

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.pegasystems.com](http://www.pegasystems.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.

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**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

**Holders**

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)
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