PEGASYSTEMS INC
Form 10-Q
November 08, 2005
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x **Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the quarterly period ended September 30, 2005

or

¨ **Transition Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the transition period from _____ to _____

Commission File Number: 1-11859

PEGASYSTEMS INC.

(Exact name of Registrant as specified in its charter)

Massachusetts	**04-2787865**
(State or other jurisdiction of incorporation or organization)	***(IRS Employer Identification No.)***

101 Main Street

Cambridge, MA **02142-1590**
(Address of principal executive offices) ***(Zip Code)***

(617) 374-9600

(Registrant s telephone number including area code)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No ¨

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes x No ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ¨ No x

There were 35,491,155 shares of the Registrant s common stock, $.01 par value per share, outstanding on November 4, 2005.

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PEGASYSTEMS INC.

Condensed Consolidated Balance Sheets

(in thousands, except share-related data)

	September 30, 2005	December 31, 2004
ASSETS		
Current assets:		
Cash and cash equivalents	**$ 18,464**	$ 20,905
Short-term investments	**90,165**	76,455
Total cash and short-term investments	**108,629**	97,360
Trade accounts receivable, net of allowance for doubtful accounts of $365 in 2005 and 2004	**25,029**	15,528
Short-term license installments	**26,758**	31,358
Prepaid expenses and other current assets	**1,881**	1,236
Total current assets	**162,297**	145,482
Long-term license installments, net of unearned interest income	**31,851**	44,344
Equipment and improvements, net of accumulated depreciation and amortization	**2,118**	1,586
Acquired technology, net of accumulated amortization	**117**	379
Other assets	**112**	118
Goodwill	**2,346**	2,346
Total assets	**$ 198,841**	$ 194,255
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accrued payroll related expenses	**$ 7,072**	$ 7,888
Accounts payable and accrued expenses	**9,781**	9,502
Deferred revenue	**16,154**	9,114
Current portion of capital lease obligation	**101**	98
Total current liabilities	**33,108**	26,602
Long-term deferred income taxes	**2,190**	1,480
Capital lease obligation, net of current portion	**89**	165
Other long-term liabilities	**1,099**	808
Total liabilities	**36,486**	29,055
Commitments and contingencies		
Stockholders equity:		
Preferred stock, $.01 par value, 1,000,000 shares authorized; no shares issued and outstanding		
Common stock, $.01 par value, 70,000,000 shares authorized; 35,457,085 shares and 36,076,649 shares issued and outstanding in 2005 and 2004, respectively	**355**	361
Additional paid-in capital	**118,220**	122,152
Stock warrant	**249**	249
Retained earnings	**43,088**	41,289
Accumulated other comprehensive income (loss):		
Net unrealized loss on investments available-for-sale	**(616)**	(267)

Foreign currency translation adjustments	**1,059**	1,416
Total stockholders equity	**162,355**	165,200
Total liabilities and stockholders equity	**$ 198,841**	$ 194,255

See notes to condensed consolidated financial statements.

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PEGASYSTEMS INC.

Condensed Consolidated Statements of Income

(in thousands, except per share amounts)

	Three months ended September 30,		Nine months ended September 30,	
	2005	**2004**	**2005**	**2004**
Revenue:				
Software license	**$ 11,637**	$ 6,883	**$ 30,521**	$ 28,223
Services	**15,209**	14,645	**44,343**	42,002
Total revenue	**26,846**	21,528	**74,864**	70,225
Cost of revenue:				
Cost of software license	**87**	88	**262**	262
Cost of services	**9,289**	6,441	**24,881**	19,121
Total cost of revenue	**9,376**	6,529	**25,143**	19,383
Gross profit	**17,470**	14,999	**49,721**	50,842
Operating expenses:				
Research and development	**4,952**	5,078	**14,854**	15,388
Selling and marketing	**7,811**	7,243	**24,664**	22,900
General and administrative	**2,880**	2,999	**9,207**	8,688
Total operating expenses	**15,643**	15,320	**48,725**	46,976
Income (loss) from operations	**1,827**	(321)	**996**	3,866
Installment receivable interest income	**632**	856	**1,763**	2,243
Other interest income, net	**808**	511	**2,177**	1,280
Other income (expense), net	**(128)**	95	**(1,144)**	(284)
Income before provision for income taxes	**3,139**	1,141	**3,792**	7,105
Provision for income taxes	**1,768**	400	**1,993**	2,500
Net income	**$ 1,371**	$ 741	**$ 1,799**	$ 4,605
Earnings per share:				
Basic	**$ 0.04**	$ 0.02	**$ 0.05**	$ 0.13
Diluted	**$ 0.04**	$ 0.02	**$ 0.05**	$ 0.12
Weighted average number of common shares outstanding, basic	**35,675**	35,786	**35,865**	35,610
Weighted average number of common shares outstanding, diluted	**36,362**	36,723	**36,550**	36,941

See notes to condensed consolidated financial statements.

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PEGASYSTEMS INC.

Condensed Consolidated Statements of Cash Flows

(in thousands)

	Nine months ended September 30,	
	2005	**2004**
Cash flows from operating activities:		
Net income	**$ 1,799**	$ 4,605
Adjustment to reconcile net income to cash flows from operating activities:		
Stock option income tax benefits	**91**	721
Deferred income taxes	**1,256**	1,150
Depreciation, amortization and other non-cash items	**1,286**	1,053
Issuance of common stock warrants		38
Loss on disposal of fixed assets	**15**	
Change in operating assets and liabilities:		
Trade accounts receivable and license installments	**7,571**	5,188
Prepaid expenses and other current assets	**(666)**	(714)
Accounts payable and accrued expenses	**(679)**	(948)
Deferred revenue	**7,040**	(4,817)
Other long-term assets and liabilities	**295**	49
Cash flows from operating activities	**18,008**	6,325
Cash flows from investing activities:		
Purchase of investments	**(38,065)**	(151,248)
Maturing and called investments	**9,018**	13,350
Sale of investments	**14,475**	83,053
Purchase of equipment and improvements	**(1,304)**	(782)
Cash flows from investing activities	**(15,876)**	(55,627)
Cash flows from financing activities:		
Payments under capital lease obligations	**(73)**	(16)
Proceeds from sale of stock under Employee Stock Purchase Plan	**240**	329
Exercise of stock options	**521**	2,457
Repurchase of common stock	**(4,791)**	
Cash flows from financing activities	**(4,103)**	2,770
Effect of exchange rate on cash and cash equivalents	**(470)**	(66)
Net decrease in cash and cash equivalents	**(2,441)**	(46,598)
Cash and cash equivalents, beginning of period	**20,905**	67,989
Cash and cash equivalents, end of period	**$ 18,464**	$ 21,391

See notes to condensed consolidated financial statements.

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PEGASYSTEMS INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. BASIS OF PRESENTATION

The unaudited condensed consolidated financial statements of Pegasystems Inc. (we or the Company) have been prepared in accordance with accounting principles generally accepted in the United States of America and with the instructions to Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and nine month periods ended September 30, 2005 are not necessarily indicative of the results that may be expected for the full year ending December 31, 2005. We suggest that these condensed consolidated financial statements be read in conjunction with the consolidated financial statements and notes thereto for the year ended December 31, 2004, included in our 2004 Annual Report on Form 10-K filed with the Securities and Exchange Commission (SEC). The condensed consolidated statement of cash flows for the nine months ended September 30, 2004 has been reclassified to conform to the current year presentation.

2. SIGNIFICANT ACCOUNTING POLICIES

(a) Business

We develop, market, license and support software to manage a broad array of business processes. We provide implementation, consulting, training, and technical support services to facilitate the use of our software.

(b) Management estimates and reporting

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the periods presented. Actual results could differ from those estimates. Significant assets and liabilities with reported amounts based on estimates include trade and installment accounts receivable, long-term license installments, deferred income taxes and deferred revenue.

(c) Principles of consolidation

The consolidated financial statements include the accounts of Pegasystems Inc. and its wholly owned subsidiaries, Pegasystems Limited (a United Kingdom company), Pegasystems Company (a Canadian company), Pegasystems Worldwide Inc. (a United States corporation), Pegasystems Pty Ltd. (an Australian company), Pegasystems Investment Inc. (a United States corporation) and Pegasystems Private Limited (a

Singapore company). All inter-company accounts and transactions have been eliminated in consolidation.

(d) Foreign currency translation

The translation of assets and liabilities of our foreign subsidiaries is made at period-end exchange rates, while revenue and expense accounts are translated at the average exchange rates during the period transactions occurred. The resulting translation adjustments are reflected in accumulated other comprehensive income. Realized and unrealized exchange gains or losses from transactions and adjustments are reflected in other income (expense), net, in the accompanying consolidated statements of income.

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PEGASYSTEMS INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(e) Revenue recognition

Software revenue is recognized in accordance with Statement of Position (SOP) 97-2, Software Revenue Recognition , as amended. We generally have multiple element arrangements including software licenses, professional services, maintenance and training. We do not have vendor specific objective evidence of fair value for the software license and, therefore, allocate the arrangement fee to each of the elements based on the residual method in accordance with Statement of Position 98-9 Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transactions . We determine fair value for the remaining elements as the price for each element when it has been sold separately. Revenue from arrangements in which the fair value of one or more undelivered elements is unknown is deferred until such time that the fair value of those elements is known and the residual value of the license can be determined.

Perpetual license fees are recognized as revenue when the software is delivered provided all other revenue recognition criteria are met. Term software license fees are generally payable on a monthly basis under license agreements that generally have a five-year term and may be renewed for additional years at the customer s option. The present value of future term license payments is generally recognized as revenue upon customer acceptance, provided that no significant obligations or contingencies exist related to the software, other than maintenance support, provided all other revenue recognition criteria are met. In certain circumstances, such as when license fees are not fixed or determinable, revenue from such licenses is recognized over the term of the agreement as payments become due, or ratably over the term of the license when payments are made in advance. Our standard license terms provide that the software is accepted upon delivery.

Services revenue is comprised of fees for software implementation, consulting, maintenance and training services. Implementation and consulting services do not generally involve producing new software or customizing or modifying the licensed software, but rather involve helping customers deploy the software to their specific business processes. As the services provided are not essential to the functionality of the software and are described in the agreement such that the total price of the arrangement would be expected to vary as the result of the inclusion or exclusion of the services, we account separately for the services element of the arrangement. Revenue for time and material projects is recognized as services are provided. . Revenue for fixed-price services projects is recognized as the services are provided based upon the hours incurred at amounts equal to direct costs incurred, up to the amounts billed to date, resulting in no gross profit recognized at that point. Generally, when the fixed-price services project is complete, the remaining revenue and gross profit associated with the fixed-price services project will be recognized. Maintenance revenues are recognized ratably over the related contract period, generally twelve months. Training revenue is recognized as the services are provided.

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PEGASYSTEMS INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(f) Cash and equivalents and short-term investments

	September 30, 2005			
(in thousands)	**Amortized Cost**	**Unrealized Gains**	**Unrealized Losses**	**Fair Value**
Cash and cash equivalents:				
Cash	**$ 15,579**	**$**	**$**	**$ 15,579**
Certificates of deposit				
Commercial Paper	**1,293**		**(1)**	**1,292**
Money market mutual funds	**1,593**			**1,593**
Cash and cash equivalents	**$ 18,465**	**$**	**$ (1)**	**$ 18,464**
Short-term investments:				
U.S. government and agency securities	**$ 71,982**	**$**	**$ (858)**	**$ 71,124**
Corporate bonds	**16,196**		**(147)**	**16,049**
Municipal bonds	**3,004**		**(12)**	**2,992**
Auction rate securities				
Short-term investments	**$ 91,182**	**$**	**$ (1,017)**	**$ 90,165**
Cash and cash equivalents and short-term investments	**$ 109,647**	**$**	**$ (1,018)**	**$ 108,629**

	December 31, 2004			
(in thousands)	**Amortized Cost**	**Unrealized Gains**	**Unrealized Losses**	**Fair Value**
Cash and cash equivalents:				
Cash	**$ 10,764**	**$**	**$**	**$ 10,764**
Certificates of deposit	**8,397**			**8,397**
Money market mutual funds	**1,744**			**1,744**
Cash and cash equivalents	**$ 20,905**	**$**	**$**	**$ 20,905**
Short-term investments:				
U.S. government and agency securities	**$ 49,233**	**$**	**$ (318)**	**$ 48,915**

Corporate bonds	**12,758**		**(109)**	**12,649**
Municipal bonds	**3,007**		**(16)**	**2,991**
Auction rate securities	**11,900**			**11,900**
Short-term investments	**$ 76,898**	**$**	**$ (443)**	**$ 76,455**
Cash and cash equivalents and short-term investments	**$ 97,803**	**$**	**$ (443)**	**$ 97,360**

We consider debt securities with maturities of three months or less, when purchased, to be cash equivalents. Auction rate securities are classified as short-term investments. Purchases and sales of securities are recorded on a trade-date basis. Interest is recorded when earned. All of our investments are classified as available-for-sale and are carried at fair value with unrealized gains and losses recorded as a component of accumulated other comprehensive income. We determine the appropriate classification of our investments in debt securities at the time of purchase and re-evaluate such determination at each balance sheet date. There have been no reclassifications between available-for-sale and held-to-maturity investment categories. As of September 30, 2005, remaining maturities of marketable debt securities ranged from October 2005 to July 2008. As of December 31, 2004, remaining maturities of marketable debt securities ranged from January 2005 to May 2007.

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PEGASYSTEMS INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(g) Earnings per share

Basic earnings per share are computed based on the weighted average number of common shares outstanding during the period. Diluted earnings per share includes, to the extent inclusion of such shares would be dilutive to earnings per share, the effect of outstanding options and warrants, computed using the treasury stock method.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
(in thousands, except per share data)				
Basic				
Net income	**$ 1,371**	$ 741	**$ 1,799**	$ 4,605
Weighted average common shares outstanding	**35,675**	35,786	**35,865**	35,610
Earnings per share, basic	**$ 0.04**	$ 0.02	**$ 0.05**	$ 0.13
Diluted				
Net income	**$ 1,371**	$ 741	**$ 1,799**	$ 4,605
Weighted average common shares outstanding	**35,675**	35,786	**35,865**	35,610
Effect of assumed exercise of stock options and warrant	**687**	937	**685**	1,331
Weighted average common shares outstanding, assuming dilution	**36,362**	36,723	**36,550**	36,941
Earnings per share, diluted	**$ 0.04**	$ 0.02	**$ 0.05**	$ 0.12
Outstanding options excluded as impact would be anti-dilutive	**5,517**	4,226	**5,748**	1,582

(h) Segment reporting

We currently operate in one operating segment rules based business process management, or BPM, software. We derive substantially all of our operating revenue from the sale and support of one group of similar products and services. Substantially all of our assets are located within the United States. We derived our operating revenue from the following geographic areas (sales outside the United States are principally through export from the United States):

	Three months ended September 30,	Nine months ended September 30,

($ in thousands)	2005		2004		2005		2004	
United States	**$ 13,481**	**50%**	$ 17,077	79%	**$ 47,089**	**63%**	$ 46,667	67%
United Kingdom	**9,061**	**34%**	2,134	10%	**14,219**	**19%**	10,048	14%
Europe, other	**3,261**	**12%**	1,733	8%	**9,182**	**12%**	8,968	13%
Other	**1,043**	**4%**	584	3%	**4,374**	**6%**	4,542	6%
	$ 26,846	**100%**	$ 21,528	100%	**$ 74,864**	**100%**	$ 70,225	100%

During the three months ended September 30, 2005, one customer represented 29% of our total revenue. During the three months ended September 30, 2004, two customers represented 18% and 13% of our total revenue, respectively. During the nine months ended September 30, 2005, one customer accounted for approximately 11% of our total revenue. During the nine months ended September 30, 2004, no customer accounted for more than 10% of our revenue.

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PEGASYSTEMS INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(i) Stock options

We periodically grant stock options for a fixed number of shares to employees, directors and non-employee contractors with an exercise price equal to the fair market value of the shares at the date of the grant. We account for stock option grants to employees and directors using the intrinsic value method. Under the intrinsic value method, compensation associated with stock awards to employees and directors is determined as the difference, if any, between the current fair value of the underlying common stock on the date compensation is measured and the price an employee or director must pay to exercise the award. The measurement date for employee and director awards is generally the date of grant.

Stock options granted to non-employee contractors are accounted for using the fair value method. Under the fair value method, compensation associated with stock awards to non-employee contractors is determined based on the estimated fair value of the award itself, measured using either current market data or an established option pricing model.

Stock options summary

The following table presents activity for stock options:

	Three months ended March 31, 2005		Three months ended June 30, 2005		Three months ended September 30, 2005	
(in thousands, except per share amounts)	**Number of Options**	**Weighted Average Exercise Price**	**Number of Options**	**Weighted Average Exercise Price**	**Number of Options**	**Weighted Average Exercise Price**
Outstanding options at beginning of period:	9,255	$ 7.70	9,074	$ 7.69	8,905	7.66
Granted	47	6.26	185	5.75	103	6.05
Exercised	(18)	5.05	(34)	4.41	(77)	3.66
Cancelled	(210)	7.67	(320)	7.89	(264)	8.06
Outstanding options at end of period	9,074	7.69	8,905	7.66	8,667	7.66
Exercisable options at end of period	6,286	8.21	7,937	7.99	7,718	7.97

Weighted average fair value of options granted during the period	$4.01	$2.25	$3.71

	Three months ended March 31, 2004		Three months ended June 30, 2004		Three months ended September 30, 2004	
(in thousands, except per share amounts)	**Number of Options**	**Weighted Average Exercise Price**	**Number of Options**	**Weighted Average Exercise Price**	**Number of Options**	**Weighted Average Exercise Price**
Outstanding options at beginning of period:	8,440	$ 7.65	7,907	$ 7.52	7,918	$ 7.60
Granted	110	8.91	297	8.29	135	6.98
Exercised	(288)	5.17	(176)	4.51	(69)	2.52
Cancelled	(355)	12.74	(110)	9.13	(134)	7.03
Outstanding options at end of period	7,907	7.52	7,918	7.60	7,850	7.64
Exercisable options at end of period	5,578	8.48	5,689	8.41	5,786	8.33
Weighted average fair value of options granted during the period	$3.39		$2.62		$2.34	

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PEGASYSTEMS INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table presents weighted average price and life information about significant option groups outstanding and exercisable at September 30, 2005:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding (in thousands)	Weighted Average Remaining Contractual Life (years)	Weighted Average Exercise Price	Number Exercisable (in thousands)	Weighted Average Exercise Price
$0.38 4.38	2,702	5.73	$ 4.01	2,171	$ 3.99
4.48 7.33	2,294	8.10	6.78	1,876	6.86
7.35 8.08	2,228	3.26	7.73	2,228	7.73
8.11 25.75	1,443	4.82	15.76	1,443	15.76
	8,667			7,718	

No stock-based employee compensation expense was recorded in the first nine months of 2005 or 2004 under the intrinsic value method.

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 123R, Share-Based Payment (SFAS No. 123R). This Statement is a revision of SFAS No. 123, Accounting for Stock-Based Compensation, and supersedes Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25), and its related implementation guidance. SFAS No. 123R focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. The Statement requires entities to recognize stock compensation expense for awards of equity instruments to employees based on the grant date fair value of those awards (with limited exceptions). SFAS No. 123R as published was to be effective for the first interim or annual reporting period that began after June 15, 2005.

On April 14, 2005, the Securities and Exchange Commission (SEC) announced the adoption of a rule that deferred the required effective date of SFAS No. 123R. The SEC rule provides that SFAS No. 123R is now effective for registrants as of the beginning of the first fiscal year beginning after June 15, 2005, instead of at the beginning of the first quarter after June 15, 2005, delaying the applicability of the required change to us until January 1, 2006.

We are evaluating the two methods of adoption allowed by SFAS No. 123R: the modified-prospective transition method and the modified-retrospective transition method.

Adoption of SFAS No. 123R will significantly increase compensation expense. The actual impact on future years will be dependent on a number of factors, including our stock price and the level of future grants and awards. In addition, SFAS No. 123R requires that excess tax benefits related to stock compensation expense be reported as a financing cash inflow rather than as a reduction of taxes paid in cash flow from operations.

On April 6, 2005, in response to the issuance of SFAS 123R, the Compensation Committee of our Board of Directors approved accelerating the vesting of out-of-the-money, unvested stock options held by certain current employees, excluding officers as defined under Section 16(a) of the Securities Exchange Act of 1934. Unvested options having an exercise price greater than $7.00 per share, representing the right to purchase a total of approximately 1.6 million shares, became exercisable as a result of the vesting acceleration. All other terms and conditions in the original grants remain unchanged. The acceleration of vesting did not result in the recognition of compensation expense for the nine months ended September 30, 2005 as the exercise price of the accelerated options exceeded the fair market value of the underlying common stock on the date of modification resulting in no intrinsic value under APB 25. The pro-forma results reported in the second quarter of 2005 as a footnote to the financial statements include approximately $4 million of pro-forma compensation expense resulting from the vesting acceleration.

The decision to accelerate vesting of these options was made primarily to reduce compensation expense that would otherwise be recognized after the adoption of SFAS No. 123R. We estimate that the maximum future compensation expense that would otherwise have been recorded, based on adopting FAS 123R on January 1, 2006, was approximately $4 million.

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PEGASYSTEMS INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

On April 6, 2005, our Board of Directors approved a modification to certain director stock option grants. The modification extended the exercise period of options held by directors who have served as such for five years or more to the scheduled expiration date of the options (typically 10 years from the date of grant). The modification only applied to options with an exercise price equal to or greater than the fair market value of the Company s common stock on April 6, 2005. As a result, no compensation expense was recorded under APB 25 due to this modification.

The following table illustrates the effect on net income and earnings per share if we had applied the fair value method to stock-based employee and director compensation:

	Three months ended September 30,		Nine months ended September 30,	
(in thousands, except per share amounts)	**2005**	**2004**	**2005**	**2004**
Net income, as reported	**$ 1,371**	**$ 741**	**$ 1,799**	**$ 4,605**
less: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	**(166)**	**(448)**	**(5,506)**	**(2,058)**
Pro forma net income (loss)	**$ 1,205**	**$ 293**	**$ (3,707)**	**$ 2,547**
Earnings (loss) per share:				
Basic as reported	**$ 0.04**	**$ 0.02**	**$ 0.05**	**$ 0.13**
Basic pro forma	**$ 0.03**	**$ 0.01**	**($0.10)**	**$ 0.07**
Diluted as reported	**$ 0.04**	**$ 0.02**	**$ 0.05**	**$ 0.12**
Diluted pro forma	**$ 0.03**	**$ 0.01**	**($0.10)**	**$ 0.07**

The fair value of options at the date of grant was estimated using the Black-Scholes multiple option pricing model with the following weighted-average assumptions:

	Nine months ended September 30,	
	2005	**2004**
Volatility	**73%**	45%
Expected option life, years from vesting	**2.5**	1.0
Interest rate (risk free)	**3.92%**	3.23%
Dividends	**None**	None

The effects on 2005 and 2004 pro-forma net income (loss) and earnings per share of the estimated fair value of stock options and estimated dilutive shares are not necessarily representative of the effects on the results of operations in the future. In addition, the estimates made utilize a pricing model developed for traded options with relatively short lives; our option grants typically have a life of up to ten years and are not transferable. Therefore, the actual fair value of a stock option grant may be different from our estimates. We believe that our estimates incorporate all relevant information and represent a reasonable approximation in light of the difficulties involved in valuing non-traded stock options.

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PEGASYSTEMS INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. VALUATION AND QUALIFYING ACCOUNTS

We maintain allowances for bad debts based on factors such as the composition of accounts receivable, historical bad debt experience, and current economic trends. These estimates are adjusted periodically to reflect changes in facts and circumstances. Our allowance for doubtful accounts was $0.4 million at September 30, 2005 and December 31, 2004. The following is a roll forward of the allowance for doubtful accounts:

	Nine months ended September 30, 2005	Year ended December 31, 2004
($ in thousands)		
Balance at beginning of year	**$ 365**	$ 365
Provision for doubtful accounts		
Write-offs		
Balance at end of period	**$ 365**	$ 365

We record allowances for estimates of potential credit memos and sales returns when the related revenue is recorded. We base these estimates on historical analyses of credit memo data, current economic trends, and our experience with customer disputes, products, customer industry and other factors. These estimated amounts are deferred or reserved until the related elements of the agreement are completed and provided to the customer or the dispute is resolved. Our allowance for credit memos was $0.3 million at September 30, 2005 and $0.6 million at December 31, 2004. The following is a roll forward of the allowance for credit memos:

	Nine months ended September 30, 2005	Year ended December 31, 2004
($ in thousands)		
Balance at beginning of year	**$ 642**	$ 815
Revenue deferred (recognized)	**33**	224
Credit memos issued	**(422)**	(397)
Balance at end of period	**$ 253**	$ 642

4. COMPREHENSIVE INCOME

SFAS No. 130, Reporting Comprehensive Income requires presentation of the components of comprehensive income, including the changes in equity from non-owner sources such as unrealized gains (losses) on hedging transactions, securities and foreign currency translation adjustments. Our total comprehensive income is as follows:

	Three months ended September 30,		Nine months ended September 30,	
($ in thousands)	**2005**	**2004**	**2005**	**2004**
Comprehensive income:				
Net income	**$ 1,371**	$ 741	**$ 1,799**	$ 4,605
Other comprehensive income (loss):				
Foreign currency translation adjustments	**(90)**	102	**(357)**	(64)
Unrealized gain (loss) on securities	**(173)**	(19)	**(349)**	(193)
Comprehensive income (loss)	**$ 1,108**	$ 824	**$ 1,093**	$ 4,348

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PEGASYSTEMS INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. INCOME TAXES

The Company recorded tax provisions of $1.8 million and $0.4 million for the three months ended September 30, 2005 and 2004, for effective tax rates of 56% and 35%, respectively. The Company recorded tax provisions of $2.0 million and $2.5 million for the nine months ended September 30, 2005 and 2004, for effective tax rates of 53% and 35%, respectively. The increased rate in 2005 resulted specifically from certain adjustments to deferred tax liabilities related to term license installments. We anticipate that the effective tax rate will be closer to statutory rates for the remainder of 2005.

The American Jobs Creation Act of 2004 (the Act) was enacted in October 2004. The Act creates a temporary incentive for U.S. corporations to repatriate foreign subsidiary earnings by providing an elective 85 percent dividends received deduction for certain dividends from controlled corporations. The deduction is subject to a number of limitations and requirements, including a specific domestic reinvestment plan for the repatriated funds. On January 13, 2005, the U.S. Treasury published Notice 2005-10 providing guidance on the implementation of the repatriation deduction. Based on our current understanding of the Act, we believe that we will repatriate no dividends subject to the elective 85 percent dividends received deduction.

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

Results of Operations

Overview

Total revenue increased 7% to $74.9 million for the first three quarters of 2005 from $70.2 million for the first three quarters of 2004 due to a $2.3 million increase in services revenue and a $2.3 million increase in license revenue. Consistent with our strategy of working with accounts in target customer organizations to identify opportunities for follow-on sales, a majority of our revenue in the first three quarters of 2005 was from existing customers who chose to add on to, renew or extend their use for our software. However, in the first three quarters of 2005, new customers (meaning companies or organizational divisions which are not current licensees of our software) accounted for $13.4 million, or 18%, of our total revenue. The increase in license revenue in the first three quarters of 2005 was primarily due to a $3.6 million increase in term license renewals, extensions and additions. The increase in services revenue in the first three quarters of 2005 was primarily due to a $3.6 million increase in maintenance services associated with an expanded installed base of software and a higher proportion of perpetual licenses which yield greater maintenance revenue. Increased implementation and consulting services costs during the first three quarters of 2005 resulted in a ten percentage point reduction in service gross margin compared to the first three quarters of 2004. Historically, our mix of license and services revenue has fluctuated from period to period, and we believe that the composition of license and services revenue will continue to fluctuate.

License signings in the third quarter of 2005 improved significantly from the value of license signings in the first and second quarters of 2005. License signings in the first three quarters of 2005 were also higher than the value of license signings in the first three quarters of 2004. The increase in the value of license signings for the third quarter of 2005 and the first three quarters of 2005 was due to the increased success of our strategy of focusing on initial and follow-on sales to target accounts. We are investing in sales and marketing to drive continued growth in our license signings, however actual license signings are likely to vary considerably quarter to quarter. Our license signings in the fourth quarter of 2004 were particularly strong and despite our license signings success in the third quarter of 2005 it is uncertain whether the value of license signings in 2005 as a whole will exceed the value of license signings in 2004.

Income before provision for income taxes decreased to $3.8 million in the first three quarters of 2005 from $7.1 million in the first three quarters of 2004 primarily due to a $3.4 million decrease in services gross margin, a $1.7 million increase in operating expenses, a $0.9 million increase in currency related expense, partially offset by a $2.3 million increase in license gross margin and a $0.9 million improvement in interest income. Net income for the first three quarters of 2005 decreased to $1.8 million from $4.6 million for the first three quarters of 2004.

We ended the first three quarters of 2005 with $108.6 million in cash and short-term investments compared to $97.4 million at the end of 2004, and $58.6 million in combined short and long-term license installment receivables compared to $75.7 million at the end of 2004.

We believe that the following trends in our business are occurring and are significant in understanding our results of operations:

First, the percentage of our license revenue relating to our PegaRULES Process Commander software and related frameworks has been increasing. These products often require less implementation assistance than prior generations of our software products, which in many cases has enabled us to shorten the length of the sales process and the time required to receive customer acceptance of the software product. Significantly, PegaRULES Process Commander and related frameworks can also be used by customers outside of

our traditional financial services and health care markets, which enables us to sell to target accounts in other markets.

Second, we are increasingly focusing on sales to accounts within target customer organizations. We frequently sell small initial licenses to these target accounts rather than selling large application licenses, to allow our customers to realize business value from our software quickly and for a limited up-front investment. Once a customer has realized this initial value, we work with the customer to identify opportunities for follow-on sales. Follow-on sales are often larger than the initial sales, and the sales process for follow-on sales is often shorter as a result of the established relationship with the customer.

Third, our use of perpetual licenses, under which a customer pays a single license fee at the commencement of the license, continues to increase for license signings with new customers, compared to our use of term licenses, under which a customer pays a monthly fee during the license term and must renew the license for additional fees to continue to use the software past the original term, although term license revenue was higher than perpetual license revenue in the third quarter of 2005 due to one large term license signing in the quarter. We expect that our use of perpetual licenses for new customers will continue to increase in the foreseeable future, although we expect to enter into new term licenses in certain instances at the request of

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our customers. Our increased use of perpetual licenses rather than term licenses has the effect, with respect to a given transaction, of increasing our license revenue and cash flow in the short term, but of decreasing the amount of renewal revenue and cash flow in the future.

Fourth, we are increasing our reliance on partners to provide implementation services for our customers. We have developed a network of trained and qualified partners that have the capability to provide these services to our customers. By utilizing these partners, we have increased the supply of skilled service consultants that can assist our customers. In certain cases, our partners are also able to offer lower rates to our customers due to the use of resources located in other countries, thereby reducing the overall cost to our customers. Some of our partners have more headcount dedicated to consulting services for our products than we have. We believe that this trend is good for our business because of the breadth of domain expertise that our partners can bring to solutions. We expect that our services revenue may grow more slowly over time than if we did not rely on our partners.

Three and Nine Months ended September 30, 2005 compared to Three and Nine Months ended September 30, 2004

Revenue

Total revenue for the third quarter of 2005 increased 25% to $26.8 million from $21.5 million for the third quarter of 2004. Total revenue for the first three quarters of 2005 increased 7% to $74.9 million from $70.2 million for the first three quarters of 2004. These increases were primarily attributable to increases in term license renewals, extensions and additions and increased maintenance revenue. The following table summarizes our revenue composition:

	Three months ended September 30,		Nine months Ended September 30,	
(in millions)	2005	2004	2005	2004
License revenue (1)				
Perpetual licenses	$ 2.5	$ 2.5	$ 13.5	$ 14.8
Term licenses	9.1	4.4	17.0	13.4
Total license revenue	11.6	6.9	30.5	28.2
Services revenue				
Implementation, consulting and training services	10.0	10.4	29.2	30.5
Maintenance	5.2	4.2	15.2	11.5
Total services revenue	15.2	14.6	44.4	42.0
Total revenue	$ 26.8	$ 21.5	$ 74.9	$ 70.2

(1) License revenue composition amounts reported in previous periods have been restated to the current presentation. The total license revenue amount has not changed from prior presentation.

Total license revenue for the third quarter of 2005 increased 69% to $11.6 million from $6.9 million for the third quarter of 2004. The increase in total license revenue primarily was the result of a $4.7 million increase in term licenses, specifically one large new term license transaction. Software license revenue for the first three quarters of 2005 increased to $30.5 million from $28.2 million for the first three quarters of 2004. The increase in total license revenue for the first three quarters was the result of a $3.6 million increase in term licenses, partially offset by a $1.3 million decrease in perpetual licenses. Term license renewals scheduled for 2005 are modestly higher than actual term license renewals in 2004. While historically a majority of customers have renewed their term licenses, there can be no assurance that this will continue.

Services revenue for the third quarter of 2005 increased 4% to $15.2 million from $14.6 million for the third quarter of 2004. The increase in service revenue was primarily due to a 24% increase in maintenance revenue to $5.2 million from $4.2 million. This increase in maintenance revenue for the third quarter was partially offset by a $0.4 million decrease in implementation, consulting and training services to $10.0 million from $10.4 million. Services revenue for the first three quarters of 2005 increased 6% to $44.4 million from $42.0 million for the first three quarters of 2004. The increase in service revenue was primarily due to a 31% increase in maintenance revenue to $15.2 million from $11.5 million for the first three quarters of 2004. This increase in maintenance revenue for the first three quarters of 2005 was partially offset by a $1.3 million decrease in implementation, consulting, and training services to $29.2 million from $30.5 million. The increase in maintenance revenue for the third quarter of 2005 and the first three quarters of

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2005 was due to a larger installed base of software and a higher proportion of perpetual licenses which yield greater maintenance revenue. The decrease in implementation, consulting, and training services revenue in the first three quarters of 2005 reflects the fact that the first three quarters of 2004 benefited from $2.5 million of revenue associated with the completion of two unusually large fixed price contracts. Typically, we derive substantial revenue from services provided in connection with the implementation of software licensed by new customers. Going forward, as we continue to complement our direct selling and support efforts with those of our alliance partners, we do not expect to see significant growth in implementation and consulting services revenue.

Deferred revenue at September 30, 2005 consisted primarily of the fees billed in connection with arrangements for which acceptance of the software license or service milestone had not occurred and of the advance payment of maintenance fees. Deferred revenue balances increased to $16.2 million as of September 30, 2005, from $9.1 million as of December 31, 2004. The increase was due primarily to new license arrangements for which acceptance of the software or service milestones had not occurred, and the timing of annual maintenance billings.

International revenue increased to 50% of total revenue for the third quarter of 2005 from 21% for the third quarter of 2004. International revenue increased to 37% of total revenue for the first three quarters of 2005 from 33% for the first three quarters of 2004. The increases for these periods were primarily caused by one large international license transaction in the third quarter of 2005. Our international revenue may fluctuate in the future because such revenue is generally dependent upon a small number of license transactions during a given period. We expect that due to competition from vendors who will do business in foreign currencies, more of our customer transactions may be denominated in foreign currencies in the future, which may expose us to increased currency exchange risk.

Cost of revenue

The cost of implementation, consulting, maintenance and training services for the third quarter of 2005 increased 44% to $9.3 million from $6.4 million for the third quarter of 2004. Cost of services as a percentage of services revenue increased to 61% for the third quarter of 2005 from 44% for the third quarter of 2004. Such increases were primarily due to a $1.8 million increase in compensation costs, a $0.6 million increase in contracted services, and a $0.4 million increase in travel costs. These increases reflect an investment in expanding the pool of trained service personnel, including partners and new services employees, to better meet anticipated demand associated with increased license signings. Service gross margin was $5.9 million for the third quarter of 2005, as compared to $8.2 million for the third quarter of 2004. The decrease in services gross margin was primarily due a $2.8 million increase in cost of services partially offset by a $0.6 million increase in revenue.

Cost of services for the first three quarters of 2005 increased 30% to $24.9 million from $19.1 million for the first three quarters of 2004. Cost of services as a percentage of services revenue increased to 56% for the first three quarters of 2005 from 46% for the first three quarters of 2004. Such increases were due primarily to a $3.9 million increase in compensation costs, a $1.0 million increase in contracted services, and a $0.6 million increase in travel costs. These increases reflect an investment in expanding the pool of trained service personnel, including new services employees and partners. Service gross margin was $19.5 million for the first three quarters of 2005, as compared to $22.9 million for the first three quarters of 2004. The decrease in services gross margin reflects the increase in services costs, partially offset by growth in maintenance revenue. Such decrease also reflects the fact that the first quarter of 2004 benefited from $2.5 million of revenue associated with two unusually large fixed price contracts completed during that period.

Operating Expenses

Selling and marketing expenses for the third quarter of 2005 increased 8% to $7.8 million from $7.2 million for the third quarter of 2004. This increase was due primarily to increased sales commissions resulting from increased license signings. As a percentage of total revenue, selling

and marketing expenses decreased to 29% for the third quarter of 2005 from 34% from the third quarter in 2004, due to increased revenue which was only partially offset by increased selling and marketing expenses. Selling and marketing expenses for the first three quarters of 2005 increased 8% to $24.7 million from $22.9 million for the first three quarters of 2004. The increase was primarily due to a $0.7 million increase in sales commissions related to the increase in license signings, increased wages and benefits expenses of $0.5 million due to higher headcount, and an increase in marketing program spending of $0.4 million. As a percentage of total revenue, selling and marketing expenses were 33% for the first three quarters of 2005 and 2004.

Research and development expenses for the third quarter of 2005 decreased 2% to $5.0 million from $5.1 million for the third quarter of 2004. As a percentage of total revenue, research and development expenses decreased to 18% for the third quarter of 2005, compared to 24% for the third quarter of 2004, primarily due to increased revenue. Research and development expenses for the first three quarters of 2005 decreased 3% to $14.9 million from $15.4 million for the first three quarters of 2004. As a percentage of total revenue, research and development expenses were 20% for 2005 and 22% for 2004. We expect research and development expenses will remain flat during the fourth quarter of 2005.

General and administrative expenses for the third quarter of 2005 decreased 4% to $2.9 million from $3.0 million for the third quarter

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of 2004. As a percentage of total revenue, general and administrative expenses decreased to 11% for the third quarter of 2005, compared to 14% for the third quarter of 2004, primarily due to increased revenue. General and administrative expenses for the first three quarters of 2005 increased 6% to $9.2 million from $8.7 million for the first three quarters of 2004. This increase was primarily due to the combined effect of increased incentive accruals, additional staff, salary increases and increased audit fees. As a percentage of total revenue, general and administrative expenses were 12% for the first three quarters of 2005 and 2004.

Installment receivable interest income

Installment receivable interest income, which consists of the portion of all term license fees under software license agreements attributable to the time value of money, decreased in the third quarter of 2005 to $0.6 million from $0.9 million for the third quarter of 2004. Installment receivable interest income for the first three quarters of 2005 decreased to $1.8 million from $2.2 million for the first three quarters of 2004. The decrease was due primarily to a lower average discount rate for our portfolio of term software licenses. A portion of the fee from each term license arrangement is initially deferred and recognized as installment receivable interest income over the remaining term of the license. For purposes of the present value calculations, the discount rates used are estimates of customers borrowing rates, typically below prime rate, and have varied between 3.25% and 5.0% during the past few years.

Other interest income, net

Other interest income increased to $0.8 million for the third quarter of 2005 from $0.5 million for the third quarter of 2004. Other interest income increased to $2.2 million for the first three quarters of 2004 compared to $1.3 million for the first three quarters of 2004. These increases were primarily due to increased cash and investment balances and improved yields.

Other income (expense), net

Other income (expense), net, which consists mostly of currency exchange gain and losses, was ($0.1) million expense for the third quarter of 2005 compared to $0.1 million income for the third quarter of 2004. Other income (expense), net was ($1.1) million expense for the first three quarters of 2005 compared to ($0.3) million expense for the first three quarters of 2004. The unfavorable increase in other expense, net, resulted primarily from the revaluation of assets and liabilities on our US ledger valued in foreign currencies, consisting primarily of cash, investments, license installments, receivables, accounts payable and accruals. In particular, changes in the exchange rates of European currencies have unfavorably impacted foreign currency denominated assets.

Income before provision for income taxes

Income before provision for income taxes increased 175% to $3.1 million for the third quarter of 2005 from $1.1 million for the third quarter of 2004. This increase was primarily due to $4.8 million increase in license gross margin, partially offset by a $2.3 million decrease in services gross margin and a $0.3 million increase in operating expenses. Income before provision for income taxes decreased to $3.8 million for the first three quarters of 2005 compared to $7.1 million for the first three quarters of 2004. This decrease was due to a $3.4 million decrease in services gross margin, a $1.7 million increase in operating expenses primarily due to investments in sales and marketing, a $0.9 million increase in other expense, partially offset by a $2.3 million improvement in license gross margin and a $0.9 million improvement in other interest income, net.

Provision for income taxes

Our effective tax rate for the third quarter and first three quarters of fiscal 2005 was 56% and 53%, respectively. The effective tax rate was 35% for the third quarter and first three quarters of fiscal 2004. The increased rates in 2005 resulted specifically from certain adjustments to deferred tax liabilities related to term license installments. We anticipate that the effective tax rate will be closer to statutory rates for the remainder of 2005.

Liquidity and capital resources

We have funded our operations primarily from cash flow from operations. At September 30, 2005, we had cash and equivalents and short-term investments of $108.6 million, a $11.2 million increase from $97.4 million at December 31, 2004. This increase was primarily due to $18.0 million of cash flow from operations partially offset by $4.8 million used to repurchase outstanding shares of our common stock and $1.3 million used to purchase fixed assets.

Working capital was $129.2 million at September 30, 2005, a $10.3 million increase from $118.9 million at December 31, 2004. Working capital increased primarily due to the $11.2 million increase in cash and investments and a $9.5 million increase in accounts receivable, partially offset by a $7.0 million increase in deferred revenue and a $4.6 million decrease in short-term license installments.

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The $7.0 million increase in deferred revenue was primarily associated with new license signings for which acceptance of the software or of service milestones had not occurred, and the timing of annual maintenance billings. The $4.6 million decrease in short-term license installments was primarily due to prepayments of $3.0 million of term license fees.

Cash flow from operating activities for the first three quarters of 2005 increased to $18.0 million from $6.3 million for the first three quarters of 2004, despite a decline in net income from $4.6 million for the first three quarters of 2004 to $1.8 million for the first three quarters of 2005. During the first three quarters of 2005, net cash provided benefited from a $7.0 million increase in deferred revenue and a $17.1 million reduction in short and long-term license installments, partially offset by a $9.5 million increase in accounts receivable. The increase in deferred revenue was primarily associated with new license signings for which acceptance of the software or of service milestones had not yet occurred, and the timing of annual maintenance billings. Short and long-term license installments decreased primarily because license fees billed during the first three quarters of 2005 exceeded the term license revenue that we recognized during that period, with $6.2 million of the decrease due to billings for customers who chose to pay their term license commitments in advance. Of the $9.5 million increase in accounts receivable, approximately $6.5 million was due to slower payments by some large customers and $3.0 million was due to increased billings in Q3 2005.

Net cash used in investing activities for the first three quarters of 2005 was ($15.9) million, primarily due to net purchases of marketable debt securities. This compared with ($55.6) million used in investing activities in the first three quarters of 2004, which was also primarily due to net purchases of marketable debt securities.

Net cash used in financing activities for the first three quarters of 2005 was ($4.1) million compared with net cash provided by financing activities of $2.8 million for the first three quarters of 2004. The use of cash in the first three quarters of 2005 was primarily for the repurchase of $4.8 million of our common stock. The net cash provided in the first three quarters of 2004 was primarily from the proceeds of stock option exercises.

At the end of 2004, our Board of Directors authorized the repurchase of up to $10 million of our outstanding common stock. The purchases are being made from time to time on the open market or in privately negotiated transactions. Under the program, shares may be purchased in such amounts as market conditions warrant, subject to regulatory and other considerations. During the first three quarters of 2005, we repurchased 803,312 shares for $4.8 million under the program in open market purchases. The authorization to repurchase shares was originally scheduled to expire on September 30, 2005, but was extended to June 30, 2006 by our Board of Directors. The repurchase program may be suspended or discontinued at any time without prior notice. Our repurchase activity was as follows:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Aggregate Number of Shares Purchased as Part of Publicly Announced Share Repurchase Program	Approximate Dollar Value Of Shares That May Yet Be Purchased Under The Share Repurchase Program (in thousands)
March 2005	163,000	$ 5.71	163,000	$ 9,069
April 2005		$	163,000	$ 9,069

May 2005	148,439	$	5.67	311,439	$	8,228
June 2005	97,682	$	5.94	409,121	$	7,647
July 2005		$		409,121	$	7,647
August 2005	213,248	$	6.29	622,369	$	6,305
September 2005	180,943	$	6.06	803,312	$	5,209
Total	803,312	$	5.96			

We believe that current cash, cash equivalents, and cash flow from operations will be sufficient to fund our business for at least the next twelve months. Material risks to cash flow from operations include, delayed or reduced cash payments accompanying sales of new licenses or a decline in our services business. 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. In addition, there can be no assurance that additional capital if needed will be available on reasonable terms, if at all, at such time as we require.

As of September 30, 2005, we did not have material commitments for capital or operating expenditures other than a three-year purchase commitment for customer support services and capital and operating leases. Our principal administrative, sales, marketing, support, and research and development operations are located in an 85,228 square foot leased facility in Cambridge, Massachusetts. The lease for this facility expires in 2013, with the option to extend for two additional five-year periods. We also lease space for our other offices in the United States, Canada, Australia, France, and the United Kingdom. These leases expire at various dates through

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2010. Rent expense under operating leases is recognized on a straight-line basis, under which scheduled rent increases are expensed in advance of payment. The excess of expense over current payments is recorded as deferred rent and included in other long-term liabilities. As of September 30, 2005, our known contractual obligations were as follows:

	Payment due by period (in thousands)				
Contractual obligations:	**Total**	**Remainder of 2005**	**2006 & 2007**	**2008 & 2009**	**2010 and after**
Purchase commitments	$ 1,824	$ 203	$ 1,621	$	$
Capital lease obligations	200	27	173		
Operating lease obligations	27,215	929	6,867	7,044	12,375
Total	$ 29,239	$ 1,159	$ 8,661	$ 7,044	$ 12,375

Our liquidity is affected by the manner in which we collect cash for certain types of license transactions. Historically, our term licenses have provided for monthly license payments, generally over five years. The following amounts of cash are due for receipt in connection with our existing term license agreements:

Years ending December 31,	**License installments**
	(in thousands)
Remainder of 2005	**$ 5,572**
2006	**25,046**
2007	**17,288**
2008	**8,846**
2009	**2,081**
2010 and thereafter	**4,517**
Total	**$ 63,350**

License installments on the balance sheet represent the present value of term license fees which have not yet been billed, and have already been recognized as revenue. License installments at September 30, 2005 decreased $17.1 million from December 31, 2004, primarily because license fees billed during the first three quarters of 2005 exceeded term license revenue recognized, with $6.2 million of the decrease due to prepayments of term license fees. The decrease reflects the lower average remaining life of our term licenses. The renewal value of our term licenses has declined by approximately 7% since December 31, 2004. The timing of term license renewals can impact the license installments balance. License installments would increase during periods when term license revenue exceeds billings. Term license renewals scheduled for 2005 are modestly higher than actual term license renewals in 2004. While historically a majority of customers have renewed their term licenses, there can be no assurance that this will continue.

Critical accounting policies and estimates

Management s discussion and analysis of the financial condition and results of operations is based upon the consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. We base our estimates and judgments on historical experience, knowledge of current conditions and beliefs of what could occur in the future given available information. We consider the following accounting policies to be both those most important to the portrayal of our financial condition and those that require the most subjective judgment. If actual results differ significantly from management s estimates and projections, there could be a material effect on our financial statements. The significant accounting policies that we believe are the most critical to aid in fully understanding and evaluating our reported financial results include the following:

Revenue recognition,

Deferred revenue,

Allowance for doubtful accounts and allowance for credit memos,

Stock-based compensation,

Accounting for income taxes, and

Contingencies.

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A full discussion of these accounting policies is included in our 2004 Annual Report on Form 10-K filed with the Securities and Exchange Commission and we refer the reader to that discussion. The following information regarding critical accounting policies has been updated since our 10-K:

Revenue recognition

Our revenue is derived from two primary sources: software license fees and service fees. Software revenue is recognized in accordance with Statement of Position (SOP) 97-2, Software Revenue Recognition , as amended. Our license arrangements, whether involving a perpetual license or a term license, generally contain multiple elements. In addition to the license, these elements generally include professional consulting services, training and maintenance services. We do not have vendor specific objective evidence of fair value for the license and, therefore, recognize revenue based on the residual value method as prescribed in Statement of Position 98-9 Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transactions . We typically determine fair value for the remaining elements as the price for each element when it has been sold separately. Revenue from arrangements in which the fair value of one or more undelivered elements is unknown is deferred until such time that the fair value of those elements is known and the residual value of the license can be determined.

Perpetual license fees are generally payable at the time the software is delivered, and are generally recognized as revenue when the software is delivered, any acceptance required by contract is obtained, and no significant obligations or contingencies exist related to the software, other than maintenance support, provided all other revenue recognition criteria are met.

Term software license fees are generally payable on a monthly basis under license agreements that generally have a five-year term and may be renewed for additional years at the customer s option. We have a history of successfully collecting payments under such term software license arrangements, and therefore, the present value of future license payments is generally recognized as revenue upon customer acceptance, provided that no significant obligations or contingencies exist related to the software, other than maintenance support, provided all other revenue recognition criteria are met. A portion of the license fees payable under each term license agreement (equal to the difference between the total license payments and the discounted present value of those payments) is initially deferred and recognized as installment receivable interest income (and is not part of total revenue) over the license term. Many of our license agreements provide for license fee increases based on inflation. When such an increase occurs, as determined by the terms of the license agreement, we recognize the present value of such increases as revenue; the remainder of the increase is recognized as installment receivable interest income over the remaining license term. For purposes of the present value calculations, the discount rates used are estimates of customers borrowing rates at the time of recognition, typically below prime rate, and have varied between 3.25% and 5.0% for the past few years. As a result, revenue that we recognize relative to new license arrangements of this type would be impacted by changes in market interest rates.

Our standard license terms provide that the software is accepted upon delivery. Some of our license arrangements, however, provide that the acceptance does not occur until later, based on customer specific criteria. In certain circumstances, such as when license fees are not fixed or determinable, revenue from such licenses is recognized over the term of the agreement as payments become due, or ratably over the term of the license when payments are made in advance.

Our services revenue is comprised of fees for software implementation, consulting, maintenance and training services. Implementation and consulting services generally do not involve producing new software or customizing or modifying the licensed software, but rather involve helping customers create rule sets that enable those customers to deploy the software to their specific business processes. Our software implementation and consulting agreements typically require us to provide services at an hourly rate or for a fixed fee. Revenues for time and material projects are recognized as services are delivered and fees are billed. As the services provided are not essential to the functionality of the software and are described in the agreement such that the total price of the arrangement would be expected to vary as the result of the inclusion or exclusion of the services, we account separately for the services element of the arrangement and allocate revenue accordingly among the

elements based on the fair value. Our fair value for the rate per service hour is established as the actual rate charged per hour for time and materials services that have been sold separately. The fair value of services is determined by multiplying the fair value rate per hour by the services hours incurred, or committed.

We do not have vendor specific objective evidence of the fair values of fixed-price services projects because we do not have a reliable track record for accurately estimating the time and resources needed to complete such projects. Revenue for fixed-price services projects is recognized as the services are provided based upon the hours incurred at amounts equal to direct costs incurred, up to the amounts billed to date, resulting in no gross profit recognized at that point. Generally, when the fixed-price services project is complete, the remaining revenue and gross profit associated with the fixed-price services project will be recognized.

Software license customers are offered the option to enter into a maintenance contract, which usually requires the customer to pay a monthly maintenance fee over the term of the maintenance agreement, typically renewable annually. Prepaid maintenance fees are deferred and are recognized evenly over the term of the maintenance agreement. We generally recognize training fees revenue as the services are provided.

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We have very limited revenue through resellers, therefore we typically have not provided price protection or stock rotation rights. We have, in a small number of instances, provided limited rights of return or cancellation. We record allowances for estimates of potential credit memos and sales returns when the related revenue is recorded, and review them periodically. These estimates are based on historical analyses of credit memo data, current economic trends, and experience with customer disputes, products customer industry and other known factors. These estimated amounts are deferred or reserved until the related elements of the agreement are completed and provided to the customer or the dispute is resolved.

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

Our agreements with customers generally require us to indemnify the customer against claims that our software infringes third party patent, copyright, trademark or other proprietary rights. Such indemnification obligations are generally limited in a variety of industry-standard respects, including our right to replace an infringing product. As of September 30, 2005, we had not experienced any material losses related to these indemnification obligations and no claims with respect thereto were outstanding. We do not expect significant claims related to these indemnification obligations, and consequently, we have not established any related reserves.

Allowance for doubtful accounts and allowance for credit memos

We maintain an allowance for doubtful accounts using estimates that we make based on factors we believe appropriate such as the composition of the accounts receivable aging, historical bad debts, changes in payment patterns, customer creditworthiness and current economic trends. If we used different assumptions, or if the financial condition of customers were to deteriorate, resulting in an impairment of their ability to make payments, additional provisions for doubtful accounts would be required and would increase bad debt expense.

We record allowances for estimates of potential credit memos and sales returns when the related revenue is recorded and review them periodically. We base these estimates on historical analyses of credit memo data, current economic trends, and our experience with customer disputes, products, customer industry and other known factors. These estimated amounts are deferred or reserved until the related elements of the agreement are completed and provided to the customer or the dispute is resolved. If we used different assumptions in calculating the allowance, adjustments would be reflected in changes to revenue. During the first quarter of 2005, we refined our estimate of allowances for credit memos which resulted in an increase in services revenue of $0.3 million.

Stock-based compensation

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 123R, *Share-Based Payment* (SFAS No. 123R). This Statement is a revision of SFAS No. 123, *Accounting for Stock-Based Compensation*, and supersedes Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, and its related implementation guidance. SFAS No. 123R focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. The Statement requires entities to recognize stock compensation expense for awards of equity instruments to employees based on the grant-date fair value of those awards (with limited exceptions). SFAS No. 123R as published was to be effective for the first interim or annual reporting period that begins after June 15, 2005.

On April 14, 2005, the Securities and Exchange Commission (SEC) announced the adoption of a rule that defers the required effective date of SFAS No. 123R. The SEC rule provides that Statement 123R is now effective for registrants as of the beginning of the first fiscal year beginning after June 15, 2005, instead of at the beginning of the first quarter after June 15, 2005, delaying the applicability of the required change to us until January 1, 2006.

We are evaluating the two methods of adoption allowed by SFAS No. 123R: the modified-prospective transition method and the modified-retrospective transition method.

Adoption of SFAS No. 123R will significantly increase compensation expense. The actual impact on future years will be dependent on a number of factors, including our stock price and the level of future grants and awards. In addition, SFAS No. 123R requires that excess tax benefits related to stock compensation expense be reported as a financing cash inflow rather than as a reduction of taxes paid in cash flow from operations.

On April 6, 2005, in response to the issuance of SFAS 123R, the Compensation Committee of our Board of Directors approved accelerating the vesting of out-of-the-money, unvested stock options held by certain current employees, excluding officers as defined under Section 16(a) of the Securities Exchange Act of 1934. Unvested options having an exercise price greater than $7.00 per share, representing the right to purchase a total of approximately 1.6 million shares, became exercisable as a result of the vesting acceleration. All other terms and conditions in the original grants remain unchanged. The acceleration of vesting did not result in the

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recognition of compensation expense for the six months ended June 30, 2005 as the exercise price was in excess of the fair market value on the date of modification resulting in no intrinsic value under APB25. The pro-forma results reported for the second quarter of 2005 as a footnote to the financial statements include approximately $4 million of compensation expense resulting from the vesting acceleration.

The decision to accelerate vesting of these options was made primarily to reduce compensation expense that would otherwise be recognized after the adoption of SFAS No. 123R. We estimate that the maximum future compensation expense that would otherwise have been recorded, based on adopting FAS 123R on January 1, 2006, was approximately $4 million.

Accounting for Income Taxes

We account for income taxes in accordance with Statement of Financial Accounting Standards No. 109, or SFAS 109, Accounting for Income Taxes, which requires that deferred tax assets and liabilities be recognized using enacted tax rates for the effect of temporary differences between the book and tax bases of recorded assets and liabilities.

Principal differences between our book and tax accounts are related to the treatment of our license transactions. We use the operating lease method of recognizing license revenue for tax purposes, so that to the extent we continue to enter into term license contracts, we establish deferred tax liabilities for such future taxable income. In addition, because we defer recognition of this income into future periods for tax purposes, we have generated substantial tax loss carry forwards which partially offset the related liabilities. We also earn tax credits in various jurisdictions for our ongoing investment in research and development activities.

Our remaining valuation allowance relates to tax benefits from stock option exercises which will increase additional paid in capital, and loss carry forwards acquired in the 1mind acquisition, the recognition of which will generally reduce goodwill.

Judgment is required in determining our worldwide income tax expense provision. 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 transactions and arrangements made among related parties, transfer pricing for transactions with our subsidiaries, and potential challenges to nexus and credit estimates. We estimate our exposure to unfavorable outcomes related to these uncertainties and estimate the probability for such outcomes. Although we believe our estimates are reasonable, no assurance can be given that the final tax outcome of these matters will not be different from what is reflected in our historical income tax provisions, returns and accruals. Such differences could have a material impact on our income tax provision and operating results in the period in which such a determination is made. Provisions have been made for such uncertainties, with reserves totaling approximately $2 million.

The American Jobs Creation Act of 2004 (the Act) was enacted in October 2004. The Act creates a temporary incentive for U.S. corporations to repatriate foreign subsidiary earnings by providing an elective 85 percent dividends received deduction for certain dividends from controlled corporations. The deduction is subject to a number of limitations and requirements, including a specific domestic reinvestment plan for the repatriated funds. On January 13, 2005, the U.S. Treasury published Notice 2005-10 providing guidance on the implementation of the repatriation deduction.

In December 2004, the FASB issued FASB Staff Position No. 109-1, Application of FASB Statement No.109 (SFAS 109), Accounting for Income Taxes, to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004, which clarifies

that the manufacturer s deduction provided for under the Act should be accounted for as a special deduction in accordance with SFAS 109 and not as a tax rate reduction. On January 19, 2005, the U.S. Treasury published Notice 2005-14 providing guidance on the implementation of the manufacturer s deduction. Based on our current understanding of the Act, we believe that there is no current tax benefit.

The FASB also issued FASB Staff Position No. 109-2, Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004 (FSP 109-2). The Act introduces a special one-time dividends received deduction on the repatriation of certain foreign earnings to a U.S. taxpayer (repatriation provision), provided certain criteria are met. The FSP 109-2 provides accounting and disclosure guidance for the repatriation provision.

The FSP 109-2 grants an enterprise additional time beyond the year ended December 31, 2004, in which the Act was enacted, to evaluate the effects of the Act on its plan for reinvestment or repatriation of un-remitted earnings. The FSP 109-2 calls for enhanced disclosures of, among other items, the status of a Company s evaluations, the effects of completed evaluations, and the potential range of income tax effects of repatriations. Based on our current understanding of the Act, we believe that we will repatriate no dividends subject to the elective 85 percent dividends received deduction.

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Inflation

Inflation has not had a significant impact on our operating results to date, and we do not expect it to have a significant impact in the future. Our unbilled license and maintenance fees are typically subject to annual increases based on recognized inflation indices.

Significant customers

During the three months ended September 30, 2005, one customer represented 29% of our total revenue. During the three months ended September 30, 2004, two customers represented 18% and 13% of our total revenue, respectively. During the nine months ended September 30, 2005, one customer accounted for approximately 11% of our total revenue. During the nine months ended September 30, 2004, no customer accounted for more than 10% of our revenue.

Forward-looking statements

This Quarterly Report on Form 10-Q contains or incorporates forward-looking statements within the meaning of section 27A of the Securities Act of 1933 and section 21E of the Securities Exchange Act of 1934. In addition, we may make, or others may make on our behalf, other written or oral statements in the future that constitute forward-looking statements. 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. Words such as expect, anticipate, intend, plan, believe, seek, estimate, may, variations of such words and similar expressions are intended to ide 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 included important factors in the cautionary statements below under the heading Factors that may affect future results 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.

Factors that may affect future results

The following important factors, among others, 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 from time to time.

Factors relating to our revenues

We have increasingly been entering into perpetual license transactions with new customers rather than term licenses, which, with respect to such transactions, has the effect of increasing our license revenue and cash flow in the short term and of decreasing the amount of license revenue and cash flow in the future. In prior years, we typically licensed our software under term licenses requiring the customer to make monthly payments over the license term. More recently, we have been selling perpetual licenses to our software with a single license fee typically being payable at the commencement of the license. We expect that our use of perpetual licenses will continue to increase in the foreseeable future, although we expect to enter into new term licenses in certain instances at the request of our customers. Our increased use of

perpetual licenses has the effect, with respect to such transactions, of increasing our license revenue and cash flow in the short term, but of decreasing the amount of license revenue and cash flow in the future. If we are unable to increase the volume of new license transactions, given the anticipated decline in the recurring revenue from term license arrangements, our license revenue and cash flow will likely decline in future periods.

If existing customers do not renew their term licenses, our financial results may suffer. Term license renewal negotiations have required more effort due to economic pressures and consolidation among our customers. A significant portion of our total revenue has been attributable to term license renewals, although this portion has been declining in recent periods due to the increase in perpetual licenses. While historically a majority of customers have renewed their term licenses, there can be no assurance that a majority of customers will continue to renew expiring term licenses. In addition, customers may choose to renew their expiring term licenses, but on business terms that require us to account for such renewals on a subscription basis, thereby reducing the amount of revenue we can recognize at the time of renewal under our existing revenue recognition practices. A decrease in term license renewal revenue absent offsetting revenue from other sources would have a material adverse effect on future financial performance.

Our professional services revenue is dependent to a significant extent on closing license transactions with new customers. We derive a substantial portion of our professional services revenue from implementation of software licensed by new customers and the development of applications by our customers using our software. Increasingly, we are relying on business partners to provide the implementation services for our customers, thus reducing the amount of professional services revenue we derive relative to a given level of license revenue. Accordingly, it is imperative that we close more license transactions with new customers if we are to maintain or grow our services revenue.

Factors relating to fluctuations in our financial results

The timing of our license revenue is difficult to predict accurately, due to the uncertain timing of the completion of implementation

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services and product acceptance by the customer. Our quarterly revenue may fluctuate significantly, in part because a large portion of our revenue in any quarter is attributable to product acceptance or license renewal by a relatively small number of customers. Fluctuations also reflect our policy of recognizing revenue upon product acceptance or, in the case of term licenses, license renewal. Customers in some cases will not accept products until the end of a lengthy sales cycle and an implementation period, typically ranging from six to twelve months but in some cases significantly longer. In 2004, we introduced a new set of products based on our PegaRULES technology. In many cases, these new products have a shorter sales cycle and implementation period than our traditional product line. Any increases in these cycles may adversely affect our financial performance, due in part to the recognition of sales staff and commission costs in advance of revenue recognition. In addition, risks over which we have little or no control, including customers budgets, staffing allocation and internal authorization reviews, can significantly affect the sales and acceptance cycles. Changes requested by customers may further delay product implementation and revenue recognition.

Our quarterly operating results have varied considerably in the past and are likely to vary considerably in the future. Historically, most of our revenue in a quarter has been attributable to a small number of transactions. This has caused our quarterly revenue to fluctuate, sometimes significantly. These fluctuations could cause us to be unprofitable on an annual or quarterly basis and to fail to meet analysts expectations regarding our earnings or revenue. Our current strategy to rely more heavily on third party services in support of license sales may increase these fluctuations because we will have less control over the timing of customer acceptance of our software. While future fluctuations in our quarterly operating results may be buffered to some extent by the increasing percentage of our total revenue attributable to maintenance services and by an increase in the number of license transactions, we expect those fluctuations will continue to be significant at least in the near term. We plan selling and marketing expenses, product development and other expenses based on anticipated future revenue. If revenue falls below expectations, 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 operating results are not necessarily meaningful and should not be relied upon to predict future performance.

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 arising from term license installments, transactions and arrangements made among related parties, transfer pricing for transactions with our subsidiaries, and potential challenges to nexus and credit estimates. We estimate our exposure to unfavorable outcomes related to these uncertainties and estimate the probability for such outcomes. 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 could have a material impact on our income tax provisions, require us to change the recorded value of deferred tax assets and adversely affect our financial results.

Our stock price has been volatile. The market price of our common stock has been and may continue to be highly volatile. Factors that are difficult to predict, such as quarterly revenues and operating results, statements and ratings by financial analysts, and overall market performance will have a significant effect on the price for shares of our common stock.

Factors relating to our products and markets

We will need to develop new products, evolve existing ones and adapt to technology change. Technical developments, customer 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 develop and introduce new products that meet customer 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. Our products are complex and may contain errors. Errors in products will require us to ship corrected products to customers. Errors in products could cause the loss of or delay in market acceptance or sales and revenue, the diversion of development resources, injury to our

reputation, or increased service and warranty costs which would have an adverse effect on financial performance.

The market for our offerings is increasingly and intensely competitive, rapidly changing and highly fragmented. The market for business process management software and related implementation, consulting and training services is intensely competitive and highly fragmented. We currently encounter significant competition from internal information systems departments of potential or existing customers that develop custom software. We also compete with companies that target the customer interaction and workflow markets and 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 competitors 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 customer requirements or preferences. Competitors may also be able to devote greater

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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.

We have historically sold to the financial services and healthcare markets. These markets are continuing to consolidate, and face uncertainty due to many other factors. We have historically derived a significant portion of our revenue from customers in the financial services and healthcare markets, and increased sales to these markets are important for our future growth, although we have been increasing our sales to other markets. Competitive pressures, industry consolidation, decreasing operating margins, regulatory changes and privacy concerns affect the financial condition of our customers in these markets and their willingness to pay. In addition, customers purchasing patterns in these industries for large technology projects are largely discretionary. The financial services market is undergoing intense domestic and international consolidation, and consolidation has been increasing in the healthcare market. Consolidation may interrupt normal buying behaviors and increase the volatility of our operating results. In recent years, several customers have been merged or consolidated. 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 customers in these industries, and could adversely affect our business, operating results and financial condition.

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 relational database management system applications and development tool vendors, 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. 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 their relationships with or support of us.

We face risks from operations and customers based outside of the U.S. Sales to customers headquartered outside of the United States represented approximately 32% of our total revenue in 2004, 20% in 2003 and 22% in 2002. We, in part through our wholly-owned subsidiaries based in the United Kingdom, Singapore, Canada, and Australia, market products and render consulting and training services to customers based in Canada, the United Kingdom, France, Germany, the Netherlands, Belgium, Switzerland, Austria, Ireland, Sweden, South Africa, Mexico, Australia, Hong Kong and Singapore. We have established offices in continental Europe and Australia. We believe that growth will necessitate expanded international operations requiring a diversion of managerial attention and financial resources. 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 will 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. Risks inherent in our international business activities generally include unexpected changes in regulatory requirements, increased tariffs and other trade barriers, the costs of localizing products for local markets and complying with local business customs, changes in currency exchange rates, longer accounts receivable patterns and difficulties in collecting foreign accounts receivable, difficulties in enforcing contractual and intellectual property rights, heightened risks of political and economic instability, the possibility of nationalization or expropriation of industries or properties, difficulties in managing international operations, 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. 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.

Factors relating to our internal operations and potential liabilities

We depend on certain key personnel, and we 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 Mr. Alan Trefler, our Chief Executive Officer. The loss of key personnel could adversely affect our 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 face product liability and warranty claims. 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. These terms contain exclusions in some cases, and these exclusions expose

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us to greater liability for certain types of claims. Also, there is a risk that these contract terms might not bind a party other than the direct customer. Furthermore, some of our licenses with our customers 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.

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. In October 1998, we were granted a patent by the United States Patent and Trademark Office relating to the architecture of our systems. We cannot assure that such patent will not be invalidated or circumvented or that rights granted thereunder or the description contained therein will provide competitive advantages to our competitors or others.

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 United States. 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.

We are not aware that any of our products infringe the proprietary rights of third parties. There can be no assurance, however, 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 customers 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.

Investor confidence and share value may be adversely impacted if our management is unable to provide an unqualified assessment regarding the adequacy of our internal control over financial reporting, or if our independent auditors are unable to provide us with their attestation regarding our management s assessment, for our 2005 fiscal year or beyond, as required by Section 404 of the Sarbanes-Oxley Act of 2002. The Securities and Exchange Commission, as directed by Section 404 of the Sarbanes-Oxley Act of 2002, adopted rules requiring public companies to include a report of management on the company s internal control over financial reporting in its annual reports on Form 10-K that contain an assessment by management of the effectiveness of the company s internal control over financial reporting. In addition, the company s independent auditors must attest to and report on management s assessment of the effectiveness of the company s internal control over financial reporting. For the year ended December 31, 2004, management s assessment was included on page 31 of our Annual Report on Form 10-K and our independent auditors attestation was included on page 33 of our Annual Report on Form 10-K. These reports, however, speak only as of the date they were filed. For future periods, although we intend to diligently and regularly review and update our internal control over financial reporting in order to ensure compliance with the Section 404 requirements, our management may not be able to provide an unqualified assessment for our 2005 fiscal year or beyond, and our independent auditors may be unwilling to provide an attestation for any of these years. For example, in our Quarterly Report on Form 10-Q for the second quarter of 2005, we disclosed a material weakness in our internal control over financial reporting relating to the accounting for one customer transaction. Any such event could result in an adverse reaction in the financial marketplace due to a loss of investor confidence in the reliability of our financial statements, which ultimately could negatively impact the market price of our shares.

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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 fluctuations in foreign exchange rates and interest rates. We have not entered into derivative or hedging transactions to manage risk in connection with such fluctuations.

Foreign currency exposure

We derived approximately 37% of our total revenue in the first nine months of 2005 from sales to customers based outside of the United States. Some of our international sales are denominated in foreign currencies, such as the British pound and Euro. The price in United States dollars of products and services sold outside the United States in foreign currencies will vary as the value of the United States dollar fluctuates against those foreign currencies. There can be no assurance that sales denominated in foreign currencies will not be material in the future and that there will not be increases in the value of the United States dollar against such currencies that will reduce the dollar return to us on the sale of our products and services in such foreign currencies. The foreign currency exposure related to revenue is largely offset by the expenses we incur in foreign currencies.

Because most of our transactions with customers are invoiced from our offices in the US, and some of those transactions are denominated in currencies other than the US dollar, we have receivables and license installments that are valued in other currencies. In addition, our US company holds some cash and investments in currencies other than the US dollar in order to support operations in other countries. When there are changes in the exchange rates for those other currencies versus our US dollar functional currency we recognize a currency gain or (loss) in the statement of income as other income (expense). We had net assets valued in foreign currencies, consisting primarily of cash, investments, license installments, and receivables, partially offset by accounts payable and accruals, with a carrying value of $19 million as of September 30, 2005. A ten percent change in currency exchange rates would change by approximately $2 million the carrying value of those net assets as reported on our balance sheet as of September 30, 2005, with most of that change recognized in the statement of income as other income (expense).

Interest rate exposure

Our balance sheet contains interest bearing assets which have fixed rates of interest. These assets are license installments receivable generated in the normal course of business through transactions with customers and investments of excess cash in marketable debt securities.

License installments receivable bear interest at the rate in effect when the license revenue was recognized, which does not vary throughout the life of the contractual cash flow stream. We believe that at current market interest rates, the fair value of license installments receivable approximates the carrying value as reported on our balance sheets. However, there can be no assurance that the fair market value will approximate the carrying value in the future. Factors such as increasing interest rates can reduce the fair market value of the license installments receivable. Changes in market rates do not affect net earnings, as the license installments receivable are carried at cost and, since they are not financial instruments and are held until maturity, are not marked to market to reflect changes in the fair value of the portfolio. The carrying value of $59 million as of September 30, 2005 reflects the weighted average of historic discount rates used to record each term license arrangement. The average rate changes with market rates as new license installments receivable are added to the portfolio, which mitigates exposure to market interest rate risk. A 200 basis point increase in market interest rates would have decreased the fair value of our license installments receivable by approximately $2 million as of September 30, 2005

We have invested in fixed rate marketable debt securities. A 200 basis point increase in market interest rates would have reduced the fair value of our marketable debt securities by approximately $2 million as of September 30, 2005. Changes in market rates and the related impact on fair value of the investments do not generally affect net earnings as our investments are fixed rate securities and are classified as available-for-sale. Investments classified as available-for-sale are carried at fair value with unrealized gains and losses recorded as a component of accumulated other comprehensive income.

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Item 4. Controls and Procedures

(a) *Evaluation of Disclosure Controls and Procedures.* Our management, with the participation of our Chief Executive Officer, or CEO, and Chief Financial Officer, or CFO, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act) as of September 30, 2005. In designing and evaluating our disclosure controls and procedures, our management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives, and our management necessarily applied its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on this evaluation, our CEO and CFO concluded that, as of September 30, 2005, our disclosure controls and procedures were (1) designed to ensure that material information relating to us, including our consolidated subsidiaries, is made known to our CEO and CFO by others within those entities, particularly during the period in which this report was being prepared, and (2) effective, in that they provide reasonable assurance that information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the Securities and Exchange Commission s rules and forms.

(b) *Changes in Internal Control over Financial Reporting.* In our Quarterly Report on Form 10-Q for the second quarter of 2005, we disclosed the assessment of our CEO and CFO that our disclosure controls and procedures were not effective as of June 30, 2005. This conclusion resulted from our determination that a material weakness in our internal control over financial reporting existed as of that date. Specifically, we determined there was a material weakness in our internal controls designed to ensure the accurate recognition of revenue. Our Revenue Accounting Manager departed shortly before the end of the second quarter of 2005, and we were without the benefit of his services and experience during the accounting review of the revenue transactions that occurred during that quarter. The remaining accounting staff took on additional workload and responsibilities as a result. This strain on our accounting staff resulted in one customer transaction in our initial consolidated trial balance not being properly accounted for. This transaction, involving revenue of approximately $1 million, had unique acceptance circumstances involving potential undelivered services. Our accounting staff analyzed the terms of this transaction and determined that the fair value of the undelivered services could be estimated and deferred, and that the residual software license revenue should be recognized. This residual revenue was booked on our initial trial balance and draft financial statements. The company s independent auditors reviewed the transaction and determined that vendor specific objective evidence of fair value of the undelivered services did not exist, and, therefore, the residual value of the software license was not yet determinable. Our management agreed with the analysis of the independent auditors and decided not to recognize the revenue in that period. This revenue was deferred prior to the public release of our financial results for the second quarter of 2005 and did not affect any of our reported results.

After a thorough review of the circumstances surrounding this transaction, our management concluded that a material weakness existed in its internal control over financial reporting as of June 30, 2005. Our independent auditors advised the company that they concurred in management s assessment that this situation was a material weakness in internal control over financial reporting.

We made material changes to our internal control over financial reporting in the third quarter of 2005 to remediate this material weakness. We appointed a new Revenue Accounting Manager to fill the position vacated by the employee who resigned, and strengthened our other revenue accounting staff and management to reduce reliance on any single individual. We also reinforced our controls and procedures for the recording of revenue events through education of staff. In addition, we improved our protocol for reviewing revenue transactions with unusual terms and conditions. Management has concluded that these changes to our internal control over financial reporting have been designed properly and that they are now functioning as designed. Other than these changes, no change in internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act) occurred during the fiscal quarter ended September 30, 2005 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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Part II - Other Information:

Item 1. Legal Proceedings

Not applicable.

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

At the end of 2004, our Board of Directors authorized the repurchase of up to $10 million of our outstanding common stock. The purchases are being made from time to time on the open market or in privately negotiated transactions. Under the program, shares may be purchased in such amounts as market conditions warrant, subject to regulatory and other considerations. During the first three quarters of 2005, we repurchased 803,312 shares for $4.8 million under the program in open market purchases. The authorization to repurchase shares was originally scheduled to expire on September 30, 2005, but was extended to June 30, 2006 by our Board of Directors. The repurchase program may be suspended or discontinued at any time without prior notice. Our repurchase activity was as follows:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Aggregate Number of Shares Purchased as Part of Publicly Announced Share Repurchase Program	Approximate Dollar Value Of Shares That May Yet Be Purchased Under The Share Repurchase Program (in thousands)
March 2005	163,000	$ 5.71	163,000	$ 9,069
April 2005		$	163,000	$ 9,069
May 2005	148,439	$ 5.67	311,439	$ 8,228
June 2005	97,682	$ 5.94	409,121	$ 7,647
July 2005		$	409,121	$ 7,647
August 2005	213,248	$ 6.29	622,369	$ 6,305
September 2005	180,943	$ 6.06	803,312	$ 5,209
Total	803,312	$ 5.96		

Item 3. Defaults upon Senior Securities

Not applicable.

Item 4. Submission of Matters to a Vote of Security Holders

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits

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

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SIGNATURES

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

Pegasystems Inc.

Date: November 8, 2005

By: /s/ ALAN TREFLER
Alan Trefler
Chairman and Chief Executive Officer
(principal executive officer)

Date: November 8, 2005

By: /s/ CHRISTOPHER SULLIVAN
Christopher Sullivan
Senior Vice President, Chief Financial Officer and Treasurer
(principal financial and 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 Financial Officer.
32.1	Certification pursuant to 18 U.S.C. Section 1350 of the Chief Executive Officer.
32.2	Certification pursuant to 18 U.S.C. Section 1350 of the Chief Financial Officer.