PEGASYSTEMS INC
Form 10-Q
November 04, 2014
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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, 2014**

**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.)*** |
| **One Rogers Street Cambridge, MA** | **02142-1209** |
| ***(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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

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

| | | | |
|---|---|---|---|
| Large accelerated filer x | Accelerated filer ¨ | Non-accelerated filer ¨<br>(Do not check if smaller reporting company) | Smaller reporting company ¨ |

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

There were 76,348,914 shares of the Registrant s common stock, $.01 par value per share, outstanding on October 24, 2014.

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**PEGASYSTEMS INC.**

**UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS**

**(in thousands)**

| | As of September 30, 2014 | As of December 31, 2013 |
|---|---|---|
| ***ASSETS*** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 136,545 | $ 80,231 |
| Marketable securities | 92,026 | 76,461 |
| Total cash, cash equivalents, and marketable securities | 228,571 | 156,692 |
| Trade accounts receivable, net of allowance of $1,589 and $1,997 | 103,439 | 165,641 |
| Deferred income taxes | 12,328 | 12,336 |
| Income taxes receivable | 11,949 | 4,392 |
| Other current assets | 10,096 | 9,148 |
| Total current assets | 366,383 | 348,209 |
| Property and equipment, net | 28,881 | 28,957 |
| Long-term deferred income taxes | 58,129 | 56,745 |
| Long-term other assets | 2,882 | 2,526 |
| Intangible assets, net | 47,880 | 56,574 |
| Goodwill | 45,009 | 43,469 |
| Total assets | $ 549,164 | $ 536,480 |
| ***LIABILITIES AND STOCKHOLDERS EQUITY*** | | |
| Current liabilities: | | |
| Accounts payable | $ 8,060 | $ 3,671 |
| Accrued expenses | 35,039 | 31,624 |
| Accrued compensation and related expenses | 40,462 | 44,401 |
| Deferred revenue | 128,259 | 110,690 |
| Total current liabilities | 211,820 | 190,386 |
| Income taxes payable | 20,951 | 21,269 |

| | | | | |
|---|---|---|---|---|
| Long-term deferred revenue | | 20,645 | | 34,196 |
| Other long-term liabilities | | 17,473 | | 18,841 |
| Total liabilities | | 270,889 | | 264,692 |
| Stockholders equity (1): | | | | |
| Preferred stock, 1,000 shares authorized; no shares issued and outstanding | | | | |
| Common stock, 200,000 shares and 100,000 shares authorized; 76,381 shares and 76,324 shares issued and outstanding | | 764 | | 764 |
| Additional paid-in capital | | 140,464 | | 139,565 |
| Retained earnings | | 135,246 | | 127,826 |
| Accumulated other comprehensive income | | 1,801 | | 3,633 |
| Total stockholders equity | | 278,275 | | 271,788 |
| Total liabilities and stockholders equity | $ | 549,164 | $ | 536,480 |

(1) The number of common shares outstanding for all prior periods has been retroactively restated to reflect the Company s two-for-one common stock split effected in the form of a common stock dividend distributed on April 1, 2014.

See notes to unaudited condensed consolidated financial statements.

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**PEGASYSTEMS INC.**

**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

**(in thousands, except per share amounts)**

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | **2014** | **2013** | **2014** | **2013** |
| Revenue: | | | | |
| Software license | $ 48,292 | $ 44,802 | $ 154,918 | $ 128,217 |
| Maintenance | 47,281 | 37,979 | 137,555 | 112,238 |
| Services | 42,058 | 39,230 | 128,607 | 115,117 |
| Total revenue | 137,631 | 122,011 | 421,080 | 355,572 |
| Cost of revenue: | | | | |
| Software license | 1,076 | 1,592 | 3,832 | 4,751 |
| Maintenance | 5,385 | 3,599 | 15,093 | 11,106 |
| Services | 39,921 | 32,907 | 120,061 | 97,772 |
| Total cost of revenue | 46,382 | 38,098 | 138,986 | 113,629 |
| Gross profit | 91,249 | 83,913 | 282,094 | 241,943 |
| Operating expenses: | | | | |
| Selling and marketing | 48,623 | 42,663 | 150,772 | 127,279 |
| Research and development | 28,558 | 19,786 | 80,490 | 59,123 |
| General and administrative | 8,825 | 7,130 | 28,377 | 21,203 |
| Acquisition-related | 54 | 545 | 417 | 545 |
| Restructuring | 192 | | 192 | |
| Total operating expenses | 86,252 | 70,124 | 260,248 | 208,150 |
| Income from operations | 4,997 | 13,789 | 21,846 | 33,793 |
| Foreign currency transaction (loss) gain | (2,845) | 661 | (2,527) | (1,666) |
| Interest income, net | 181 | 123 | 468 | 376 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Other income (expense), net | | 19 | | (1,163) | | (507) | | (418) |
| Income before provision for income taxes | | 2,352 | | 13,410 | | 19,280 | | 32,085 |
| Provision for income taxes | | 470 | | 4,700 | | 6,129 | | 9,603 |
| Net income | $ | 1,882 | $ | 8,710 | $ | 13,151 | $ | 22,482 |
| Earnings per share (1): | | | | | | | | |
| Basic | $ | 0.02 | $ | 0.11 | $ | 0.17 | $ | 0.30 |
| Diluted | $ | 0.02 | $ | 0.11 | $ | 0.17 | $ | 0.29 |
| Weighted-average number of common shares outstanding (1): | | | | | | | | |
| Basic | | 76,351 | | 75,910 | | 76,312 | | 75,900 |
| Diluted | | 78,653 | | 78,158 | | 78,531 | | 77,744 |
| Cash dividends declared per share | $ | 0.030 | $ | 0.015 | $ | 0.075 | $ | 0.045 |

(1) The number of common shares and per share amounts have been retroactively restated for all prior periods presented to reflect the Company s two-for-one common stock split effected in the form of a common stock dividend distributed on April 1, 2014.

See notes to unaudited condensed consolidated financial statements.

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**PEGASYSTEMS INC.**

**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE (LOSS) INCOME**

**(in thousands)**

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | **2014** | **2013** | **2014** | **2013** |
| Net income | $ 1,882 | $ 8,710 | $ 13,151 | $ 22,482 |
| Other comprehensive (loss) income: | | | | |
| Unrealized (loss) gain on securities, net of tax | (90) | 113 | (62) | (32) |
| Foreign currency translation adjustments | (3,046) | 2,340 | (1,770) | (147) |
| Total other comprehensive (loss) income | (3,136) | 2,453 | (1,832) | (179) |
| Comprehensive (loss) income | $ (1,254) | $ 11,163 | $ 11,319 | $ 22,303 |

See notes to unaudited condensed consolidated financial statements.

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**PEGASYSTEMS INC.**

**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

**(in thousands)**

| | Nine Months Ended September 30, 2014 | Nine Months Ended September 30, 2013 |
|---|---|---|
| Operating activities: | | |
| Net income | $ 13,151 | $ 22,482 |
| Adjustments to reconcile net income to cash provided by operating activities: | | |
| Excess tax benefits from exercise or vesting of equity awards | (3,754) | (2,670) |
| Deferred income taxes | (1,845) | (537) |
| Depreciation and amortization | 17,167 | 14,173 |
| Stock-based compensation expense | 13,721 | 9,713 |
| Foreign currency transaction loss | 2,527 | 1,666 |
| Other non-cash items | 939 | 2,736 |
| Change in operating assets and liabilities: | | |
| Trade accounts receivable | 59,049 | 42,611 |
| Income taxes receivable and other current assets | (3,839) | 2,599 |
| Accounts payable and accrued expenses | (1,448) | (5,762) |
| Deferred revenue | 4,287 | (3,836) |
| Other long-term assets and liabilities | (1,688) | 260 |
| Cash provided by operating activities | 98,267 | 83,435 |
| Investing activities: | | |
| Purchase of marketable securities | (36,232) | (56,645) |
| Matured and called marketable securities | 22,156 | 21,129 |
| Payments for acquisitions, net of cash acquired | (2,600) | |
| Investment in property and equipment | (5,809) | (4,158) |
| Cash used in investing activities | (22,485) | (39,674) |

| | | |
|---|---|---|
| Financing activities: | | |
| Issuance of common stock for share-based compensation plans | 629 | 970 |
| Excess tax benefits from exercise or vesting of equity awards | 3,754 | 2,670 |
| Dividend payments to shareholders | (4,581) | (2,281) |
| Common stock repurchases for tax withholdings for net settlement of equity awards | (4,939) | (4,123) |
| Common stock repurchases under share repurchase programs | (12,266) | (9,178) |
| Cash used in financing activities | (17,403) | (11,942) |
| Effect of exchange rate on cash and cash equivalents | (2,065) | (517) |
| Net increase in cash and cash equivalents | 56,314 | 31,302 |
| Cash and cash equivalents, beginning of period | 80,231 | 77,525 |
| Cash and cash equivalents, end of period | $ 136,545 | $ 108,827 |

See notes to unaudited condensed consolidated financial statements.

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**PEGASYSTEMS INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

## 1. ACCOUNTING POLICIES

***Basis of Presentation***

Pegasystems Inc. (together with its subsidiaries, the Company ) has prepared the accompanying unaudited condensed consolidated financial statements pursuant to the rules and regulations of the U.S. Securities and Exchange Commission ( SEC ) regarding interim financial reporting. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America ( U.S. ) for complete financial statements and should be read in conjunction with the Company s audited financial statements included in the Annual Report on Form 10-K for the year ended December 31, 2013.

In the opinion of management, the Company has prepared the accompanying unaudited condensed consolidated financial statements on the same basis as its audited financial statements, and these financial statements include all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the results of the interim periods presented. The operating results for the interim periods presented are not necessarily indicative of the results expected for the full year 2014.

During the third quarter and nine months of 2014, the Company adjusted the purchase price allocation of its acquisition of Antenna Software, Inc. (together with its subsidiaries, Antenna ) on October 9, 2013. As required by applicable business combination accounting rules, these adjustments were applied retrospectively. These revisions did not have any impact on the Company s previously reported results of operations or cash flows. See Note 7 Acquisitions and Note 8 Goodwill and Other Intangible Assets for further discussion of these adjustments.

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## 2. NEW ACCOUNTING PRONOUNCEMENTS

***Revenue from Contracts with Customers:*** In May 2014, the Financial Accounting Standard Board ( FASB ) issued Accounting Standards Update ( ASU ) No. 2014-09, Revenue from Contracts with Customers (Topic 606) . This ASU amends the guidance for revenue recognition to replace numerous, industry-specific requirements and converges areas under this topic with those of the International Financial Reporting Standards. This ASU implements a five-step process for customer contract revenue recognition that focuses on transfer of control, as opposed to transfer of risk and rewards. This ASU also requires enhanced disclosures regarding the nature, amount, timing and uncertainty of revenues and cash flows from contracts with customers. Other major provisions include ensuring the time value of money is considered in the transaction price, and allowing estimates of variable consideration to be recognized before contingencies are resolved in certain circumstances. The amendments in this ASU are effective for reporting periods beginning after December 15, 2016, and early adoption is not permitted. Entities can transition to the standard either retrospectively or as a cumulative-effect adjustment as of the date of adoption. This ASU will be effective for the Company January 1, 2017. Management is currently assessing the impact the adoption of this ASU will have on the Company s consolidated financial statements.

## 3. MARKETABLE SECURITIES

| (in thousands) | September 30, 2014 | | | |
|---|---|---|---|---|
| | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value |
| Municipal bonds | $ 35,595 | 68 | (4) | $ 35,659 |
| Corporate bonds | 53,483 | 25 | (83) | 53,425 |
| Certificates of deposit | 2,939 | 3 | | 2,942 |
| | $ 92,017 | 96 | (87) | $ 92,026 |

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

The Company considers debt securities with maturities of three months or less from the purchase date to be cash equivalents. Interest is recorded when earned. All of the Company s investments are classified as available-for-sale and are carried at fair value with unrealized gains and losses recorded as a component of accumulated other comprehensive income, net of related income taxes.

As of September 30, 2014, remaining maturities of marketable debt securities ranged from October 2014 to February 2017, with a weighted-average remaining maturity of approximately 13 months.

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## 4. DERIVATIVE INSTRUMENTS

The Company has historically used foreign currency forward contracts ( forward contracts ) to manage its exposure to changes in foreign currency denominated accounts receivable, intercompany payables and cash primarily held by the U.S. operating company. The Company is primarily exposed to fluctuations in the British pound, Euro, Australian dollar and Indian rupee relative to the U.S. dollar.

The forward contracts utilized by the Company are not designated as hedging instruments and as a result, the Company records the fair value of these contracts at the end of each reporting period in its consolidated balance sheet as other current assets for unrealized gains and accrued expenses for unrealized losses, with any fluctuations in the value of these contracts recognized in other income (expense), net, in its consolidated statement of operations. These forward contracts have terms of 90 days or less.

The Company is in the process of reassessing its hedging strategy and has not entered into any forward contracts since February 2014. As of September 30, 2014 and December 31, 2013, the Company did not have any forward contracts outstanding.

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

| | Notional Amount | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Three Months Ended September 30, | | | | Nine Months Ended September 30, | | | |
| **Foreign currency (in thousands)** | **2014** | | **2013** | | **2014** | | **2013** | |
| Euro | | | | 28,500 | | 21,900 | | 61,000 |
| British pound | £ | | £ | 26,000 | £ | 26,500 | £ | 59,500 |
| Australian dollar | A$ | | A$ | 15,500 | A$ | 12,900 | A$ | 15,500 |
| Indian rupee | Rs | | Rs | 460,000 | Rs | 204,000 | Rs | 460,000 |

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

| | Change in Fair Value in USD | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Three Months Ended September 30, | | | | Nine Months Ended September 30, | | | |
| **(in thousands)** | **2014** | | **2013** | | **2014** | | **2013** | |
| (Loss) included in other income (expense), net | $ | | $ | (1,173) | $ | (532) | $ | (430) |

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## 5. FAIR VALUE MEASUREMENTS

*Assets Measured at Fair Value on a Recurring Basis*

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

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

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

| | | Fair Value Measurements at Reporting Date Using | |
|---|---|---|---|
| **(in thousands)** | **September 30, 2014** | **Quoted Prices in Active Markets for Identical Assets (Level 1)** | **Significant Other Observable Inputs (Level 2)** |
| Money market funds | $ 4,722 | $ 4,722 | $ |
| Marketable securities: | | | |
| Municipal bonds | $ 35,659 | $ 10,401 | $ 25,258 |
| Corporate bonds | 53,425 | 53,425 | |
| Certificates of deposit | 2,942 | | 2,942 |
| Total marketable securities | $ 92,026 | $ 63,826 | $ 28,200 |

| (in thousands) | December 31, 2013 | Fair Value Measurements at Reporting Date Using Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) |
|---|---|---|---|
| Money market funds | $ 2,232 | $ 2,232 | $ |
| | | | |
| Marketable securities: | | | |
| Municipal bonds | $ 41,600 | $ 10,569 | $ 31,031 |
| Corporate bonds | 31,916 | 31,916 | |
| Certificates of deposit | 2,945 | | 2,945 |
| | | | |
| Total marketable securities | $ 76,461 | $ 42,485 | $ 33,976 |

*Assets Measured at Fair Value on a Nonrecurring Basis*

Assets recorded at fair value on a nonrecurring basis, such as property and equipment, and intangible assets, are recognized at fair value when they are impaired. During the nine months of 2014 and 2013, the Company did not recognize any impairments on its assets measured at fair value on a nonrecurring basis.

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## 6. TRADE ACCOUNTS RECEIVABLE, NET OF ALLOWANCE

| (in thousands) | September 30, 2014 | December 31, 2013 |
|---|---|---|
| Trade accounts receivable | $ 79,717 | $ 129,020 |
| Unbilled trade accounts receivable | 25,311 | 38,618 |
| Total accounts receivable | 105,028 | 167,638 |
| Allowance for sales credit memos | (1,589) | (1,997) |
| | $ 103,439 | $ 165,641 |

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

## 7. ACQUISITIONS

***Profeatable***

On July 1, 2014, the Company acquired all of the outstanding capital stock of Profeatable Corporation ( Profeatable ), the provider of Firefly co-browsing technology, based in Philadelphia, Pennsylvania, for $2.3 million in cash consideration, inclusive of $0.2 million in cash acquired, of which $1.1 million will be paid within one year from the acquisition date or earlier, based on the achievement of certain performance milestones.

***MeshLabs***

On April 28, 2014, the Company acquired the assets of MeshLabs Software Private Limited ( MeshLabs ), a provider of advanced text analytics and social engagement solutions based in Bangalore, India, for $0.8 million in cash consideration.

***Antenna***

On October 9, 2013, the Company acquired Antenna, a leading provider of mobile application development platforms. The Company acquired all of the outstanding capital stock of Antenna in a cash merger for $27.1 million, including the final working capital adjustment to the purchase price, which was paid by the Company in the first quarter of 2014. The total purchase price of $27.1 million included $4.2 million, which was deposited in escrow to secure the selling stockholders indemnification obligations to the Company. Under the merger agreement, this amount may be due to the former shareholders of Antenna in or before April 2015 less any amounts presented and approved for payment against the escrow. During the nine months of 2014, the Company incurred and recorded direct and incremental expenses associated with the transaction of $0.3 million, which were primarily professional fees.

The operations of Antenna are included in the Company s operating results from the date of acquisition. Due to the integration of the products, sales force, and operations of Antenna, other than the maintenance and hosting revenue attributable to the recognition of the fair value of acquired deferred maintenance and hosting revenue, it is no longer feasible for the Company to identify revenue from new arrangements solely attributable to Antenna.

In the nine months of 2014, the Company made $6 million in purchase price adjustments to goodwill. These purchase price adjustments are also reflected retrospectively as of December 31, 2013 in the accompanying unaudited condensed consolidated balance sheet.

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As of September 30, 2014, as a result of the purchase price allocation, the Company recognized $23.0 million of goodwill, which is primarily due to the expected synergies of the combined entities and the workforce in place. The goodwill created by the transaction is nondeductible for tax purposes. The Company recorded $37.2 million of deferred tax assets, a $27.7 million valuation allowance related to the Company s determination it will not be able to utilize all of the acquired Antenna federal and foreign net operating losses due to various limitations and restrictions, and a $6.9 million deferred tax liability associated with the acquired intangibles, for a net deferred tax asset of $2.6 million. A summary of the final purchase price allocation for the acquisition of Antenna is as follows:

| **(in thousands)** | | |
|---|---|---|
| Total purchase consideration: | | |
| Cash | $ | 27,141 |
| | | |
| Allocation of the purchase consideration: | | |
| Cash | $ | 783 |
| Accounts receivable, net of allowance | | 4,184 |
| Other assets | | 3,951 |
| Property and equipment | | 655 |
| Deferred tax assets, net | | 2,638 |
| Identifiable intangible assets | | 10,355 |
| Goodwill | | 23,018 |
| Accounts payable | | (1,396) |
| Accrued liabilities | | (12,861) |
| Deferred revenue | | (4,186) |
| | | |
| Net assets acquired | $ | 27,141 |

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

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

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

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

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***Pro forma Information***

The following pro forma financial information presents the combined results of operations of the Company and Antenna as if the acquisition had occurred on January 1, 2012 after giving effect to certain pro forma adjustments. The pro forma adjustments reflected herein include only those adjustments that are directly attributable to the Antenna acquisition, factually supportable, and expected to have a continuing impact on the Company. These pro forma adjustments include a net increase in amortization expense to eliminate historical amortization of Antenna intangible assets and to record amortization expense for the $10.4 million of acquired identifiable intangibles, a decrease in interest income as a result of the cash paid for the acquisition, and a decrease in interest expense as a result of the repayment of all Antenna outstanding debt in connection with the acquisition. The pro forma financial information does not reflect any adjustments for anticipated synergies resulting from the acquisition and is not necessarily indicative of the operating results that would have actually occurred had the transaction been consummated on January 1, 2012.

| (in thousands, except per share amounts) | Pro Forma Three Months Ended September 30, 2013 | Pro Forma Nine Months Ended September 30, 2013 |
|---|---|---|
| Revenue | $ 131,301 | $ 379,595 |
| Net income | $ 9,750 | $ 19,413 |
| Net income per basic share | $ 0.13 | $ 0.26 |
| Net income per diluted share | $ 0.12 | $ 0.25 |

**8. GOODWILL AND OTHER INTANGIBLE ASSETS**

Changes in the carrying amount of goodwill:

| (in thousands) | 2014 |
|---|---|
| Balance as of January 1, | $ 37,463 |
| Purchase price adjustments to goodwill retroactively applied (1) | 6,006 |
| Goodwill acquired | 1,540 |
| Balance as of September 30, | $ 45,009 |

(1) The purchase price adjustments identified during the nine months of 2014 have been retroactively applied as of December 31, 2013.

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

| (in thousands) | Range of Useful Lives | | Cost | | Accumulated Amortization | | Net Book Value |
|---|---|---|---|---|---|---|---|
| **As of September 30, 2014** | | | | | | | |
| Customer related intangibles | 4-9 years | $ | 48,634 | $ | (22,813) | $ | 25,821 |
| Technology | 3-9 years | | 48,342 | | (27,539) | | 20,803 |
| Other intangibles | 1-5 years | | 5,361 | | (4,105) | | 1,256 |
| Total | | $ | 102,337 | $ | (54,457) | $ | 47,880 |

| | | | Cost | | Accumulated Amortization | | Net Book Value |
|---|---|---|---|---|---|---|---|
| **As of December 31, 2013** | | | | | | | |
| Customer related intangibles | 4-9 years | $ | 48,634 | $ | (18,317) | $ | 30,317 |
| Technology | 3-9 years | | 47,102 | | (22,873) | | 24,229 |
| Other intangibles | 1-5 years | | 4,658 | | (2,630) | | 2,028 |
| Total | | $ | 100,394 | $ | (43,820) | $ | 56,574 |

Amortization of intangibles was reflected in the Company s unaudited condensed consolidated statements of operations as follows:

| | Three Months Ended September 30, | | | | Nine Months Ended September 30, | | | |
|---|---|---|---|---|---|---|---|---|
| (in thousands) | 2014 | | 2013 | | 2014 | | 2013 | |
| Cost of revenue | $ | 1,382 | $ | 1,540 | $ | 4,666 | $ | 4,622 |
| Selling and marketing | | 1,501 | | 1,232 | | 4,496 | | 3,696 |
| General and administrative | | 574 | | | | 1,475 | | 4 |
| Total amortization expense | $ | 3,457 | $ | 2,772 | $ | 10,637 | $ | 8,322 |

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

| (in thousands) as of September 30, 2014 | Future estimated amortization expense |
|---|---|
| Remainder of 2014 | $ 3,149 |
| 2015 | 12,073 |
| 2016 | 11,386 |
| 2017 | 9,688 |
| 2018 | 8,688 |
| 2019 | 2,896 |
| | $ 47,880 |

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## 9. ACCRUED EXPENSES

| (in thousands) | September 30, 2014 | December 31, 2013 |
|---|---|---|
| Partner commissions | $ 1,592 | $ 4,106 |
| Other taxes | 10,080 | 10,381 |
| Employee reimbursable expenses | 2,378 | 1,539 |
| Dividends payable | 2,293 | 1,145 |
| Professional services contractor fees | 2,318 | 1,997 |
| Self-insurance health and dental claims | 1,351 | 1,265 |
| Professional fees | 1,860 | 2,868 |
| Short-term deferred rent | 1,401 | 740 |
| Income taxes payable | 733 | 1,450 |
| Acquisition-related expenses and merger consideration | 1,259 | 902 |
| Restructuring | 816 | 371 |
| Marketing expenses and programs | 2,166 | 1,279 |
| Purchased securities settled after period end | 2,997 | |
| Other | 3,795 | 3,581 |
| | $ 35,039 | $ 31,624 |

## 10. DEFERRED REVENUE

| (in thousands) | September 30, 2014 | December 31, 2013 |
|---|---|---|
| Software license | $ 44,470 | $ 28,826 |
| Maintenance | 73,573 | 72,715 |
| Cloud | 3,826 | 2,360 |
| Services and other | 6,390 | 6,789 |
| Current deferred revenue | 128,259 | 110,690 |
| Software license | 20,227 | 32,727 |
| Maintenance and services | 380 | 1,115 |

| | | | | |
|---|---|---|---|---|
| Cloud | | 38 | | 354 |
| Long-term deferred revenue | | 20,645 | | 34,196 |
| | $ | 148,904 | $ | 144,886 |

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## 11. ACCRUED RESTRUCTURING

During the fourth quarter of 2013, in connection with the Company s evaluation of its combined facilities with Antenna, the Company approved a plan to eliminate space within one facility. The Company ceased use of this space during the fourth quarter of 2013 and recognized $1.7 million of restructuring expenses. During the third quarter of 2014, the Company restructured the remaining space within the same facility, revised its restructuring estimate, and recognized $0.2 million in additional restructuring expense. These restructuring expenses represent future lease payments and demising costs, net of estimated sublease income for this space. The lease expires in 2021.

A summary of the restructuring activity is as follows:

| **(in thousands)** | | |
|---|---|---|
| Balance as of December 31, 2013 | $ | 1,591 |
| Restructuring expenses | | 192 |
| Cash payments | | (257) |
| Other | | (128) |
| Balance as of September 30, 2014 | $ | 1,398 |

| **(in thousands)** | | **As of September 30, 2014** | | **As of December 31, 2013** |
|---|---|---|---|---|
| Reported as: | | | | |
| Accrued expenses | $ | 816 | $ | 371 |
| Other long-term liabilities | | 582 | | 1,220 |
| | $ | 1,398 | $ | 1,591 |

## 12. STOCK-BASED COMPENSATION

Stock-based compensation expense was reflected in the Company s unaudited condensed consolidated statements of operations as follows:

| | **Three Months Ended September 30,** | | | | **Nine Months Ended September 30,** | | | |
|---|---|---|---|---|---|---|---|---|
| **(in thousands)** | | **2014** | | **2013** | | **2014** | | **2013** |
| Cost of services | $ | 1,418 | $ | 947 | $ | 3,816 | $ | 3,134 |
| Operating expenses | | 3,850 | | 2,053 | | 9,905 | | 6,579 |

| | | | | |
|---|---|---|---|---|
| Total stock-based compensation before tax | $ 5,268 | $ 3,000 | $ 13,721 | $ 9,713 |
| Income tax benefit | (1,395) | (893) | (3,977) | (2,941) |

On April 1, 2014, the Company effected a two-for-one stock split of the Company s common stock in the form of a stock dividend. All shares of common stock and per share amounts in the Company s unaudited condensed consolidated financial statements and in the accompanying notes for all prior periods presented have been restated to reflect the stock split, except for the number of authorized shares of common stock.

During the nine months of 2014, the Company issued approximately 635,000 shares to its employees and 29,000 shares to its non-employee directors under the Company s share-based compensation plans.

During the nine months of 2014, the Company granted approximately 1,193,000 restricted stock units ( RSUs ) and 1,299,000 non-qualified stock options to its employees with total fair values of approximately $23.7 million and $9.9 million, respectively. Approximately 100,000 RSUs were issued in connection with the election by employees to receive 50% of their 2014 target incentive compensation under the Company s Corporate Incentive Compensation Plan (the CICP ) in the form of RSUs instead of cash. Stock-based compensation of approximately $2 million associated with this RSU grant will be recognized over a one-year period beginning on the grant date.

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The Company recognizes stock based compensation on the accelerated recognition method, while treating each vesting tranche as if it were an individual grant. As of September 30, 2014, the Company had approximately $24.2 million of unrecognized stock-based compensation expense, net of estimated forfeitures, related to all unvested RSUs and unvested stock options that is expected to be recognized over a weighted-average period of 2.1 years.

## 13. EARNINGS PER SHARE

Basic earnings per share is computed using the weighted-average number of common shares outstanding during the applicable period. Diluted earnings per share is computed using the weighted-average number of common shares outstanding during the applicable period, plus the dilutive effect of outstanding options, RSUs, and warrants, using the treasury stock method and the average market price of the Company s common stock during the applicable period. Certain shares related to some of the Company s outstanding stock options and RSUs were excluded from the computation of diluted earnings per share because they were antidilutive in the periods presented, but could be dilutive in the future.

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| *(in thousands, except per share amounts)* | **2014** | **2013** | **2014** | **2013** |
| ***Basic (1)*** | | | | |
| Net income | $ 1,882 | $ 8,710 | $ 13,151 | $ 22,482 |
| Weighted-average common shares outstanding | 76,351 | 75,910 | 76,312 | 75,900 |
| Earnings per share, basic | $ 0.02 | $ 0.11 | $ 0.17 | $ 0.30 |
| ***Diluted (1)*** | | | | |
| Net income | $ 1,882 | $ 8,710 | $ 13,151 | $ 22,482 |
| Weighted-average common shares outstanding, basic | 76,351 | 75,910 | 76,312 | 75,900 |
| Weighted-average effect of dilutive securities: | | | | |
| Stock options | 1,730 | 1,826 | 1,754 | 1,458 |
| RSUs | 572 | 422 | 465 | 386 |
| Effect of assumed exercise of stock options, warrants and RSUs | 2,302 | 2,248 | 2,219 | 1,844 |
| Weighted-average common shares outstanding, diluted | 78,653 | 78,158 | 78,531 | 77,744 |
| Earnings per share, diluted | $ 0.02 | $ 0.11 | $ 0.17 | $ 0.29 |
| | 107 | 66 | 110 | 292 |

Outstanding options and RSUs excluded as impact would be antidilutive

(1) The number of common shares and per share amounts have been retroactively restated for all prior periods presented to reflect the Company s two-for-one common stock split effected in the form of a common stock dividend distributed on April 1, 2014.

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## 14. GEOGRAPHIC INFORMATION AND MAJOR CLIENTS

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker ( CODM ) in deciding how to allocate resources and in assessing performance.

The Company develops and licenses its software solutions and provides consulting services, maintenance, and training related to its software. The Company derives substantially all of its revenue from the sale and support of one group of similar products and services software that provides business process solutions in the enterprise applications market. To assess performance, the Company s CODM reviews financial information on a consolidated basis. The Company has one operating segment after completing the integration of Antenna s operations. Therefore, the Company determined it has one reportable segment Digital Enterprise Business Solutions.

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

| | Three Months Ended September 30, | | | | Nine Months Ended September 30, | | | |
|---|---|---|---|---|---|---|---|---|
| *llars in thousands)* | 2014 | | 2013 | | 2014 | | 2013 | |
| | $ 77,792 | 57 % | $ 59,034 | 49 % | $ 230,220 | 55 % | $ 189,489 | 53 |
| er Americas | 12,195 | 9 % | 4,208 | 3 % | 21,499 | 5 % | 14,419 | 4 |
| ed Kingdom | 19,098 | 14 % | 22,115 | 18 % | 72,655 | 17 % | 58,782 | 17 |
| er EMEA | 15,910 | 11 % | 24,910 | 20 % | 66,218 | 16 % | 66,538 | 19 |
| Pacific | 12,636 | 9 % | 11,744 | 10 % | 30,488 | 7 % | 26,344 | 7 |
| | $ 137,631 | 100 % | $ 122,011 | 100 % | $ 421,080 | 100 % | $ 355,572 | 100 |

There were no clients accounting for 10% or more of the Company s total revenue during the third quarter and nine months of 2014 and 2013. Clients accounting for 10% or more of the Company s total outstanding trade receivables, net, are as follows:

| *(Dollars in thousands)* | As of September 30, 2014 | As of December 31, 2013 |
|---|---|---|
| **Trade receivables, net of allowance** | **$ 103,439** | **$ 165,641** |
| Client A | n/a | 16 % |

## 15. SUBSEQUENT EVENT

On October 31, 2014, the Company acquired, Ultima IT ( Ultima ), a leading provider of consulting and services for developing strategic business applications, CRM and IT Infrastructure in the Turkish market, for $3.1 million in cash consideration, inclusive of $1.7 million in cash acquired. In addition, the Ultima shareholders are eligible to receive additional cash consideration based on the achievement of certain performance milestones through the end of 2016.

The Company believes the acquisition will reinforce its support network for existing and new clients in Turkey.

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

### Forward-Looking Statements

This Quarterly Report on Form 10-Q contains or incorporates forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements include, but are not limited to, statements about our future financial performance and business plans, the adequacy of our liquidity and capital resources, the continued payment of quarterly dividends by the Company, and the timing of recognizing revenue under existing term license agreements. These forward-looking statements are based on current expectations, estimates, forecasts and projections about the industry and markets in which we operate and management s beliefs and assumptions. In addition, other written or oral statements that constitute forward-looking statements may be made by us or on our behalf. Words such as expect, anticipate, intend, plan, believe, could, estimate, may, target, project, or variations of s similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions that are difficult to predict. Important factors that could cause actual future activities and results to differ include, among others, variation in demand for our products and services and the difficulty in predicting the completion of product acceptance and other factors affecting the timing of license revenue recognition, the ongoing uncertainty and volatility in the global financial markets, the ongoing consolidation in the financial services and healthcare markets, reliance on third party relationships, the potential loss of vendor specific objective evidence for our consulting services, and management of the Company s growth. These risks are described more completely in Item 1A of Part I of our Annual Report on Form 10-K for the year ended December 31, 2013. We do not intend to update publicly any forward-looking statements, whether as a result of new information, future events or otherwise.

### Business overview

We develop, market, license, and support a software application development platform that enables enterprises to build and integrate strategic business processes into their customer engagement strategies. Our Pega 7 platform ( Pega 7 ) assists our clients in building, deploying, and evolving enterprise applications, creating an environment in which business and IT can collaborate to manage back office operations, front office sales, marketing, and/or customer service needs. We also provide consulting services, maintenance, and training for our software, as well as a variety of applications. Pega 7 is available for installation on premises, and is also cloud enabled.

Our current clients are primarily Global 500 companies and government agencies that seek to manage complex enterprise systems and customer service issues more nimbly and cost-effectively. Our license revenue is primarily derived from sales of the Pega 7 platform and our related applications in the areas of customer service and support, sales and onboarding, marketing, and operations.

Our platform provides a model-driven, visual code-free approach to application development that enables business and IT to collaborate in delivering applications faster and more accurately than traditional Java-based development approaches. Our software uses visual models to capture business processes, and then generates the code for the application from the model. Changes to the code are made by changing the model, and application documentation is generated directly from the model as well. Our recently introduced Pega Cloud® service also provides our clients with the option to build, test, and deploy their applications in a Cloud environment.

Pega 7 and our related applications are used by our clients in financial services, insurance, healthcare, communications and media, life sciences, manufacturing, high technology, government, and other verticals. We continue to invest heavily in research and development to continue improving our software, and most recently have added mobile and co-browsing capabilities as more fully described below. We sell our software directly, and also through a network of business and technology alliances. Our partners include major systems integrators, management consulting firms, technology providers, and application developers.

Customer Service and Support:

Our acquisition of Profeatable Corporation ( Profeatable ) on July 1, 2014, allows us to integrate Profeatable s Firefly Cloud-based collaboration technology into the Pega 7 platform as well as our customer service and sales applications. The Firefly technology enables users to share content by simultaneously co-browsing Web pages. The Profeatable technology is designed to allow our clients to engage customers in real time and on line, and can also be used to enable employees to collaborate on work, regardless of location.

Social Context:

Our acquisition of MeshLabs Software Private Limited ( MeshLabs ) on April 28, 2014, unified MeshLabs social listening, text analytics, and natural language processing with the existing capabilities of our customer service, marketing, and case management applications. The combined solutions are designed to enable our clients to collect social content (tweets, blogs, and posts on Facebook or in other social communities), and enrich it by detecting language, topic, taxonomy, and sentiment. Using this combination, our clients are able to monitor, triage, and respond to social content across multiple channels, and turn it into actionable social intelligence.

Mobile:

Our acquisition of Antenna Software, Inc. and its subsidiaries ( Antenna ) on October 9, 2013 expanded our Application Mobility Platform that is designed to help clients efficiently build, manage, and deploy mobile applications as part of a unified Omni channel experience. By using our Mobility Platform, enterprises can manage the complex elements of the mobile application lifecycle including security, integration, testing, and management of mobile applications and devices. Our mobile application development solutions help businesses to reduce their development time, deployment costs, and the complexity associated with run-the-business mobile applications. The operations of Antenna are included in our operating results from the date of acquisition. Due to the integration of the products, sales force, and operations of Antenna, other than the maintenance and hosting revenue attributable to the recognition of the fair value of acquired deferred maintenance and hosting revenue, it is no longer feasible for us to identify revenue from new arrangements solely attributable to Antenna.

Training:

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

**Critical accounting policies**

Management s Discussion and Analysis of Financial Condition and Results of Operations is based upon our unaudited condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America ( U.S. GAAP ) and the rules and regulations of the SEC for interim financial reporting. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. We base our estimates and judgments on historical experience, knowledge of current conditions, and beliefs of what could occur in the future given available information.

There have been no changes in our critical accounting policies as disclosed in our Annual Report on Form 10-K for the year ended December 31, 2013. For more information regarding our critical accounting policies, we encourage you to read the discussion contained in Item 7 under the heading Critical Accounting Policies, Significant Judgments, and Estimates and Note 2 Significant Accounting Policies included in the notes to the Consolidated Financial Statements contained in our Annual Report on Form 10-K for the year ended December 31, 2013.

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**Results of Operations**

| *(Dollars in thousands)* | Three Months Ended September 30, 2014 | Three Months Ended September 30, 2013 | Increase (Decrease) | | Nine Months Ended September 30, 2014 | Nine Months Ended September 30, 2013 | Increase (Decrease) | |
|---|---|---|---|---|---|---|---|---|
| Total revenue | $ 137,631 | $ 122,011 | $ 15,620 | 13 % | $ 421,080 | $ 355,572 | $ 65,508 | 18 % |
| Gross profit | $ 91,249 | $ 83,913 | $ 7,336 | 9 % | $ 282,094 | $ 241,943 | $ 40,151 | 17 % |
| Total operating expenses | $ 86,252 | $ 70,124 | $ 16,128 | 23 % | $ 260,248 | $ 208,150 | $ 52,098 | 25 % |
| Income from operations | $ 4,997 | $ 13,789 | $ (8,792) | (64)% | $ 21,846 | $ 33,793 | $ (11,947) | (35)% |
| Income before provision for income taxes | $ 2,352 | $ 13,410 | $ (11,058) | (82)% | $ 19,280 | $ 32,085 | $ (12,805) | (40)% |

***Revenue***

| *in thousands)* | Three Months Ended September 30, 2014 | | 2013 | | Increase (Decrease) | | Nine Months Ended September 30, 2014 | | 2013 | | Incre |
|---|---|---|---|---|---|---|---|---|---|---|---|
| ***revenue*** | | | | | | | | | | | |
| l licenses | $ 27,338 | 57 % | $ 28,971 | 65 % | $ (1,633) | | $ 83,995 | 54 % | $ 79,978 | 62 % | $ 4,017 |
| enses | 19,220 | 40 % | 14,077 | 31 % | 5,143 | | 65,086 | 42 % | 42,987 | 34 % | 22,099 |
| tion | 1,734 | 3 % | 1,754 | 4 % | (20) | | 5,837 | 4 % | 5,252 | 4 % | 585 |
| ense revenue | $ 48,292 | 100 % | $ 44,802 | 100 % | $ 3,490 | 8 % | $ 154,918 | 100 % | $ 128,217 | 100 % | $ 26,701 |

The aggregate value of new license arrangements executed during the nine months of 2014 significantly increased compared to the nine months of 2013 due to a higher number and higher total value of license arrangements executed in this period compared to the same period in 2013. The increase in the aggregate value of license arrangements executed was primarily due to one perpetual license arrangement executed in the second quarter of 2014 for more than $10 million. The aggregate value of new license arrangements executed fluctuates quarter to quarter. During the nine months of 2014 and 2013, approximately 86% and 72%, respectively, of the value of new license arrangements were executed with existing clients.

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

The decrease in perpetual license revenue during the third quarter of 2014 compared to the third quarter of 2013 was primarily due to the lower value of perpetual arrangements executed and recognized into revenue during the third quarter of 2014 compared to the same period in 2013. The increase in perpetual license revenue during the nine months of 2014 compared to the nine months of 2013 was primarily due to license arrangements executed in the first half of 2014. The aggregate value of payments due under noncancellable perpetual licenses was $15.3 million as of September 30, 2014 compared to $30.5 million as of September 30, 2013. We expect to recognize $7.1 million of the $15.3 million as revenue in the fourth quarter of 2014.

The increases in term license revenue were primarily due to term license arrangements executed in the fourth quarter of 2013 and first half of 2014 and a $1.5 million prepayment of a client arrangement in the first quarter of 2014. The aggregate value of payments due under noncancellable term licenses and our Pega Cloud arrangements grew to $250 million as of September 30, 2014 compared to $217.9 million as of September 30, 2013. We expect to recognize $21.3 million of the $250 million as revenue in the fourth quarter of 2014 in addition to new term license and Pega Cloud agreements we may complete in the fourth quarter of 2014 or prepayments we may receive from existing term license agreements. See the table of future cash receipts in Liquidity and Capital Resources - Cash Provided by Operating Activities.

Subscription revenue primarily consists of the ratable recognition of license, maintenance and bundled services revenue on license arrangements that include a right to successor products or unspecified future products. Subscription revenue does not include revenue from our Pega Cloud arrangements, which is included in services. The timing of scheduled payments under client arrangements may limit the amount of revenue recognized in a reporting period. Consequently, our subscription revenue may vary quarter to quarter. The increase in subscription revenue for the nine months of 2014 compared to the same period in 2013 was primarily due to the timing of payments for a client arrangement.

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| (Dollars in thousands) | Three Months Ended September 30, 2014 | Three Months Ended September 30, 2013 | Increase | | Nine Months Ended September 30, 2014 | Nine Months Ended September 30, 2013 | Increase | |
|---|---|---|---|---|---|---|---|---|
| ***Maintenance revenue*** | | | | | | | | |
| Maintenance | $ 47,281 | $ 37,979 | $ 9,302 | 24 % | $ 137,555 | $ 112,238 | $ 25,317 | 23 % |

The increases in maintenance revenue were primarily due to the growth in the aggregate value of the installed base of our software and continued strong renewal rates. Maintenance revenue primarily attributable to recognition of the fair value of the acquired Antenna deferred maintenance revenue was $0.1 million and $0.7 million in the third quarter and nine months of 2014, respectively.

| rs in thousands) | Three Months Ended September 30, 2014 | | Three Months Ended September 30, 2013 | | Increase (Decrease) | | Nine Months Ended September 30, 2014 | | Nine Months Ended September 30, 2013 | | Increase (Decrease) |
|---|---|---|---|---|---|---|---|---|---|---|---|
| ***es revenue*** | | | | | | | | | | | |
| lting services | $ 35,951 | 85 % | $ 36,459 | 93 % | $ (508) | (1) % | $ 112,862 | 88 % | 105,831 | 92 % | $ 7,031 |
| | 4,561 | 11 % | 1,638 | 4 % | 2,923 | 178 % | 12,146 | 9 % | 5,441 | 5 % | 6,705 12 |
| ng | 1,546 | 4 % | 1,133 | 3 % | 413 | 36 % | 3,599 | 3 % | 3,845 | 3 % | (246) |
| ervices | $ 42,058 | 100 % | $ 39,230 | 100 % | $ 2,828 | 7 % | $ 128,607 | 100 % | $ 115,117 | 100 % | $ 13,490 1 |

Consulting services primarily relate to new license implementations. The increase in consulting services revenue during the nine months of 2014 was a result of revenue from Antenna and unusually low services revenue in the first quarter of 2013 mainly because many of our large fourth quarter 2012 license arrangements were for the purchase of additional usage, which did not require implementation services. Our consulting services may be lower in future periods as our clients become enabled and our partners lead more projects.

Cloud represents revenue from our Pega Cloud offerings. The increases in cloud revenue during the third quarter and nine months of 2014 were primarily due to growth of our cloud client base and revenue attributable to Antenna.

The increase in training revenue during the third quarter of 2014 was due to an increase in the number of clients taking courses through our PegaACADEMY self-service online training during the third quarter of 2014 compared to the third quarter of 2013. The decrease in training revenue during the nine months of 2014 was primarily due to the increased adoption of our PegaACADEMY self-service online training by our partners, which has a significantly lower average price per student as compared to our traditional instructor-led training.

***Gross profit***

| Three Months Ended September 30, 2014 | Three Months Ended September 30, 2013 | Increase (Decrease) | Nine Months Ended September 30, 2014 | Nine Months Ended September 30, 2013 | Increase (Decrease) |
|---|---|---|---|---|---|

| *(Dollars in thousands)* | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| ***Gross Profit*** | | | | | | | | |
| Software license | $ 47,216 | $ 43,210 | $ 4,006 | 9 % | $ 151,086 | $ 123,466 | $ 27,620 | 22 % |
| Maintenance | 41,896 | 34,380 | 7,516 | 22 % | 122,462 | 101,132 | 21,330 | 21 % |
| Services | 2,137 | 6,323 | (4,186) | (66) % | 8,546 | 17,345 | (8,799) | (51) % |
| Total gross profit | $ 91,249 | $ 83,913 | $ 7,336 | 9 % | $ 282,094 | $ 241,943 | $ 40,151 | 17 % |
| Total gross profit % | 66 % | 69 % | | | 67 % | 68 % | | |
| Software license gross profit % | 98 % | 96 % | | | 98 % | 96 % | | |
| Maintenance gross profit % | 89 % | 91 % | | | 89 % | 90 % | | |
| Services gross profit % | 5 % | 16 % | | | 7 % | 15 % | | |

The increases in total gross profit were primarily due to increases in software license and maintenance revenue.

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The decreases in services gross profit percent were primarily due to increased subcontractor and employee-related costs associated with higher headcount, primarily related to Antenna, and costs incurred on several consulting projects in the third quarter and nine months of 2014, for which the corresponding revenue will be recognized in future periods, as revenue recognition criteria had not been met. In addition, European professional services utilization rates declined 16% and 8% during the third quarter and nine months of 2014 compared to the same periods in 2013, primarily due to the weakening overall economic conditions in Europe and the completion of a large project.

***Operating expenses***

| (Dollars in thousands) | Three Months Ended September 30, 2014 | Three Months Ended September 30, 2013 | Increase (Decrease) | | Nine Months Ended September 30, 2014 | Nine Months Ended September 30, 2013 | Increase | |
|---|---|---|---|---|---|---|---|---|
| ***Amortization of intangibles:*** | | | | | | | | |
| Cost of revenue | $ 1,382 | $ 1,540 | $ (158) | (10) % | $ 4,666 | $ 4,622 | $ 44 | 1 % |
| Selling and marketing | 1,501 | 1,232 | 269 | 22 % | 4,496 | 3,696 | 800 | 22 % |
| General and administrative | 574 | | 574 | n/m | 1,475 | 4 | 1,471 | n/m |
| | $ 3,457 | $ 2,772 | $ 685 | 25 % | $ 10,637 | $ 8,322 | $ 2,315 | 28 % |

n/m - not meaningful

The increases in amortization expense were primarily due to the amortization associated with $10.4 million of intangibles acquired from Antenna in October 2013.

| (Dollars in thousands) | Three Months Ended September 30, 2014 | Three Months Ended September 30, 2013 | Increase | | Nine Months Ended September 30, 2014 | Nine Months Ended September 30, 2013 | Increase | |
|---|---|---|---|---|---|---|---|---|
| ***Selling and marketing*** | | | | | | | | |
| Selling and marketing | $ 48,623 | $ 42,663 | $ 5,960 | 14 % | $ 150,772 | $ 127,279 | $ 23,493 | 18 % |
| As a percent of total revenue | 35 % | 35 % | | | 36 % | 36 % | | |
| Selling and marketing headcount at September 30, | | | | | 637 | 538 | 99 | 18 % |

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

The increase in selling and marketing expenses during the third quarter of 2014 compared to the same period in 2013 was primarily due to a $5.1 million increase in compensation and benefits associated with higher headcount, partially due to Antenna, and a $1.5 million increase in marketing and sales program expenses, partially offset by a $2.6 million decrease in partner commissions.

The increase in selling and marketing expenses during the nine months of 2014 compared to the same period in 2013 was primarily due to a $12.8 million increase in compensation and benefit expenses associated with higher headcount, partially due to Antenna, a $3.5 million increase in marketing and sales program expenses primarily related to PegaWORLD, our annual user conference, a $2.7 million increase in commission expense associated with the higher value of new license arrangements executed during the nine months of 2014 compared to the same period in 2013, a $0.9 million increase in contracted services, and a $0.8 million increase in amortization expense due to the Antenna customer related intangible assets, partially offset by a $2.8 million decrease in partner commissions.

Effective January 1, 2014, we realigned the organizational structure of our product management and design team. As a result of this realignment, we changed the classification of this team s expenses from selling and marketing to research and development as the roles of the members of this team are now aligned with our research and development efforts. The decrease caused by this realignment partially offset the increase in headcount as well as the overall increase in selling and marketing expenses during the third quarter and nine months of 2014 compared to the same periods in 2013.

| (Dollars in thousands) | Three Months Ended September 30, 2014 | 2013 | Increase | | Nine Months Ended September 30, 2014 | 2013 | Increase | |
|---|---|---|---|---|---|---|---|---|
| ***Research and development*** | | | | | | | | |
| Research and development | $ 28,558 | $ 19,786 | $ 8,772 | 44 % | $ 80,490 | $ 59,123 | $ 21,367 | 36 % |
| As a percent of total revenue | 21 % | 16 % | | | 19 % | 17 % | | |
| Research and development headcount at September 30, | | | | | 1,046 | 817 | 229 | 28 % |

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

The realignment of the organizational structure of our product management and design team as discussed above contributed to the increase in headcount as well as the overall increase in research and development expense during the third quarter and nine months of 2014 compared to the same periods in 2013.

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

The increase in research and development expenses during the third quarter of 2014 compared to the same period in 2013 was primarily due to a $6.2 million increase in compensation and benefit expenses associated with higher headcount inclusive of the compensation and benefit expenses associated with our product management and design group now included in research and development, a $0.8 million increase in contracted professional services, and a $0.7 million increase in equipment-related costs.

The increase in research and development expenses during the nine months of 2014 compared to the same period in 2013 was primarily due to a $15 million increase in compensation and benefit expenses associated with higher headcount inclusive of the compensation and benefit expenses associated with our product management and design group now included in research and development, a $1.9 million increase in equipment-related costs, and a $1.4 million increase in contracted professional services.

| *(Dollars in thousands)* | Three Months Ended September 30, 2014 | 2013 | Increase | Nine Months Ended September 30, 2014 | 2013 | Increase |
|---|---|---|---|---|---|---|
| ***General and administrative*** | | | | | | |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| General and administrative | $ 8,825 | $ 7,130 | $ 1,695 | 24 % | $ 28,377 | $ 21,203 | $ 7,174 | 34 % |
| As a percent of total revenue | 6 % | 6 % | | | 7 % | 6 % | | |
| General and administrative headcount at September 30, | | | | | 298 | 248 | 50 | 20 % |

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

The increase in general and administrative expenses during the third quarter of 2014 compared to the same period in 2013 was primarily due to a $1 million increase in compensation and benefits associated with higher headcount and a $0.6 million increase in amortization associated with the Antenna trademark intangible asset and the non-compete intangible assets related to the Antenna, MeshLabs, and Profeatable acquisitions.

The increase in general and administrative expenses during the nine months of 2014 compared to the same period in 2013 was primarily due to a $2.7 million increase in compensation and benefits associated with higher headcount, a $1.7 million increase in professional fees, and a $1.5 million increase in amortization associated with the Antenna trademark intangible asset and the non-compete intangible assets related to the Antenna, MeshLabs, and Profeatable acquisitions.

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***Restructuring expenses***

The restructuring expenses represent future lease payments and demising costs, net of estimated sublease income for space acquired in connection with the Antenna acquisition. During the fourth quarter of 2013, we ceased use of some of this space as part of our integration of Antenna. During the third quarter of 2014, we restructured the remaining space and revised our estimate of sublease income for the previously restructured space, recognizing $0.2 million in expenses. See Note 11 Accrued Restructuring for further discussion.

***Stock-based compensation***

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

| *(Dollars in thousands)* | **Three Months Ended September 30, 2014** | **2013** | **Increase** | | **Nine Months Ended September 30, 2014** | **2013** | **Increase** | |
|---|---|---|---|---|---|---|---|---|
| Cost of services | $ 1,418 | $ 947 | $ 471 | 50% | $ 3,816 | $ 3,134 | $ 682 | 22 % |
| Operating expenses | 3,850 | 2,053 | 1,797 | 88% | 9,905 | 6,579 | 3,326 | 51 % |
| Total stock-based compensation before tax | 5,268 | 3,000 | 2,268 | 76% | 13,721 | 9,713 | 4,008 | 41 % |
| Income tax benefit | (1,395) | (893) | | | (3,977) | (2,941) | | |

The increases in stock-based compensation expense during the third quarter and nine months of 2014 were primarily due to the timing of the 2013 and 2012 annual periodic equity grants, which occurred in March 2014 and December 2012, respectively, as well as the higher value of the 2013 annual periodic equity grant, executive new hire grants made since September 30, 2013, and awards granted in connection with the 2014 acquisitions.

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

| *(Dollars in thousands)* | **Three Months Ended September 30, 2014** | **2013** | **Change** | | **Nine Months Ended September 30, 2014** | **2013** | **Change** | |
|---|---|---|---|---|---|---|---|---|
| Foreign currency transaction (loss) gain | $ (2,845) | $ 661 | $ (3,506) | (530) % | $ (2,527) | $ (1,666) | $ (861) | 52 % |
| Interest income, net | 181 | 123 | 58 | 47 % | 468 | 376 | 92 | 24 % |
| Other income (expense), net | 19 | (1,163) | 1,182 | (102) % | (507) | (418) | (89) | 21 % |
| Non-operating loss | $ (2,645) | $ (379) | $ (2,266) | 598 % | $ (2,566) | $ (1,708) | $ (858) | 50 % |

We have historically used foreign currency forward contracts ( forward contracts ) to manage our exposure to changes in foreign currency denominated accounts receivable, intercompany payables, and cash primarily held by our U.S. operating company. We have not designated these forward contracts as hedging instruments and as a result, we record the fair value of the outstanding contracts at the end of the reporting period in our consolidated balance sheet, with any fluctuations in the value of these contracts recognized in other income (expense), net. The fluctuations in the value of these forward contracts recorded in other income (expense), net, partially offset in net income, the gains and losses from the remeasurement or settlement of the foreign currency denominated accounts receivable, intercompany payables, and cash held by the U.S. operating company recorded in foreign currency transaction (loss) gain.

We are in the process of reassessing our hedging strategy and have not entered into any forward contracts since February 2014.

We are primarily exposed to the fluctuation in the British pound, Euro, Australian dollar and Indian rupee relative to the U.S. dollar. See Note 4 Derivative Instruments in the notes to the accompanying unaudited condensed consolidated financial statements for discussion of our use of forward contracts.

The total change in the fair value of our forward contracts recorded in other income (expense), net, during the nine months of 2014 and 2013 was a loss of $0.5 million and $0.4 million, respectively.

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### *Provision for income taxes*

We account for income taxes at each interim period using our estimated annual effective tax rate and adjust for discrete tax items recorded in the same period. The provision for income taxes represents current and future amounts owed for federal, state, and foreign taxes. During the third quarter of 2014 and 2013, we recorded a tax provision of $0.5 million and $4.7 million, respectively, which resulted in an effective tax rate of 20% and 35%, respectively. During the nine months of 2014 and 2013, we recorded a provision of $6.1 million and $9.6 million, respectively, which resulted in an effective tax rate of 32% and 30%, respectively. Our effective tax rates for the third quarter and nine months of 2014 were below the statutory rate primarily due to our domestic production activities deduction and a favorable foreign tax rate differential. In addition, our effective tax rate for the third quarter of 2014 was impacted by favorable discrete items due to the lapse of certain foreign income tax statutes and transfer pricing rulings. Our effective tax rate for the nine months of 2013 was below the statutory rate primarily due to a $0.8 million tax benefit related to our 2012 research and experimentation credit recognized in the first quarter of 2013 as a result of the American Taxpayer Relief Act of 2012 that was signed into law in January 2013. Our effective tax rate for nine months of 2014 was higher than in the same period in 2013 primarily because the research and experimentation credit has not yet been extended to 2014.

### Liquidity and capital resources

| (in thousands) | Nine Months Ended September 30, 2014 | 2013 |
|---|---|---|
| Cash provided by (used in): | | |
| Operating activities | $ 98,267 | $ 83,435 |
| Investing activities | (22,485) | (39,674) |
| Financing activities | (17,403) | (11,942) |
| Effect of exchange rate on cash | (2,065) | (517) |
| Net increase in cash and cash equivalents | $ 56,314 | $ 31,302 |

| | As of September 30, 2014 | As of December 31, 2013 |
|---|---|---|
| Total cash, cash equivalents, and marketable securities | $ 228,571 | $ 156,692 |

The increase in cash and cash equivalents was primarily due to the significant increase in cash provided by operating activities associated with our strong accounts receivable collections during the nine months of 2014, which were generated from the significant value of arrangements executed in the fourth quarter of 2013 and nine months of 2014. We believe that our current cash, cash equivalents, marketable securities, and cash flow from operations will be sufficient to fund our operations, our dividend payments and our share repurchase program for at least the next 12 months.

We evaluate acquisition opportunities from time to time, which if pursued, could require use of our funds. On October 9, 2013, we acquired Antenna for $26.3 million in cash. During the first quarter of 2014, we paid $0.8 million of the remaining merger consideration related to the final working capital adjustment for Antenna, and we incurred $0.3 million of direct and incremental expenses associated with this transaction during the nine months of 2014. During the second quarter of 2014, we paid $0.8 million in cash consideration to acquire MeshLabs. On July 1, 2014, we acquired Profeatable for $2.3 million in cash consideration, inclusive of $0.2 million in cash acquired, of which $1.2 million was paid upon closing and $1.1 million will be paid within one year from the acquisition or earlier, based on the achievement of certain performance milestones.

As of September 30, 2014, approximately $58.7 million of our cash and cash equivalents was held in our foreign subsidiaries. If it becomes necessary to repatriate these funds, we may be required to pay U.S. tax, net of any applicable foreign tax credits, upon repatriation. We consider the earnings of our foreign subsidiaries to be permanently reinvested and, as a result, U.S. taxes on such earnings are not provided. It is impractical to estimate the amount of U.S. tax we could have to pay upon repatriation due to the complexity of the foreign tax credit calculations and because we consider our earnings permanently reinvested. There can be no assurance that changes in our plans or other events affecting our operations will not result in materially accelerated or unexpected expenditures.

**Cash provided by operating activities**

The primary drivers of cash provided by operating activities during the nine months of 2014 were net income of $13.2 million and the $56.4 million net change in assets and liabilities. The net change in assets and liabilities primarily consisted of a decrease in accounts receivable due to our strong collections, partially offset by an increase in income taxes receivable due to estimated tax payments and the tax benefits associated with domestic stock-based compensation.

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The primary drivers of cash provided by operating activities during the nine months of 2013 were net income of $22.5 million and the $35.9 million net change in assets and liabilities. The net change in assets and liabilities primarily consisted of a decrease in accounts receivable due to higher collections, partially offset by a decrease in accounts payable and accrued expenses due to the timing of payments for compensation-related accruals.

*Future Cash Receipts from License and Cloud Arrangements*

Total contractual future cash receipts due from our existing license and Pega Cloud agreements was approximately $265.3 million as of September 30, 2014 compared to $248.4 million as of September 30, 2013. The future cash receipts due are summarized as follows:

| **(in thousands) as of September 30, 2014** | **Contractual payments for term licenses and cloud arrangements not recorded on the balance sheet (1)** | **Other contractual license payments not recorded on the balance sheet (2)** | **Total** |
|---|---|---|---|
| Remainder of 2014 | $ 21,338 | $ 7,123 | $ 28,461 |
| 2015 | 81,148 | 4,772 | 85,920 |
| 2016 | 72,921 | 3,400 | 76,321 |
| 2017 | 39,964 | | 39,964 |
| 2018 and thereafter | 34,643 | | 34,643 |
| Total | $ 250,014 | $ 15,295 | $ 265,309 |

(1) These amounts include contractual future cash receipts related to our on-premise term licenses and hosted Pega Cloud service offerings. The amounts related to our on-premise term licenses will be recognized as term license revenue in the future over the term of the agreement as payments become due or earlier if prepaid. Future fees associated with our Pega Cloud arrangements will be recognized ratably as cloud revenue within services revenue over the term of the agreement.

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

**Cash used in investing activities**

During the nine months of 2014, cash used in investing activities was primarily for purchases of marketable debt securities of $36.2 million, partially offset by the proceeds received from the maturities of marketable debt securities of $22.2 million.

During the nine months of 2013, cash used in investing activities was primarily for purchases of marketable debt securities of $56.6 million, partially offset by the proceeds received from the maturities of marketable debt securities of $21.1 million.

Payments for acquisitions during the nine months of 2014 totaled $2.6 million, comprised of the payment of the final working capital adjustment to the Antenna shareholders in the first quarter of 2014 and cash consideration to acquire MeshLabs and Profeatable, paid in the second and third quarters of 2014, respectively.

**Cash used in financing activities**

Cash used in financing activities during the nine months of 2014 and 2013 was primarily for repurchases of our common stock. Since 2004, our Board of Directors has approved annual stock repurchase programs that have authorized the repurchase in the aggregate of up to $104.5 million of our common stock. Purchases under these programs have been made on the open market.

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On March 6, 2014, our Board of Directors approved a two-for-one stock split of our common stock in the form of a stock dividend. On April 1, 2014, each stockholder of record at the close of business on March 20, 2014 (the Record Date ) received as a dividend one additional share of common stock, par value $.01, for each share of common stock held on the Record Date. The number of shares and per share amounts for all prior periods presented have been retroactively restated to reflect our two-for-one common stock split, except for the number of authorized shares of common stock. The following table is a summary of our repurchase activity under all of our repurchase programs during the nine months of 2014 and 2013:

| | Nine Months Ended September 30, | | | |
|---|---|---|---|---|
| | 2014 | | 2013 | |
| *(Dollars in thousands)* | **Shares** | **Amount** | **Shares** | **Amount** |
| Prior year authorization as of January 1, | | $ 14,433 | | $ 14,793 |
| Repurchases paid | 598,273 | (12,112) | 619,384 | (9,102) |
| Repurchases unsettled | 10,125 | (197) | 6,626 | (130) |
| Authorization remaining as of September 30, | | $ 2,124 | | $ 5,561 |

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

During the nine months of 2014 and 2013, option and RSU holders net settled stock options and vested RSUs representing the right to purchase a total of 948,000 shares and 1,058,000 shares, respectively, of which only 529,000 shares and 551,000 shares, respectively, were issued to the option and RSU holders and the balance of the shares were surrendered to us to pay for the exercise price and the applicable taxes. During the nine months of 2014 and 2013, instead of receiving cash from the equity holders, we withheld shares with a value of $4.9 million and $4.1 million, respectively, for withholding taxes, and $4.9 million and $3.9 million, respectively, for the exercise price. The value of share repurchases and shares withheld for net settlement of our employee stock option exercises and vesting of RSUs offset the proceeds received under our various share-based compensation plans during the nine months of 2014 and 2013.

*Dividends*

We declared a cash dividend of $0.075 and $0.045 per share on a post-split basis in the nine months of 2014 and 2013, respectively. We paid cash dividends of $4.6 million and $2.3 million in the nine months of 2014 and 2013, respectively. Our Board of Directors authorized the acceleration of the payment of the fourth quarter 2012 dividend to be paid in December 2012 rather than in January 2013. Therefore, there was no dividend payment in the first quarter of 2013. It is our current intention to pay a quarterly cash dividend of $0.03 per share; however, the Board of Directors may terminate or modify this dividend program at any time without notice.

**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

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

We have historically entered into foreign currency forward contracts to partially mitigate our exposure to the fluctuations in foreign exchange rates. The fluctuations in the value of these forward contracts partially offset the gains and losses from the remeasurement or settlement of the foreign currency denominated accounts receivable, intercompany payables, and cash held by the U.S. operating company recorded in foreign currency transaction (loss) gain, thus partially mitigating the volatility.

We are in the process of reassessing our hedging strategy, and we have not entered into any forward contracts since February 2014.

See Note 4 Derivative Instruments for further discussion.

There were no significant changes to our quantitative and qualitative disclosures about market risk during the nine months of 2014. Please refer to Part II, Item 7A. Quantitative and Qualitative Disclosures about Market Risk included in our Annual Report on Form 10-K for the year ended December 31, 2013 for a more complete discussion of our market risk exposure.

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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, 2014. In designing and evaluating our disclosure controls and procedures, our management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives, and our management necessarily applied its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on this evaluation, our CEO and CFO concluded that our disclosure controls and procedures were effective as of September 30, 2014.

***(b) Changes in Internal Control over Financial Reporting.***

There have been no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act) during the quarter ended September 30, 2014 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## Part II Other Information:

## Item 1A. Risk Factors

We encourage you to carefully consider the risk factors identified in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2013. These risk factors could materially affect our business, financial condition and future results and could cause our actual business and financial results to differ materially from those contained in forward-looking statements made in this Quarterly Report on Form 10-Q or elsewhere by management from time to time. There have been no material changes during the nine months of 2014 to the risk factors disclosed in our Annual Report on Form 10-K for the year ended December 31, 2013.

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

The following table sets forth information regarding our repurchases of our common stock during the third quarter of 2014:

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Share Repurchase Programs (1) | Approximate Dollar Value of Shares That May Yet Be Purchased Under Publicly Announced Share Repurchase Programs (in thousands) |
|---|---|---|---|---|
| 7/1/2014 - 7/31/2014 | 55,982 | $ 21.39 | 55,982 | $ 4,930 |
| 8/1/2014 - 8/31/2014 | 54,884 | 21.77 | 54,884 | 3,735 |
| 9/1/2014 - 9/30/2014 | 77,632 | 20.77 | 77,632 | 2,124 |

| | | | |
|---|---|---|---|
| Total | 188,498 | $ | 21.24 |

(1) Since 2004, our Board of Directors has approved stock repurchase programs that have authorized the repurchase, in the aggregate, of up to $104.5 million of our common stock. On December 16, 2013, we announced that our Board of Directors extended the expiration date of the current stock repurchase program (the Current Program ) to December 31, 2014 and authorized the Company to repurchase up to $15 million of our stock between December 11, 2013 and December 31, 2014. Under the Current Program, purchases may be made from time to time on the open market or in privately negotiated transactions. Shares may be repurchased in such amounts as market conditions warrant, subject to regulatory and other considerations. We have established a pre-arranged stock repurchase plan, intended to comply with the requirements of Rule 10b5-1 under the Securities Exchange Act of 1934, as amended, and Rule 10b-18 of the Exchange Act (the 10b5-1 Plan ). All share repurchases under the Current Program during closed trading window periods will be made pursuant to the 10b5-1 Plan.

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## Item 6. Exhibits

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

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## SIGNATURE

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

**Pegasystems Inc.**

Date: November 4, 2014 By: /s/ RAFEAL E. BROWN

**Rafeal E. Brown**
**Chief Financial Officer, Chief Administrative Officer and Senior Vice President**
**(Principal Financial Officer)**

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**PEGASYSTEMS INC.**

**Exhibit Index**

| Exhibit No. | Description |
|---|---|
| 3.1 | Restated Articles of Organization of the Registrant and Amendments thereto. |
| 10.1+ | Compensation program for non-employee members of the Registrant s Board of Directors. (Filed as Exhibit 10.1 to the Registrant s June 30, 2014 Form 10-Q and incorporated herein by reference.) |
| 31.1 | Certification pursuant to Exchange Act Rules 13a-14 and 15d-14 of the Chief Executive Officer. |
| 31.2 | Certification pursuant to Exchange Act Rules 13a-14 and 15d-14 of the Chief Financial Officer. |
| 32 | Certification pursuant to 18 U.S.C. Section 1350 of the Chief Executive Officer and the Chief Financial Officer. |
| 101 | The following materials from Pegasystems Inc. s Quarterly Report on Form 10-Q for the quarter ended September 30, 2014 formatted in XBRL (Extensible Business Reporting Language): (i) the Unaudited Condensed Consolidated Balance Sheets, (ii) the Unaudited Condensed Consolidated Statements of Operations, (iii) the Unaudited Condensed Consolidated Statements of Comprehensive Income, (iv) the Unaudited Condensed Consolidated Statements of Cash Flows, and (v) the Notes to Unaudited Condensed Consolidated Financial Statements. |

+ Management contracts and compensatory plans or arrangements.