

PEGASYSTEMS INC
Form 10-Q
May 05, 2016
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

**Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended March 31, 2016**

or

**Transition Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from _____ to _____**

Commission File Number: 1-11859

PEGASYSTEMS INC.

(Exact name of Registrant as specified in its charter)

Massachusetts
(State or other jurisdiction of
incorporation or organization)

04-2787865
(IRS Employer
Identification No.)

One Rogers Street Cambridge, MA
(Address of principal executive offices)

02142-1209
(Zip Code)

(617) 374-9600

(Registrant's telephone number including area code)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

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

Large accelerated filer Accelerated filer

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

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

There were 76,308,871 shares of the Registrant's common stock, \$.01 par value per share, outstanding on April 22, 2016.

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PEGASYSTEMS INC.

UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands)

| | As of March 31, 2016 | As of December 31, 2015 |
|--|----------------------------|-------------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 92,180 | \$ 93,026 |
| Marketable securities | 101,733 | 126,052 |
| Total cash, cash equivalents, and marketable securities | 193,913 | 219,078 |
| Trade accounts receivable, net of allowance of \$5,028 and \$4,631 | 202,399 | 211,846 |
| Deferred income taxes | 12,414 | 12,380 |
| Income taxes receivable | 4,898 | 4,770 |
| Other current assets | 23,199 | 10,791 |
| Total current assets | 436,823 | 458,865 |
| Property and equipment, net | 35,940 | 31,319 |
| Long-term deferred income taxes | 52,536 | 53,350 |
| Long-term other assets | 3,728 | 4,030 |
| Intangible assets, net | 30,431 | 33,418 |
| Goodwill | 46,724 | 46,776 |
| Total assets | \$ 606,182 | \$ 627,758 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 11,978 | \$ 12,675 |
| Accrued expenses | 46,062 | 42,768 |
| Accrued compensation and related expenses | 32,472 | 55,872 |
| Deferred revenue | 158,181 | 155,873 |
| Total current liabilities | 248,693 | 267,188 |
| Income taxes payable | 5,648 | 5,618 |

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| | | |
|---|-------------------|-------------------|
| Long-term deferred revenue | 13,458 | 15,805 |
| Other long-term liabilities | 15,879 | 16,288 |
| Total liabilities | 283,678 | 304,899 |
| Stockholders' equity: | | |
| Preferred stock, 1,000 shares authorized; no shares issued and outstanding | | |
| Common stock, 200,000 shares authorized; 76,385 shares and 76,488 shares issued and outstanding | 764 | 765 |
| Additional paid-in capital | 138,075 | 145,418 |
| Retained earnings | 186,893 | 180,183 |
| Accumulated other comprehensive loss | (3,228) | (3,507) |
| Total stockholders' equity | 322,504 | 322,859 |
| Total liabilities and stockholders' equity | \$ 606,182 | \$ 627,758 |

See notes to unaudited condensed consolidated financial statements.

Table of Contents**PEGASYSTEMS INC.****UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(in thousands, except per share amounts)**

| | Three Months Ended March 31, | |
|--|---|----------------|
| | 2016 | 2015 |
| Revenue: | | |
| Software license | \$ 68,345 | \$ 57,975 |
| Maintenance | 52,975 | 48,752 |
| Services | 57,538 | 47,191 |
| Total revenue | 178,858 | 153,918 |
| Cost of revenue: | | |
| Software license | 1,021 | 1,076 |
| Maintenance | 5,915 | 5,180 |
| Services | 49,574 | 43,803 |
| Total cost of revenue | 56,510 | 50,059 |
| Gross profit | 122,348 | 103,859 |
| Operating expenses: | | |
| Selling and marketing | 61,078 | 55,735 |
| Research and development | 34,920 | 29,844 |
| General and administrative | 11,048 | 6,345 |
| Acquisition-related | 919 | 26 |
| Restructuring | 258 | |
| Total operating expenses | 108,223 | 91,950 |
| Income from operations | 14,125 | 11,909 |
| Foreign currency transaction gain (loss) | 1,376 | (2,962) |
| Interest income, net | 290 | 313 |
| Other expense, net | (2,298) | |

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| | | |
|---|----------|----------|
| Income before provision for income taxes | 13,493 | 9,260 |
| Provision for income taxes | 4,488 | 3,325 |
| Net income | \$ 9,005 | \$ 5,935 |
| Earnings per share: | | |
| Basic | \$ 0.12 | \$ 0.08 |
| Diluted | \$ 0.11 | \$ 0.08 |
| Weighted-average number of common shares outstanding: | | |
| Basic | 76,375 | 76,401 |
| Diluted | 78,878 | 78,592 |
| Cash dividends declared per share | \$ 0.03 | \$ 0.03 |

See notes to unaudited condensed consolidated financial statements.

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

| | Three Months Ended March 31, | |
|---|---|-------------|
| | 2016 | 2015 |
| Net income | \$ 9,005 | \$ 5,935 |
| Other comprehensive gain (loss), net: | | |
| Unrealized gain on available-for-sale marketable securities, net of tax | 286 | 91 |
| Foreign currency translation adjustments | (7) | (3,096) |
| Total other comprehensive gain (loss), net | 279 | (3,005) |
| Comprehensive income | \$ 9,284 | \$ 2,930 |

See notes to unaudited condensed consolidated financial statements.

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

| | Three Months Ended March 31, | |
|--|---|----------------|
| | 2016 | 2015 |
| Operating activities: | | |
| Net income | \$ 9,005 | \$ 5,935 |
| Adjustments to reconcile net income to cash provided by operating activities: | | |
| Excess tax benefits from exercise or vesting of equity awards | (1,398) | (822) |
| Deferred income taxes | 650 | (3) |
| Depreciation and amortization | 5,466 | 5,624 |
| Stock-based compensation expense | 8,935 | 6,269 |
| Foreign currency transaction (gain) loss | (1,376) | 2,962 |
| Other non-cash | 2,712 | 161 |
| Change in operating assets and liabilities: | | |
| Trade accounts receivable | 6,697 | (299) |
| Income taxes receivable and other current assets | (201) | (4,403) |
| Accounts payable and accrued expenses | (23,427) | (21,621) |
| Deferred revenue | 1,129 | 33,919 |
| Other long-term assets and liabilities | 450 | (201) |
| Cash provided by operating activities | 8,642 | 27,521 |
| Investing activities: | | |
| Purchases of marketable securities | (8,193) | (18,120) |
| Proceeds from maturities and called marketable securities | 15,890 | 16,549 |
| Sales of marketable securities | 6,179 | |
| Payments for acquisitions, net of cash acquired | (255) | (535) |
| Investment in property and equipment | (4,251) | (3,275) |
| Cash provided by (used in) investing activities | 9,370 | (5,381) |
| Financing activities: | | |

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| | | |
|---|-----------|------------|
| Issuance of common stock for share-based compensation plans | 44 | 146 |
| Excess tax benefits from exercise or vesting of equity awards | 1,398 | 822 |
| Dividend payments to shareholders | (2,297) | (2,294) |
| Common stock repurchases for tax withholdings for net settlement of equity awards | (5,682) | (2,584) |
| Common stock repurchases under share repurchase programs | (11,887) | (2,427) |
| Cash used in financing activities | (18,424) | (6,337) |
| Effect of exchange rates on cash and cash equivalents | (434) | (2,908) |
| Net (decrease) increase in cash and cash equivalents | (846) | 12,895 |
| Cash and cash equivalents, beginning of period | 93,026 | 114,585 |
| Cash and cash equivalents, end of period | \$ 92,180 | \$ 127,480 |

See notes to unaudited condensed consolidated financial statements.

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PEGASYSTEMS INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. ACCOUNTING POLICIES

Basis of Presentation

Pegasystems Inc. (together with its subsidiaries, the Company) has prepared the accompanying unaudited condensed consolidated financial statements pursuant to the rules and regulations of the U.S. Securities and Exchange Commission (SEC) regarding interim financial reporting. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America (U.S.) for complete financial statements and should be read in conjunction with the Company's audited financial statements included in the Annual Report on Form 10-K for the year ended December 31, 2015.

In the opinion of management, the Company has prepared the accompanying unaudited condensed consolidated financial statements on the same basis as its audited financial statements, and these financial statements include all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the results of the interim periods presented. The operating results for the interim periods presented are not necessarily indicative of the results expected for the full year 2016.

2. NEW ACCOUNTING PRONOUNCEMENTS

Recently issued accounting guidance:

Improvements to Employee Share-Based Payment Accounting: In March 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2016-09, Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting, which is intended to simplify various aspects of the accounting for employee share-based payments transactions, including accounting for income taxes, forfeitures, and statutory tax withholding requirements, as well as classification in the statement of cash flows. The effective date for the Company will be January 1, 2017, with early adoption permitted. The Company is currently evaluating the effect this ASU will have on its consolidated financial statements and related disclosures.

Leases: In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842), which requires lessees to record most leases on their balance sheets, recognizing a lease liability for the obligation to make lease payments and a right-to-use asset for the right to use the underlying asset for the lease term. The effective date for the Company will be January 1, 2019, with early adoption permitted. The Company is currently evaluating the effect this ASU will have on its consolidated financial statements and related disclosures. The Company currently expects that most of its operating lease commitments will be subject to the ASU and recognized as operating lease liabilities and right-of-use assets upon adoption.

Balance Sheet Classification of Deferred Taxes: In November 2015, the FASB issued ASU No. 2015-17, Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes. The guidance requires that deferred income tax liabilities and assets be classified as noncurrent in a classified balance sheet. The effective date for the Company will be January 1, 2017, with early adoption permitted. The Company does not expect this ASU to have a material impact on its consolidated financial statements and related disclosures.

Revenue from Contracts with Customers: In May 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. This ASU amends the guidance for revenue recognition to replace numerous, industry-specific requirements and converges areas under this topic with those of the International Financial Reporting Standards. This ASU implements a five-step process for customer contract revenue recognition that focuses on transfer of control, as opposed to transfer of risk and rewards. This ASU also requires enhanced disclosures regarding the nature, amount, timing and uncertainty of revenues and cash flows from contracts with customers. Other major provisions include ensuring the time value of money is considered in the transaction price, and allowing estimates of variable consideration to be recognized before contingencies are resolved in certain circumstances. This ASU originally had an effective date for the Company of January 1, 2017. In August 2015, the FASB issued ASU No. 2015-14, *Revenue from Contracts with Customers (Topic 606) Deferral of the Effective Date*, which defers the effective date by one year while providing the option to adopt the standard on the original effective date. In March 2016, the FASB issued ASU 2016-08, *Revenue*

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from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net) . This ASU clarifies the implementation guidance on principal versus agent considerations contained in ASU 2014-09. The effective date for these ASUs for the Company will be January 1, 2018. The Company has not yet selected a transition method and is currently evaluating the effect that these ASUs will have on its consolidated financial statements and related disclosures.

Recently adopted accounting guidance:

Simplifying the Accounting for Measurement-Period Adjustments: In September 2015, the FASB issued ASU No. 2015-16, *Simplifying the Accounting for Measurement-Period Adjustments* . This ASU amends guidance for business combinations to simplify the presentation of adjustments to the initial purchase price allocation identified during the measurement period of a business combination. ASU 2015-16 requires that an acquirer in a business combination recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined, and eliminates the requirement to retrospectively account for adjustments made to provisional amounts recognized in a business combination. The Company adopted this ASU beginning January 1, 2016. Adoption of this ASU did not have a material impact on its consolidated financial statements and related disclosures.

3. MARKETABLE SECURITIES

| (in thousands) | March 31, 2016 | | | |
|-------------------------|----------------|------------------|-------------------|------------|
| | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value |
| Municipal bonds | \$ 50,156 | \$ 103 | \$ (10) | \$ 50,249 |
| Corporate bonds | 49,513 | 84 | (15) | 49,582 |
| Certificates of deposit | 1,901 | 1 | | 1,902 |
| | \$ 101,570 | \$ 188 | \$ (25) | \$ 101,733 |

| (in thousands) | December 31, 2015 | | | |
|-------------------------|-------------------|------------------|-------------------|------------|
| | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value |
| Municipal bonds | \$ 57,394 | \$ 7 | \$ (66) | \$ 57,335 |
| Corporate bonds | 66,960 | 2 | (147) | 66,815 |
| Certificates of deposit | 1,903 | | (1) | 1,902 |
| | \$ 126,257 | \$ 9 | \$ (214) | \$ 126,052 |

The Company considers debt securities with maturities of three months or less from the purchase date to be cash equivalents. Interest is recorded when earned. All of the Company's investments are classified as available-for-sale and are carried at fair value. Unrealized gains and losses considered to be other-than-temporary in nature are recorded as a

component of accumulated other comprehensive loss, net of related income taxes. The Company reviews all investments for reductions in fair value that are other-than-temporary. When such reductions occur, the cost of the investment is adjusted to fair value through recording a loss on investments in the unaudited condensed consolidated statements of operations. Gains and losses on investments are calculated on the basis of specific identification. As of March 31, 2016, the Company did not hold any investments with unrealized gains and losses that are considered to be other-than-temporary.

As of March 31, 2016, remaining maturities of marketable debt securities ranged from June 2016 to January 2019, with a weighted-average remaining maturity of approximately 18 months.

During the first quarter of 2016, the Company sold \$10.1 million of marketable securities, which did not settle until April 2016 and are reflected in other current assets in the accompanying unaudited condensed consolidated balance sheets.

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The Company uses foreign currency forward contracts (forward contracts) to hedge its exposure to fluctuations in foreign currency exchange rates associated with its foreign currency denominated cash, accounts receivable, and intercompany receivables and payables held by its U.S. operating company and United Kingdom subsidiary.

The Company is primarily exposed to foreign currency exchange rate fluctuations in the U.S. dollar, the Euro, and the Australian dollar relative to the British pound and the Euro, the British pound, and the Indian rupee relative to the U.S. dollar.

The forward contracts are not designated as hedging instruments. As a result, the Company records the fair value of these contracts at the end of each reporting period in the accompanying unaudited condensed consolidated balance sheets 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, net, in the accompanying unaudited condensed consolidated statements of operations. The cash flows related to these forward contracts are classified as operating activities in the accompanying unaudited condensed consolidated statements of cash flows. The Company does not enter into any forward contracts for trading or speculative purposes.

As of March 31, 2016 and December 31, 2015, the total notional amount of the Company's outstanding forward contracts was \$59.3 million and \$32.3 million, respectively.

The fair value of the Company's outstanding forward contracts was as follows:

| (in thousands) | March 31, 2016 | | December 31, 2015 | |
|------------------------------------|------------------------|------------|------------------------|------------|
| | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value |
| Asset Derivatives | | | | |
| Foreign currency forward contracts | Other current assets | \$ 722 | Other current assets | \$ 48 |
| Liability Derivatives | | | | |
| Foreign currency forward contracts | Accrued expenses | \$ 447 | Accrued expenses | \$ 1,052 |

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

| Currency (in thousands) | Notional Amount Three Months Ended March 31, | |
|-------------------------|--|------|
| | 2016 | 2015 |
| Euro | 34,435 | |
| British pound | £ 9,105 | £ |

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| | | | |
|----------------------|-----|---------|-----|
| Australian dollar | A\$ | 36,275 | A\$ |
| Indian rupee | Rs | 968,500 | Rs |
| United States dollar | \$ | 48,820 | \$ |

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| (in thousands) | Three Months Ended | |
|---|--------------------|------------|
| | March 31, | |
| | 2016 | 2015 |
| Loss from the change in the fair value of forward contracts included in other expense, net | \$ (2,297) | \$ |
| Foreign currency transaction gains (losses) from the remeasurement of foreign currency assets and liabilities | \$ 1,376 | \$ (2,962) |

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

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

The Company's money market funds are classified within Level 1 of the fair value hierarchy. The Company's investments classified within Level 2 of the fair value hierarchy are valued based on a market approach using quoted prices, when available, or matrix pricing compiled by third party pricing vendors, using observable market inputs such as interest rates, yield curves, and credit risk. The Company's foreign currency forward contracts, which are all classified within Level 2 of the fair value hierarchy, are valued based on the notional amounts and rates under the contracts and observable market inputs such as currency exchange rates and credit risk. If applicable, the Company will recognize transfers into and out of levels within the fair value hierarchy at the end of the reporting period in which the actual event or change in circumstance occurs. There were no transfers between Level 1 and Level 2 during the three months ended March 31, 2016.

The Company's assets and liabilities measured at fair value on a recurring basis consisted of the following:

| (in thousands) | March 31, 2016 | Fair Value Measurements at Reporting Date Using | |
|------------------------|----------------|---|-----------|
| | | Level 1 | Level 2 |
| Fair Value Assets: | | | |
| Money market funds | \$ 6,273 | \$ 6,273 | \$ |
| Marketable securities: | | | |
| Municipal bonds | \$ 50,249 | \$ | \$ 50,249 |
| Corporate bonds | 49,582 | | 49,582 |

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| | | | | |
|------------------------------------|-----------|----------------|-----------|-------------------|
| Certificates of deposit | | 1,902 | | 1,902 |
| Total marketable securities | \$ | 101,733 | \$ | \$ 101,733 |
| Foreign currency forward contracts | \$ | 722 | \$ | \$ 722 |
| Fair Value Liabilities: | | | | |
| Foreign currency forward contracts | \$ | 447 | \$ | \$ 447 |

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| (in thousands) | Fair Value Measurements at Reporting Date Using | | |
|------------------------------------|---|-----------|-------------------|
| | December 31, 2015 | Level 1 | Level 2 |
| Fair Value Assets: | | | |
| Money market funds | \$ 573 | \$ 573 | \$ |
| Marketable securities: | | | |
| Municipal bonds | \$ 57,335 | \$ | \$ 57,335 |
| Corporate bonds | 66,815 | | 66,815 |
| Certificates of deposit | 1,902 | | 1,902 |
| Total marketable securities | \$ 126,052 | \$ | \$ 126,052 |
| Foreign currency forward contracts | \$ 48 | \$ | \$ 48 |
| Fair Value Liabilities: | | | |
| Foreign currency forward contracts | \$ 1,052 | \$ | \$ 1,052 |

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 the first three months of 2016 and 2015, the Company did not recognize any impairments on its assets measured at fair value on a nonrecurring basis.

6. TRADE ACCOUNTS RECEIVABLE, NET OF ALLOWANCE

Unbilled trade accounts receivable primarily relate to services earned under time and materials arrangements and to license, maintenance, and cloud arrangements that have commenced or been delivered in excess of scheduled invoicing.

| (in thousands) | March 31, 2016 | December 31, 2015 |
|------------------------------------|-------------------|-------------------|
| Trade accounts receivable | \$ 189,022 | \$ 190,820 |
| Unbilled trade accounts receivable | 18,405 | 25,657 |
| Total accounts receivable | 207,427 | 216,477 |
| Allowance for sales credit memos | (5,028) | (4,631) |
| | \$ 202,399 | \$ 211,846 |

7. GOODWILL AND OTHER INTANGIBLE ASSETS

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

| (in thousands) | 2016 |
|--------------------------|-------------|
| Balance as of January 1, | \$ 46,776 |
| Translation adjustments | (52) |
| Balance as of March 31, | \$ 46,724 |

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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 |
|------------------------------|-----------------------|-------------------|--------------------------|------------------|
| As of March 31, 2016 | | | | |
| Customer related intangibles | 4-9 years | \$ 49,519 | \$ (31,990) | \$ 17,529 |
| Technology | 3-9 years | 48,342 | (35,628) | 12,714 |
| Other intangibles | 3 years | 5,361 | (5,173) | 188 |
| Total | | \$ 103,222 | \$ (72,791) | \$ 30,431 |

| (in thousands) | Range of Useful Lives | Cost | Accumulated Amortization | Net Book Value |
|--------------------------------|-----------------------|-------------------|--------------------------|------------------|
| As of December 31, 2015 | | | | |
| Customer related intangibles | 4-9 years | \$ 49,546 | \$ (30,465) | \$ 19,081 |
| Technology | 3-9 years | 48,342 | (34,282) | 14,060 |
| Other intangibles | 3 years | 5,361 | (5,084) | 277 |
| Total | | \$ 103,249 | \$ (69,831) | \$ 33,418 |

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

| (in thousands) | Three Months Ended March 31, | |
|-----------------------------------|------------------------------|-----------------|
| | 2016 | 2015 |
| Cost of revenue | \$ 1,346 | \$ 1,343 |
| Selling and marketing | 1,530 | 1,531 |
| General and administrative | 89 | 264 |
| Total amortization expense | \$ 2,965 | \$ 3,138 |

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

| (in thousands) as of March 31, 2016 | Future estimated amortization expense |
|--|--|
| Remainder of 2016 | \$ 8,562 |
| 2017 | 9,812 |
| 2018 | 8,812 |
| 2019 | 3,020 |
| 2020 and thereafter | 225 |
| | \$ 30,431 |

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| (in thousands) | March 31, 2016 | December 31, 2015 |
|---|-------------------|----------------------|
| Partner commissions | \$ 3,211 | \$ 3,319 |
| Other taxes | 9,803 | 10,070 |
| Employee reimbursable expenses | 2,626 | 1,426 |
| Dividends payable | 2,295 | 2,297 |
| Professional services contractor fees | 4,087 | 4,580 |
| Self-insurance health and dental claims | 2,265 | 2,129 |
| Professional fees | 4,202 | 2,937 |
| Short-term deferred rent | 1,617 | 1,600 |
| Income taxes payable | 2,826 | 5,464 |
| Acquisition-related expenses and merger consideration | 1,072 | 834 |
| Restructuring | 282 | 394 |
| Marketing and sales program expenses | 2,530 | 1,397 |
| Cloud hosting expenses | 1,425 | 1,370 |
| Foreign currency forward contracts | 447 | 1,052 |
| Fixed assets in progress | 4,314 | 1,632 |
| Other | 3,060 | 2,267 |
| | \$ 46,062 | \$ 42,768 |

9. DEFERRED REVENUE

| (in thousands) | March 31, 2016 | December 31, 2015 |
|--------------------------|-------------------|----------------------|
| Software license | \$ 35,457 | \$ 40,886 |
| Maintenance | 102,780 | 95,262 |
| Cloud | 10,940 | 8,948 |
| Services | 9,004 | 10,777 |
| Current deferred revenue | 158,181 | 155,873 |
| Software license | 9,898 | 12,389 |

| | | |
|----------------------------|------------|------------|
| Maintenance and services | 2,065 | 2,227 |
| Cloud | 1,495 | 1,189 |
| Long-term deferred revenue | 13,458 | 15,805 |
| | \$ 171,639 | \$ 171,678 |

10. STOCK-BASED COMPENSATION

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

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| (in thousands) | Three Months Ended March 31, | |
|---|---------------------------------|------------|
| | 2016 | 2015 |
| Cost of revenues | \$ 2,680 | \$ 1,953 |
| Operating expenses | 6,255 | 4,316 |
| Total stock-based compensation before tax | \$ 8,935 | \$ 6,269 |
| Income tax benefit | \$ (2,605) | \$ (1,783) |

During the first three months of 2016, the Company issued approximately 415,000 shares of common stock to its employees under the Company's share-based compensation plans.

During the first three months of 2016, the Company granted approximately 1,336,000 restricted stock units (RSUs) and 1,808,000 non-qualified stock options to its employees with total fair values of approximately \$32.5 million and \$15.4 million, respectively. This includes approximately 220,000 RSUs which were granted in connection with the election by employees to receive 50% of their 2016 target incentive compensation under the Company's Corporate Incentive Compensation Plan in the form of RSUs instead of cash. Stock-based compensation of approximately \$4.7 million associated with this RSU grant will be recognized over a one-year period beginning on the grant date.

The Company recognizes stock based compensation on the accelerated recognition method, treating each vesting tranche as if it were an individual grant. As of March 31, 2016, the Company had approximately \$59.3 million of unrecognized stock-based compensation expense, net of estimated forfeitures, related to all unvested RSUs and unvested stock options that is expected to be recognized over a weighted-average period of 2.3 years.

11. EARNINGS PER SHARE

Basic earnings per share is computed using the weighted-average number of common shares outstanding during the applicable period. Diluted earnings per share is computed using the weighted-average number of common shares outstanding during the applicable period, plus the dilutive effect of outstanding options 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 and RSUs were excluded from the computation of diluted earnings per share because they were anti-dilutive in the periods presented, but could be dilutive in the future.

| (in thousands, except per share amounts) | Three Months Ended March 31, | |
|--|---------------------------------|----------|
| | 2016 | 2015 |
| Basic | | |
| Net income | \$ 9,005 | \$ 5,935 |
| Weighted-average common shares outstanding | 76,375 | 76,401 |

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| | | | | |
|--|----|--------|----|--------|
| Earnings per share, basic | \$ | 0.12 | \$ | 0.08 |
| <i>Diluted</i> | | | | |
| Net income | \$ | 9,005 | \$ | 5,935 |
| Weighted-average common shares outstanding, basic | | 76,375 | | 76,401 |
| Weighted-average effect of dilutive securities: | | | | |
| Stock options | | 1,444 | | 1,510 |
| RSUs | | 1,059 | | 681 |
| Effect of assumed exercise of stock options and RSUs | | 2,503 | | 2,191 |
| Weighted-average common shares outstanding, assuming dilution | | 78,878 | | 78,592 |
| Earnings per share, diluted | \$ | 0.11 | \$ | 0.08 |
| Outstanding options and RSUs excluded as impact would be anti-dilutive | | 492 | | 60 |

Table of Contents**12. 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 strategic software applications and Pega 7 platform, and provides consulting services, maintenance, and training related to its offerings. 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, who is the chief executive officer, reviews financial information on a consolidated basis. Therefore, the Company determined it has one reportable segment Digital Enterprise Business Solutions, and one reporting unit.

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

| (Dollars in thousands) | Three Months Ended March 31, | | | |
|---------------------------|---------------------------------|------|------------|------|
| | 2016 | | 2015 | |
| U.S. | \$ 93,228 | 52% | \$ 90,164 | 59% |
| Other Americas | 25,559 | 14% | 12,296 | 8% |
| United Kingdom | 24,355 | 14% | 20,227 | 13% |
| Other EMEA ⁽¹⁾ | 21,267 | 12% | 18,869 | 12% |
| Asia Pacific | 14,449 | 8% | 12,362 | 8% |
| | \$ 178,858 | 100% | \$ 153,918 | 100% |

⁽¹⁾ Includes Europe, other than the United Kingdom, the Middle East and Africa (Other EMEA). Clients accounting for 10% or more of the Company s total revenue were as follows:

| (Dollars in thousands) | Three Months Ended March 31, | |
|------------------------|---------------------------------|------------|
| | 2016 | 2015 |
| Total revenue | \$ 178,858 | \$ 153,918 |
| Client A | 10% | % |

Clients accounting for 10% or more of the Company s total outstanding trade receivables, net of allowance, were as follows:

| (Dollars in thousands) | As of March 31, 2016 | As of December 31, 2015 |
|--------------------------------------|-------------------------------------|--|
| Trade receivables, net of allowances | \$ 202,399 | \$ 211,846 |
| Client B | | % |
| | | 10% |

13. SUBSEQUENT EVENT

On April 11, 2016, the Company acquired OpenSpan, Inc. (OpenSpan), a privately held software provider of robotic process automation and workforce analytics software, through the merger of a wholly-owned subsidiary of the Company with and into OpenSpan, with OpenSpan surviving the merger as a wholly-owned subsidiary of the Company (the Merger). The Company paid a purchase price of \$52.3 million in cash, subject to a customary post-closing adjustment based on the final determination of closing net working capital. \$7.6 million of the purchase price was deposited in escrow for an 18-month period after the closing of the Merger as security for the indemnification obligations of the former securityholders of OpenSpan and as security for the post-closing adjustment

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obligations. In addition, \$1.5 million of the purchase price is subject to a holdback and contingent on the achievement of certain revenue targets by June 30, 2016. The Company is in the process of preparing an allocation of the purchase price to the fair value of assets acquired and liabilities assumed, and currently expects that a substantial portion of the OpenSpan purchase price will ultimately be allocated to intangible assets, and that such assets are likely to include acquired core technology, customer related assets, and goodwill. During the first quarter of 2016, the Company incurred \$0.9 million of direct and incremental expenses that were primarily legal and advisory fees and due diligence costs to affect the acquisition.

The Company believes the acquisition will enable its and OpenSpan's clients to experience the benefits of a fully-unified Customer Relationship Management (CRM) solution and to optimize their complex customer service representative processes by providing advanced robotic automation and workforce analytics capabilities to complement and enhance the Company's CRM application suite and Business Process Management platform.

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**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations
Forward-Looking Statements**

This Quarterly Report on Form 10-Q contains or incorporates forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements include, but are not limited to, statements about our future financial performance and business plans, the adequacy of our liquidity and capital resources, the continued payment of quarterly dividends by the Company, the timing of recognizing revenue under existing license and cloud arrangements, and the allocation of the purchase price related to our acquisition of OpenSpan, Inc. (OpenSpan). These forward-looking statements are based on current expectations, estimates, forecasts, and projections about the industry and markets in which we operate, and management's beliefs and assumptions. In addition, other written or oral statements that constitute forward-looking statements may be made by us or on our behalf. Words such as expect, anticipate, intend, plan, believe, could, estimate, may, target, strategy, is intended to, project, of such words and similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties, and assumptions that are difficult to predict. Important factors that could cause actual future activities and results to differ include, among others, variation in demand for our products and services and the difficulty in predicting the completion of product acceptance and other factors affecting the timing of license revenue recognition; the ongoing consolidation in the financial services, insurance, healthcare, and communications markets; reliance on third party relationships; the potential loss of vendor specific objective evidence (VSOE) for our consulting services; the inherent risks associated with international operations and the continued weakness in international economies; foreign currency exchange rates; the financial impact of the Company's past acquisitions, including the OpenSpan acquisition, and any future acquisitions; and management of the Company's growth. These risks are described more completely in Item 1A of Part I of our Annual Report on Form 10-K for the year ended December 31, 2015. We do not intend to update or revise any forward-looking statements publicly, whether as a result of new information, future events, or otherwise.

Business overview

We develop, market, license, and support strategic software applications for marketing, sales and onboarding, customer service, and operations. In addition, we license our Pega 7 platform for clients that wish to build and extend their own applications. Pega 7 assists our clients in building, deploying, and evolving enterprise applications, creating an environment in which business and IT can collaborate to manage back office operations, front office sales, marketing, and/or customer service needs. We also provide consulting services, maintenance, and training for our software and our applications. Our applications and Pega 7 can be deployed in the cloud or on-premises.

Pega 7 and our related applications are used by our clients in the financial services, healthcare, insurance, communications and media, public sector, manufacturing, life sciences, and other markets. We sell our software directly and also through a network of business and technology alliances. Our partners include major systems integrators, management consulting firms, technology providers, and application developers.

Our clients include Global 3000 companies and government agencies that seek to manage complex enterprise systems and customer service issues more nimbly and cost-effectively. Our strategy is to sell a client a series of licenses, each focused on a specific purpose or area of operations.

In the first quarter of 2016 and 2015, sales to clients based outside of the United States of America (U.S.) represented approximately 48% and 41% of our total revenue, respectively.

Our license revenue is primarily derived from sales of our applications in the areas of marketing, sales and onboarding, customer service, and operations, as well as our Pega 7 platform. Our consulting services revenue is

primarily related to new license implementations. Our consulting services revenue may be lower in future periods as our clients become enabled to perform their own implementation and our partners lead more projects. We offer training for our staff, clients, and partners at our regional training facilities and at third-party facilities, including client sites. Our online training through PegaACADEMY provides an alternative way to learn our software in a virtual environment. We believe that this online training will continue to expand the number of trained experts at a faster pace.

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We continue to invest heavily in research and development to improve our software. We also regularly evaluate acquisitions or investment opportunities in complementary businesses, services and technologies, and intellectual property rights in an effort to expand and enhance our product offerings. On April 11, 2016, we acquired OpenSpan, a privately held software provider of robotic process automation and workforce analytics software for \$52.3 million in cash, subject to a customary post-closing adjustment based on the final determination of closing net working capital. We believe the acquisition will enable our and OpenSpan's clients to experience the benefits of a fully-unified CRM solution and to optimize their complex customer service representatives processes by providing advanced robotic automation and workforce analytics capabilities to complement and enhance our CRM application suite and Business Process Management platform.

| (Dollars in thousands, except per share amounts) | Three Months Ended | | Increase (Decrease) | |
|--|--------------------|------------|---------------------|-------|
| | 2016 | 2015 | | |
| Total revenue | \$ 178,858 | \$ 153,918 | \$ 24,940 | 16% |
| License revenue | \$ 68,345 | \$ 57,975 | \$ 10,370 | 18% |
| Diluted earnings per share | \$ 0.11 | \$ 0.08 | \$ 0.03 | 38% |
| Cash flow provided by operating activities | 8,642 | 27,521 | (18,879) | (69)% |

In addition to the key financial metrics listed above, management also focuses on total license and cloud backlog. We compute license and cloud backlog by adding deferred license and cloud revenue as recorded on the balance sheet and license and cloud commitments, which are not billed and not recorded on our balance sheet. License and cloud backlog may vary in any given period depending on the amount and timing of when arrangements are executed, as well as the mix between perpetual, term, and cloud license arrangements, which is dependent on our clients' needs.

| (Dollars in thousands) | As of March 31, | | % Change |
|---|-----------------|------------|----------|
| | 2016 | 2015 | |
| Total billed deferred license and cloud revenue | \$ 57,790 | \$ 79,639 | (27)% |
| Total off-balance sheet license and cloud commitments | 331,870 | 294,412 | 13% |
| Total license and cloud backlog | \$ 389,660 | \$ 374,051 | 4% |

Critical accounting policies

Management's Discussion and Analysis of Financial Condition and Results of Operations is based upon our unaudited condensed 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 interim financial reporting. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues, and expenses, and the related disclosure of contingent assets and liabilities. We base our estimates and judgments on historical experience, knowledge of current conditions, and beliefs of what could occur in the future given available information.

There have been no changes in our critical accounting policies as disclosed in our Annual Report on Form 10-K for the year ended December 31, 2015. For more information regarding our critical accounting policies, we encourage you to read the discussion contained in Item 7 under the heading Critical Accounting Estimates and Significant Judgments and Note 2 Significant Accounting Policies included in the notes to the Consolidated Financial Statements contained in our Annual Report on Form 10-K for the year ended December 31, 2015.

Table of Contents**Results of Operations**

| (Dollars in thousands) | Three Months Ended | | Increase | |
|--|--------------------|------------|-----------|-----|
| | March 31, | | | |
| | 2016 | 2015 | | |
| Total revenue | \$ 178,858 | \$ 153,918 | \$ 24,940 | 16% |
| Gross profit | \$ 122,348 | \$ 103,859 | \$ 18,489 | 18% |
| Total operating expenses | \$ 108,223 | \$ 91,950 | \$ 16,273 | 18% |
| Income from operations | \$ 14,125 | \$ 11,909 | \$ 2,216 | 19% |
| Income before provision for income taxes | \$ 13,493 | \$ 9,260 | \$ 4,233 | 46% |

Revenue**Software license revenue**

| (Dollars in thousands) | Three Months Ended | | | | (Decrease) Increase | |
|------------------------|--------------------|------|-----------|------|---------------------|-------|
| | March 31, | | | | | |
| | 2016 | | 2015 | | | |
| Perpetual licenses | \$ 14,013 | 21% | \$ 27,926 | 48% | \$ (13,913) | (50)% |
| Term licenses | 54,332 | 79% | 30,049 | 52% | 24,283 | 81% |
| Total license revenue | \$ 68,345 | 100% | \$ 57,975 | 100% | \$ 10,370 | 18% |

The aggregate value of new license arrangements executed during the first quarter of 2016 significantly decreased compared to the same period of 2015, primarily due to a lower number and lower average value of arrangements executed in the first quarter of 2016. The lower average value of new license arrangements executed during the first quarter of 2016 was primarily due to a perpetual license arrangement greater than \$10 million executed in the first quarter of 2015. The aggregate value of new license arrangements executed fluctuates quarter to quarter. During the first three months of 2016 and 2015, approximately 75% and 46%, 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. Additionally, 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 decrease in perpetual license revenue was primarily due to the lower average value of arrangements executed during the first quarter of 2016 and the completion of the ratable revenue recognition for a large arrangement in the first half of 2015. The aggregate value of payments due under noncancellable perpetual licenses was \$43.9 million as of March 31, 2016 compared to \$33.1 million as of March 31, 2015. We expect to recognize \$25.7 million of the

\$43.9 million as revenue during the remainder of 2016.

The significant increase in term license revenue was primarily due to a license arrangement greater than \$10 million for which the full license term was prepaid and revenue was recognized during the first quarter of 2016. The aggregate value of payments due under noncancellable term licenses and our cloud arrangements grew to \$287.9 million as of March 31, 2016 compared to \$261.4 million as of March 31, 2015. We expect to recognize \$69.1 million of the \$287.9 million as revenue during the remainder 2016 in addition to new term license and Pega Cloud arrangements we may complete or prepayments we may receive from existing term license agreements. See the table of future cash receipts in Liquidity and Capital Resources - Cash Provided by Operating Activities.

Table of Contents***Maintenance revenue***

| (Dollars in thousands) | Three Months Ended | | Increase | |
|-------------------------------|---------------------------|-------------|-----------------|----|
| | March 31, | | | |
| | 2016 | 2015 | | |
| Maintenance | \$ 52,975 | \$ 48,752 | \$ 4,223 | 9% |

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

Services revenue

| (Dollars in thousands) | Three Months Ended | | | | Increase | |
|-------------------------------|---------------------------|------|-------------|------|-----------------|-----|
| | March 31, | | | | | |
| | 2016 | | 2015 | | | |
| Consulting services | \$ 47,176 | 82% | \$ 39,511 | 84% | \$ 7,665 | 19% |
| Cloud | 8,498 | 15% | 6,177 | 13% | 2,321 | 38% |
| Training | 1,864 | 3% | 1,503 | 3% | 361 | 24% |
| Total services | \$ 57,538 | 100% | \$ 47,191 | 100% | \$ 10,347 | 22% |

Consulting services revenue represents revenue primarily from new license implementations. Our consulting services revenue may fluctuate in future periods depending on the mix of new implementation projects we perform as compared to those performed by our enabled clients or led by our partners. The increase in consulting services revenue was due to unusually low demand in the first quarter of 2015 in Europe. The increase was also due to revenue recognized on a large project in the first quarter of 2016, which had been delayed from the fourth quarter of 2015.

Cloud revenue represents revenue from our Pega Cloud offerings. The increase in cloud revenue was primarily due to growth of our cloud client base.

Gross profit

| (Dollars in thousands) | Three Months Ended | | Increase | |
|-------------------------------|---------------------------|-------------|-----------------|------|
| | March 31, | | | |
| | 2016 | 2015 | | |
| Software license | \$ 67,324 | \$ 56,899 | \$ 10,425 | 18% |
| Maintenance | 47,060 | 43,572 | 3,488 | 8% |
| Services | 7,964 | 3,388 | 4,576 | 135% |
| Total gross profit | \$ 122,348 | \$ 103,859 | \$ 18,489 | 18% |

| | | |
|---------------------------------|-----|-----|
| Total gross profit % | 68% | 67% |
| Software license gross profit % | 99% | 98% |
| Maintenance gross profit % | 89% | 89% |
| Services gross profit % | 14% | 7% |

The increase in total gross profit was primarily due to the increase in software license revenue.

The significant increase in services gross profit percent was primarily due to the recognition of revenue in the first quarter of 2016 related to several large projects which had been delayed from prior periods, for which the associated costs had already been recognized, and also due to expense overruns primarily related to one project in the first quarter of 2015.

Table of Contents***Operating expenses******Amortization of intangibles***

| (Dollars in thousands) | Three Months Ended | | Increase (Decrease) | |
|-------------------------------|---------------------------|------------------|----------------------------|-------|
| | March 31, | March 31, | | |
| | 2016 | 2015 | | |
| Cost of revenue | \$ 1,346 | \$ 1,343 | \$ 3 | 0% |
| Selling and marketing | 1,530 | 1,531 | (1) | 0% |
| General and administrative | 89 | 264 | (175) | (66)% |
| | \$ 2,965 | \$ 3,138 | \$ (173) | (6)% |

The decrease was primarily the result of certain non-compete agreements becoming fully amortized in 2015.

Selling and marketing

| (Dollars in thousands) | Three Months Ended | | Increase | |
|--|---------------------------|------------------|-----------------|-----|
| | March 31, | March 31, | | |
| | 2016 | 2015 | | |
| Selling and marketing | \$ 61,078 | \$ 55,735 | \$ 5,343 | 10% |
| As a percent of total revenue | 34% | 36% | | |
| Selling and marketing headcount at March 31, | 775 | 657 | 118 | 18% |

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 was primarily due to a \$6.8 million increase in compensation, benefits and employee travel expenses associated with higher headcount and a \$0.4 million increase in partner commissions, partially offset by a \$2.4 million decrease in sales commissions associated with the lower value of new license arrangements executed during the first quarter of 2016 compared to the first quarter of 2015.

The increase in headcount reflects our efforts to increase our sales capacity to target new accounts in existing industries as well as to expand coverage in new industries and geographies, and to increase the number of our sales opportunities.

Research and development

| | Three Months Ended | Increase |
|--|---------------------------|-----------------|
| | March 31, | |
| | | |

| (Dollars in thousands) | 2016 | 2015 | | |
|---|-------------|-------------|----------|-----|
| Research and development | \$ 34,920 | \$ 29,844 | \$ 5,076 | 17% |
| As a percent of total revenue | 20% | 19% | | |
| Research and development headcount at March 31, | 1,277 | 1,095 | 182 | 17% |

Research and development expenses include compensation, benefits, contracted services, and other headcount-related expenses associated with the creation and development of our products as well as enhancements and design changes to existing products and integration of acquired technologies.

The increase was primarily due to a \$4 million increase in compensation and benefit expenses associated with higher headcount, a \$0.5 million increase in computer and computer-related costs, and a \$0.2 million increase in outsourced hosting services.

The increase in headcount primarily reflects the growth in our India research facility which usually lowers our average compensation expense per employee.

Table of Contents**General and administrative**

| (Dollars in thousands) | Three Months Ended | | Increase | |
|---|--------------------|----------|----------|-----|
| | March 31, | | | |
| | 2016 | 2015 | | |
| General and administrative | \$ 11,048 | \$ 6,345 | \$ 4,703 | 74% |
| As a percent of total revenue | 6% | 4% | | |
| General and administrative headcount at March 31, | 356 | 299 | 57 | 19% |

General and administrative expenses include compensation, benefits, and other headcount-related expenses associated with finance, legal, corporate governance, and other administrative headcount. They also include 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 our other functional departments.

The increase was primarily due to the fact that the first quarter of 2016 did not include the following benefits, which reduced our general and administrative expenses in the first quarter of 2015: a \$1.8 million benefit from the settlement of our indemnification claims against the former Antenna, Inc. shareholders and a \$1.6 million benefit from the settlement of certain indirect tax liabilities. The increase was also due to a \$1 million increase in legal expenses in first quarter of 2016 compared to first quarter of 2015.

Stock-based compensation

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

| (Dollars in thousands) | Three Months Ended | | Increase | |
|---|--------------------|------------|----------|-----|
| | March 31, | | | |
| | 2016 | 2015 | | |
| Cost of revenues | \$ 2,680 | \$ 1,953 | \$ 727 | 37% |
| Operating expenses | 6,255 | 4,316 | 1,939 | 45% |
| Total stock-based compensation before tax | \$ 8,935 | \$ 6,269 | \$ 2,666 | 43% |
| Income tax benefit | \$ (2,605) | \$ (1,783) | | |

The increase was primarily due to continued vesting of the 2014 annual periodic equity award granted in March 2015, which was significantly higher than the 2013 award granted in March 2014, in addition to the inclusion of the 2015 annual periodic equity award granted in March 2016. These awards generally have a five-year vesting schedule.

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

| (Dollars in thousands) | Three Months Ended | | | |
|--|--------------------|------------|----------|--------|
| | March 31, | | | |
| | 2016 | 2015 | | |
| Foreign currency transaction gain (loss) | \$ 1,376 | \$ (2,962) | \$ 4,338 | (146)% |
| Interest income, net | 290 | 313 | (23) | (7)% |
| Other expense, net | (2,298) | | (2,298) | n/m |
| Non-operating loss | \$ (632) | \$ (2,649) | \$ 2,017 | (76)% |

n/m - not meaningful

We use foreign currency forward contracts (forward contracts) to hedge our exposure to fluctuations in foreign currency exchange rates associated with our foreign currency denominated cash, accounts receivable, and intercompany receivables and payables held by our U.S. operating company in currencies other than the U.S. dollar and by our United Kingdom subsidiary in currencies other than the British pound.

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These forward contracts are not designated as hedging instruments. 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, net.

See Note 4 *Derivative Instruments* in the notes to the accompanying unaudited condensed consolidated financial statements for discussion of our use of forward contracts.

Provision for income taxes

We account for income taxes at each interim period using our estimated annual effective tax rate and adjust for discrete tax items recorded in the same period. The provision for income taxes represents current and future amounts owed for federal, state, and foreign taxes. During the first quarter of 2016 and 2015, we recorded tax provisions of \$4.5 million and \$3.3 million, respectively, which resulted in an effective tax rate of 33.3% and 35.9%, respectively. The decrease in our effective tax rate during the first quarter of 2016 compared to the same period in 2015 was primarily due to an increase in our anticipated deduction associated with U.S.-based software development activities and the benefit of the research and experimentation credit (R&E credit), which was not available in the first quarter of 2015. In December 2015, the R&E credit was permanently extended retroactively to January 1, 2015.

Liquidity and capital resources

| (in thousands) | Three Months Ended | |
|---|--------------------|-------------------|
| | March 31, | |
| | 2016 | 2015 |
| Cash provided by (used in): | | |
| Operating activities | \$ 8,642 | \$ 27,521 |
| Investing activities | 9,370 | (5,381) |
| Financing activities | (18,424) | (6,337) |
| Effect of exchange rate on cash | (434) | (2,908) |
| Net (decrease) increase in cash and cash equivalents | \$ (846) | \$ 12,895 |
| | | |
| | As of | As of |
| | March 31, 2016 | December 31, 2015 |
| Total cash, cash equivalents, and marketable securities | \$ 193,913 | \$ 219,078 |

The slight decrease in cash and cash equivalents during the first three months of 2016 was primarily due to cash used in financing activities, primarily for share repurchases under our current common stock repurchase program. We believe that our current cash, cash equivalents, marketable securities, and cash flow from operations will be sufficient to fund our operations, our dividend payments, and our share repurchase program for at least the next 12 months.

We evaluate acquisition opportunities from time to time, which if pursued, could require use of our funds. During the first quarter of 2016 and 2015, we paid \$0.3 million and \$0.5 million, respectively, representing additional cash consideration to the selling shareholders of one of the three companies acquired in 2014 based on the achievement of certain performance milestones. We may be required to pay an additional \$0.5 million in cash to the same selling shareholders based on the achievement of additional performance milestones through the end of 2016. On April 11, 2016, we acquired OpenSpan for \$52.3 million in cash, subject to a customary post-closing adjustment based on the final determination of closing net working capital. During the first quarter of 2016, we incurred direct and incremental expenses associated with the transaction of \$0.9 million and expect to incur an additional estimated \$1.1 million of such expenses that are primarily professional fees to affect the acquisition.

As of March 31, 2016, approximately \$33.5 million of our cash and cash equivalents was held in our foreign subsidiaries. If it becomes 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

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to the complexity of the foreign tax credit calculations. There can be no assurance that changes in our plans or other events affecting our operations will not result in materially accelerated or unexpected expenditures.

Cash provided by operating activities

The primary drivers during the first three months of 2016 were a \$23.4 million decrease in accounts payable and accrued expenses primarily due to the payout of annual bonuses and commissions earned in 2015, partially offset by a \$6.7 million decrease in trade accounts receivable due to the timing of collections.

The primary drivers during the first three months of 2015 were net income of \$5.9 million and a \$33.9 million increase in deferred revenue due to the timing of our annual billings, partially offset by a \$21.6 million decrease in accounts payable and accrued expenses primarily due to the timing of payments for compensation-related accruals.

Future Cash Receipts from License and Cloud Arrangements

Total contractual future cash receipts due from our existing license and cloud arrangements was approximately \$331.9 million as of March 31, 2016, compared to \$294.4 million as of March 31, 2015. The future cash receipts due are summarized as follows:

| (in thousands) as of March 31, 2016 | Contractual payments for term licenses and cloud arrangements not recorded on the balance sheet ⁽¹⁾ | Other contractual license payments not recorded on the balance sheet ⁽²⁾ | Total |
|-------------------------------------|---|--|-------------------|
| Remainder of 2016 | \$ 69,069 | \$ 25,698 | \$ 94,767 |
| 2017 | 79,974 | 13,040 | 93,014 |
| 2018 | 65,495 | 3,680 | 69,175 |
| 2019 | 44,260 | 1,526 | 45,786 |
| 2020 and thereafter | 29,128 | | 29,128 |
| Total | \$ 287,926 | \$ 43,944 | \$ 331,870 |

(1) These amounts include contractual future cash receipts related to our on-premises term licenses and hosted Pega Cloud service offerings. The timing of future revenue recognition may not coincide with the timing of the cash receipts.

(2) These amounts include contractual future cash receipts related to perpetual licenses with extended payment terms and/or additional rights of use.

Cash provided by / used in investing activities

During the first three months of 2016, cash provided by investing activities was primarily proceeds received from sales, maturities and called marketable debt securities of \$22.1 million, partially offset by purchases of marketable debt securities of \$8.2 million. We also invested \$4.3 million primarily for internally developed software and leasehold improvements for the build out of additional office space at our corporate headquarters in Cambridge, Massachusetts.

During the first three months of 2015, cash used in investing activities was primarily for purchases of marketable debt securities of \$18.1 million, partially offset by the proceeds received from the maturities of marketable debt securities of \$16.5 million. We also invested \$3.3 million primarily in leasehold improvements for the build-out of our new office in Hyderabad, India.

Cash used in financing activities

Cash used in financing activities during the first three months of 2016 and 2015 was primarily for repurchases of our common stock, share repurchases for tax withholdings for the net settlement of our equity awards, and the payment of our quarterly dividend.

Since 2004, our Board of Directors has approved annual stock repurchase programs that have authorized the repurchase in the aggregate of up to \$169 million of our common stock. Purchases under these programs have been made on the open market.

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The following table is a summary of our repurchase activity under all of our repurchase programs during the first three months of 2016 and 2015:

| (Dollars in thousands) | Three Months Ended March 31, | | | |
|---|---------------------------------|-----------|---------|-----------|
| | 2016 | 2015 | 2016 | 2015 |
| | Shares | Amount | Shares | Amount |
| Prior year authorization as of January 1, | | \$ 40,534 | | \$ 13,284 |
| Repurchases paid | 501,104 | (11,667) | 106,290 | (2,132) |
| Repurchases unsettled | 17,160 | (429) | 400 | (9) |
| Authorization remaining as of March 31, | | \$ 28,438 | | \$ 11,143 |

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

During the first three months of 2016 and 2015, option and RSU holders net settled a total of 713,000 shares and 501,000 shares, respectively, of which only 405,000 shares and 297,000 shares, respectively, were issued to the option and RSU holders. 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 the first three months of 2016 and 2015, instead of receiving cash from the equity holders, we withheld shares with a value of \$5.7 million and \$2.6 million, respectively, for withholding taxes, and \$2.1 million and \$1.5 million, respectively, for the exercise price of options.

Dividends

We declared a cash dividend of \$0.03 per share and paid cash dividends of \$2.3 million in each of the first three months of 2016 and 2015. 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.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

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

We use foreign currency forward contracts to hedge our exposures to fluctuations in non-functional currency exchange rates. See Note 4 *Derivative Instruments* in the notes to the accompanying unaudited condensed consolidated financial statements for further discussion.

There were no significant changes to our quantitative and qualitative disclosures about market risk during the first three months of 2016. Please refer to Part II, Item 7A. *Quantitative and Qualitative Disclosures about Market Risk* included in our Annual Report on Form 10-K for the year ended December 31, 2015 for a more complete discussion of our market risk exposure.

Item 4. Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures.

Our management, with the participation of our Chief Executive Officer, or CEO, and Chief Accounting Officer, or CAO, 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 March 31, 2016. 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 CAO concluded that our disclosure controls and procedures were effective as of March 31, 2016.

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(b) Changes in Internal Control over Financial Reporting.

There have been no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act) during the quarter ended March 31, 2016 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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

We encourage you to carefully consider the risk factors identified in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2015. These risk factors could materially affect our business, financial condition, and future results and could cause our actual business and financial results to differ materially from those contained in forward-looking statements made in this Quarterly Report on Form 10-Q or elsewhere by management from time to time. There have been no material changes during the first three months of 2016 to the risk factors disclosed in our Annual Report on Form 10-K for the year ended December 31, 2015.

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

The following table sets forth information regarding our repurchases of our common stock during the first quarter of 2016:

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number | Approximate Dollar |
|----------------------|--|------------------------------------|--|--|
| | | | of Shares Purchased as Part of Publicly Announced Share Repurchase Programs ⁽¹⁾ | Value of Shares That May Yet Be Purchased Under Publicly Announced Share Repurchase Programs ⁽¹⁾ (in thousands) |
| 1/1/2016 - 1/31/2016 | 131,017 | \$ 24.35 | 131,017 | \$ 37,344 |
| 2/1/2016 - 2/29/2016 | 254,850 | \$ 21.98 | 254,850 | \$ 31,741 |
| 3/1/2016 - 3/31/2016 | 132,397 | \$ 24.95 | 132,397 | \$ 28,438 |
| Total | 518,264 | \$ 23.34 | | |

- ⁽¹⁾ Since 2004, our Board of Directors has approved stock repurchase programs that have authorized the repurchase, in the aggregate, of up to \$169 million of our common stock. On June 4, 2015, we announced that our Board of Directors extended the expiration date of the current stock repurchase program to June 30, 2016 and authorized the Company to repurchase an additional \$50 million of our stock between June 4, 2015 and June 30, 2016 (the Current Program). 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 (the Exchange Act), and Rule 10b-18 under 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.

Item 6. Exhibits

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

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SIGNATURE

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

Pegasystems Inc.

Date: May 5, 2016

By: /s/ EFSTATHIOS KOUNINIS
Efstathios Kouninis

**Vice President of Finance and Chief Accounting
Officer**

(Principal Accounting Officer)

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PEGASYSTEMS INC.

Exhibit Index

Exhibit

| No. | Description |
|------------|--|
| 31.1 | Certification pursuant to Exchange Act Rules 13a-14 and 15d-14 of the Chief Executive Officer. |
| 31.2 | Certification pursuant to Exchange Act Rules 13a-14 and 15d-14 of the Chief Accounting Officer. |
| 32 | Certification pursuant to 18 U.S.C. Section 1350 of the Chief Executive Officer and the Chief Accounting Officer. |
| 101 | The following materials from Pegasystems Inc. s Quarterly Report on Form 10-Q for the quarter ended March 31, 2016 formatted in XBRL (Extensible Business Reporting Language): (i) the Unaudited Condensed Consolidated Balance Sheets, (ii) the Unaudited Condensed Consolidated Statements of Operations, (iii) the Unaudited Condensed Consolidated Statements of Comprehensive Income, (iv) the Unaudited Condensed Consolidated Statements of Cash Flows, and (v) the Notes to Unaudited Condensed Consolidated Financial Statements. |