,451</b>          | <b>272,904</b>   | <b>241,383</b>   |
| Income from operations                                      | 58,097                  | 31,426           | 10,494           |
| Foreign currency transaction (loss) gain                    | (1,593)                 | 780              | (935)            |
| Interest income, net  | 524                     | 419              | 398              |
| Other (expense) income, net                                 | (635)                   | (1,680)          | 856              |
| Income before provision for income taxes                    | 56,393                  | 30,945           | 10,813           |
| Provision for income taxes                                  | 18,350                  | 9,077            | 705              |
| <b>Net income</b>   | <b>\$ 38,043</b>        | <b>\$ 21,868</b> | <b>\$ 10,108</b> |
| <b>Earnings per share:</b>                                  |                         |                  |                  |
| Basic   | \$ 1.00                 | \$ 0.58          | \$ 0.27          |
| Diluted   | \$ 0.98                 | \$ 0.56          | \$ 0.26          |
| <b>Weighted-average number of common shares outstanding</b> |                         |                  |                  |
| Basic   | 37,973                  | 37,853           | 37,496           |
| Diluted   | 38,987                  | 38,859           | 39,404           |

See notes to consolidated financial statements.



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

|  | Year ended December 31, |           |           |
|--|-------------------------|-----------|-----------|
|  | 2013                    | 2012      | 2011      |
| Net income                                       | \$ 38,043               | \$ 21,868 | \$ 10,108 |
| Other comprehensive income:                      |                         |           |           |
| Unrealized (loss) gain on securities, net of tax | (11)                    | 31        | 93        |
| Foreign currency translation adjustments         | 469                     | 1,495     | 296       |
| Total other comprehensive income                 | 458                     | 1,526     | 389       |
| Comprehensive income                             | \$ 38,501               | \$ 23,394 | \$ 10,497 |

See notes to consolidated financial statements.

**Table of Contents****PEGASYSTEMS INC.****CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY**

(in thousands, except per share amounts)

|  | Common Stock |        | Additional | Retained  | Accumulated   | Total        |
|--|--------------|--------|------------|-----------|---------------|--------------|
|  | Number       | Amount | Paid-In    | Earnings  | Other         | Stockholders |
|  | of Shares    |        | Capital    |           | Comprehensive | Equity       |
|  |              |        |            |           | Income        |              |
| Balance at January 1, 2011   | 37,250       | \$ 372 | \$ 122,607 | \$ 71,431 | \$ 1,260      | \$ 195,670   |
| Repurchase of common stock   | (139)        | (1)    | (4,863)    |           |               | (4,864)      |
| Issuance of common stock for share-based compensation plans  | 575          | 6      | (4,293)    |           |               | (4,287)      |
| Issuance of stock under Employee Stock Purchase Plan   | 18           |        | 647        |           |               | 647          |
| Issuance of stock awards   | 8            |        | 350        |           |               | 350          |
| Stock-based compensation expense   |              |        | 8,678      |           |               | 8,678        |
| Tax benefit from exercise or vesting of equity awards, net of deferred tax asset deficiencies of \$83  |              |        | 6,575      |           |               | 6,575        |
| Cash dividends declared (\$0.12 per share)   |              |        |            | (4,510)   |               | (4,510)      |
| Other comprehensive income   |              |        |            |           | 389           | 389          |
| Net income   |              |        |            | 10,108    |               | 10,108       |
| Balance at December 31, 2011   | 37,712       | \$ 377 | \$ 129,701 | \$ 77,029 | \$ 1,649      | \$ 208,756   |
| Repurchase of common stock   | (185)        | (2)    | (5,204)    |           |               | (5,206)      |
| Issuance of common stock for share-based compensation plans  | 382          | 4      | (3,869)    |           |               | (3,865)      |
| Exercise of Common Stock Warrants  | 2            |        |            |           |               |              |
| Issuance of stock under Employee Stock Purchase Plan   | 22           |        | 603        |           |               | 603          |
| Issuance of stock awards   | 12           |        |            |           |               |              |
| Stock-based compensation expense   |              |        | 11,506     |           |               | 11,506       |
| Tax benefit from exercise or vesting of equity awards, net of deferred tax asset deficiencies of \$284 |              |        | 5,839      |           |               | 5,839        |
| Cash dividends declared (\$0.12 per share)   |              |        |            | (4,548)   |               | (4,548)      |
| Other comprehensive income   |              |        |            |           | 1,526         | 1,526        |
| Net income   |              |        |            | 21,868    |               | 21,868       |
| Balance at December 31, 2012   | 37,945       | \$ 379 | \$ 138,576 | \$ 94,349 | \$ 3,175      | \$ 236,479   |
| Repurchase of common stock   | (390)        | (4)    | (12,521)   |           |               | (12,525)     |
| Issuance of common stock for share-based compensation plans  | 574          | 7      | (5,686)    |           |               | (5,679)      |
| Issuance of stock under Employee Stock Purchase Plan   | 19           |        | 545        |           |               | 545          |
| Issuance of stock awards   | 14           |        |            |           |               |              |
| Stock-based compensation expense   |              |        | 12,869     |           |               | 12,869       |
| Tax benefit from exercise or vesting of equity awards, net of deferred tax asset deficiencies of \$435 |              |        | 6,164      |           |               | 6,164        |
| Cash dividends declared (\$0.12 per share)   |              |        |            | (4,566)   |               | (4,566)      |

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|                              |        |    |     |    |         |        |         |        |       |    |         |
|------------------------------|--------|----|-----|----|---------|--------|---------|--------|-------|----|---------|
| Other comprehensive income   |        |    |     |    |         |        | 458     | 458    |       |    |         |
| Net income                   |        |    |     |    |         | 38,043 |         | 38,043 |       |    |         |
| Balance at December 31, 2013 | 38,162 | \$ | 382 | \$ | 139,947 | \$     | 127,826 | \$     | 3,633 | \$ | 271,788 |

See notes to consolidated financial statements.

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

|   | Year ended December 31, |                  |                  |
|---|-------------------------|------------------|------------------|
|   | 2013                    | 2012             | 2011             |
| <b>Operating activities:</b>  |                         |                  |                  |
| Net income  | \$ 38,043               | \$ 21,868        | \$ 10,108        |
| Adjustment to reconcile net income to cash provided by operating activities:      |                         |                  |                  |
| Excess tax benefits from exercise or vesting of equity awards                     | (6,435)                 | (6,031)          | (6,658)          |
| Deferred income taxes   | (7,008)                 | (6,164)          | (15,269)         |
| Depreciation and amortization   | 20,035                  | 18,566           | 17,462           |
| Amortization of investments   | 1,776                   | 1,419            | 849              |
| Stock-based compensation expense  | 12,869                  | 11,506           | 9,028            |
| Foreign currency transaction loss (gain)  | 1,593                   | (780)            | 935              |
| Other non-cash  | 1,670                   | 3,357            | 1,749            |
| Change in operating assets and liabilities:                                       |                         |                  |                  |
| Trade accounts receivable   | (28,316)                | (33,664)         | (18,450)         |
| Income taxes receivable and other current assets                                  | 7,076                   | 6,570            | 10,519           |
| Accounts payable and accrued expenses   | 5,794                   | (7,656)          | 9,038            |
| Deferred revenue  | 26,362                  | 24,787           | 14,595           |
| Other long-term assets and liabilities  | 7,244                   | 9,801            | 5,909            |
| <b>Cash provided by operating activities</b>                                      | <b>80,703</b>           | <b>43,579</b>    | <b>39,815</b>    |
| <b>Investing activities:</b>  |                         |                  |                  |
| Purchases of marketable securities  | (60,648)                | (20,204)         | (57,249)         |
| Proceeds from maturities and called marketable securities                         | 27,814                  | 24,576           | 20,648           |
| Sale of marketable securities   |                         |                  | 1,048            |
| Payment for 2013 acquisition, net of cash acquired                                | (25,565)                |                  |                  |
| Investment in property and equipment  | (5,598)                 | (23,610)         | (9,835)          |
| <b>Cash used in investing activities</b>  | <b>(63,997)</b>         | <b>(19,238)</b>  | <b>(45,388)</b>  |
| <b>Financing activities:</b>  |                         |                  |                  |
| Issuance of common stock for share-based compensation plans                       | 2,210                   | 1,128            | 2,622            |
| Excess tax benefits from exercise or vesting of equity awards                     | 6,435                   | 6,031            | 6,658            |
| Dividend payments to shareholders   | (3,421)                 | (5,680)          | (4,495)          |
| Common stock repurchases for tax withholdings for net settlement of equity awards | (7,345)                 | (4,391)          | (6,262)          |
| Common stock repurchases under share repurchase programs                          | (12,446)                | (5,179)          | (4,835)          |
| <b>Cash used in financing activities</b>  | <b>(14,567)</b>         | <b>(8,091)</b>   | <b>(6,312)</b>   |
| Effect of exchange rate on cash and cash equivalents                              | 567                     | 922              | 1,111            |
| <b>Net increase (decrease) in cash and cash equivalents</b>                       | <b>2,706</b>            | <b>17,172</b>    | <b>(10,774)</b>  |
| Cash and cash equivalents, beginning of year                                      | 77,525                  | 60,353           | 71,127           |
| <b>Cash and cash equivalents, end of year</b>                                     | <b>\$ 80,231</b>        | <b>\$ 77,525</b> | <b>\$ 60,353</b> |

Supplemental disclosures:



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|  |           |          |          |
|--|-----------|----------|----------|
| Income taxes paid                          | \$ 11,107 | \$ 5,106 | \$ 2,566 |
| Non-cash investing and financing activity: |           |          |          |
| Dividends payable                          | \$ 1,145  | \$       | \$ 1,132 |

See notes to consolidated financial statements.

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**PEGASYSTEMS INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. BASIS OF PRESENTATION**

***(a) Business***

The Company develops, markets, licenses, and supports software to automate complex, changing business processes. The Company provides implementation, consulting, training, technical support and hosting services to facilitate the use of its software.

***(b) Management estimates and reporting***

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America ( U.S. ) requires management to make estimates and judgments that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the periods presented. Actual results could differ from those estimates. Accounts with reported amounts based on significant estimates and judgments include revenue, allowance for sales credit memos, deferred income taxes, income taxes payable, fair value of assets acquired and liabilities assumed, intangible assets, goodwill, accrued expenses, deferred revenue, and stock-based compensation.

***(c) Principles of consolidation***

The consolidated financial statements include Pegasystems Inc. and its wholly owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation.

**2. SIGNIFICANT ACCOUNTING POLICIES**

***(a) Revenue recognition***

The Company's revenue is derived primarily from software licenses, maintenance fees related to the Company's software licenses, and consulting services. The Company's license arrangements, whether involving a perpetual license or a term license, generally contain multiple elements, including consulting services, training, and software maintenance services.

Software revenue recognition requires judgment, including whether a software arrangement includes multiple elements, and if so, whether vendor-specific objective evidence ( VSOE ) of fair value exists for those elements. The amount of arrangement consideration allocated to undelivered elements is based on the VSOE of fair value for those elements and recognized as those elements are delivered. Any remaining portion of the total arrangement fee is allocated to the software license, the first delivered element.

Before the Company can recognize revenue, the following four basic criteria must be met:

*Persuasive evidence of an arrangement* As evidence of the existence of an arrangement, the Company uses a contract or purchase order signed by the client for software and maintenance, and a statement of work for consulting services. In the event the client is a reseller the Company ensures a binding agreement exists between the reseller and end user of the software.

*Delivery of product* The Company delivers its software electronically or ships it via disk media. Services, including maintenance, are considered delivered as the work is performed or, in the case of maintenance, over the contractual service period.

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**PEGASYSTEMS INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

*Fee is fixed or determinable* The Company assesses whether a fee is fixed or determinable at the outset of the arrangement. In addition, the Company assesses whether contract modifications to an existing term arrangement constitute a concession. The Company's agreements do not include a right of return.

*Collection of fee is probable* The Company assesses the probability of collecting from each client at the outset of the arrangement based on a number of factors, including the client's payment history, its current creditworthiness, economic conditions in the client's industry and geographic location, and general economic conditions. If in the Company's judgment collection of a fee is not probable, revenue is recognized as cash is collected, provided all other conditions for revenue recognition have been met.

**Software license revenues**

Perpetual software license fees are recognized as revenue when the software is delivered, any acceptance required by contract that is not perfunctory is obtained, no significant obligations or contingencies exist related to the software, other than maintenance, and all other revenue recognition criteria are met.

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

As a result of the Company's focus on frequent sales to its targeted clients, the Company's strategy is to sell initial term licensing agreements to those clients with the goal to generate follow-on sales, and as a result of extended payment terms and other factors, such as the risk of concessions, the Company recognizes term license revenue over the term of the agreement as payments become due or earlier if prepaid, provided all other criteria for revenue recognition have been met.

Subscription revenue primarily consists of license, maintenance, and bundled services revenue recognized on the Company's license arrangements that include a right to unspecified future products, which is recognized ratably over the term of the subscription period.

**Maintenance revenues**

First-year maintenance typically is sold with the related software license and renewed on an annual basis thereafter. Maintenance revenue is deferred and recognized ratably over the term of the support period, which is generally one year and subject to annual renewals. Perpetual license maintenance obligations are based on separately stated renewal rates in the arrangement that are substantive and therefore represent VSOE of fair value. Term license arrangements include separately stated maintenance fees and the Company uses separate sales to determine VSOE of fair value.

**Services revenues**

The Company's services revenue is comprised of fees for training, consulting services including software implementation, reimbursable expenses, and sales of its Pega Cloud® as-a-platform offering ( Pega Cloud® ). Consulting services may be provided on a stand-alone basis or bundled with a license and software maintenance services.

Revenue from stand-alone training services and consulting services under time and materials contracts is recognized as services are performed. The Company has VSOE of fair value for its training services and consulting services under time and materials contracts in North America, Australia, and Europe.

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**PEGASYSTEMS INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Consulting services may be provided on a fixed-price basis. The Company does not have VSOE of fair value for fixed-price services or time and materials services in certain geographical regions. When these services are part of a multiple element arrangement, and the services are not essential to the functionality of the software, and when services including maintenance, are the only undelivered element, the Company recognizes the revenue from the total arrangement ratably over the longer of the software maintenance period or the service period. Revenue from fixed-price services that are not bundled with a software license is generally recognized ratably during the service period, which is typically less than four months.

Revenue from stand-alone sales of Pega Cloud® is recognized ratably over the term of the service. When implementation services are sold together with the Company's Pega Cloud® offering and these services have stand-alone value to the client, the Company accounts for these services separately from its Pega Cloud® offering as described earlier. Stand-alone value is established through the client's ability to buy these services from many trained partner system integrators and from transactions sold independently from the sale of Pega Cloud®. Since these multiple-element arrangements are not software license sales, the Company applies a selling price hierarchy. Under the selling price hierarchy, third-party evidence of selling price ( TPE ) will be considered if VSOE does not exist, and estimated selling price ( ESP ) will be used if neither VSOE nor TPE is available. Generally, the Company is not able to determine TPE as its sales strategy is customized to the needs of its clients and the Company's products and services are dissimilar to comparable products or services in the marketplace. In determining ESP, the Company applies significant judgment as it weighs a variety of factors, based on the facts and circumstances of the arrangement. The Company typically arrives at an ESP for a service that is not sold separately by considering company-specific factors such as geographies, competitive landscape, and pricing practices used to establish bundled pricing and discounting.

**Warranties and Indemnification**

The Company warrants to its clients that its software products will conform to documented specifications for a limited period. The Company has not experienced significant claims related to software warranties beyond the scope of maintenance support, which it is already obligated to provide, and consequently it has not established reserves for warranty obligations.

The Company's agreements with clients generally require it to indemnify the client against claims that the Company's software infringes third party patent, copyright, trademark or other proprietary rights. Such indemnification obligations are generally limited in a variety of industry-standard respects, including the Company's right to replace an infringing product. As of December 31, 2013, the Company had not experienced any losses related to these indemnification obligations and no claims were outstanding.

**Deferred revenue**

Deferred software license revenue typically results from contractual billings for which all of the criteria to recognize revenue have not been met. Deferred maintenance revenue represents software license updates and product support contracts that are typically billed in advance and are recognized ratably over the support periods. Deferred services revenue represents advanced billings for consulting hosting, and training services that are recognized as the services are performed.

***(b) Fair value of financial instruments***

The principal financial instruments held by the Company consist of cash equivalents, marketable securities, accounts receivable, and accounts payable. The carrying value of these instruments approximates their fair value due to their short maturities. See Note 3 Marketable Securities and Note 5 Fair Value Measurements for further discussion of financial instruments that are carried at fair value on a recurring basis.

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**PEGASYSTEMS INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

***(c) Derivative instruments***

The Company uses foreign currency forward contracts to manage its exposures to changes in foreign currency exchange rates associated with its foreign currency denominated accounts receivable, intercompany payables, and cash. The foreign currency forward 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 operations. The fluctuations in the value of these foreign currency forward contracts partially offset the gains and losses from the remeasurement or settlement of the foreign currency denominated accounts receivable, intercompany payables, and cash held by the U.S. operating company, thus partly mitigating the volatility. Generally, the Company enters into foreign currency forward contracts with terms of 90 days or less.

***(d) Property and equipment***

Property and equipment are recorded at cost. Depreciation and amortization are computed using the straight-line method over the estimated useful lives of the assets, which are three years for equipment and five years for furniture and fixtures. Leasehold improvements are amortized over the lesser of the term of the lease or the useful life of the asset. Repairs and maintenance costs are expensed as incurred.

The Company capitalizes and amortizes certain direct costs associated with computer software developed or purchased for internal use. The Company amortizes capitalized software costs generally over three to five years commencing on the date the software is placed into service. During 2013, 2012, and 2011, the Company did not capitalize any costs for computer software developed for internal use.

***(e) Goodwill***

Goodwill represents the residual purchase price paid in a business combination after all identified assets and liabilities have been recorded. Goodwill is not amortized. The Company performed its qualitative assessment in the fourth quarters of 2013, 2012, and 2011, and concluded it was not more likely than not that the fair value of its reporting units was less than their carrying value.

***(f) Intangible Assets***

All of the Company's intangible assets are amortized using the straight-line method over their estimated useful life. The Company evaluates its intangible assets for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Impairment is assessed by comparing the undiscounted cash flows expected to be generated by the intangible asset to its carrying value. If impairment exists, the Company calculates the impairment by comparing the carrying value of the intangible asset to its fair value as determined by discounted expected cash flows. The Company did not record any impairment in 2013, 2012, or 2011.

***(g) Research and development and software costs***

Research and development costs are expensed as incurred. Capitalization of computer software developed for resale begins upon the establishment of technological feasibility, generally demonstrated by a working model or an operative version of the computer software product. Such costs have not been material to date as technological feasibility is established within a short timeframe from the software's general availability and, as a result, no costs were capitalized in 2013, 2012, or 2011.

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**PEGASYSTEMS INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

***(h) Stock-Based Compensation***

The Company recognizes stock-based compensation expense associated with equity awards based on the fair value of these awards at the grant date. Stock-based compensation is recognized over the requisite service period, which is generally the vesting period of the equity award, and is adjusted each period for anticipated forfeitures. The Company recognizes stock-based compensation using the ratable method, which treats each vesting tranche as if it were an individual grant. See Note 15 *Stock-based Compensation* for discussion of the Company's key assumptions included in determining the fair value of its equity awards at grant date.

***(i) Acquisition-related costs***

Acquisition-related costs are expensed as incurred and include direct and incremental costs associated with an impending or completed acquisition. During 2013, the \$1.3 million of acquisition-related costs were primarily professional fees associated with the Company's acquisition of Antenna Software, Inc. ( *Antenna* ). During 2011, the \$0.5 million of acquisition-related costs were primarily legal fees associated with litigation assumed in the Company's acquisition of Chordiant Software, Inc. ( *Chordiant* ).

***(j) Restructuring costs***

Restructuring costs are recorded when a plan of restructuring is in place and management has committed to execution of the plan. To the extent that a restructuring plan provides employee benefits for services rendered in future periods beyond a minimum period, the costs are recognized over the requisite service period. In 2013, restructuring costs include future lease payments and demising costs, net of estimated sublease income, for the elimination of space within one facility related to the integration of Antenna. See Note 12 *Accrued Restructuring Costs* for further detail.

***(k) Foreign currency translation***

The translation of assets and liabilities for the majority of the Company's foreign subsidiaries is made at period-end exchange rates, while revenue and expense accounts are translated at the average exchange rates during the period transactions occurred. The resulting translation adjustments are reflected in accumulated other comprehensive income. The Company's India subsidiary uses the U.S. dollar as its functional currency, therefore, its monetary assets and liabilities are remeasured at current rates and its non-monetary assets are recorded at historical exchange rates. Realized and unrealized exchange gains or losses from transactions and remeasurement adjustments are reflected in foreign currency transaction gain (loss), in the accompanying consolidated statements of operations.

***(l) Accounting for Income Taxes***

The Company uses the asset and liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are determined based on temporary differences between the financial statement and tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. Future realization of the Company's deferred tax assets ultimately depends on the existence of sufficient taxable income within the available carryback or carryforward periods. Sources of taxable income include taxable income in prior carryback years, future reversals of existing taxable temporary differences, tax planning strategies, and future taxable income. The Company records a valuation allowance to reduce its deferred tax assets to an amount it believes is more-likely-than-not to be realized. Changes in the valuation allowance impacts income tax expense in the period of adjustment. The Company's deferred tax valuation allowance requires significant judgment and uncertainties, including assumptions about future taxable income that are based on historical and projected information. The Company recognizes excess tax benefits when they are realized, through a reduction in income taxes payable using the with and without stock option method.

**Table of Contents****PEGASYSTEMS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The Company assesses its income tax positions and records tax benefits based upon management's evaluation of the facts, circumstances, and information available at the reporting date. For those tax positions where it is more-likely-than-not that a tax benefit will be sustained, the Company records the largest amount of tax benefit with a greater than 50 percent likelihood of being realized upon ultimate settlement with a taxing authority having full knowledge of all relevant information. For those income tax positions where it is not more-likely-than-not that a tax benefit will be sustained, no tax benefit is recognized in the financial statements. The Company classifies liabilities for uncertain tax positions as non-current liabilities unless the uncertainty is expected to be resolved within one year. The Company classifies interest and penalties on uncertain tax positions as income tax expense.

As a global company, the Company uses significant judgment to calculate and provide for income taxes in each of the tax jurisdictions in which it operates. In the ordinary course of the Company's business, there are transactions and calculations undertaken whose ultimate tax outcome cannot be certain. Some of these uncertainties arise as a consequence of transfer pricing for transactions with the Company's subsidiaries and nexus and tax credit estimates. In addition, the calculation of acquired tax attributes and the associated limitations are complex. See Note 16 Income Taxes for further information.

**3. MARKETABLE SECURITIES**

| (in thousands)          | December 31, 2013 |                     |                      |            |
|-------------------------|-------------------|---------------------|----------------------|------------|
|                         | Amortized<br>Cost | Unrealized<br>Gains | Unrealized<br>Losses | Fair Value |
| Marketable securities:  |                   |                     |                      |            |
| Municipal bonds         | \$ 41,545         | 75                  | (20)                 | \$ 41,600  |
| Corporate bonds         | 31,868            | 52                  | (4)                  | 31,916     |
| Certificates of deposit | 2,948             | 1                   | (4)                  | 2,945      |
| Marketable securities   | \$ 76,361         | 128                 | (28)                 | \$ 76,461  |

| (in thousands)         | December 31, 2012 |                     |                      |            |
|------------------------|-------------------|---------------------|----------------------|------------|
|                        | Amortized<br>Cost | Unrealized<br>Gains | Unrealized<br>Losses | Fair Value |
| Marketable securities: |                   |                     |                      |            |
| Municipal bonds        | \$ 30,488         | 48                  | (10)                 | \$ 30,526  |
| Corporate bonds        | 14,853            | 83                  | (2)                  | 14,934     |
| Marketable securities  | \$ 45,341         | 131                 | (12)                 | \$ 45,460  |

The Company considers debt securities with maturities of three months or less when purchased, 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 December 31, 2013, remaining maturities of marketable debt securities ranged from January 2014 to February 2016, with a weighted-average remaining maturity of approximately 12 months.

**Table of Contents****PEGASYSTEMS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****4. DERIVATIVE INSTRUMENTS**

The Company uses foreign currency forward contracts to manage its exposure to changes in foreign currency exchange rates associated with its foreign currency denominated accounts receivable, cash and intercompany payables. The U.S. operating company invoices most of its foreign clients 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, intercompany payables 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 has been primarily exposed to the fluctuation in the British pound and Euro relative to the U.S. dollar. More recently, the Company has experienced increased levels of exposure to the Australian dollar and Indian rupee, for which it began to use forward contracts in the third quarter of 2013.

The foreign currency forward 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 operations. However, the fluctuations in the value of these foreign currency forward contracts partially offset the gains and losses from the remeasurement or settlement of the foreign currency denominated accounts receivable, intercompany payables, and cash held by the U.S. operating company, thus partly mitigating the volatility. Generally, the Company enters into foreign currency forward contracts with terms not greater than 90 days.

As of December 31, 2013, 2012, and 2011, the Company did not have any forward contracts outstanding.

The Company entered into forward contracts with notional values as follows:

| Foreign currency (in thousands) | Year Ended December 31, |          |          |
|---------------------------------|-------------------------|----------|----------|
|                                 | 2013                    | 2012     | 2011     |
| Euro                            | 102,300                 | 49,700   | 28,500   |
| British pound                   | £ 85,400                | £ 52,000 | £ 19,500 |
| Australian dollar               | A\$ 26,300              | A\$      | A\$      |
| Indian rupee                    | Rs 690,000              | Rs       | Rs       |

The total change in the fair value of the Company's forward contracts recorded in other (expense) income, net, was as follows:

| (in thousands)                                      | Change in Fair Value in USD<br>Year Ended December 31, |            |        |
|---|--|------------|--------|
|   | 2013   | 2012       | 2011   |
| (Loss) gain included in other (expense) income, net | \$ (747)   | \$ (1,738) | \$ 764 |



**Table of Contents****PEGASYSTEMS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****5. FAIR VALUE MEASUREMENTS**

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.

The Company's investments classified within Level 1 of the fair value hierarchy are valued using quoted market prices. The Company's investments classified within Level 2 of the fair value hierarchy are valued based on matrix pricing compiled by third party pricing vendors, using observable market inputs such as interest rates, yield curves, and credit risk.

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

| (in thousands)              | December 31, 2013 | 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          | \$ 2,232          | \$ 2,232   | \$  |
| Marketable securities:      |                   |  |   |
| Municipal bonds             | \$ 41,600         | \$ 10,569  | \$ 31,031                                     |
| Corporate bonds             | 31,916            | 31,916   |   |
| Certificates of deposit     | 2,945             |  | 2,945   |
| Total marketable securities | \$ 76,461         | \$ 42,485  | \$ 33,976                                     |

| (in thousands)         | December 31, 2012 | 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     | \$ 2,873          | \$ 2,873   | \$  |
| Marketable securities: |                   |  |   |
| Municipal bonds        | \$ 30,526         | \$ 11,966  | \$ 18,560                                     |
| Corporate bonds        | 14,934            | 14,934   |   |

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|                             |    |        |    |        |    |        |
|-----------------------------|----|--------|----|--------|----|--------|
| Total marketable securities | \$ | 45,460 | \$ | 26,900 | \$ | 18,560 |
|-----------------------------|----|--------|----|--------|----|--------|

### Assets Measured at Fair Value on a Nonrecurring Basis

Assets recorded at fair value on a nonrecurring basis, such as property and equipment, and intangible assets are recognized at fair value when they are impaired. During 2013, 2012, and 2011, the Company did not recognize any impairments on its assets measured at fair value on a nonrecurring basis.

**Table of Contents****PEGASYSTEMS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****6. TRADE ACCOUNTS RECEIVABLE, NET OF ALLOWANCE**

Unbilled trade accounts receivable relate to services earned under time and material arrangements, maintenance and license arrangements that had not been invoiced.

| (in thousands)                   | December 31,      |                   |
|----------------------------------|-------------------|-------------------|
|                                  | 2013              | 2012              |
| Trade accounts receivable        | \$ 128,973        | \$ 112,106        |
| Unbilled accounts receivable     | 38,618            | 22,923            |
| <b>Total accounts receivable</b> | <b>167,591</b>    | <b>135,029</b>    |
| Allowance for sales credit memos | (1,997)           | (963)             |
|                                  | <b>\$ 165,594</b> | <b>\$ 134,066</b> |

The Company records an allowance for estimates of potential sales credit memos when the related revenue is recorded and reviews this allowance periodically. The following reflects the activity of the allowance for sales credit memos:

| (in thousands)               | Year Ended December 31, |               |               |
|------------------------------|-------------------------|---------------|---------------|
|                              | 2013                    | 2012          | 2011          |
| Balance at beginning of year | \$ 963                  | \$ 895        | \$ 1,027      |
| Provision for credit memos   | 5,374                   | 1,773         | 2,877         |
| Credit memos issued          | (4,340)                 | (1,705)       | (3,009)       |
|                              | <b>\$ 1,997</b>         | <b>\$ 963</b> | <b>\$ 895</b> |

**7. PROPERTY AND EQUIPMENT**

| (in thousands)                                  | December 31,     |                  |
|---|------------------|------------------|
|   | 2013             | 2012             |
| Leasehold improvements                          | \$ 24,242        | \$ 23,065        |
| Computer equipment                              | 13,004           | 11,715           |
| Furniture and fixtures                          | 5,150            | 5,160            |
| Computer software purchased                     | 3,750            | 3,048            |
| Computer software developed for internal use    | 721              | 721              |
| Fixed assets in progress                        | 449              | 161              |
|   | <b>47,316</b>    | <b>43,870</b>    |
| Less: accumulated depreciation and amortization | (18,359)         | (13,043)         |
| <b>Property and equipment, net</b>              | <b>\$ 28,957</b> | <b>\$ 30,827</b> |

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Depreciation and amortization expense was approximately \$8.2 million, \$7.5 million, and \$6.1 million, for the years ended December 31, 2013, 2012, and 2011, respectively.

**Table of Contents****PEGASYSTEMS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****8. ACQUISITION**

On October 9, 2013, the Company acquired Antenna, a leading provider of mobile application development platforms. The Company acquired all of the outstanding capital stock of Antenna in a cash merger for \$27.7 million, subject to a working capital adjustment calculated at the time of closing that is preliminary. The total purchase price of \$27.7 million included \$4.2 million, which was deposited in escrow to secure the selling stockholders' indemnification obligations to the Company under the merger agreement that will be paid to the former shareholders of Antenna over certain periods through April 2015 less any amounts presented and approved for payment against the escrow. During 2013, the Company incurred direct and incremental expenses associated with the transaction of \$1.3 million and expects to incur an additional estimated \$0.4 million of such expenses that are primarily professional fees.

The Company believes the acquisition will offer its collective clients faster time-to-market and increased flexibility in end-to-end mobile application development, powerful device management and cloud-based mobile Backend-as-a-Service.

The operations of Antenna are included in the Company's operating results from the date of acquisition. The amount of revenue and earnings of Antenna included in the Company's consolidated statement of operations were approximately \$3.9 million and a loss of approximately \$2.6 million, respectively. Due to the rapid integration of the products, sales force, and operations of Antenna, other than the maintenance and hosting revenue attributable to the recognition of the fair value of acquired deferred maintenance and hosting revenue, it may not be feasible for the Company to identify revenue from new arrangements attributable to Antenna.

The Company is in the process of investigating the facts and circumstances existing as of the acquisition date in order to finalize the allocation of the purchase price to the fair value of assets acquired and liabilities assumed and establish the related tax basis. As a result of the preliminary purchase price allocation, the Company recognized \$17 million of goodwill, which is primarily due to the expected synergies of the combined entities and the workforce in place. The goodwill created by the transaction is nondeductible for tax purposes. The Company recorded \$36.7 million of deferred tax assets, a \$24.2 million valuation allowance related to the Company's preliminary determination it will not be able to utilize the acquired Antenna federal and foreign NOLs due to various limitations and restrictions, and a \$6.9 million deferred tax liability associated with the acquired intangibles, for a net deferred tax asset of \$5.6 million. A summary of the preliminary purchase price allocation for the acquisition of Antenna is as follows:

| <b>(in thousands)</b>                            |           |
|--|-----------|
| <b>Total purchase consideration:</b>             |           |
| Cash   | \$ 27,698 |
| <b>Allocation of the purchase consideration:</b> |           |
| Cash   | \$ 783    |
| Accounts receivable, net of allowance            | 4,136     |
| Other assets                                     | 3,947     |
| Property and equipment                           | 655       |
| Deferred tax assets, net                         | 5,589     |
| Identifiable intangible assets                   | 10,355    |
| Goodwill   | 17,012    |
| Accounts payable                                 | (1,470)   |
| Accrued liabilities                              | (8,931)   |
| Deferred revenue                                 | (4,378)   |
| Net assets acquired                              | \$ 27,698 |

**Table of Contents****PEGASYSTEMS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The valuation of the assumed deferred revenue was based on the Company's contractual commitment to provide post-contract customer support to Antenna clients and future contractual performance obligations under existing hosting arrangements. The fair value of this assumed liability was based on the estimated cost plus a reasonable margin to fulfill these service obligations. The majority of the deferred revenue is expected to be recognized in the 12 months following the acquisition.

The valuation of the acquired intangible assets is inherently subjective and relies on significant unobservable inputs. The Company used an income approach to value the acquired customer related, technology and trade name intangible assets. The non-compete assets were valued using the with-and-without method, a form of the income approach which considers the cash flow differentials under multiple scenarios with or without key executives. The valuation for each of these intangible assets was based on estimated projections of expected cash flows to be generated by the assets, discounted to the present value at discount rates commensurate with perceived risk. The valuation assumptions take into consideration the Company's estimates of contract renewal, technology attrition and revenue growth projections.

The estimated fair values for specifically identifiable intangible assets acquired, by major asset class, are as follows:

| (in thousands)                     |           | Weighted-average<br>amortization<br>period<br>(in years) |
|------------------------------------|-----------|--|
| Customer related intangible assets | \$ 4,279  | 4  |
| Technology                         | 3,656     | 3  |
| Non-compete                        | 1,342     | 1  |
| Trade name                         | 1,078     | 3  |
|                                    | \$ 10,355 | 3.2  |

**Pro forma Information**

The following pro forma financial information presents the combined results of operations of the Company and Antenna as if the acquisition had occurred on January 1, 2012 after giving effect to certain pro forma adjustments. The pro forma adjustments reflected herein include only those adjustments that are directly attributable to the Antenna acquisition, factually supportable, and expected to have a continuing impact on the Company. These pro forma adjustments include a net increase in amortization expense to eliminate historical amortization of Antenna intangible assets and to record amortization expense for the \$10.4 million of acquired identifiable intangibles, a decrease in interest income as a result of the cash paid for the acquisition, a decrease in interest expense as a result of the repayment of all Antenna outstanding debt in connection with the acquisition, and the elimination of approximately \$1.3 million of acquisition-related costs, including transaction costs incurred by the Company and Antenna. 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 on January 1, 2012.

| (in thousands, except per share amounts) | Pro Forma<br>Year Ended December 31, |            |
|--|--------------------------------------|------------|
|  | 2013                                 | 2012       |
| Revenue                                  | \$ 532,978                           | \$ 499,839 |
| Net income                               | \$ 35,814                            | \$ 9,028   |

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|                              |    |      |    |      |
|------------------------------|----|------|----|------|
| Net income per basic share   | \$ | 0.94 | \$ | 0.24 |
| Net income per diluted share | \$ | 0.92 | \$ | 0.23 |

**Table of Contents****PEGASYSTEMS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****9. GOODWILL AND OTHER INTANGIBLE ASSETS**

As discussed in Note 18 Geographic Information and Major Clients, the Company operates in one reportable segment, business process solutions, and has two reporting units.

The following table presents the changes in the carrying amount of goodwill:

| (in thousands)                    | Year Ended December 31, |           |           |
|-----------------------------------|-------------------------|-----------|-----------|
|                                   | 2013                    | 2012      | 2011      |
| Balance as of January 1,          | \$ 20,451               | \$ 20,451 | \$ 20,451 |
| Goodwill acquired during the year | 17,012                  |           |           |
| Balance as of December 31,        | \$ 37,463               | \$ 20,451 | \$ 20,451 |

Intangible assets are recorded at cost and are amortized using the straight-line method over their estimated useful lives.

| (in thousands)               | Range of Useful Lives | Cost       | Accumulated Amortization | Net book value |
|------------------------------|-----------------------|------------|--------------------------|----------------|
| <b>December 31, 2013</b>     |                       |            |                          |                |
| Customer related intangibles | 4-9 years             | \$ 48,634  | \$ (18,317)              | \$ 30,317      |
| Technology                   | 3-9 years             | 47,102     | (22,873)                 | 24,229         |
| Other intangibles            | 1-5 years             | 4,658      | (2,630)                  | 2,028          |
| Total                        |                       | \$ 100,394 | \$ (43,820)              | \$ 56,574      |
| <b>December 31, 2012</b>     |                       |            |                          |                |
| Customer related intangibles | 9 years               | \$ 44,355  | \$ (13,142)              | \$ 31,213      |
| Technology                   | 4-9 years             | 43,446     | (16,431)                 | 27,015         |
| Other intangibles            | 1-5 years             | 2,238      | (2,234)                  | 4              |
| Total                        |                       | \$ 90,039  | \$ (31,807)              | \$ 58,232      |

Amortization expense of acquired intangibles was reflected in the Company's consolidated statements of operations as follows:

| (in thousands)             | Year Ended December 31, |           |           |
|----------------------------|-------------------------|-----------|-----------|
|                            | 2013                    | 2012      | 2011      |
| Amortization expense:      |                         |           |           |
| Cost of revenue            | \$ 6,443                | \$ 6,189  | \$ 6,284  |
| Selling and marketing      | 5,174                   | 4,928     | 4,928     |
| General and administrative | 396                     | 20        | 103       |
| Total amortization expense | \$ 12,013               | \$ 11,137 | \$ 11,315 |





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As of December 31, 2013, future estimated amortization expense is as follows:

| (in thousands)      | Future estimated<br>amortization<br>expense |
|---------------------|---|
| 2014                | 13,170                                      |
| 2015                | 11,336                                      |
| 2016                | 10,973                                      |
| 2017                | 9,512                                       |
| 2018 and thereafter | 11,583                                      |
|                     | \$ 56,574                                   |

**10. ACCRUED EXPENSES**

| (in thousands)                                     | December 31, |           |
|--|--------------|-----------|
|  | 2013         | 2012      |
| Partner commissions                                | \$ 4,106     | \$ 1,723  |
| Other taxes  | 6,492        | 2,711     |
| Employee reimbursable expenses                     | 1,539        | 879       |
| Dividends payable                                  | 1,145        |           |
| Professional services contractor fees              | 1,997        | 602       |
| Self-insurance health and dental claims            | 1,265        | 1,707     |
| Professional fees                                  | 2,378        | 1,114     |
| Short-term deferred rent                           | 740          | 1,111     |
| Income taxes payable                               | 1,770        | 1,167     |
| Acquisition-related and merger consideration costs | 1,459        |           |
| Restructuring                                      | 371          | 441       |
| Other  | 5,157        | 4,079     |
|  | \$ 28,419    | \$ 15,534 |

**11. DEFERRED REVENUE**

| (in thousands)           | December 31, |           |
|--------------------------|--------------|-----------|
|                          | 2013         | 2012      |
| Software license         | \$ 28,826    | \$ 24,303 |
| Maintenance              | 72,715       | 62,144    |
| Services                 | 9,341        | 9,099     |
| Current deferred revenue | 110,882      | 95,546    |

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|                            |            |            |
|----------------------------|------------|------------|
| Software license           | 32,727     | 15,407     |
| Maintenance and services   | 1,469      | 3,312      |
| Long-term deferred revenue | 34,196     | 18,719     |
|                            | \$ 145,078 | \$ 114,265 |

**Table of Contents****PEGASYSTEMS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****12. ACCRUED RESTRUCTURING COSTS**

During the fourth quarter of 2013, in connection with the Company's evaluation of its combined facilities with Antenna, the Company approved a plan to eliminate space within one facility. The Company ceased use of this space during the fourth quarter of 2013 and recognized \$1.7 million of restructuring expenses, representing future lease payments and demising costs, net of estimated sublease income for this space. The lease expires in 2021.

A summary of the restructuring activity is as follows:

| (in thousands)                  | 2010<br>personnel<br>restructuring | 2010 facilities<br>restructuring | 2013 personnel<br>and facilities<br>restructuring<br>(1) | Total    |
|---------------------------------|------------------------------------|----------------------------------|--|----------|
| Balance as of December 31, 2010 | \$ 2,752                           | \$ 2,117                         | \$   | \$ 4,869 |
| Restructuring costs             |                                    | (62)                             |  | (62)     |
| Cash payments                   | (2,509)                            | (1,255)                          |  | (3,764)  |
| Balance as of December 31, 2011 | 243                                | 800                              |  | 1,043    |
| Cash payments                   | (243)                              | (359)                            |  | (602)    |
| Balance as of December 31, 2012 |                                    | 441                              |  | 441      |
| Restructuring costs             |                                    |                                  | 1,731  | 1,731    |
| Cash payments                   |                                    | (441)                            |  | (441)    |
| Other (2)                       |                                    |                                  | (140)  | (140)    |
| Balance as of December 31, 2013 | \$                                 | \$                               | \$ 1,591   | \$ 1,591 |

(1) Includes \$34 thousand of severance and related benefit costs for the reduction of six personnel in redundant roles that will be paid by the end of the second quarter of 2014.

(2) Reflects the asset initially recorded for the acquired below market operating lease terms at acquisition, which was subsequently restructured and included in restructuring costs above.

| (in thousands)              | December 31, |        |
|-----------------------------|--------------|--------|
| Reported as:                | 2013         | 2012   |
| Accrued expenses            | \$ 371       | \$ 441 |
| Other long-term liabilities | 1,220        |        |
|                             | \$ 1,591     | \$ 441 |

**13. COMMITMENTS AND CONTINGENCIES**

Commitments

The Company leases space for its offices under noncancellable operating leases that expire at various dates through 2023.

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As of December 31, 2013, the Company's future minimum rental payments required under operating leases with noncancellable terms in excess of one year were as follows:

(in thousands)

| For the calendar year | Operating<br>Leases |
|-----------------------|---------------------|
| 2014                  | \$ 11,947           |
| 2015                  | 11,634              |
| 2016                  | 10,991              |
| 2017                  | 9,875               |
| 2018                  | 9,552               |
| 2019 & Thereafter     | 41,430              |
|                       | \$ 95,429           |

Rent expense under operating leases is recognized on a straight-line basis to account for scheduled rent increases and landlord tenant allowances. In connection with the Company's lease for its office headquarters, the Company has a landlord tenant allowance totaling approximately \$8.4 million, all of which was used and reimbursed to the Company as of December 31, 2012 and will be amortized as a reduction to rent expense on a straight-line basis over the term of the lease. Total rent expense under operating leases was approximately \$11.7 million, \$14.1 million and \$11.4 million for the years ended December 31, 2013, 2012 and 2011, respectively.

**Contingencies**

The Company is a party in various contractual disputes, litigation and potential claims arising in the ordinary course of business. 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.

**14. STOCKHOLDERS EQUITY*****(a) Preferred stock***

The Company has authorized 1,000,000 shares of preferred stock, which may be issued from time to time in one or more series. The Board of Directors has the authority to issue the shares of preferred stock in one or more series, to establish the number of shares to be included in each series, and to fix the designation, powers, preferences and rights of the shares of each series and the qualifications, limitations or restrictions thereof, without any further vote or action by the stockholders. The issuance of preferred stock could decrease the amount of earnings and assets available for distribution to holders of common stock, and may have the effect of delaying, deferring or defeating a change in control of the Company. The Company had not issued any shares of preferred stock through December 31, 2013.

***(b) Common stock***

The Company has 100,000,000 authorized shares of common stock, \$0.01 par value per share, of which 38,162,000 shares were issued and outstanding at December 31, 2013.

Since 2004, the Company's Board of Directors has approved stock repurchase programs that have authorized the Company to repurchase in the aggregate up to \$104.5 million of its common stock. Purchases under these programs have been made on the open market.



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The following table is a summary of the Company's repurchase activity under all of the Company's repurchase programs for the years ended December 31:

| (Dollars in thousands)                          | Year Ended December 31, |           |         |           |         |           |
|---|-------------------------|-----------|---------|-----------|---------|-----------|
|   | 2013                    |           | 2012    |           | 2011    |           |
|   | Shares                  | Amount    | Shares  | Amount    | Shares  | Amount    |
| Prior year authorizations at January 1,         |                         | \$ 14,793 |         | \$ 13,963 |         | \$ 13,237 |
| Authorizations                                  |                         | 12,164    |         | 6,036     |         | 5,590     |
| Repurchases paid                                | 386,629                 | (12,370)  | 181,803 | (5,130)   | 137,429 | (4,815)   |
| Repurchases unsettled                           | 3,141                   | (154)     | 3,399   | (76)      | 1,688   | (49)      |
| Authorized dollars remaining as of December 31, |                         | \$ 14,433 |         | \$ 14,793 |         | \$ 13,963 |

**(c) Dividends**

On May 30, 2006, the Company's Board of Directors approved an ongoing quarterly cash dividend of \$0.03 per share, beginning with the second quarter ended June 30, 2006. For the years ended December 31, 2013 and 2011, the Company declared dividends of \$0.12 per share and paid cash dividends of \$3.4 million, and \$4.5 million, respectively. The Company declared \$0.12 per share for the year ended December 31, 2012, but the Board of Directors authorized the acceleration of the fourth quarter dividend otherwise payable in January 2013 to December 2012. Therefore, the Company paid \$5.7 million in dividends in 2012. It is the Company's current intention to pay a quarterly cash dividend of \$0.03 per share, however, the Board of Directors may terminate or modify this dividend program at any time without notice.

**(d) Warrants summary**

In January 2012, a former stockholder of Imind Corporation (Imind) exercised a warrant to purchase 2,464 shares of the Company's common stock, which was originally issued as part of the consideration for the Company's acquisition of Imind in 2002. In accordance with the net exercise provisions of this warrant, the Company withheld 78 shares of its common stock to cover the exercise price of the warrant, which shares were valued at \$2,094 based on the average closing price of its common stock over the ten consecutive trading days ending on the third trading day prior to the exercise date, and issued 2,386 shares of its common stock. The issuance of these shares was made in reliance on an exemption from registration under Regulation D under the Securities Act of 1933. As of December 31, 2013 and December 31, 2012, there were no warrants outstanding.

**15. STOCK-BASED COMPENSATION**

The majority of the Company's stock-based compensation arrangements vest over either a four or five year vesting schedule and the Company's stock options have a ten-year term. The Company recognizes stock-based compensation using the ratable method, which treats each vesting tranche as if it were an individual grant.

The Company periodically grants stock options and restricted stock units (RSUs) for a fixed number of shares to employees and non-employee Directors. The exercise price for stock options is greater than or equal to the fair market value of the shares at the grant date. RSUs deliver to the recipient a right to receive a specified number of shares of the Company's common stock upon vesting. Unlike stock options, there is no cost to the employee at share issuance. The Company values its RSUs at the fair value of its common stock on the grant date, which is the closing price of its common stock on the grant date, less the present value of expected dividends, as the employee is not entitled to dividends during the requisite service period. Upon vesting of the RSUs, the Company withholds shares of common stock in an amount sufficient to cover the minimum statutory tax withholding obligations and issues shares of its common stock for the remaining amount.





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**PEGASYSTEMS INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Employees may elect to receive 50% of their target incentive compensation under the Company's Corporate Incentive Compensation Plan (the CICP) in the form of RSUs instead of cash. If elected by an employee, the equity amount is equal in value on the date of grant to 50% of his or her target incentive opportunity, based on the employee's base salary. The number of RSUs granted is determined by dividing 50% of the employee's target incentive opportunity by the fair value of a RSU on the grant date. If elected, the award vests 100% on the CICP payout date of the following year for all participants. Vesting is conditioned upon the performance conditions of the CICP and on continued employment; if threshold funding does not occur, the equity grant will be cancelled. The Company considers vesting to be probable on the grant date and recognizes the associated stock-based compensation expense over the requisite service period beginning on the grant date and ending on the vest date.

The Company grants options that allow for the settlement of vested stock options on a net share basis ( net settled stock options ), instead of settlement with a cash payment ( cash settled stock options ). With net settled stock options, the employee does not surrender any cash or shares upon exercise. Rather, the Company withholds the number of shares to cover the option exercise price and the minimum statutory tax withholding obligations from the shares that would otherwise be issued upon exercise. The settlement of vested stock options on a net share basis results in fewer shares issued by the Company.

**Share-Based Compensation Plans:**

***(a) 1994 Long-term Incentive Plan***

In 1994, the Company adopted a 1994 Long-Term Incentive Plan (as amended in 2003, the 1994 Plan) to provide employees, Directors and consultants with opportunities to purchase stock through incentive stock options and non-qualified stock options. In addition to options, participants under the 1994 Plan were eligible to receive stock appreciation rights, restricted stock and long-term performance awards. As of December 31, 2013, options to purchase an aggregate of approximately 5,000 shares of common stock were outstanding under the 1994 Plan. The Company does not intend to issue any additional options or make any other awards under the 1994 Plan in the future.

***(b) 1996 Non-Employee Director Stock Option Plan***

In 1996, the Company adopted a 1996 Non-Employee Director Stock Option Plan (the Director Plan), which provided for the grant to non-employee Directors of the Company of options to purchase shares of its common stock. All shares authorized for issue under this plan have been awarded. Since 2006, in lieu of granting fully vested options, the Company has granted shares of its common stock to its non-employee directors under the 2004 Long-Term Incentive Plan, as described below. As of December 31, 2013, options to purchase an aggregate of approximately 30,000 shares of common stock were outstanding under the Director Plan.

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**PEGASYSTEMS INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

***(c) Amended and Restated 2004 Long-Term Incentive Plan***

In 2004, the Company adopted a 2004 Long-Term Incentive Plan (the 2004 Plan ) to provide employees, non-employee Directors and consultants with opportunities to purchase stock through incentive stock options and non-qualified stock options. In addition to options, eligible participants under the 2004 Plan may be granted stock purchase rights and other stock-based awards. In July 2011, the Company's stockholders approved the Pegasystems Inc. Amended and Restated 2004 Long-Term Incentive Plan (the Restated 2004 Plan ), which authorized the issuance of an additional 5,000,000 shares under the plan and extended the term of the plan to 2021. Since 2006, the Company has granted to each non-employee director of the Company shares of common stock on an annual basis in consideration of their board service. For each of 2013, 2012, and 2011 the number of shares granted to each non-employee director was equal to \$70,000, divided by the fair market value of the Company's common stock on the grant date. As of December 31, 2013, approximately 3,427,000 shares were subject to outstanding options and stock-based awards under the Restated 2004 Plan.

***(d) 2006 Employee Stock Purchase Plan***

In 2006, the Company adopted a 2006 Employee Stock Purchase Plan (the 2006 ESPP ) pursuant to which the Company's employees are entitled to purchase up to an aggregate of 500,000 shares of common stock at a price equal to at least 85% of the fair market value of the Company's common stock on either the commencement date or completion date for offerings under the plan, whichever is less, or such higher price as the Company's Board of Directors may establish from time to time. Until the Company's Board of Directors determines otherwise, the Board has set the purchase price at 95% of the fair market value on the completion date of the offering period. As a result, the 2006 ESPP is non-compensatory and is tax qualified. Therefore, as of December 31, 2013, no compensation expense related to shares issued under the plan had been recognized. In October 2012, the Company's Board of Directors amended the term of the 2006 ESPP such that it will continue until there are no shares remaining to be issued under the plan or until the plan is terminated by the Board of Directors, whichever occurs first. As of December 31, 2013, approximately 138,000 shares had been issued thereunder.

***Shares reserved***

As of December 31, 2013, there were approximately 4,086,000 shares remaining for issuance for future equity grants under the Company's stock plans, consisting of approximately 3,724,000 shares under the Restated 2004 Plan and approximately 362,000 shares under the 2006 ESPP. There were no shares available for future equity grants under the 1994 Plan or the Director Plan.

**Equity grants, assumptions and activity**

During 2013, the Company issued approximately 593,000 shares to its employees under the Company's share-based compensation plans and approximately 14,000 shares to the non-employee members of its Board of Directors.

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The following table presents the stock-based compensation expense included in the Company's consolidated statements of operations:

| (in thousands)                            | Year ended December 31, |          |          |
|---|-------------------------|----------|----------|
|   | 2013                    | 2012     | 2011     |
| Stock-based compensation expense:         |                         |          |          |
| Cost of services                          | \$ 4,085                | \$ 3,655 | \$ 2,737 |
| Operating expenses                        | 8,784                   | 7,851    | 6,291    |
| Total stock-based compensation before tax | 12,869                  | 11,506   | 9,028    |
| Income tax benefit                        | (3,918)                 | (3,699)  | (2,854)  |

**Stock Options**

The Company estimates the fair value of stock options using a Black-Scholes option valuation model. Key inputs used to estimate the fair value of stock options include the exercise price of the award, the expected term of the option, the expected volatility of the Company's common stock over the option's expected term, the risk-free interest rate over the option's expected term, and the Company's expected annual dividend yield. The amount of stock-based compensation recognized during a period is based on the value of the awards that are ultimately expected to vest. Forfeitures are estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Ultimately, the Company recognizes the actual expense over the vesting period only for the shares that vest. The weighted-average grant-date fair value for stock options granted in 2013, 2012, and 2011, was \$13.43, \$9.43 and \$11.91, respectively.

The weighted-average assumptions used in the Black-Scholes option valuation model are as follows:

|                                    | Year ended December 31, |       |       |
|------------------------------------|-------------------------|-------|-------|
|                                    | 2013                    | 2012  | 2011  |
| Expected volatility (1)            | 49%                     | 54%   | 45%   |
| Expected term in years (2)         | 4.5                     | 4.3   | 5.1   |
| Risk-free interest rate (3)        | 1.02%                   | 0.63% | 1.18% |
| Expected annual dividend yield (4) | 0.42%                   | 0.52% | 0.58% |

- (1) The expected volatility for each grant is determined based on the average of historical daily price changes of the Company's common stock over a period of time which approximates the expected option term.
- (2) The expected option term for each grant is determined based on the historical exercise behavior of employees and post-vesting employment termination behavior.
- (3) The risk-free interest rate is based on the yield of zero-coupon U.S. Treasury securities for a period that is commensurate with the expected option term at the time of grant.
- (4) The expected annual dividend yield is based on the weighted-average of the dividend yield assumptions used for options granted during the applicable period. The expected annual dividend is based on the expected dividend of \$0.12 per share, per year (\$0.03 per share, per quarter times 4 quarters) divided by the average stock price.

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The Company elected to adopt the alternative transition method ( short cut method ) in calculating their historical pool of windfall tax benefits in regards to its share-based compensation.

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The following table summarizes the combined stock option activity under the Company's stock option plans for the year ended December 31, 2013:

|  | Shares<br>(in thousands) | Weighted-average<br>exercise price | Weighted-<br>average<br>remaining<br>contractual<br>term (in years) | Aggregate<br>intrinsic value<br>(in thousands) |
|--|--------------------------|------------------------------------|---|--|
| Options outstanding as of January 1, 2013        | 3,897                    | \$ 19.32                           |   |  |
| Granted  | 104                      | 34.40                              |   |  |
| Exercised  | (785)                    | 13.59                              |   |  |
| Forfeited/Cancelled                              | (218)                    | 24.20                              |   |  |
| Options outstanding as of December 31, 2013      | 2,998                    | \$ 20.97                           |   |  |
| Vested and expected to vest as December 31, 2013 | 2,524                    | \$ 20.24                           | 6.5   | \$ 73,048                                      |
| Exercisable as of December 31, 2013              | 1,332                    | \$ 16.33                           | 4.5   | \$ 43,771                                      |

The aggregate intrinsic value of stock options exercised (i.e., the difference between the market price at exercise and the price paid by the employee at exercise) in 2013, 2012, and 2011 was \$20.6 million, \$8.5 million and \$19.4 million, respectively. The aggregate intrinsic value of stock options outstanding and exercisable as of December 31, 2013 is based on the difference between the closing price of the Company's stock of \$49.18 on December 31, 2013 and the exercise price of the applicable stock options.

As of December 31, 2013, the Company had unrecognized stock-based compensation expense related to the unvested portion of stock options of approximately \$7.0 million that is expected to be recognized as expense over a weighted-average period of approximately 2.3 years.

**RSUs**

The weighted-average grant-date fair value for RSUs granted in 2013, 2012, and 2011 was \$32.11, \$32.35, and \$30.87, respectively. The following table summarizes the combined RSU activity for periodic grants and the CICP under the Restated 2004 Plan for the year ended December 31, 2013:

|                                   | Shares<br>(in thousands) | Weighted-<br>Average<br>Grant-Date<br>Fair Value | Aggregate<br>Intrinsic Value<br>(in thousands) |
|-----------------------------------|--------------------------|--|--|
| Nonvested as of January 1, 2013   | 567                      | \$ 31.19   |  |
| Granted                           | 179                      | 32.11  |  |
| Vested                            | (216)                    | 30.27  |  |
| Forfeited                         | (66)                     | 30.81  |  |
| Nonvested as of December 31, 2013 | 464                      | \$ 32.04   | \$ 22,814                                      |

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|  |     |    |       |    |        |
|--|-----|----|-------|----|--------|
| Expected to vest as of December 31, 2013 | 335 | \$ | 31.93 | \$ | 16,470 |
|--|-----|----|-------|----|--------|

The RSUs associated with periodic grants vest over five years with 20% vesting after one year and the remaining 80% vesting in equal quarterly installments over the remaining four years. Approximately 59,000 RSUs granted in connection with the 2013 CICP are expected to vest 100% in March 2014.

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The fair value of RSUs vested in 2013, 2012, and 2011 was \$7.3 million, \$7.1 million, and \$6.4 million, respectively. The aggregate intrinsic value of RSUs outstanding and expected to vest as of December 31, 2013 is based on the closing price of the Company's stock of \$49.18 on December 31, 2013.

As of December 31, 2013, the Company had approximately \$4.8 million of unrecognized stock-based compensation expense related to all unvested RSUs that is expected to be recognized as expense over a weighted-average period of approximately 2 years.

**16. INCOME TAXES***Effective tax rate*

The components of income before provision for income taxes are as follows for the years ended December 31:

| (in thousands)                       | 2013             | 2012             | 2011             |
|--------------------------------------|------------------|------------------|------------------|
| Domestic                             | \$ 47,054        | \$ 20,497        | \$ 1,862         |
| Foreign                              | 9,339            | 10,448           | 8,951            |
| <b>Total income before provision</b> | <b>\$ 56,393</b> | <b>\$ 30,945</b> | <b>\$ 10,813</b> |

The components of the provision for income taxes are as follows for the years ended December 31:

| (in thousands)                 | 2013             | 2012            | 2011            |
|--------------------------------|------------------|-----------------|-----------------|
| <b>Current:</b>                |                  |                 |                 |
| Federal                        | \$ 20,277        | \$ 12,128       | \$ 11,698       |
| State                          | 2,054            | 971             | 1,775           |
| Foreign                        | 3,027            | 2,142           | 2,501           |
| <b>Total current provision</b> | <b>25,358</b>    | <b>15,241</b>   | <b>15,974</b>   |
| <b>Deferred:</b>               |                  |                 |                 |
| Federal                        | (6,069)          | (4,759)         | (13,978)        |
| State                          | (634)            | (870)           | (2,204)         |
| Foreign                        | (305)            | (535)           | 913             |
| <b>Total deferred benefit</b>  | <b>(7,008)</b>   | <b>(6,164)</b>  | <b>(15,269)</b> |
| <b>Total provision</b>         | <b>\$ 18,350</b> | <b>\$ 9,077</b> | <b>\$ 705</b>   |



**Table of Contents****PEGASYSTEMS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The effective income tax rate differed from the statutory federal income tax rate due to the following:

|  | 2013  | 2012  | 2011   |
|--|-------|-------|--------|
| Statutory federal income tax rate                          | 35.0% | 35.0% | 35.0%  |
| Valuation allowance  |       | (3.0) | 3.0    |
| Transaction costs  | 0.4   |       |        |
| State income taxes, net of federal benefit and tax credits | 1.4   | (0.8) | (4.6)  |
| Permanent differences                                      | 1.0   | 1.7   | 5.4    |
| Domestic production activities                             | (3.8) | (3.9) | (13.6) |
| Federal research and experimentation credits               | (2.8) | 0.0   | (5.3)  |
| Tax effects of foreign activities                          | (1.9) | (2.7) | 1.7    |
| Tax-exempt income  | (0.1) | (0.1) | (0.3)  |
| Provision to return adjustments                            | 0.8   | 0.6   | 2.5    |
| Non-deductible compensation                                | 1.2   | 1.5   | 3.0    |
| Provision for uncertain tax positions                      | 1.5   | 2.8   | (19.7) |
| Other  | (0.2) | (1.8) | (0.6)  |
| Effective income tax rate                                  | 32.5% | 29.3% | 6.5%   |

***Deferred income taxes***

Deferred income taxes reflect the tax attributes and tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of net deferred tax assets and liabilities are as follows:

| (in thousands)                   | 2013        | 2012      |
|----------------------------------|-------------|-----------|
| <b>Deferred tax assets:</b>      |             |           |
| Net operating loss carryforwards | \$ 91,927   | \$ 61,248 |
| Accruals and reserves            | 19,946      | 16,521    |
| Software revenue                 | 7,863       | 6,529     |
| Depreciation                     | 4,753       | 4,882     |
| Tax credit carryforwards         | 5,359       | 4,914     |
| Other                            | (22)        | (31)      |
| Total deferred tax assets        | 129,826     | 94,063    |
| Less valuation allowances        | (36,484)    | (12,128)  |
| Total deferred tax assets        | \$ 93,342   | \$ 81,935 |
| <b>Deferred tax liabilities:</b> |             |           |
| Intangibles                      | \$ (21,311) | (22,441)  |
| Total deferred tax liabilities   | (21,311)    | (22,441)  |
| Net deferred income tax assets   | \$ 72,031   | \$ 59,494 |

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|                                      |    |        |           |
|--------------------------------------|----|--------|-----------|
| Reported as:                         |    |        |           |
| Current deferred tax asset           | \$ | 11,106 | \$ 10,202 |
| Long-term deferred income tax assets |    | 60,925 | 49,292    |
| Total deferred income taxes          | \$ | 72,031 | \$ 59,494 |

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**PEGASYSTEMS INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The Company regularly assesses the need for a valuation allowance against its deferred tax assets. In making that assessment, the Company considers both positive and negative evidence related to the likelihood of realization of the deferred tax assets to determine, based on the weight of available evidence, whether it is more-likely-than-not that some or all of the deferred tax assets will not be realized. This determination requires significant judgment, including assumptions about future taxable income that are based on historical and projected information. The \$24.4 million net increase in the valuation allowance during 2013 primarily relates to the valuation allowance recorded against the acquired Antenna federal and foreign net operating losses ( NOLs ) that the Company has preliminarily determined it will not be able to utilize due to various limitations and restrictions. The \$0.9 million net decrease in the valuation allowance during 2012 primarily relates to the release of a \$1.1 million valuation allowance previously recorded against NOLs as a result of the expiration of their applicable statute, partially offset by a \$0.2 million valuation allowance recorded against certain state tax credits generated during the year.

The Company acquired approximately \$52 million and \$58.1 million of federal and foreign NOLs, respectively, in the Antenna acquisition. The Company has preliminarily determined that it may utilize \$18.4 million of the acquired Antenna federal NOLs under the applicable section 382 limitation, and these losses are scheduled to expire through 2032. A valuation allowance is recorded on the deferred tax assets in excess of the federal NOLs that are deemed recoverable under the preliminary limitation. With regard to the acquired foreign NOLs, a full valuation allowance has been recorded as of December 31, 2013 due to uncertainty regarding the availability of these NOLs to offset future income generated by the related foreign businesses due to limitations under local country change in control provisions.

As of December 31, 2013, the Company had approximately \$127.5 million of acquired Chordiant federal NOLs, which are subject to annual use limitations under section 382. Based on those limitations, the Company anticipates using \$101.7 million of the remaining NOLs by 2029. In addition, the Company has \$0.9 million of deferred tax assets related to state NOLs as of December 31, 2013.

As of December 31, 2013, the Company had available \$5.8 million of state tax research and experimentation ( R&E ) credits and \$0.5 million of investment tax credits expiring in the years 2014 through 2028.

The Company's India subsidiary is a development center in an area designated as a Special Economic Zone ( SEZ ) and is entitled to a tax holiday in India. The tax holiday reduces or eliminates income tax in that country and is scheduled to expire in 2022. For the years ended December 31, 2013, 2012, and 2011, the effect of the income tax holiday was to reduce the overall income tax provision by approximately \$0.5 million, \$0.5 million, and \$0.3 million, respectively.

In 2013, the Company reduced its income tax payable by \$5.5 million for the tax benefit realized from the exercise, sale or vesting of equity awards.

Undistributed earnings of the Company's foreign subsidiaries amounted to approximately \$41.4 million as of December 31, 2013. The Company has not provided any additional federal or state income taxes or foreign withholding taxes on the undistributed earnings as such earnings have been indefinitely reinvested in the business. It is impractical to estimate the amount of tax the Company could have to pay upon repatriation due to the complexity of foreign tax credit calculations and because the Company considers its earnings permanently reinvested.

**Table of Contents****PEGASYSTEMS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)*****Uncertain tax benefits and other considerations***

A reconciliation of the beginning and ending balances of the total amounts of gross unrecognized tax benefits is as follows:

| <b>(in thousands)</b>  | <b>2013</b> | <b>2012</b> | <b>2011</b> |
|--|-------------|-------------|-------------|
| Balance as of January 1,                                     | \$ 26,317   | \$ 25,312   | \$ 20,266   |
| Additions based on tax positions related to the current year | 4,320       | 3,855       | 7,231       |
| Additions for tax positions of prior years                   | 350         | 969         | 3           |
| Additions for acquired uncertain tax benefits                | 10,268      |             |             |
| Reductions for tax positions of prior years                  | (326)       | (3,819)     | (2,188)     |
| Balance as of December 31,                                   | \$ 40,929   | \$ 26,317   | \$ 25,312   |

As of December 31, 2013, the Company had approximately \$40.9 million of total unrecognized tax benefits, of which \$25.2 million would decrease the Company's effective tax rate if recognized. However, approximately \$15.7 million of these unrecognized tax benefits relate to acquired NOLs and research tax credits, which are subject to limitations on use. The Company expects that the changes in the unrecognized benefits within the next twelve months will be approximately \$0.1 million, all of which relate to the expiration of applicable statute of limitations and would reduce the Company's effective tax rate if realized.

For the years ended December 31, 2013, 2012, and 2011, the reductions for tax positions of prior years were related to the lapse in the applicable statute of limitations for the Company's tax years 2009 and earlier.

The Company recognizes interest accrued and penalties related to unrecognized tax benefits in the income tax provision. For the years ended December 31, 2013 and 2012, the Company recognized interest expense of approximately \$0.3 million and \$0.1 million, respectively. For the year ended December 31, 2011, the Company recognized a reduction of interest expense of approximately \$0.4 million. For the years ended December 31, 2013, 2012, and 2011, the Company did not recognize any significant penalties. As of December 31, 2013 and 2012, the Company had accrued approximately \$1.1 million and \$0.7 million, respectively, for interest and penalties.

The Company files income tax returns in the U.S. and in foreign jurisdictions. The Company's 2008 and 2010 federal income tax returns are under examination. The Company is generally not subject to U.S. federal, state, or local, or foreign income tax examinations by tax authorities for the years before 2008. With few exceptions, the statute of limitations remains open in all other jurisdictions for the tax years 2008 to the present.

**Table of Contents****PEGASYSTEMS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****17. 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, warrants, and RSUs, using the treasury stock method and the average market price of the Company's common stock during the applicable period. Certain shares related to some of the Company's outstanding stock options, warrants 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.

| (in thousands, except per share amounts)  | Year Ended December 31, |           |           |
|---|-------------------------|-----------|-----------|
|   | 2013                    | 2012      | 2011      |
| <b>Basic</b>  |                         |           |           |
| Net income  | \$ 38,043               | \$ 21,868 | \$ 10,108 |
| Weighted-average common shares outstanding                                      | 37,973                  | 37,853    | 37,496    |
| Earnings per share, basic   | \$ 1.00                 | \$ 0.58   | \$ 0.27   |
| <b>Diluted</b>  |                         |           |           |
| Net income  | \$ 38,043               | \$ 21,868 | \$ 10,108 |
| Weighted-average common shares outstanding                                      | 37,973                  | 37,853    | 37,496    |
| Weighted-average effect of dilutive securities:                                 |                         |           |           |
| Stock options and warrants  | 813                     | 777       | 1,612     |
| RSUs  | 201                     | 229       | 296       |
| Effect of assumed exercise of stock options, warrants and RSUs                  | 1,014                   | 1,006     | 1,908     |
| Weighted-average common shares outstanding, assuming dilution                   | 38,987                  | 38,859    | 39,404    |
| Earnings per share, diluted   | \$ 0.98                 | \$ 0.56   | \$ 0.26   |
| Outstanding options, warrants and RSUs excluded as impact would be antidilutive | 113                     | 62        | 32        |

**18. GEOGRAPHIC INFORMATION AND MAJOR CLIENTS**

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 software solutions and provides consulting 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 reviews financial information for two operating segments, which the Company has determined can be aggregated and represent one reportable segment business process solutions.

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

| (Dollars in thousands) | Year ended December 31, |      |            |      |            |      |
|------------------------|-------------------------|------|------------|------|------------|------|
|                        | 2013                    |      | 2012       |      | 2011       |      |
| U.S.                   | \$ 278,945              | 55%  | \$ 250,022 | 54%  | \$ 216,365 | 52%  |
| Other Americas         | 18,942                  | 4%   | 27,741     | 6%   | 16,779     | 4%   |
| United Kingdom         | 83,134                  | 16%  | 87,135     | 19%  | 94,338     | 23%  |
| Other EMEA (1)         | 82,743                  | 16%  | 70,583     | 15%  | 72,004     | 17%  |
| Asia Pacific           | 45,190                  | 9%   | 26,229     | 6%   | 17,189     | 4%   |
|                        | \$ 508,954              | 100% | \$ 461,710 | 100% | \$ 416,675 | 100% |

(1) Includes Europe other than the UK, the Middle East and Africa, ( Other EMEA ).

Long-lived assets related to the Company's U.S. and international operations were as follows:

| (Dollars in thousands) | December 31, |      |           |      |
|------------------------|--------------|------|-----------|------|
|                        | 2013         |      | 2012      |      |
| U.S.                   | \$ 21,282    | 74%  | \$ 22,693 | 73%  |
| India                  | 4,645        | 16%  | 5,461     | 18%  |
| International, other   | 3,030        | 10%  | 2,673     | 9%   |
|                        | \$ 28,957    | 100% | \$ 30,827 | 100% |

There were no clients accounting for 10% or more of the Company's total revenue in 2013, 2012, and 2011. There was one client that accounted for 10% or more of the Company's trade receivables, net, as of December 31, 2013 and one client as of December 31, 2012, as listed below. The Company's financial services, healthcare and insurance clients as a group represent a significant amount of the Company's revenues and receivables. However, the Company determined this concentration did not have a material impact on its allowance for sales credit memos as of December 31, 2013.

| (Dollars in thousands)                     | December 31,      |                   |
|--|-------------------|-------------------|
|  | 2013              | 2012              |
| <b>Trade receivables, net of allowance</b> | <b>\$ 165,594</b> | <b>\$ 134,066</b> |
| Client A                                   | 16%               |                   |
| Client B                                   |                   | 10%               |

Marketable securities are another financial instrument that potentially subject the Company to a concentration of credit risk. See Note 3 Marketable Securities and Note 5 Fair Value Measurements for further discussion.

**19. EMPLOYEE BENEFIT PLANS**

The Company sponsors a 401(k) defined contribution retirement plan for qualifying employees pursuant to which the Company makes discretionary matching contributions. Company contributions under the plan totaled approximately \$2.9 million in 2013, \$2.8 million in 2012, and \$2.5 million in 2011. In addition, the Company has defined contribution plans for qualifying international employees and contributions expensed under those plans totaled approximately \$3.7 million in 2013, \$3.2 million in 2012, and \$2.1 million in 2011.

**Table of Contents****PEGASYSTEMS INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****20. SELECTED QUARTERLY INFORMATION (UNAUDITED)**

| (in thousands, except per share amounts) | 2013        |             |             |                 |
|--|-------------|-------------|-------------|-----------------|
|  | 1st Quarter | 2nd Quarter | 3rd Quarter | 4th Quarter (1) |
| Revenue                                  | \$ 116,246  | \$ 117,315  | \$ 122,011  | \$ 153,382      |
| Gross profit                             | 78,593      | 79,437      | 83,913      | 109,605         |
| Income from operations                   | 12,951      | 7,053       | 13,789      | 24,304          |
| Income before provision for income taxes | 12,018      | 6,657       | 13,410      | 24,308          |
| Net income                               | 9,069       | 4,703       | 8,710       | 15,561          |
| Net earnings per share, basic            | \$ 0.24     | \$ 0.12     | \$ 0.23     | \$ 0.41         |
| Net earnings per share, diluted          | \$ 0.23     | \$ 0.12     | \$ 0.22     | \$ 0.40         |

(1) Reflects the Company's acquisition of Antenna on October 9, 2013.

| (in thousands, except per share amounts)                  | 2012        |             |             |             |
|---|-------------|-------------|-------------|-------------|
|   | 1st Quarter | 2nd Quarter | 3rd Quarter | 4th Quarter |
| Revenue   | \$ 111,167  | \$ 105,056  | \$ 101,657  | \$ 143,830  |
| Gross profit  | 69,633      | 65,069      | 63,992      | 105,636     |
| Income (loss) from operations                             | 5,919       | (2,684)     | 401         | 27,790      |
| Income (loss) before provision (benefit) for income taxes | 5,931       | (3,168)     | 32          | 28,150      |
| Net income (loss)   | 4,057       | (2,267)     | (331)       | 20,409      |
| Net earnings (loss) per share, basic                      | \$ 0.11     | \$ (0.06)   | \$ (0.01)   | \$ 0.54     |
| Net earnings (loss) per share, diluted                    | \$ 0.10     | \$ (0.06)   | \$ (0.01)   | \$ 0.53     |



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**ITEM 9. Changes In and Disagreements with Accountants on Accounting and Financial Disclosure**

None.

**ITEM 9A. 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 December 31, 2013. 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 December 31, 2013.

***(b) Management's Report on Internal Control over Financial Reporting.***

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act. Under the supervision and with the participation of our management, including our CEO and CFO, we conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in *Internal Control - Integrated Framework* (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission ( COSO ).

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

Our management assessed the effectiveness of our internal control over financial reporting as of December 31, 2013. Based on this evaluation, our management concluded that we maintained effective internal control over financial reporting as of December 31, 2013, based on criteria in *Internal Control - Integrated Framework* (1992) issued by the COSO.

Deloitte & Touche LLP, our independent registered public accounting firm which also audited our consolidated financial statements, has issued an attestation report on our internal control over financial reporting, which is included on page 41 in Item 8 Financial Statements and Supplementary Data.

***(c) 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 December 31, 2013 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**ITEM 9B. Other Information**

None.

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**PART III**

**ITEM 10. Directors, Executive Officers, and Corporate Governance**

Except as set forth below, the information required by this Item is contained in our proxy statement for our 2014 annual stockholders meeting (the 2014 proxy statement ) under the heading Election of Directors, and is incorporated herein by reference. Information relating to certain filings on Forms 3, 4, and 5 is contained in our 2014 proxy statement under the heading Section 16(a) Beneficial Ownership Reporting Compliance, and is incorporated herein by reference. Information required by this item pursuant to Items 407 (c) (3), 407(d) (4), and 407(d) (5) of Regulation S-K relating to an audit committee financial expert, the identification of the audit committee of our Board of Directors and procedures of security holders to recommend nominees to our Board of Directors is contained in the 2014 proxy statement under the heading Corporate Governance and is incorporated herein by reference.

We have adopted a written code of conduct that applies to our Board of Directors and all of our employees, including our principal executive officer, principal financial officer, principal accounting officer, or persons performing similar functions. A copy of our code of conduct can be found on our website, [www.pegasystems.com](http://www.pegasystems.com). We intend to satisfy the disclosure requirements under Item 5.05 of Form 8-K and under the applicable the NASDAQ Global Select Market rules by posting such information on our website in accordance with such requirements.

**EXECUTIVE OFFICERS**

The names of our executive officers and certain information about them are set forth below as of February 1, 2014:

*Alan Trefler*, age 57, a founder of Pegasystems, serves as Chief Executive Officer and Chairman and has been a Director since we organized in 1983. Prior to 1983, he managed an electronic funds transfer product for TMI Systems Corporation, a software and services company. Mr. Trefler holds a B.A. degree in Economics and Computer Science from Dartmouth College.

*Rafeal Brown*, age 45, joined Pegasystems in October 2013 as Chief Financial Officer, Chief Administrative Officer and Senior Vice President. From 2004 to 2013, Mr. Brown served as a Senior Vice President of Finance, treasury and tax, at Salesforce.com, a leading provider of cloud computing software applications. From 1999 to 2004, Mr. Brown worked at Cisco Systems, a leading provider of networking technologies. Mr. Brown is a certified public accountant and holds a B.S. in accounting from Southern Utah University and a Masters in accounting from Brigham Young University.

*Efstathios Kouninis*, age 52, joined Pegasystems in April 2008 as Vice President of Finance. In May 2008, the Board of Directors appointed Mr. Kouninis as the Company's Chief Accounting Officer. From February 2006 to April 2008, Mr. Kouninis served as Chief Financial Officer and Treasurer of Tasker Products Corporation, a publicly traded manufacturer of antimicrobial chemicals. From November 2004 to February 2006, Mr. Kouninis served on the Staff of the Division of Corporation Finance of the U. S. Securities and Exchange Commission. Mr. Kouninis holds a Post Baccalaureate in Accounting, a M.S. in taxation from Bentley College, and a B.S. from the University of Massachusetts.

*Douglas Kra*, age 51, joined Pegasystems in November 2004 as Vice President of Global Services. From 2002 to 2004, Mr. Kra served as Vice President at eLoyalty Corp., a consulting company specializing in customer relationship management. From 2000 to 2001, Mr. Kra served as President of Zefer Corp., an internet consulting firm. Prior to Zefer, Mr. Kra spent ten years at Cambridge Technology Partners Inc. in a variety of senior roles. He holds a B.A. in Computer Science from Brandeis University and an M.B.A. in finance from the New York University Stern School of Business.

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*Michael Pyle*, age 59, joined Pegasystems in 1985 and has served as Senior Vice President of Product Development since August 2000. Including his positions with Pegasystems, Mr. Pyle's professional background encompasses almost thirty years of software development and managerial experience throughout Europe and the U.S. Mr. Pyle completed his B.C.S. specializing in Computer Science and Systems Programming at the Civil Service College in London.

*Leon Trefler*, age 53, joined Pegasystems in April 1998 as an Account Executive for Strategic Business Development. Since then he has held various senior sales management positions across the Company and in Channel Sales. In 2002, he launched the commercialization of PRPC. From April 2007 to January 2010, Mr. Trefler served as Vice President of Sales, North America and in January 2010, Mr. Trefler was promoted to Senior Vice President of Sales. Mr. Trefler holds a B.A. degree from Dartmouth College.

Alan Trefler and Leon Trefler are brothers. There are no other family relationships among any of our executive officers or Directors.

**ITEM 11. Executive Compensation**

The information required by this item is contained in the 2014 proxy statement under the headings "Director Compensation", "Compensation Discussion and Analysis", and "Executive Compensation" and is incorporated herein by reference.

**ITEM 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters**

Information required by this item with respect to stock ownership of certain beneficial owners and management is contained in the 2014 proxy statement under the heading "Security Ownership of Certain Beneficial Owners and Management" and is incorporated herein by reference.

**Table of Contents****Equity Compensation Plan Information**

The following table provides certain information with respect to our equity compensation plans in effect as of December 31, 2013:

| (In thousands, except per share amounts)                   | (a)  | (b)  | (c)  |
|--|--|--|--|
|  | Number of shares of common stock to be issued upon exercise of outstanding stock options and vesting of RSUs (3) | Weighted-average exercise price per share of outstanding stock options (4) | Number of shares of Common stock Remaining available For future issuance (excluding those in Column (a)) (5) |
| Equity compensation plans approved by stockholders (1)     | 3,422  | \$ 20.89   | 4,086  |
| Equity compensation plans not approved by stockholders (2) | 40   | \$ 26.81   |  |

(1) Our equity compensation plans include the Amended and Restated 1994 Long-Term Incentive Plan (the 1994 Plan), the 1996 Non-Employee Director Stock Option Plan (the Director Plan), the Amended and Restated 2004 Long-Term Incentive Plan (the Restated 2004 Plan), and the 2006 Employee Stock Purchase Plan as amended, (the 2006 ESPP). Our stockholders previously approved each of these plans and all amendments that were subject to stockholder approval. In addition to the issuance of stock options, the 1994 Plan allowed for the issuance of stock appreciation rights, restricted stock, and long-term performance awards. The Company does not intend to issue any additional options or make any other awards under the 1994 Plan or the Director Plan in the future. In addition to the issuance of stock options, the Restated 2004 Plan allows for the issuance of stock purchase rights and other stock-based awards, including RSUs. See Note 15 Stock-Based Compensation included in the notes to the accompanying audited consolidated financial statements for further information and description of our equity compensation plans.

(2) These stock options were assumed in connection with our acquisition of Chordiant and were originally granted under the Chordiant Software, Inc. 2005 Equity Incentive Plan (the 2005 Plan), the Chordiant Software, Inc. 2000 Nonstatutory Equity Incentive Plan (the 2000 Plan), the Chordiant Software, Inc. Amended and Restated 1999 Non-Employee Director Stock Option Plan (the 1999 Director Plan), and the Prime Response Group, Inc. 1998 Stock Options/Stock Issuance Plan (the 1998 Prime Response Plan) (collectively, the Chordiant Plans). No additional awards were or may be granted under the Chordiant Plans following the date of acquisition. These plans were not approved by our stockholders since they were adopted at the date of acquisition. In connection with our acquisition of Chordiant, all outstanding equity awards issued under the Chordiant Plans with an exercise price of \$6.00 or lower were assumed by us and converted into the right to receive 0.13 shares of Pegasystems common stock for every one share of Chordiant common stock covered by such awards. All other outstanding equity awards issued under the Chordiant Plans were cancelled.

The 2005 Plan was approved by Chordiant's stockholders and provided for the grant of incentive stock options, nonstatutory stock options, stock purchase awards, RSAs, RSUs and other forms of equity compensation. Awards granted under the 2005 Plan generally expire four to ten years after the grant date and generally become exercisable over a period of two to four years, with either yearly or monthly vesting. The 2000 Plan provided for the grant of nonstatutory stock options, restricted stock and stock bonuses to employees. Generally, awards under the 2000 Plan vest over a period of four years in equal monthly installments with 25% of the shares vesting after one year, and the remainder vesting in equal monthly installments over the remaining three years. The 1999 Director Plan provided directors to be issued a single grant at each year's annual meeting of the stockholders equal to a number of shares of restricted stock equal to \$100,000 divided by the fair market value of Chordiant's common stock on the date of the annual meeting. These shares of restricted stock generally vest on the earlier of the next Chordiant annual meeting or twelve months from the date of grant. The 1998 Prime Response Plan provided for the grant of stock options, common stock and stock bonuses to employees, non-employee directors, and consultants or other independent advisors who provided service to Prime Response. Awards granted under this plan had a maximum expiration of ten years.



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- (3) The number of shares of common stock issued upon exercise of vested stock options and vesting of RSUs will be less than 3,462,000 because of the net settlement feature of most of these stock options and RSUs. This feature enables the employee to satisfy the cost to exercise (in the case of stock options) and, if applicable, taxes due (in the case of stock options and RSUs) by surrendering shares to the Company based on the fair value of the shares at the exercise date (in the case of stock options) or vesting date (in the case of RSUs), instead of selling all of the shares on the open market to satisfy these obligations. The settlement of vested stock options and vested RSUs on a net share basis will result in fewer shares issued by the Company. During 2013, stock option and RSU holders net settled stock options and RSUs representing the right to purchase a total of 861,000 shares, of which only 432,000 were issued to the stock option and RSU holders and the balance of the shares were surrendered to the Company to pay for the exercise price and the applicable taxes.
- (4) The weighted-average exercise price does not take into account the shares issuable upon vesting of outstanding RSUs, which have no exercise price.
- (5) Includes approximately 362,000 shares remaining available for issuance as of December 31, 2013 under the 2006 ESPP.

**ITEM 13. Certain Relationships and Related Transactions, and Director Independence**

The information required by this item is contained in the 2014 proxy statement under the headings Certain Relationships and Related Transactions and Determination of Independence and is incorporated herein by reference.

**ITEM 14. Principal Accounting Fees and Services**

The information required by this item is contained in the 2014 proxy statement under the heading Independent Registered Public Accounting Firm Fees and Services and is incorporated herein by reference.

**PART IV**

**ITEM 15. Exhibits, Financial Statement Schedules**

(a) The following are filed as part of this Annual Report on Form 10-K:

*(1) Financial Statements*

The following consolidated financial statements are included in Item 8:

|  | <b>Page</b> |
|--|-------------|
| Consolidated Balance Sheets as of December 31, 2013 and 2012   | 42          |
| Consolidated Statements of Operations for the years ended December 31, 2013, 2012, and 2011                  | 43          |
| Consolidated Statements of Comprehensive Income (Loss) for the years ended December 31, 2013, 2012, and 2011 | 44          |
| Consolidated Statements of Stockholders' Equity for the years ended December 31, 2013, 2012, and 2011        | 45          |
| Consolidated Statements of Cash Flows for the years ended December 31, 2013, 2012, and 2011                  | 46          |
| (b) Exhibits   |             |

The exhibits listed in the Exhibit Index immediately preceding such exhibits are filed as part of this Annual Report on Form 10-K.

(c) Financial Statement Schedules

## Edgar Filing: PEGASYSTEMS INC - Form 10-K

All financial statement schedules are omitted because the required information is not present or not present in sufficient amounts to require submission of the schedule or because the information is reflected in the consolidated financial statements or notes thereto.

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**Signatures**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this Annual Report on Form 10-K to be signed on its behalf by the undersigned, thereunto duly authorized.

PEGASYSTEMS INC.

By: /s/ RAFEAL E. BROWN  
**Rafeal E. Brown**  
*Chief Financial Officer, Chief Administrative Officer  
 and Senior Vice President*  
  
*(principal financial officer)*

Date: February 25, 2014

Pursuant to the requirements of the Securities Exchange Act of 1934, this Annual Report on Form 10-K has been signed below on February 25, 2014 by the following persons on behalf of the Registrant and in the capacities indicated.

| Signature                  | Title   |
|----------------------------|---|
| /s/ ALAN TREFLER           | Chief Executive Officer and Chairman  |
| <b>Alan Trefler</b>        | (principal executive officer)   |
| /s/ RAFEAL E. BROWN        | Chief Financial Officer, Chief Administrative Officer and Senior Vice President |
| <b>Rafeal E. Brown</b>     | (principal financial officer)   |
| /s/ EFSTATHIOS KOUNINIS    | Vice President of Finance and Chief Accounting Officer                          |
| <b>Efstathios Kouninis</b> | (principal accounting officer)  |
| /s/ RICHARD JONES          |   |
| <b>Richard Jones</b>       | Vice Chairman and Director  |
| /s/ PETER GYENES           |   |
| <b>Peter Gyenes</b>        | Director  |
| /s/ STEVEN KAPLAN          |   |
| <b>Steven Kaplan</b>       | Director  |
| /s/ JAMES O HALLORAN       |   |
| <b>James O Halloran</b>    | Director  |
| /s/ LARRY WEBER            |   |
| <b>Larry Weber</b>         | Director  |
| /s/ WILLIAM WYMAN          | Director  |



**William Wyman**

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**EXHIBIT INDEX**

| <b>Exhibit No.</b> | <b>Description</b>  |
|--------------------|---|
| 2.1                | Agreement and Plan of Merger, dated as of March 14, 2010, by and among Pegasystems Inc., Maple Leaf Acquisition Corp. and Chordiant Software, Inc. (Filed as Exhibit 2.1 to the Registrant's March 15, 2010 Form 8-K and incorporated herein by reference.)   |
| 2.2                | Agreement and Plan of Merger, dated as of October 9, 2013, by and among Pegasystems Inc., Aries Merger Sub, Inc., Antenna Software, Inc. and Shareholder Representative Services LLC, solely in its capacity as representative of Stockholders thereunder. (Filed as Exhibit 2.1 to the Registrant's October 11, 2013 Form 8-K and incorporated herein by reference.) |
| 3.1                | Restated Articles of Organization of the Registrant and Amendment thereto. (Filed as Exhibit 3.1 to the Registrant's 2012 Form 10-K and incorporated herein by reference.)  |
| 3.2                | Amended and Restated Bylaws of Pegasystems Inc. (Filed as Exhibit 3.1 to the Registrant's December 17, 2013 Form 8-K and incorporated herein by reference.)   |
| 4.1                | Specimen Certificate Representing the Common Stock. (Filed as Exhibit 4.1 to the Registrant's Registration Statement on Form S-1 (Registration No. 333-03807) or an amendment thereto and incorporated herein by reference.)  |
| 10.1++             | Amended and Restated 1994 Long-Term Incentive Plan. (Filed in the Registrant's Proxy Statement for its 2003 annual stockholders meeting and incorporated herein by reference.)  |
| 10.2++             | 1996 Non-Employee Director Stock Option Plan. (Filed in the Registrant's Proxy Statement for its 2000 annual stockholders meeting and incorporated herein by reference.)  |
| 10.3               | Lease Agreement dated February 26, 1993 between the Registrant and Riverside Office Park Joint Venture. (Filed as Exhibit 10.13 to the Registrant's Registration Statement on Form S-1 (Registration No. 333-03807) or an amendment thereto and incorporated herein by reference.)  |
| 10.4               | Amendment Number 1 to Lease Agreement dated August 17, 1994 between the Registrant and Riverside Office Park Joint Venture. (Filed as Exhibit 10.14 to the Registrant's Registration Statement on Form S-1 (Registration No. 333-03807) or an amendment thereto and incorporated herein by reference.)  |
| 10.5               | Amendment Number 8 to Lease Agreement dated July 31, 2002 between the Registrant and NOP Riverfront LLC. (Filed as Exhibit 10.23 to the Registrant's 2002 Form 10-K and incorporated herein by reference.)  |
| 10.6               | Letter Amendment to Lease Agreement dated July 31, 2002 between the Registrant and NOP Riverfront LLC. (Filed as Exhibit 10.24 to the Registrant's 2002 Form 10-K and incorporated herein by reference.)  |
| 10.7++             | Amended and Restated 2004 Long-Term Incentive Plan, dated May 18, 2011 (Filed as Appendix A within the Registrant's 2011 Proxy Statement, filed May 23, 2011 and incorporated herein by reference).   |
| 10.8++             | Form of Employee Stock Option Agreement, as amended on December 15, 2009. (Filed as Exhibit 10.8 to the Registrant's 2009 Form 10-K and incorporated herein by reference.)  |
| 10.9++             | Form of Restricted Stock Unit Agreement, as amended on December 15, 2009. (Filed as Exhibit 10.9 to the Registrant's 2009 Form 10-K and incorporated herein by reference.)  |
| 10.10              | Form of Non-Employee Director Stock Option Agreement. (Filed as Exhibit 10.2 to the Registrant's September 30, 2004 Form 10-Q and incorporated herein by reference.)  |
| 10.11++            | Offer Letter between the Registrant and Douglas I. Kra dated October 19, 2004. (Filed as Exhibit 10.20 to the Registrant's 2004 Form 10-K and incorporated herein by reference.)  |
| 10.12              | Form of Director Indemnification Agreement. (Filed as Exhibit 99.1 to the Registrant's April 11, 2005 Form 8-K and incorporated herein by reference.)   |

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**EXHIBIT INDEX (CONTINUED)**

| <b>Exhibit No.</b> | <b>Description</b>   |
|--------------------|--|
| 10.13++            | Compensation program for members of the Registrant's Board of Directors, effective May 30, 2006. (Detailed in Registrant's June 5, 2006 Form 8-K and incorporated herein by reference.)  |
| 10.14              | Amendment Number 10 to Lease Agreement dated July 24, 2006 between the Registrant and NOP Riverfront LLC. (Filed as Exhibit 10.1 to the Registrant's September 30, 2006 Form 10-Q and incorporated herein by reference.)   |
| 10.15++            | Amendment to Stock Option Agreement between the Registrant and Richard H. Jones dated December 29, 2006. (Filed as Exhibit 99.1 to the Registrant's January 4, 2007 Form 8-K and incorporated herein by reference.)  |
| 10.16              | Amendment Number 11 to Lease Agreement dated as of June 11, 2008 between the Registrant and NOP Riverfront LLC. (Filed as Exhibit 10.2 to the Registrant's June 30, 2008 Form 10-Q and incorporated herein by reference.)  |
| 10.17              | Form of Tender and Voting Agreement by and among Pegasystems Inc., Maple Leaf Acquisition Corp. and the individuals listed on the signatures pages thereto, dated as of March 14, 2010 (Filed as Exhibit 10.1 to the Registrant's March 15, 2010 Form 8-K and incorporated herein by reference.) |
| 10.18              | Lease Agreement, dated June 29, 2011 between Charles Park One, LLC and Pegasystems Inc. for premises at One Charles Park (Filed as Exhibit 99.1 to the Registrant's Form 8-K/A filed on July 6, 2011 and incorporated herein by reference.)  |
| 10.19++            | 2012 Section 16 Officer/FLT Member Corporate Incentive Compensation Plan. (Filed as Exhibit 99.1 to the Registrant's February 22, 2012 Form 8-K and incorporated herein by reference.)   |
| 10.20++            | 2012 Section 16 Executive Officers Base Salaries and Target Bonus Payments. (Filed as Exhibit 99.2 to the Registrant's February 22, 2012 Form 8-K and incorporated herein by reference.)   |
| 10.21++            | 2006 Employee Stock Purchase Plan, as amended on October 25, 2012. (Filed as Exhibit 10.24 to the Registrant's 2012 Form 10-K and incorporated herein by reference.)   |
| 10.22++            | 2013 Section 16 Officer/FLT Member Corporate Incentive Compensation Plan. (Filed as Exhibit 99.1 to the Registrant's February 21, 2013 Form 8-K and incorporated herein by reference.)   |
| 10.23++            | 2013 Section 16 Executive Officers Base Salaries and Target Bonus Payments. (Filed as Exhibit 99.2 to the Registrant's February 21, 2013 Form 8-K and incorporated herein by reference.)   |
| 10.24++            | Offer Letter between Pegasystems Inc. and Rafeal E. Brown dated August 28, 2013. (Filed as Exhibit 99.1 to the Registrant's September 4, 2013 Form 8-K and incorporated herein by reference.)  |
| +21.1              | Subsidiaries of the Registrant.  |
| +23.1              | Consent of Independent Registered Public Accounting Firm Deloitte & Touche LLP.  |
| +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.   |

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**EXHIBIT INDEX (CONTINUED)**

| <b>Exhibit no.</b> | <b>Description</b>                                    |
|--------------------|---|
| 101.INS **         | XBRL Instance document.                               |
| 101.SCH**          | XBRL Taxonomy Extension Schema Document.              |
| 101.CAL**          | XBRL Taxonomy Calculation Linkbase Document.          |
| 101.DEF**          | XBRL Taxonomy Extension Definition Linkbase Document. |
| 101.LAB**          | XBRL Taxonomy Label Linkbase Document.                |
| 101.PRE**          | XBRL Taxonomy Presentation Linkbase Document.         |

++ Management contracts and compensatory plan or arrangements required to be filed pursuant to Item 15(b) of Form 10-K.

+ Filed herewith

\*\* Submitted electronically herewith Attached as Exhibit 101 to this report are the following formatted in XBRL (Extensible Business Reporting Language): (i) Consolidated Balance Sheets as of December 31, 2013 and December 31, 2012, (ii) Consolidated Statements of Operations for the years ended December 31, 2013, 2012 and 2011, (iii) Consolidated Statements of Comprehensive Income (Loss) for the years ended December 31, 2013, 2012 and 2011, (iv) Consolidated Statements of Stockholders' Equity (v) Consolidated Statements of Cash Flows for the years ended December 31, 2013, 2012 and 2011, and (vi) Notes to Consolidated Financial Statements.