PEGASYSTEMS INC
Form 10-Q
August 05, 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 June 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 ¨ (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 76,308,501 shares of the Registrant s common stock, $.01 par value per share, outstanding on July 25, 2014.

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PEGASYSTEMS INC.

UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands)

		As of June 30, 2014		As of December 31, 2013
ASSETS				
Current assets:				
Cash and cash equivalents	$	127,111	$	80,231
Marketable securities		89,102		76,461
Total cash, cash equivalents, and marketable securities		216,213		156,692
Trade accounts receivable, net of allowance of $1,865 and $1,997		114,642		165,628
Deferred income taxes		12,052		12,014
Income taxes receivable		11,690		4,708
Other current assets		8,982		9,148
Total current assets		363,579		348,190
Property and equipment, net		27,223		28,957
Long-term deferred income taxes		61,264		60,291
Long-term other assets		2,998		2,526
Intangible assets, net		50,060		56,574
Goodwill		40,463		40,329
Total assets	$	545,587	$	536,867
LIABILITIES AND STOCKHOLDERS EQUITY				
Current liabilities:				
Accounts payable	$	6,827	$	3,678
Accrued expenses		31,609		31,814
Accrued compensation and related expenses		42,397		44,399
Deferred revenue		120,501		110,882
Total current liabilities		201,334		190,773
Income taxes payable		21,469		21,269

Long-term deferred revenue		24,535		34,196
Other long-term liabilities		17,693		18,841
Total liabilities		265,031		265,079
Stockholders equity (1):				
Preferred stock, 1,000 shares authorized; no shares issued and outstanding				
Common stock, 200,000 shares authorized; 76,348 shares and 76,324 shares issued and outstanding		763		764
Additional paid-in capital		139,198		139,565
Retained earnings		135,658		127,826
Accumulated other comprehensive income		4,937		3,633
Total stockholders equity		280,556		271,788
Total liabilities and stockholders equity	$	545,587	$	536,867

(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 June 30,		Six Months Ended June 30,	
	2014	**2013**	**2014**	**2013**
Revenue:				
Software license	$ 54,012	$ 40,206	$ 106,626	$ 83,415
Maintenance	45,393	37,937	90,274	74,259
Services	43,580	39,172	86,549	75,887
Total revenue	142,985	117,315	283,449	233,561
Cost of revenue:				
Software license	1,177	1,576	2,756	3,159
Maintenance	5,044	3,772	9,708	7,507
Services	40,470	32,530	80,140	64,865
Total cost of revenue	46,691	37,878	92,604	75,531
Gross profit	96,294	79,437	190,845	158,030
Operating expenses:				
Selling and marketing	56,342	45,346	102,149	84,616
Research and development	27,323	19,761	51,932	39,337
General and administrative	10,250	7,277	19,552	14,073
Acquisition-related costs	157		363	
Total operating expenses	94,072	72,384	173,996	138,026
Income from operations	2,222	7,053	16,849	20,004
Foreign currency transaction (loss) gain	(4)	(437)	318	(2,327)
Interest income, net	163	135	287	253
Other income (expense), net	6	(94)	(526)	745

Income before provision for income taxes		2,387		6,657		16,928		18,675
Provision for income taxes		883		1,954		5,659		4,903
Net income	$	1,504	$	4,703	$	11,269	$	13,772
Earnings per share (1):								
Basic	$	0.02	$	0.06	$	0.15	$	0.18
Diluted	$	0.02	$	0.06	$	0.14	$	0.18
Weighted-average number of common shares outstanding (1):								
Basic		76,286		75,898		76,385		75,896
Diluted		78,280		77,498		78,563		77,538
Cash dividends declared per share	$	0.030	$	0.015	$	0.045	$	0.030

(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 INCOME (LOSS)

(in thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Net income	$ 1,504	$ 4,703	$ 11,269	$ 13,772
Other comprehensive income:				
Unrealized (loss) gain on securities, net of tax	(3)	(182)	28	(145)
Foreign currency translation adjustments	891	(417)	1,276	(2,487)
Total other comprehensive income (loss)	888	(599)	1,304	(2,632)
Comprehensive income	$ 2,392	$ 4,104	$ 12,573	$ 11,140

See notes to unaudited condensed consolidated financial statements.

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PEGASYSTEMS INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	Six Months Ended June 30,	
	2014	**2013**
Operating activities:		
Net income	$ 11,269	$ 13,772
Adjustments to reconcile net income to cash provided by operating activities:		
Excess tax benefits from exercise or vesting of equity awards	(2,526)	(1,718)
Deferred income taxes	(899)	(273)
Depreciation and amortization	11,412	9,419
Stock-based compensation expense	8,453	6,713
Foreign currency transaction (gain) loss	(318)	2,327
Other non-cash items	495	2,250
Change in operating assets and liabilities:		
Trade accounts receivable	51,155	37,336
Income taxes receivable and other current assets	(3,836)	(1,031)
Accounts payable and accrued expenses	94	(10,051)
Deferred revenue	(214)	5,166
Other long-term assets and liabilities	(1,150)	370
Cash provided by operating activities	73,935	64,280
Investing activities:		
Purchase of marketable securities	(29,547)	(32,690)
Matured and called marketable securities	15,996	8,540
Payments for acquisitions	(1,593)	
Investment in property and equipment	(2,864)	(1,972)
Cash used in investing activities	(18,008)	(26,122)

Financing activities:		
Issuance of common stock for share-based compensation plans	338	801
Excess tax benefits from exercise or vesting of equity awards	2,526	1,718
Dividend payments to shareholders	(2,290)	(1,142)
Common stock repurchases for tax withholdings for net settlement of equity awards	(3,402)	(2,780)
Common stock repurchases under share repurchase programs	(8,459)	(7,275)
Cash used in financing activities	(11,287)	(8,678)
Effect of exchange rate on cash and cash equivalents	2,240	(3,160)
Net increase in cash and cash equivalents	46,880	26,320
Cash and cash equivalents, beginning of period	80,231	77,525
Cash and cash equivalents, end of period	$ 127,111	$ 103,845

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.

On March 6, 2014, the Company s Board of Directors approved a two-for-one stock split of the Company s common stock, effected 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. 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 periods presented have been restated to reflect the stock split, except for the number of authorized shares of common stock.

At the Company s 2014 Annual Meeting of Stockholders, held on May 20, 2014, the stockholders approved an amendment to the Company s Restated Articles of Organization increasing the number of authorized shares of common stock from 100,000,000 to 200,000,000.

On May 27, 2014, the Company announced an increase in its quarterly cash dividend from $0.015 to $0.03 per share. As a result, it is the Company s current intention to pay a quarterly cash dividend of $0.03 per share. However, the Board of Directors may terminate or modify this dividend program at any time without notice.

During the second quarter of 2014, the Company recorded $3.5 million in adjustments to 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. Therefore, short-term and long-term deferred income tax assets, goodwill, accrued expenses, and income taxes payable have been revised as of December 31, 2013 to reflect these adjustments. 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)	**June 30, 2014**			
	Amortized Cost	**Unrealized Gains**	**Unrealized Losses**	**Fair Value**
Municipal bonds	$ 34,398	117	(5)	$ 34,510
Corporate bonds	51,625	51	(29)	51,647
Certificates of deposit	2,943	3	(1)	2,945
	$ 88,966	171	(35)	$ 89,102

(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 June 30, 2014, remaining maturities of marketable debt securities ranged from July 2014 to July 2016, 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 has been primarily exposed to the fluctuation in the British pound and Euro relative to the U.S. dollar. More recently, the Company has experienced increased levels of exposure to the Australian dollar and Indian rupee.

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.

As of June 30, 2014 and December 31, 2013, the Company did not have any forward contracts outstanding.

During the second quarter of 2014, the Company did not enter into any forward contracts. The Company is in the process of reassessing its hedging strategy.

During the first six months of 2014 and 2013, the Company entered into forward contracts with notional values as follows:

	Notional Amount							
	Three Months Ended June 30,				Six Months Ended June 30,			
Foreign currency (in thousands)	**2014**		**2013**		**2014**		**2013**	
Euro				16,500		21,900		32,500
British pound	£		£	14,500	£	26,500	£	33,500
Australian dollar	A$		A$		A$	12,900	A$	
Indian rupee	Rs		Rs		Rs	204,000	Rs	

During the first six months of 2014 and 2013, 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 June 30,				Six Months Ended June 30,			
(in thousands)	**2014**		**2013**		**2014**		**2013**	
(Loss) gain included in other income	$		$	(95)	$	(532)	$	743

(expense), net

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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)	**June 30, 2014**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**
Money market funds	$ 5,232	$ 5,232	$
Marketable securities:			
Municipal bonds	$ 34,510	$ 15,720	$ 18,790
Corporate bonds	51,647	51,647	
Certificates of deposit	2,945		2,945
Total marketable securities	$ 89,102	$ 67,367	$ 21,735

		Fair Value Measurements at Reporting Date Using	
(in thousands)	**December 31, 2013**	**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 first six months of 2014 and 2013, the Company did not recognize any impairments on its assets measured at fair value on a nonrecurring basis.

6. TRADE ACCOUNTS RECEIVABLE, NET OF ALLOWANCE

(in thousands)	June 30, 2014	December 31, 2013
Trade accounts receivable	$ 84,167	$ 129,007
Unbilled trade accounts receivable	32,340	38,618
Total accounts receivable	116,507	167,625
Allowance for sales credit memos	(1,865)	(1,997)
	$ 114,642	$ 165,628

Unbilled trade accounts receivable relate to services revenue earned under time and material arrangements, and maintenance and license arrangements that had not been invoiced as of June 30, 2014 and December 31, 2013, respectively.

7. ACQUISITIONS

MeshLabs

On April 28, 2014, the Company acquired 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 second quarter and first six months of 2014, the Company incurred and recorded direct and incremental expenses associated with the transaction of $0.1 million and $0.3 million, respectively, which were primarily professional fees.

The operations of Antenna are included in the Company s operating results from the date of acquisition. For the three and six months ended June 30, 2014, revenue of approximately $4.1 million and $8.7 million, respectively, and a net loss of approximately $2.8 million and $5.2 million, respectively, was attributable to Antenna and included in the Company s unaudited condensed consolidated statements of operations. Due to the rapid integration of the products, sales force, and operations of Antenna, other than the maintenance and hosting revenue attributable to the recognition of the fair value of acquired deferred maintenance and hosting revenue, it may not be feasible for the Company to identify revenue from new arrangements solely attributable to Antenna.

The Company is in the process of investigating the facts and circumstances existing as of the acquisition date in order to finalize the allocation of the purchase price to the fair value of assets acquired and liabilities assumed and establish the related tax basis. In the first quarter of 2014, the Company paid $0.8 million of the remaining merger consideration related to the final working capital adjustment, resulting in a $0.6 million purchase price adjustment to goodwill. In the second quarter of 2014, the Company recorded a $3.5 million purchase price adjustment related to taxes. These purchase price adjustments are also reflected retrospectively as of December 31, 2013 in the accompanying unaudited condensed consolidated balance sheet. The Company expects to finalize remaining purchase accounting adjustments during the third quarter of 2014.

As of June 30, 2014, as a result of the preliminary purchase price allocation, the Company recognized $19.9 million of goodwill, which is primarily due to the expected synergies of the combined entities and the workforce in place. The goodwill created by the transaction is nondeductible for tax purposes. The Company recorded $36.9 million of deferred tax assets, a $24.2 million valuation allowance related to the Company s preliminary determination it will not be able to utilize all of the acquired Antenna federal and foreign net operating losses due to various limitations and restrictions, and a $6.8 million deferred tax liability associated with the acquired intangibles, for a net deferred tax asset of $5.9 million. A summary of the preliminary 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		4,170
Other assets		3,978
Property and equipment		655
Deferred tax assets, net		5,862
Identifiable intangible assets		10,355
Goodwill		19,878
Accounts payable		(1,403)
Accrued liabilities		(12,759)
Deferred revenue		(4,378)
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 will be recognized in the 12 months following the acquisition.

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

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

(in thousands)			Weighted-average 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.

	Pro Forma	
	Three Months Ended	Six Months Ended
(in thousands, except per share amounts)	June 30, 2013	
Revenue	$ 124,613	$ 248,294
Net income	$ 2,537	$ 9,280
Net income per basic and diluted share	$ 0.03	$ 0.12

8. GOODWILL AND OTHER INTANGIBLE ASSETS

The following table presents the 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)	2,866
Goodwill acquired	134
Balance as of June 30,	$ 40,463

(1) The purchase price adjustments identified during the first six 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 June 30, 2014				
Customer related intangibles	4-9 years	$ 48,634	$ (21,311)	$ 27,323
Technology	3-9 years	47,616	(26,189)	21,427
Other intangibles	1-5 years	4,810	(3,500)	1,310
Total		$ 101,060	$ (51,000)	$ 50,060

		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 June 30,		Six Months Ended June 30,	
(in thousands)	2014	2013	2014	2013
Cost of revenue	$ 1,444	$ 1,541	$ 3,284	$ 3,082
Selling and marketing	1,499	1,232	2,995	2,464
General and administrative	481		901	4
Total amortization expense	$ 3,424	$ 2,773	$ 7,180	$ 5,550

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

(in thousands) as of June 30, 2014	Future estimated amortization expense
Remainder of 2014	$ 6,209
2015	11,557
2016	11,145
2017	9,564
2018	8,688
2019	2,897
	$ 50,060

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9. ACCRUED EXPENSES

(in thousands)	June 30, 2014	December 31, 2013
Partner commissions	$ 1,981	$ 4,106
Other taxes	8,529	10,349
Employee reimbursable expenses	2,214	1,539
Dividends payable	2,291	1,145
Professional services contractor fees	2,528	1,997
Self-insurance health and dental claims	1,274	1,265
Professional fees	1,845	2,378
Short-term deferred rent	1,342	740
Income taxes payable	606	1,770
Acquisition-related costs and merger consideration	175	997
Restructuring	369	371
Sales and marketing events	4,180	308
Other	4,275	4,849
	$ 31,609	$ 31,814

10. DEFERRED REVENUE

(in thousands)	June 30, 2014	December 31, 2013
Software license	$ 25,610	$ 28,826
Maintenance	83,917	72,715
Cloud	5,317	2,552
Services and other	5,657	6,789
Current deferred revenue	120,501	110,882
Software license	23,906	32,727
Maintenance and services	524	1,115
Cloud	105	354

Long-term deferred revenue		24,535		34,196
	$	145,036	$	145,078

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11. ACCRUED RESTRUCTURING COSTS

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

A summary of the restructuring activity is as follows:

(in thousands)	
Balance as of December 31, 2013	$ 1,591
Restructuring costs	
Cash payments	(170)
Balance as of June 30, 2014	$ 1,421

(in thousands)	**As of June 30, 2014**	**As of December 31, 2013**
Reported as:		
Accrued expenses	$ 369	$ 371
Other long-term liabilities	1,052	1,220
	$ 1,421	$ 1,591

12. STOCK-BASED COMPENSATION

For the second quarter and first six months of 2014 and 2013, stock-based compensation expense was reflected in the Company s unaudited condensed consolidated statements of operations as follows:

	Three Months Ended June 30,		**Six Months Ended June 30,**	
(in thousands)	**2014**	**2013**	**2014**	**2013**
Cost of services	$ 1,387	$ 1,014	$ 2,398	$ 2,187
Operating expenses	3,771	2,267	6,055	4,526
Total stock-based compensation before tax	$ 5,158	$ 3,281	$ 8,453	$ 6,713
Income tax benefit	(1,591)	(944)	(2,582)	(2,047)

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. See Note 1 Accounting Policies for further discussion.

During the first six months of 2014, the Company issued approximately 422,000 shares to its employees and 22,000 shares to its non-employee directors under the Company s share-based compensation plans.

During the first six months of 2014, the Company granted approximately 1,049,000 restricted stock units (RSUs) and 1,070,000 non-qualified stock options to its employees with total fair values of approximately $20.7 million and $8.2 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.

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 June 30, 2014, the Company had approximately $25.6 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 2.2 years.

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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 June 30,		Six Months Ended June 30,	
(in thousands, except per share amounts)	**2014**	**2013**	**2014**	**2013**
Basic (1)				
Net income	$ 1,504	$ 4,703	$ 11,269	$ 13,772
Weighted-average common shares outstanding	76,286	75,898	76,385	75,896
Earnings per share, basic	$ 0.02	$ 0.06	$ 0.15	$ 0.18
Diluted (1)				
Net income	$ 1,504	$ 4,703	$ 11,269	$ 13,772
Weighted-average common shares outstanding, basic	76,286	75,898	76,385	75,896
Weighted-average effect of dilutive securities:				
Stock options	1,607	1,234	1,766	1,272
RSUs	387	366	412	370
Effect of assumed exercise of stock options, warrants and RSUs	1,994	1,600	2,178	1,642
Weighted-average common shares outstanding, diluted	78,280	77,498	78,563	77,538
Earnings per share, diluted	$ 0.02	$ 0.06	$ 0.14	$ 0.18
Outstanding options and RSUs excluded as impact would be antidilutive	166	216	112	404

(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 for two operating segments, which the Company has determined can be aggregated and represent one reportable segment Business Process 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 June 30,				Six Months Ended June 30,			
llars in thousands)	2014		2013		2014		2013	
	$ 70,411	49 %	$ 62,313	53 %	$ 152,428	54 %	$ 130,455	56
er Americas	5,464	4 %	6,449	6 %	9,304	3 %	10,211	4
ed Kingdom	24,643	17 %	21,228	18 %	53,557	19 %	36,667	16
er EMEA	34,008	24 %	21,530	18 %	50,308	18 %	41,628	18
Pacific	8,459	6 %	5,795	5 %	17,852	6 %	14,600	6
	$ 142,985	100 %	$ 117,315	100 %	$ 283,449	100 %	$ 233,561	100

There were no clients accounting for 10% or more of the Company s total revenue. There was one client accounting for 10% or more of the Company s total outstanding trade receivables, net, as listed below:

(Dollars in thousands)	As of June 30, 2014	As of December 31, 2013
Trade receivables, net of allowance	**$ 114,642**	**$ 165,628**
Client A	n/a	16 %

15. SUBSEQUENT EVENT

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 $2.5 million in cash consideration, inclusive of $0.2 million in cash acquired.

The Company will incorporate the Firefly cloud-based collaboration technology into its Build for Change® platform and customer service and sales applications. This should enable organizations to enhance customer experience and increase employee productivity through collaboration. Firefly will also continue to be offered as a stand-alone solution.

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

We focus our sales efforts primarily on target accounts, which are large companies or divisions within companies and typically leaders in their industry. Our strategy is to sell a series of licenses that are focused on a specific purpose or area of operations.

Our license revenue is primarily derived from sales of our Pega Build for Change® platform (PegaRULES Process Commander (PRPC)) and related business solutions. PRPC is a comprehensive platform for building and managing Business Process Management (BPM) applications that unifies business rules and business processes. Our solutions, built on the capabilities of PRPC, are purpose or industry-specific collections of best practice functionality, which allow organizations to quickly implement new customer-facing practices and processes, bring new offerings to market, and provide customized or specialized processing. Our products are simpler, easier to use and often result in shorter implementation periods than competitive enterprise software products. PRPC and related business solutions can be used by a broad range of clients across markets including financial services, insurance, healthcare, communications and media, life sciences, manufacturing and high technology, and government markets.

Our business solution products include Customer Relationship Management (CRM) software, which enables unified predictive decisioning and analytics and optimizes the overall customer experience. Our decision management products and capabilities are designed to manage processes so that actions optimize the process outcomes based on business objectives. We continue to invest in the development of new products and intend to remain a leader in BPM, CRM, and decision management.

We also offer Pega Cloud®, a service offering that allows our clients to immediately build, test, and deploy their applications in a secure cloud environment, while minimizing their infrastructure and hardware costs. Revenue from our Pega Cloud offering is included in services revenue.

Our acquisition of Profeatable Corporation (Profeatable) on July 1, 2014, allows us to integrate Profeatable s Firefly cloud-based collaboration technology into our Build for Change® platform and customer service and sales applications. This should enable organizations to enhance customer experience and increase employee productivity through collaboration. Firefly will also continue to be offered as a stand-alone solution. The Firefly technology enables users to securely share content by simultaneously browsing web pages. It empowers agents to proactively engage customers when and where they need it most, improving customer satisfaction, and driving adoption of self-service tools to increase revenue. It also increases productivity, enabling employees to more easily collaborate on work, regardless of location.

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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 solutions. The combined solution enables our clients to collect social content, such as tweets, blogs, posts on Facebook or in other social communities, and enrich it by detecting language, topic, taxonomy and sentiment to deliver actionable social insight and intelligence. With this combination, our clients can monitor, triage, and respond to social content across all channels, and turn it into actionable social intelligence to improve customer engagement, increase customer retention and more effectively market and sell on social networks.

Our acquisition of Antenna Software, Inc. and its subsidiaries (Antenna) on October 9, 2013 expanded our Application Mobility Platform, which provides clients with a mobile application development platform to build, manage, and deploy mobile applications as part of a seamless omnichannel experience. Enterprises can manage the complex elements of the mobile application lifecycle including security, integration, testing, and management of mobile applications and devices. Our mobile application development solutions help businesses to significantly reduce their development time, deployment costs, and the complexity associated with run-the-business mobile applications. The operations of Antenna are included in our operating results from the date of acquisition. For the three and six months ended June 30, 2014, revenue of approximately $4.1 million and $8.7 million, respectively, and a net loss of approximately $2.8 million and $5.2 million, respectively, was attributable to Antenna and included in our unaudited condensed consolidated statements of operations. Due to the rapid integration of the products, sales force, and operations of Antenna, other than the maintenance and hosting revenue attributable to the recognition of the fair value of acquired deferred maintenance and hosting revenue, it may not be feasible for us to identify revenue from new arrangements solely attributable to Antenna.

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

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.

Results of Operations

	Increase (Decrease)	Increase (Decrease)

(Dollars in thousands)	**Three Months Ended June 30, 2014**	**2013**			**Six Months Ended June 30, 2014**	**2013**		
Total revenue	$ 142,985	$ 117,315	$ 25,670	22 %	$ 283,449	$ 233,561	$ 49,888	21 %
Gross profit	$ 96,294	$ 79,437	$ 16,857	21 %	$ 190,845	$ 158,030	$ 32,815	21 %
Total operating expenses	$ 94,072	$ 72,384	$ 21,688	30 %	$ 173,996	$ 138,026	$ 35,970	26 %
Income from operations	$ 2,222	$ 7,053	$ (4,831)	(68)%	$ 16,849	$ 20,004	$ (3,155)	(16)%
Income before provision for income taxes	$ 2,387	$ 6,657	$ (4,270)	(64)%	$ 16,928	$ 18,675	$ (1,747)	(9)%

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Revenue

	Three Months Ended June 30,				Increase (Decrease)		Six Months Ended June 30,				Increa
in thousands)	**2014**		**2013**				**2014**		**2013**		
revenue											
l licenses	$ 33,272	62 %	$ 24,647	61 %	$ 8,625		$ 56,657	53 %	$ 51,007	61 %	$ 5,650
enses	19,040	35 %	13,230	33 %	5,810		45,866	43 %	28,910	35 %	16,956
tion	1,700	3 %	2,329	6 %	(629)		4,103	4 %	3,498	4 %	605
ense revenue	$ 54,012	100 %	$ 40,206	100 %	$ 13,806	34 %	$ 106,626	100 %	$ 83,415	100 %	$ 23,211

The aggregate value of new license arrangements executed during the second quarter and first six months of 2014 significantly increased compared to the same periods in 2013 due to a higher number and higher value of license arrangements executed in these periods compared to the same periods in 2013. The increase in the aggregate value of license arrangements executed was primarily due to one perpetual license arrangement larger than $10 million executed in the second quarter of 2014. The aggregate value of new license arrangements executed fluctuates quarter to quarter. During the first six months of 2014 and 2013, approximately 84% and 64%, 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 increases in perpetual license revenue during the second quarter and first six months of 2014 compared to the same periods in 2013 were primarily due to the higher value of perpetual arrangements executed during the first six months of 2014 than during the same period in 2013. The aggregate value of payments due under noncancellable perpetual licenses was $46.7 million as of June 30, 2014 compared to $34 million as of June 30, 2013. We expect to recognize $39.4 million of the $46.7 million as revenue during the remainder of 2014.

The increases in term license revenue were primarily due to revenue recognized on term license arrangements executed in the second half of 2013 and a $1.5 million prepayment of a customer arrangement in the first quarter of 2014. The aggregate value of payments due under noncancellable term licenses and our Pega Cloud arrangements grew to $252 million as of June 30, 2014 compared to 212.8 million as of June 30, 2013. We expect to recognize $36.5 million of the $252 million as revenue during the remainder of 2014 in addition to new term license and Pega Cloud agreements we may complete or prepayments we may receive from existing term license agreements. See the table of future cash receipts in Liquidity and Capital Resources - Cash Provided by Operating Activities.

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 decrease in subscription revenue during the second quarter of 2014 and the increase in subscription revenue for the first six months of 2014 compared to the same periods in 2013 were primarily due to the timing of payments for a customer arrangement.

	Three Months Ended June 30,		**Increase**		**Six Months Ended June 30,**		**Increase**	
(Dollars in thousands)	**2014**	**2013**			**2014**	**2013**		
Maintenance revenue								
Maintenance	$ 45,393	$ 37,937	$ 7,456	20 %	$ 90,274	$ 74,259	$ 16,015	22 %

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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 $0.2 million and $0.5 million in the second quarter and first six months of 2014, respectively.

	Three Months Ended June 30,				Increase (Decrease)		Six Months Ended June 30,				Increase (Decrease)	
	2014		2013				2014		2013			
ars in thousands)												
ces revenue												
lting services	$ 38,835	89 %	$ 36,189	92 %	$ 2,646	7 %	$ 76,911	89 %	69,372	91 %	$ 7,539	1
.	3,727	9 %	1,945	5 %	1,782	92 %	7,585	9 %	3,803	5 %	3,782	9
ng	1,018	2 %	1,038	3 %	(20)	(2) %	2,053	2 %	2,712	4 %	(659)	(2
services	$ 43,580	100 %	$ 39,172	100 %	$ 4,408	11 %	$ 86,549	100 %	$ 75,887	100 %	$ 10,662	1

Consulting services primarily relate to new license implementations. The increase in consulting services revenue during the second quarter of 2014 was primarily due to the higher number of projects at higher realization rates compared to the second quarter of 2013, and $1.1 million of revenue from Antenna. The increase in consulting services revenue during the first six months of 2014 was a result of 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. In addition, the increase in consulting services revenue during the first six months of 2014 was due to $2.2 million in revenue from Antenna. Our consulting services may be lower in future periods as our clients are becoming enabled and our partners may be leading more projects.

Cloud represents revenue from our Pega Cloud offerings. The increases in cloud revenue during the second quarter and first six months of 2014 were primarily due to $1 million and $2.2 million, respectively, in revenue attributable to Antenna.

The decrease in our training revenue during the first six 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 June 30,		Increase (Decrease)		Six Months Ended June 30,		Increase (Decrease)	
(Dollars in thousands)	2014	2013			2014	2013		
Gross Profit								
	$ 52,835	$ 38,630	$ 14,205	37 %	$ 103,870	$ 80,256	$ 23,614	29 %

Software license								
Maintenance	40,349	34,165	6,184	18 %	80,566	66,752	13,814	21 %
Services	3,110	6,642	(3,532)	(53) %	6,409	11,022	(4,613)	(42) %
Total gross profit	$ 96,294	$ 79,437	$ 16,857	21 %	$ 190,845	$ 158,030	$ 32,815	21 %
Total gross profit %	67 %	68 %			67 %	68 %		
Software license gross profit %	98 %	96 %			97 %	96 %		
Maintenance gross profit %	89 %	90 %			89 %	90 %		
Services gross profit %	7 %	17 %			7 %	15 %		

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

The decreases in services gross profit percent were primarily due to $1.8 million of gross margin loss associated with Antenna projects and approximately $1.2 million of costs incurred on several consulting projects in the second quarter and first six months of 2014, for which the corresponding revenue will be recognized in future periods, as revenue recognition criteria had not been met. In addition, these services gross profit decreases were due to subcontractor and employee-related expenses as a result of the increased on-boarding and enablement costs due to demand for consulting projects.

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Operating expenses

(Dollars in thousands)	Three Months Ended June 30, 2014	2013	Increase (Decrease)		Six Months Ended June 30, 2014	2013	Increase	
Amortization of intangibles:								
Cost of revenue	$ 1,444	$ 1,541	$ (97)	(6) %	$ 3,284	$ 3,082	$ 202	7 %
Selling and marketing	1,499	1,232	267	22 %	2,995	2,464	531	22 %
General and administrative	481		481	n/m	901	4	897	n/m
	$ 3,424	$ 2,773	$ 651	23 %	$ 7,180	$ 5,550	$ 1,630	29 %

n/m - not meaningful

The increases in amortization expense during the second quarter and first six months of 2014 were due to the amortization associated with $10.4 million of intangibles acquired from Antenna in October 2013.

(Dollars in thousands)	Three Months Ended June 30, 2014	2013	Increase		Six Months Ended June 30, 2014	2013	Increase	
Selling and marketing								
Selling and marketing	$ 56,342	$ 45,346	$ 10,996	24 %	$ 102,149	$ 84,616	$ 17,533	21 %
As a percent of total revenue	39 %	39 %			36 %	36 %		
Selling and marketing headcount at June 30,					614	539	75	14 %

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 second quarter of 2014 compared to the same period in 2013 was primarily due to a $4.6 million increase in compensation and benefit expenses associated with higher headcount, a $3 million increase in commission expense associated with the higher value of new license arrangements executed during the second quarter of 2014 compared to the second quarter of 2013, a $1.6 million increase in marketing and sales program expenses primarily related to PegaWORLD, our annual user conference, a $0.8 million increase in employee travel and entertainment expenses, a $0.3 million increase in rent and rent-related expenses, and a $0.3 million increase in amortization expense due to the Antenna customer-related intangible assets.

The increase in selling and marketing expenses during the first six months of 2014 compared to the same period in 2013 was primarily due to a $7.7 million increase in compensation and benefit expenses associated with higher headcount, a $3.7 million increase in commission expense associated with the higher value of new license arrangements executed during the first six months of 2014 compared to the first six months of 2013, a $2 million increase in marketing and sales program expenses primarily related to PegaWORLD, a $1.5 million increase in employee travel and entertainment expenses, a $0.5 million increase in rent and rent-related expenses, and a $0.5 million increase in amortization expense due to the Antenna customer-related intangible assets.

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 second quarter and first six months of 2014 compared to the same periods in 2013.

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(Dollars in thousands)	Three Months Ended June 30, 2014	Three Months Ended June 30, 2013	Increase		Six Months Ended June 30, 2014	Six Months Ended June 30, 2013	Increase	
Research and development								
Research and development	$ 27,323	$ 19,761	$ 7,562	38 %	$ 51,932	$ 39,337	$ 12,595	32 %
As a percent of total revenue	19 %	17 %			18 %	17 %		
Research and development headcount at June 30,					1,020	792	228	29 %

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 second quarter and first six 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 second quarter of 2014 compared to the same period in 2013 was primarily due to a $5.6 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 $0.6 million increase in expendable equipment, a $0.5 million increase in contracted professional services, and a $0.4 million increase in rent and rent-related expenses.

The increase in research and development expenses during the first six months of 2014 compared to the same period in 2013 was primarily due to a $9.2 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 $1.2 million increase in expendable equipment, a $0.6 million increase in contracted professional services, and a $0.6 million increase in rent and rent-related expenses.

(Dollars in thousands)	Three Months Ended June 30, 2014	Three Months Ended June 30, 2013	Increase	Six Months Ended June 30, 2014	Six Months Ended June 30, 2013	Increase

General and administrative								
General and administrative	$ 10,250	$ 7,277	$ 2,973	41 %	$ 19,552	$ 14,073	$ 5,479	39 %
As a percent of total revenue	7 %	6 %			7 %	6 %		
General and administrative headcount at June 30,					286	248	38	15 %

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 second quarter of 2014 compared to the same period in 2013 was primarily due to a $1.4 million increase in compensation and benefits associated with higher headcount, a $0.8 million increase in professional fees, and a $0.4 million increase in amortization associated with the Antenna trademark intangible asset.

The increase in general and administrative expenses during the first six 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, $1.7 million increase in professional fees, and a $0.8 million increase in amortization associated with the Antenna trademark intangible asset.

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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 June 30, 2014	Three Months Ended June 30, 2013	Increase		Six Months Ended June 30, 2014	Six Months Ended June 30, 2013	Increase	
Cost of services	$ 1,387	$ 1,014	$ 373	37%	$ 2,398	$ 2,187	$ 211	10 %
Operating expenses	3,771	2,267	1,504	66%	6,055	4,526	1,529	34 %
Total stock-based compensation before tax	5,158	3,281	1,877	57%	8,453	6,713	1,740	26 %
Income tax benefit	(1,591)	(944)			(2,582)	(2,047)		

The increases in stock-based compensation expense during the second quarter and first six 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 and executive new hire grants made since June 30, 2013.

Non-operating income and expenses, net

(Dollars in thousands)	Three Months Ended June 30, 2014	Three Months Ended June 30, 2013	Change		Six Months Ended June 30, 2014	Six Months Ended June 30, 2013	Change	
Foreign currency transaction (loss) gain	$ (4)	$ (437)	$ 433	(99) %	$ 318	$ (2,327)	$ 2,645	(114) %
Interest income, net	163	135	28	21 %	287	253	34	13 %
Other income (expense), net	6	(94)	100	(106) %	(526)	745	(1,271)	(171) %
Non-operating gain (loss)	$ 165	$ (396)	$ 561	(142) %	$ 79	$ (1,329)	$ 1,408	(106) %

During the second quarter of 2014, we did not enter into any forward contracts as we are in the process of reassessing our hedging strategy.

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 have been primarily exposed to the fluctuation in the British pound and Euro relative to the U.S. dollar. More recently, we have experienced increased levels of exposure to the Australian dollar and Indian rupee. See Note 4 Derivative Instruments in the notes to the accompanying 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 first six months of 2014 and 2013 was a loss of $(0.5) million and a gain of $0.7 million, respectively.

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 second quarter of 2014 and 2013, we recorded a tax provision of $0.9 million and $2 million, respectively, which resulted in an effective tax rate of 37% and 29.4%, respectively. During the first six months of 2014 and 2013, we recorded a provision of $5.7 million and $4.9 million, respectively, which resulted in an effective tax rate of 33.4% and 26.3%, respectively. Our effective tax rate for second quarter and first six 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 the second quarter

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and first six months of 2014 was higher than in the same periods in 2013 primarily because the research and experimentation credit has not yet been extended to 2014 and the increase in non-deductible foreign stock-based compensation expense in the second quarter and first six months of 2014 compared to the same periods in 2013.

Liquidity and capital resources

	Six Months Ended June 30,	
(in thousands)	**2014**	**2013**
Cash provided by (used in):		
Operating activities	$ 73,935	$ 64,280
Investing activities	(18,008)	(26,122)
Financing activities	(11,287)	(8,678)
Effect of exchange rate on cash	2,240	(3,160)
Net increase in cash and cash equivalents	$ 46,880	$ 26,320

	As of June 30, 2014	As of December 31, 2013
Total cash, cash equivalents, and marketable securities	$ 216,213	$ 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 first six months of 2014, which were generated from our significant arrangements executed in the fourth quarter of 2013 and first six months of 2014. We believe that our current cash, cash equivalents, 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. During the second quarter of 2014, we paid $0.8 million in cash consideration to acquire Meshlabs.

As of June 30, 2014, approximately $64.2 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 first six months of 2014 were net income of $11.3 million and the $46 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 significant 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.

The primary drivers of cash provided by operating activities during the first six months of 2013 were net income of $13.8 million, and the $31.8 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.

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Future Cash Receipts from License and Cloud Arrangements

Total contractual future cash receipts due from our existing license and Pega Cloud agreements was approximately $298.7 million as of June 30, 2014 compared to $246.8 million as of June 30, 2013. The future cash receipts due as of June 30, 2014 are summarized as follows:

(in thousands) as of June 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	$ 36,483	$ 39,367	$ 75,850
2015	78,220	4,175	82,395
2016	66,564	3,128	69,692
2017	37,636		37,636
2018 and thereafter	33,085		33,085
Total	$ 251,988	$ 46,670	$ 298,658

(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 will be recognized as revenue in future periods and relate to perpetual licenses with extended payment terms and/or additional rights of use.

Cash used in investing activities

During the first six months of 2014, cash used in investing activities was primarily for purchases of marketable debt securities of $29.5 million, partially offset by the proceeds received from the maturities of marketable debt securities of $16 million.

During the first six months of 2013, cash used in investing activities was primarily for purchases of marketable debt securities of $32.7 million, partially offset by the proceeds received from the maturities of marketable debt securities of $8.5 million.

Payments for acquisitions during the first six months of 2014 totaled $1.6 million, comprised of the payment of the final working capital adjustment to the Antenna shareholders and cash consideration to acquire MeshLabs, in the first and second quarters of 2014, respectively.

Cash used in financing activities

Cash used in financing activities during the first six 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.

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 first six months of 2014 and 2013:

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	Six Months Ended June 30,					
	2014			2013		
(Dollars in thousands)	**Shares**		**Amount**	**Shares**		**Amount**
Prior year authorization as of January 1,		$	14,433		$	14,793
Repurchases paid	419,900		(8,305)	512,438		(7,199)
Repurchases unsettled				314		(5)
Authorization remaining as of June 30,		$	6,128		$	7,589

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 first six months of 2014 and 2013, option and RSU holders net settled stock options and vested RSUs representing the right to purchase a total of 700,000 shares and 731,000 shares, respectively, of which only 394,000 shares and 401,000 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 first six months of 2014 and 2013, instead of receiving cash from the equity holders, we withheld shares with a value of $3.4 million and $2.8 million, respectively, for withholding taxes, and $2.9 million and $2 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 first six months of 2014 and 2013.

Dividends

We declared a cash dividend of $0.045 and $0.03 per share on a post-split basis in the first six months of 2014 and 2013, respectively. We paid cash dividends of $2.3 million and $1.1 million in the first six 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. On May 27, 2014, we announced an increase in our quarterly cash dividend from $0.015 to $0.03 per share. As a result, 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 offsets 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.

During the second quarter of 2014, we did not enter into any forwards contracts as we are in the process of reassessing our hedging strategy.

See Note 4 Derivative Instruments in the notes to the accompanying unaudited condensed consolidated financial statements for further discussion.

There were no significant changes to our quantitative and qualitative disclosures about market risk during the first six 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 June 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 June 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 June 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 first six 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 second quarter of 2014:

Period	Total Number of Shares Purchased (1)	Average Price Paid per Share (1)	Total Number of Shares Purchased as Part of Publicly Announced Share Repurchase Programs (1) (2)	Approximate Dollar Value of Shares That May Yet Be Purchased Under Publicly Announced Share Repurchase Programs (in thousands) (2)
4/1/2014 - 4/30/2014	97,753	$ 16.96	97,753	$ 8,298

5/1/2014 - 5/31/2014	59,072		18.26	59,072	7,219
6/1/2014 - 6/30/2014	52,177		20.90	52,177	6,128
Total	209,002	$	18.31		

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

(2) 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: August 5, 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	Articles of Amendment to Restated Articles of Organization of the Registrant, as filed with the Secretary of the State of Massachusetts on June 13, 2014.
10.1+	Compensation program for non-employee members of the Registrant s Board of Directors.
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 June 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.