UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT of 1934**

For the fiscal year ended December 31, 2013

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT of 1934**

Commission File No. 1-11859

PEGASYSTEMS INC.

(Exact name of Registrant as specified in its charter)

Massachusetts

(State or other jurisdiction of incorporation or organization)

(IRS Employer Identification No. 04-2787865)

One Rogers Street

Cambridge, MA	**02142-1209**
(Address of principal executive offices)	**(zip code)**

(617) 374-9600

(Registrant s telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	**Name of Each Exchange on Which Registered**
Common Stock, $0.01 par value per share	**NASDAQ Global Select Market**

Securities registered pursuant to Section 12(g) of the Act:

None

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act of 1933. Yes ¨ No x

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes ¨ No x

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the Registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

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

Large accelerated filer x	Accelerated filer ¨	Non-accelerated filer ¨ (Do not check if a 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

The aggregate market value of the Registrant s common stock held by non-affiliates of the Registrant based on the closing price (as reported by NASDAQ) of such common stock on the last business day of the Registrant s most recently completed second fiscal quarter (June 30, 2013) was approximately $576 million.

There were 38,135,303 shares of the Registrant s common stock, $0.01 par value per share, outstanding on February 5, 2014.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant s definitive proxy statement related to its 2014 annual meeting of stockholders to be filed subsequently are incorporated by reference into Part III of this report.

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PART I

Forward-looking statements

This Annual Report on Form 10-K contains or incorporates forward-looking statements within the meaning of section 27A of the Securities Act of 1933 and section 21E of the Securities Exchange Act of 1934. These forward-looking statements are based on current expectations, estimates, forecasts and projections about the industry and markets in which we operate and management s beliefs and assumptions. Other written or oral statements that constitute forward-looking statements may be made by us or on our behalf. Words such as expect, anticipate, intend, plan, believe, could, estimate, may, target, project, or variations of such words and similar expressions are intended to identify such forward-lo statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions that are difficult to predict. We have identified certain risk factors included in Item 1A of this Annual Report on Form 10-K that we believe could cause our actual results to differ materially from the forward-looking statements we make. We do not intend to update publicly any forward-looking statements, whether as a result of new information, future events or otherwise.

ITEM 1. Business

Pegasystems Inc. was incorporated in Massachusetts in 1983. Our stock is traded on the NASDAQ Global Select Market under the symbol PEGA. Our Website address is www.pega.com. We are not including the information contained on our Website as part of, or incorporating it by reference into, this Annual Report on Form 10-K. Unless the context otherwise requires, references in this Annual Report on Form 10-K to the Company, Pega, we, us or our refer to Pegasystems Inc. and its subsidiaries.

Our business: Better Business Software

We believe that business success requires that organizations become digital enterprises in order to serve today s empowered customers, and that software either accelerates or impedes that transformation. Pega powers the digital enterprise with Better Business Software that replaces archaic programming or multiple software packages with a comprehensive model built on visual metaphors that businesspeople can understand and drive. The resulting digital enterprise engages customers, simplifies processes, and turns the power to change into a competitive advantage.

We develop, market, and license software solutions that help clients improve their business results by giving them the power to engage customers, simplify their operations, and adapt to change. Pegasystems software allows clients to build and change enterprise software applications much more rapidly than they can with traditional programming, while engaging the collaborative efforts of both businesspeople and technologists.

Pegasystems unified platform intersects with several traditional software markets, including: Customer Relationship Management (CRM), Business Process Management (BPM), Business Rules Management Systems (BRMS) Dynamic Case Management (DCM), Decision Management, including predictive and adaptive analytics, and the Vertical Specific Software (VSS) market of vertical industry solutions and packaged applications. Pegasystems unified and highly scalable platform provides superior capability and agility to its clients.

Pegasystems also provides consulting services and implementation support, training, and technical support services to help clients maximize the business value from our software. We focus our sales efforts primarily on target accounts, which are large companies or divisions within companies, and typically leaders in their industries. Our strategy is to sell a client a series of licenses, each focused on a specific purpose or area of operations. As we have found meaningful interest from smaller companies, we are working to invest in expanding our sales force to extend coverage beyond our traditional Fortune 500 focus.

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Our partners

We maintain alliances with global systems integrators and technology consulting firms that provide consulting services to our clients. Strategic partnerships with technology consulting firms and systems integrators are important to our sales efforts because they influence buying decisions, help us to identify sales opportunities, and complement our software with their domain expertise and services capabilities. These partners may deliver strategic business planning, consulting, project management, and implementation services to our clients. Currently, our partners include well respected, major firms such as Accenture Ltd., Capgemini SA, Cognizant Technology Solutions Inc., Infosys Technologies Limited, Mahindra Satyam, Tata Consultancy Services Limited, PricewaterhouseCoopers LLP, Virtusa Corporation, and Wipro Ltd.

Our products

Pega Build for Change® Platform

The Pega Build for Change® platform (PegaRULES Process Commander®) is a unified platform that enables clients to build enterprise applications in a fraction of the time it would take using traditional programming technologies. Business and IT personnel collaborate, using a visual language that models the requirements and design of the application in a readily understandable manner. This agile approach facilitates continuous improvement methodologies, such as BPM or Lean Six Sigma, to effectively manage individual projects or drive a complete enterprise transformation. All aspects of the application are defined in the model: business strategy mapping, business processes, data models, case definitions, rules, decisions, reporting, interfaces, intelligent work management capabilities, business activity monitoring, and the user experience across both web and mobile devices.

Once defined this way, the finished application and its documentation are generated and immediately ready for use. Our approach bypasses the error-prone and time-consuming process of manually translating requirements into code. The software application is automatically created directly from the model, closing the costly gap between vision and execution. The Pega Build for Change® platform is standards-based and can leverage a client s existing technology to create new business applications that cross technology silos and bridge front and back-office.

Business Process Solutions

Pegasystems also offers purpose or industry-specific solutions built on its platform. These solutions provide a best-practice starting point for key industry processes, yet maintain a flexibility not delivered by traditional commercial off the shelf products. This allows organizations to quickly implement new processes, refine customer experiences, bring new offerings to market, and provide customized or specialized processing to meet the needs of different customers, departments, geographies or regulatory requirements.

Pega Customer Engagement Solutions

Pega Customer Engagement Solutions offer a process-driven, customer-centric CRM solution to maximize the lifetime value of customers and reduce the costs of serving customers. We provide marketing, sales, and service solutions to optimize sales processes and customer service interactions. Our case management and business process solutions facilitate the fulfillment of customer requests, while our Next-Best-Action analytics predict and adapt to customer behavior to improve both business outcomes and the customer experience.

Decision management is incorporated into these solutions to guide actions and optimize process outcomes based on business objectives. Solutions, including cross-sell/up-sell, retention, service recommendations, and collections help businesses deploy automated decision making quickly. The predictive and adaptive analytics incorporated into these solutions support the creation and improvement of decision models to improve outcomes.

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Pega Application Mobility Platform

Our acquisition of Antenna Software, Inc. (Antenna) expanded our Pega Application Mobility Platform, which enables clients to build, manage, and deploy mobile applications. Our mobile application development platform permits clients to manage the complex elements of the mobile application lifecycle including security, integration, testing, and management of mobile applications and devices. It also helps businesses significantly reduce their development time, deployment cost, and the complexity associated with run-the-business mobile applications.

Pega Cloud®

Pega Cloud® is Pegasystems service offering that allows clients to create and deploy our software applications using an Internet-based infrastructure. This offering enables our clients to rapidly build, test, and deploy their applications in a secure cloud environment, while minimizing their infrastructure and hardware costs.

Our services and support

We offer services and support through our Pega consulting group, our global client support group, and our training services group. We also utilize third party contractors to assist us in providing these services.

Pega Consulting

Our Pega consulting group provides guidance and implementation services to our clients and partners on how to best apply our technology and develop strong implementation expertise.

Global Client support

Our global client support group is responsible for support of our software deployed at client sites. Support services include automated problem tracking, prioritization and escalation procedures, periodic preventive maintenance, documentation updates, and new software releases.

Training Services

The success of our sales strategy for multiple follow-on sales to target clients depends on our ability to train a large number of partners and clients to implement our technology. We offer training for our staff, clients, and partners. Training is offered at our regional training facilities in Cambridge, Massachusetts, Bedford, New Hampshire, Reading, England, Hyderabad, India, Sydney, Australia, at third party facilities in numerous other locations, and at client sites. We also offer training online through PegaACADEMY, which offers an alternative way to learn our software quickly, easily, and cost effectively. We expect that the online training will help expand the number of trained experts at a faster pace. Our courses are designed to meet the specific requirements of process architects, system architects, and system administrators.

Our markets

Our target clients are primarily large, industry-leading organizations faced with managing changes to their complex business processes in order to increase business agility, drive growth, improve productivity, retain customers, and help ensure compliance. Our clients have typically been large companies in the financial services, healthcare, insurance, government, communications and media, manufacturing and high tech, and life sciences markets. We are expanding our client base to a broader range of companies within those markets as well as to additional industries, such as energy, travel and entertainment.

Financial Services

Financial services organizations rely on software to improve the quality, accuracy, and efficiency of customer interactions and transactions processing. Pegasystems customer service process, marketing, and exceptions management products allow clients to be responsive to changing business requirements.

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Healthcare

Healthcare organizations seek products that integrate their front and back office initiatives and help drive customer service, efficiency, and productivity. Our claims products allow healthcare clients to address financial, administrative and coverage requirements of healthcare consumerism and reform.

Insurance

Insurance companies, whether competing globally or nationally for customers and channels, need software to automate the key activities of distribution management, quoting, underwriting, claims, and policy servicing as well as products that improve customer service and the overall customer experience. Pega s solutions for insurance carriers increase business value by delivering customer-focused experiences that drive higher sales, lower expense ratios, and improve risk mitigation.

Communications and Media

Communications and media organizations need to address high levels of customer churn, growing pressure to increase revenue and an ability to respond quickly to changing market conditions. Our solutions enable organizations to reshape the way they interact with customers, streamline operations and bring new services and products to market.

Government

Government agencies need to modernize legacy systems and processes to meet the growing demands for improved constituent service, lower costs and greater levels of transparency. Pegasystems offers a proven, economical and highly effective solution that delivers advanced capabilities to streamline application development and delivery via an agile, multi-channel environment.

Life Sciences

Life sciences organizations are looking for solutions to increase efficiencies and transparency across the product development lifecycle by automating and streamlining business processes across people, applications, business rules and enterprise systems. Our solutions for life sciences focus on product development, safety and risk management, CRM, and regulatory transparency delivering advanced capabilities to streamline development and bring to market industry leading solutions quickly.

Manufacturing and High Technology

Manufacturers world-wide are transforming their businesses to better engage customers and suppliers, as well as directly manage the performance of their products from the earliest designs to beyond the manufacturing stage and throughout the product life-cycle. Our manufacturing solutions address supplier risk, manage warranties, recalls, repairs, and returns, as well as extend ERP system capabilities.

Other Industries

We offer solutions to a broad range of other types of companies and industries. For example, we sell our BPM technology to clients in energy, transportation, retail, travel, and other services.

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Competition

We compete in the BPM, Case Management, CRM, Business Rules, Decision Management, and mobile application development platform software markets. These markets are intensely competitive, rapidly changing, and highly fragmented, as current competitors expand their product offerings and new companies enter the market. Competitors vary in size and in the scope and breadth of the products and services offered. We encounter competition from:

- BPM vendors, including Service-Oriented Architecture (SOA) middleware vendors such as IBM, Oracle Corporation, Software AG, and Tibco Software Inc., and other BPM vendors such as Appian Corporation and the Cordys division of Open Text;
- Case Management vendors such as the Documentum division of EMC Corporation, the FileNet division of IBM s Information Management Group, and the BPM/Case Management division of Open Text;
- CRM application vendors such as Salesforce.com, the Siebel division of Oracle, and the Microsoft Dynamics CRM division of Microsoft;
- Decision Management vendors including Business Rules Engine vendors such as the ILOG and SPSS divisions of IBM, and the Blaze division of FICO, and vendors of solutions that leverage predictive analytics in managing customer relationships including the Unica Division of IBM;
- Companies that provide application specific software for the financial services, healthcare, insurance and other specific markets such as Guidewire Software, Inc., the Detica NetReveal Division of BAE, SmartStream Technologies Ltd., SunGard, SAP, and The TriZetto Group, Inc.;
- Mobile application development platform vendors, including IBM and SAP, as well as open source mobile technologies, including the jQuery Mobile platform from the jQuery Foundation;
- Professional service organizations that develop custom software in conjunction with rendering consulting services; and
- Clients current information technology departments, which may seek to modify their existing systems or develop their own proprietary systems.

We have been most successful competing for clients whose businesses are characterized by a high degree of change, complexity, and regulation. We believe that the principal competitive factors within our market include:

- Product adaptability, scalability, functionality, and performance;
- Proven success in delivering cost-savings and efficiency improvements;
- Ease-of-use for developers, business units, and end-users;

Timely development and introduction of new products and product enhancements;

Establishment of a significant base of reference clients;

Ability to integrate with other products and technologies;

Customer service and support;

Product price;

Vendor reputation; and

Relationships with systems integrators.

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We believe we are competitively differentiated as our unified Build for Change® technology allows both client business and IT staff, using a single, intuitive user interface, to build enterprise applications in a fraction of the time it would take with the types of disjointed architectures and tools offered by our competitors. We believe we compete favorably due to our expertise in our target industries and our long-standing client relationships. We believe we compete less favorably on the basis of some of these factors with respect to our larger competitors, many of which have greater sales, marketing and financial resources, more extensive geographical presence and greater name recognition than we do. In addition, we may be at a disadvantage with respect to our ability to provide expertise outside our target industries. See Risk Factors The market for our offerings is intensely and increasingly competitive, rapidly changing and highly fragmented in Item 1A of this Annual Report on Form 10-K.

Sales and marketing

We market our software and services primarily through a direct sales force. Strategic partnerships with consultants and systems integrators are important to our sales efforts because they influence buying decisions, help us to identify sales opportunities, and complement our software and services with their domain expertise and professional services capabilities.

To support our sales efforts, we conduct a broad range of marketing programs, including client and industry targeted solution campaigns, trade shows, including our PegaWORLD user conference, solution seminars and Webinars, industry analyst and press relations, Web and digital marketing, community development, social media, and other direct and indirect marketing efforts. Our consulting staff, business partners, and other third parties also conduct joint and separate marketing campaigns that generate sales leads.

Sales by geography

In 2013, 2012, and 2011, sales to clients based outside of the United States of America (U.S.) represented approximately 45%, 46%, and 48%, respectively, of our total revenue. We currently operate in one reportable segment business process solutions. We derive substantially all of our operating revenue from the sale and support of one group of similar products and services. The majority of our assets are located within the U.S. See Note 18 Geographic Information and Major Clients included in the notes to the accompanying audited consolidated financial statements for further detail. See Risk Factors We face risks from operations and clients based outside of the U.S. in Item 1A of this Annual Report on Form 10-K.

Research and development

Our development organization is responsible for product architecture, core technology development, product testing, and quality assurance. Our product development priority is to continue expanding the capabilities of our integrator technology. We intend to maintain and extend the support of our existing solution frameworks, and we may choose to invest in additional frameworks which incorporate the latest business innovations. We also intend to maintain and extend the support of popular hardware platforms, operating systems, databases, and connectivity options to facilitate easy and rapid deployment in diverse information technology infrastructures. Our goal with all of our products is to enhance product capabilities, ease of implementation, long-term flexibility, and the ability to provide improved client service.

During 2013, 2012, and 2011, research and development expenses were approximately $79.7 million, $76.7 million, and $65.3 million, respectively. We expect that we will continue to commit significant resources to our product research and development in the future to maintain our leadership position.

Employees

As of January 31, 2014, we had 2,627 employees worldwide, of which 1,219 were based in North America, 548 were based in Europe, and 860 were based in Asia Pacific.

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Backlog of license, maintenance, and services

As of December 31, 2013, we had software license, maintenance, and services agreements with clients expected to result in approximately $506.1 million of future revenue, of which we expect approximately $279.7 million to be recognized in 2014. As of December 31, 2012, we had backlog of software license, maintenance, and services agreements with clients of approximately $438 million. Under some of these agreements, we must fulfill certain conditions prior to recognizing revenue, and there can be no assurance when, if ever, we will be able to satisfy all such conditions in each instance. Business conditions could change and, therefore, backlog may not be a reliable indicator of future financial performance.

Available Information

We make available free of charge through our Website www.pega.com/about-us/investors/sec filings our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K, and amendments to these reports, as soon as reasonably practicable after we electronically file such material with, or furnish such material to, the Securities and Exchange Commission (SEC). The SEC maintains a Website that contains reports, proxy, and information statements and other information regarding issuers that file electronically with the SEC at www.sec.gov. We make available on our Website reports filed by our executive officers and Directors on Forms 3, 4, and 5 regarding their ownership of our securities. Our Code of Conduct, and any amendments to our Code of Conduct, is also available on our Website.

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ITEM 1A. Risk Factors

The following important factors could cause our actual business and financial results to differ materially from those contained in forward-looking statements made in this Annual Report on Form 10-K or elsewhere by management from time to time.

Factors relating to our financial results

The timing of our license revenue is difficult to predict accurately, which may cause our quarterly operating results to vary considerably. A change in the number or size of high value license arrangements, or a change in the mix between perpetual licenses, term licenses, and Pega Cloud® subscriptions can cause our revenues to fluctuate materially from quarter to quarter. Our decision to enter into term licenses and Pega Cloud® subscriptions that require the revenue to be recognized over the license term may adversely affect our profitability in any period due to sales commissions being paid at the time of signing and the corresponding revenue being recognized over time. We budget for our selling and marketing, product development, and other expenses based on anticipated future revenue. If the timing or amount of revenue fails to meet our expectations in any given quarter, our financial performance is likely to be adversely affected because only small portions of expenses vary with revenue. As a result, period-to-period comparisons of our operating results are not necessarily meaningful and should not be relied upon to predict future performance.

The number of our license arrangements has been increasing, and we may not be able to sustain this growth unless we and our partners can provide sufficient high quality consulting services, training, and maintenance resources to enable our clients to realize significant business value from our software. Our clients typically request consulting services and training to assist them in implementing our products. Our clients also purchase maintenance on our products in almost all cases. As a result, an increase in the number of license arrangements is likely to increase demand for consulting services, training, and maintenance relating to our products. Given that the number of our license arrangements has been increasing, we will need to provide our clients with more consulting services, training, and maintenance to enable our clients to realize significant business value from our software. We have been increasingly enabling our partners and clients through training to create an expanded universe of people that are skilled in the implementation of our products. However, if we and our partners are unable to provide sufficient high quality consulting services, training, or maintenance resources to our clients, our clients may not realize sufficient business value from our products to justify follow-on sales, which could impact our future financial performance. In addition, the growth required to meet the increased demand for our consulting services could strain our ability to deliver our services engagements at desired levels of profitability, thereby impacting our overall profitability and financial results.

We frequently enter into a series of licenses that are focused on a specific purpose or area of operations. If we are not successful in obtaining follow-on business from these clients, our financial performance could be adversely affected. We frequently enter into a series of licenses with our new clients that are focused on a specific purpose or area of operations. Once a client has realized the value of our software, we work with the client to identify opportunities for follow-on sales. However, we may not be successful in demonstrating this value to some clients, for reasons relating to the performance of our products, the quality of the services and support we provide for our products, or external reasons. For these clients, we may not obtain follow-on sales or the follow-on sales may be delayed, and our license revenue could be limited. This could lower the total value of all transactions and adversely affect our financial performance.

Our consulting services revenue is dependent to a significant extent on closing new license transactions with clients. We derive a substantial portion of our consulting services revenue from implementation of new software licenses with our clients, both from implementations that are led by our consulting services staff and from implementations where we provide consulting to our partners and clients to support their implementations. Accordingly, it is imperative that we close more license transactions with our clients if we are to maintain or grow our services revenue.

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If we are unable to maintain vendor specific objective evidence (VSOE) of fair value of our consulting services arrangements, we may be required to delay the recognition of a portion of our revenue to future periods. We have established VSOE of fair value of our consulting services in North America, Australia, and Europe, based on the price charged when these services are sold separately. The weakened economy and significant competition within our industry have created pricing pressure on consulting services provided by technology companies. If we elect to discount our consulting services pricing or otherwise introduce variability in our consulting services arrangements to attract or retain clients, this could lead to an insufficient number of consistently priced consulting services arrangements for us to maintain VSOE. If we do not have VSOE of fair value of our consulting services, we may be required to recognize all revenue for these consulting services arrangements, including any related license, maintenance, and other services revenue if the consulting services are bundled in an arrangement, ratably over the longer of the software maintenance period or the service period.

Our financial results may be adversely affected if we are required to change certain estimates, judgments, and positions relative to our income taxes. In the ordinary course of conducting a global business enterprise, there are many transactions and calculations undertaken whose ultimate tax outcome cannot be certain. Some of these uncertainties arise as a consequence of positions we have taken regarding valuation of deferred tax assets, transfer pricing for transactions with our subsidiaries, and potential challenges to nexus and tax credit estimates. We estimate our exposure to unfavorable outcomes related to these uncertainties and estimate the probability of such outcomes. Future realization of our deferred tax assets ultimately depends on the existence of sufficient taxable income within the available carryback or carryforward periods. We record a valuation allowance to reduce our deferred tax assets to an amount we believe is more likely than not to be realized. If our taxable income is not consistent with our expectations or the timing of income is not within the applicable carryforward period, we may be required to establish a valuation allowance on all or a portion of these deferred tax assets. Changes in our valuation allowance impact income tax expense in the period of adjustment. Although we believe our estimates are reasonable, no assurance can be given that the final tax outcome of these matters or our current estimates regarding these matters will not be different from what is reflected in our historical income tax provisions, returns, and accruals. Such differences, or changes in estimates relating to potential differences, could have a material impact, unfavorable or favorable, on our income tax provisions, require us to change the recorded value of deferred tax assets, and adversely affect our financial results.

We are investing heavily in sales and marketing and support in anticipation of a continued increase in license arrangements, and we may experience decreased profitability or losses if we are unsuccessful in increasing the value of our license arrangements in the future. We have been increasing our investment in sales and marketing to meet increasing demand for our software by hiring additional sales and marketing personnel. We anticipate that we will need to provide our clients with more maintenance support as a result of this increase in demand, and have been hiring additional personnel in this area. These investments have resulted in increased fixed costs that do not vary with the level of revenue. If the increased demand for our products does not continue, we could experience decreased profitability or losses as a result of these increased fixed costs.

Factors relating to our products and markets

We will need to acquire or develop new products, evolve existing ones, and adapt to technology change. Technical developments, client requirements, programming languages, and industry standards change frequently in our markets. As a result, success in current markets and new markets will depend upon our ability to enhance current products, to acquire or develop and introduce new products that meet client needs, keep pace with technology changes, respond to competitive products, and achieve market acceptance. Product development requires substantial investments for research, refinement, and testing. There can be no assurance that we will have sufficient resources to make necessary product development investments. We may experience difficulties that will delay or prevent the successful development, introduction, or implementation of new or enhanced products. Inability to introduce or implement new or enhanced products in a timely manner would adversely affect future financial performance.

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The market for our offerings is intensely and increasingly competitive, rapidly changing, and highly fragmented. We compete in the BPM, Case Management, CRM, Decision Management, and mobile application development platform software markets. The markets for our software and related implementation, consulting, and training services are intensely competitive, rapidly changing and highly fragmented. We currently encounter significant competition from internal information systems departments of potential or existing clients that develop custom software. We also compete with companies that target the BPM, Case Management, Decision Management, and mobile application development platform markets as well as professional service organizations that develop custom software in conjunction with rendering consulting services. Competition for market share and pressure to reduce prices and make sales concessions are likely to increase. Many of our competitors, such as IBM, Oracle and SAP, are large and have far greater resources and may be able to respond more quickly and efficiently to new or emerging technologies, programming languages or standards or to changes in client requirements or preferences. Competitors may also be able to devote greater managerial and financial resources to develop, promote, and distribute products and provide related consulting and training services. There can be no assurance that we will be able to compete successfully against current or future competitors or that the competitive pressures faced by us will not materially adversely affect our business, operating results, and financial condition.

The continued weakness in the U.S and international economies may negatively impact our sales to, and the collection of receivables from, our financial services and insurance clients and possibly our clients in other industries. Our sales to, and our collection of receivables from, our clients may be impacted by adverse changes in global economic conditions, especially in the U.S., Europe and Asia Pacific. In the past few years, these regions have experienced instability in financial markets, tightening credit, and weak overall economic conditions, which has impacted the financial services and insurance industries in particular. These trends could impact the ability and willingness of our financial services and insurance clients, and possibly our clients in other industries, to make investments in technology, which may delay or reduce the amount of purchases of our software and services. These factors could also impact the ability and willingness of these clients to pay their trade obligations and honor their contractual commitments under their noncancellable term licenses. These clients may also become subject to increasingly restrictive regulatory requirements, which could limit or delay their ability to proceed with new technology purchases. Our financial services and insurance clients as a group represent a significant amount of our revenues and receivables. Accordingly, their potential financial instability could negatively impact our business, operating results, and financial condition.

We have historically sold to the financial services, insurance and healthcare markets, and rapid changes or consolidation in these markets could affect the level of demand for our products. We have historically derived a significant portion of our revenue from clients in the financial services, insurance, and healthcare markets, and sales to these markets are important for our future growth. Competitive pressures, industry consolidation, decreasing operating margins, regulatory changes, and privacy concerns affect the financial condition of our clients and their willingness to buy. In addition, clients purchasing patterns in these industries for large technology projects are somewhat discretionary. The financial services and insurance markets are undergoing intense domestic and international consolidation and financial turmoil, and consolidation has been occurring in the healthcare market. Consolidation may interrupt normal buying behaviors and increase the volatility of our operating results. In recent years, several of our clients have been merged or consolidated, and we expect this to continue in the near future. Future mergers or consolidations may cause a decline in revenues and adversely affect our future financial performance. All of these factors affect the level of demand for our products from clients in these industries, and could adversely affect our business, operating results and financial condition.

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We rely on certain third-party relationships. We have a number of relationships with third parties that are significant to sales, marketing and support activities, and product development efforts. We rely on software and hardware vendors, large system integrators, and technology consulting firms to provide marketing and sales opportunities for the direct sales force and to strengthen our products through the use of industry-standard tools and utilities. We also have relationships with third parties that distribute our products. There can be no assurance that these companies, most of which have significantly greater financial and marketing resources, will not develop or market products that compete with ours in the future or will not otherwise end or limit their relationships with us.

We face risks from operations and clients based outside of the U.S. Sales to clients located outside of the U.S. represented approximately 45% of our total revenue in 2013, approximately 46% of our total revenue in 2012, and approximately 48% of our total revenue in 2011. We, in part through our wholly owned subsidiaries, market products and render consulting and training services to clients based outside of the U.S. including clients based in Canada, Europe, Asia and Australia. We have established offices in North America, Europe, Asia, including India, and Australia. We believe that growth will necessitate expanded international operations, requiring a diversion of managerial attention and increased costs. We anticipate hiring additional personnel to accommodate international growth, and we may also enter into agreements with local distributors, representatives, or resellers. If we are unable to do one or more of these things in a timely manner, our growth, if any, in our foreign operations may be restricted, and our business, operating results, and financial condition could be materially and adversely affected.

In addition, there can be no assurance that we will be able to maintain or increase international market demand for our products. Additional risks inherent in our international business activities generally include laws and business practices favoring local competitors, compliance with multiple, conflicting and changing governmental laws and regulations, including employment, tax, privacy and data protection laws and regulations, increased tariffs and other trade barriers, the costs of localizing products for local markets, including translation into foreign languages and associated expenses and complying with local business customs, longer accounts receivable patterns and difficulties in collecting foreign accounts receivable, difficulties in enforcing contractual and intellectual property rights and pressure on the creditworthiness of sovereign nations, particularly in Europe. Liquidity issues or political actions by sovereign nations could result in decreased values of any cash balances held in our European entities. Other inherent risks include complying with regional data privacy laws, treatment of revenue from international sources and changes to tax codes, including being subject to foreign tax laws and being liable for paying withholding income or other taxes in foreign jurisdictions, potentially adverse tax consequences (including restrictions on repatriating earnings and the threat of double taxation), increased accounting and internal control expenses, and the burden of complying with a wide variety of foreign laws, heightened risks of political and economic instability, foreign currency fluctuations and controls, different pricing environments, difficulties in staffing and managing foreign operations, natural disasters, acts of war, terrorism, pandemics or security breaches, and regional economic and political conditions.

There can be no assurance that one or more of these factors will not have a material adverse effect on our foreign operations, and, consequentially, our business, operating results, and financial condition.

We are exposed to fluctuations in currency exchange rates that could negatively impact our financial results and cash flows. Because a significant portion of our business is conducted outside the U.S., we face exposure to adverse movements in foreign currency exchange rates. These exposures may change over time as business practices evolve, and they could have a material adverse impact on our financial results and cash flows. Our international sales are usually denominated in foreign currencies. The operating expenses of our foreign operations are primarily denominated in foreign currencies, which partially offset our foreign currency exposure on our international sales. Our U.S. operating company invoices most of our foreign clients in foreign currencies, so it holds cash and accounts receivable denominated in these foreign currencies, which are subject to foreign currency transaction gains or losses. Beginning in the second quarter of 2011, we have entered into foreign currency forward contracts to manage our exposure to changes in foreign currency exchange rates affecting foreign currency denominated accounts receivable and cash held by our U.S. operating company. The use of these foreign currency forward contracts partially mitigates the exposure to the foreign currency transaction gains and losses. If we were to cease or reduce our use of foreign currency forward contracts or similar hedging arrangements, a decrease in the value of foreign currencies, particularly the British pound and the Euro relative to the U.S. dollar, could adversely impact our financial results and cash flows.

Factors relating to our internal operations and potential liabilities

We depend on certain key personnel, and must be able to attract and retain qualified personnel in the future. The business is dependent on a number of key, highly skilled technical, managerial, consulting, sales, and marketing personnel, including our Chief Executive Officer. The loss of key personnel could adversely affect financial performance. We do not have any significant key-man life insurance on any officers or employees and do not plan to obtain any. Our success will depend in large part on the ability to hire and retain qualified personnel. The number of potential employees who have the extensive knowledge of computer hardware and operating systems needed to develop, sell, and maintain our products is limited, and competition for their services is intense, and there can be no assurance that we will be able to attract and retain such personnel. If we are unable to do so, our business, operating results, and financial condition could be materially adversely affected.

We may experience significant errors or security flaws in our product and services, and could face privacy, product liability and warranty claims as a result. Despite testing prior to their release, software products frequently contain errors or security flaws, especially when first introduced or when new versions are released. Errors in our software products could affect the ability of our products to work with other hardware or software products, or could delay the development or release of new products or new versions of products. The detection and correction of any security flaws can be time consuming and costly. Errors or security flaws in our software could result in the inadvertent disclosure of confidential information or personal data relating to our clients, employees, or third parties. Software product errors and security flaws in our products or services could expose us to privacy, product liability and warranty claims as well as harm our reputation, which could impact our future sales of products and services. Our license agreements typically contain provisions intended to limit the nature and extent of our risk of product liability and warranty claims. There is a risk that a court might interpret these terms in a limited way or could hold part or all of these terms to be unenforceable. Also, there is a risk that these contract terms might not bind a party other than the direct client. Furthermore, some of our licenses with our clients are governed by non-U.S. law, and there is a risk that foreign law might give us less or different protection. Although we have not experienced any material product liability claims to date, a product liability suit or action claiming a breach of warranty, whether or not meritorious, could result in substantial costs and a diversion of management s attention and our resources.

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We face risks related to intellectual property claims or appropriation of our intellectual property rights. We rely primarily on a combination of copyright, trademark and trade secrets laws, as well as confidentiality agreements to protect our proprietary rights. We have obtained patents worldwide relating to the architecture of our systems. We cannot assure that such patents will not be invalidated or circumvented or that rights granted thereunder or the claims contained therein will provide us with competitive advantages. Moreover, despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or to obtain the use of information that we regard as proprietary. In addition, the laws of some foreign countries do not protect our proprietary rights to as great an extent as do the laws of the U.S. There can be no assurance that our means of protecting our proprietary rights will be adequate or that our competitors will not independently develop similar technology.

There can be no assurance that third parties will not claim infringement by us with respect to current or future products. Although we attempt to limit the amount and type of our contractual liability for infringement of the proprietary rights of third parties, these limitations often contain certain exclusions, and we cannot be assured that these limitations will be applicable and enforceable in all cases. Even if these limitations are found to be applicable and enforceable, our liability to our clients for these types of claims could be material in amount given the size of certain of our transactions. We expect that software product developers will increasingly be subject to infringement claims as the number of products and competitors in our industry segment grows and the functionality of products in different industry segments overlaps. Any such claims, with or without merit, could be time-consuming, result in costly litigation, cause product shipment delays, or require us to enter into royalty or licensing agreements. Such royalty or licensing agreements, if required, may not be available on terms acceptable to us or at all, which could have a material adverse effect upon our business, operating results, and financial condition.

We are subject to increasingly complex and burdensome U.S. and foreign laws and regulations, and any failure to comply with these laws and regulations could subject us to, among other things, penalties and legal expenses that could harm our reputation or have a material adverse effect on our business, financial condition and results of operations. We are subject to extensive federal, state and foreign laws and regulations including but not limited to the U.S. Foreign Corrupt Practices Act, the U.K. Bribery Act, data privacy, protection and security laws, and similar laws and regulations. The Foreign Corrupt Practices Act, the U.K. Bribery Act and similar foreign anti-bribery laws generally prohibit companies and their intermediaries from making improper payments to non-U.S. persons for the purpose of obtaining or retaining business. Similar laws and regulations exist in many other countries throughout the world in which we do or intend to do business. We have developed and implemented a compliance program based on what we believe are current best practices, but we cannot guarantee that we, our employees, our consultants or our contractors are or will be in compliance with all federal, state and foreign regulations, particularly as we expand our operations outside of the U.S. If we or our representatives fail to comply with any of these laws or regulations, a range of fines, penalties and/or other sanctions could be imposed on us, which could have a material adverse effect on our business, financial condition and results of operations. Even if we are not determined to have violated these laws, government investigations into these issues typically require the expenditure of significant resources and generate negative publicity, which could also have an adverse effect on our business, financial condition and results of operations. In addition, regulation of data privacy, protection and security laws is increasing worldwide, including various restrictions on cross-border access or transfer of data including personal data of our employees, clients and customers of our clients. Compliance with such regulations may increase our costs and there is a risk of enforcement of such laws resulting in damage to our brand as well as financial penalties.

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If our security measures are breached and/or unauthorized access is obtained to confidential information from our cloud computing service offering or other offerings, we may be exposed to significant legal and financial liabilities. Our cloud computing service offering allows clients to create and deploy PRPC-based applications using an internet-based infrastructure. This offering involves the hosting of clients applications which may contain confidential information, including personal and financial data regarding their end customers on the servers of a third-party technology provider. We also rely on third-party systems including encryption, virtualized infrastructure and support. Because we do not control the transmissions between our clients and our third-party infrastructure providers, the processing of data on the servers of the third-party technology providers, or the internal controls maintained by the third-party technology providers that could prevent unauthorized access and provide appropriate data encryption, we cannot ensure the complete integrity or security of such transmissions, data or processing. Our security measures may be breached as a result of third-party action, including intentional misconduct by computer hackers, system error, human error or otherwise. Because the techniques used to obtain unauthorized access or to sabotage systems change frequently and generally are not recognized until launched against a target, we may be unable to anticipate these techniques or to implement adequate preventative measures. While we have invested in the protection of our data and our client s data to reduce these risks, there can be no assurance that our efforts will prevent breaches in our systems. Security breaches could expose us and our clients to a risk of loss or misuse of this information. Any security breach could result in a loss of confidence in the security of our service, damage our reputation, disrupt our business, lead to legal liability and negatively impact our future sales. We carry data breach insurance coverage to potentially mitigate the financial impact of such potential legal liability. In addition, privacy and security concerns in some parts of the world may inhibit demand for our cloud offering or lead to requirements to provide our products or services in configurations that may increase the cost of serving such markets.

The acquisition of other businesses and technologies may present new risks. We have recently undertaken an acquisition and we continue to evaluate and consider other potential strategic transactions, including acquisitions of businesses, technologies, services, products and other assets. These acquisitions, if undertaken, may involve significant new risks and uncertainties, including distraction of management attention away from our current business operations, insufficient new revenue to offset expenses, inadequate return on capital, integration challenges, new regulatory requirements, new third-party intellectual property infringement claims related to the acquired technology and/or services, and issues not discovered in our due diligence process. No assurance can be given that such acquisitions will be successful and will not adversely affect our profitability or operations.

ITEM 1B. Unresolved Staff Comments

None.

ITEM 2. Properties

Our principal administrative, sales, marketing, support, and research and development operations are located at One Rogers Street, Cambridge, Massachusetts in an approximately 163,000 square foot leased facility. Our lease expires in 2023, subject to our option to extend for two additional five-year periods. We also lease space for our other offices in North America, Europe and the Asia Pacific under leases that expire at various dates through 2021. We periodically evaluate the adequacy of existing facilities and additional facilities in new cities, and we believe that additional or alternative space will be available as needed in the future on commercially reasonable terms.

ITEM 3. Legal Proceedings

None.

ITEM 4. Mine Safety Disclosures

Not applicable.

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PART II

ITEM 5. Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Market Information

Our common stock is quoted on the NASDAQ Global Select Market (NASDAQ) under the symbol PEGA. The following table sets forth the range of high and low sales prices of our common stock on NASDAQ for each quarter in the years ended December 31:

	Common Stock Price			
	2013		2012	
	High	Low	High	Low
First Quarter	$ 30.35	$ 22.77	$ 39.09	$ 25.81
Second Quarter	$ 33.56	$ 24.46	$ 39.97	$ 29.76
Third Quarter	$ 40.55	$ 32.57	$ 33.36	$ 22.51
Fourth Quarter	$ 51.53	$ 36.79	$ 29.19	$ 19.00

Holders

As of February 5, 2014, we had approximately 28 stockholders of record and approximately 33,000 beneficial owners of our common stock.

Dividends

In July 2006, we began paying a quarterly cash dividend of $0.03 per share of common stock. Quarterly cash dividends are expected to continue at $0.03 per share, subject to change or elimination at any time by our Board of Directors.

Issuer Purchases of Equity Securities

The following table sets forth information regarding our repurchases of our common stock during the fourth quarter of 2013.

Period		Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Share Repurchase Program (1)	Approximate Dollar Value of Shares That May Yet Be Purchased Under Publicly Announced Share Repurchased Programs (1) (in thousands)
10/1/2013	10/31/2013	35,540	$ 38.10	35,540	$ 4,207
11/1/2013	11/30/2013	17,592	$ 44.62	17,592	$ 3,422
12/1/2013	12/31/2013	23,633	$ 48.81	23,633	$ 14,433
Total		76,765	$ 42.89		

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(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.

For the restricted stock units granted to employees, the number of shares otherwise issuable on the vesting date is reduced by a number of shares having a value equal to the minimum statutory income withholding tax that we are required pay in cash to the applicable taxing authorities on behalf of our employees. We do not consider these transactions to be common stock repurchases.

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Stock Performance Graph and Cumulative Total Stockholder Return

The following performance graph represents a comparison of the cumulative total stockholder return (assuming the reinvestment of dividends) for a $100 investment on December 31, 2008 in our common stock, the Total Return Index for the NASDAQ Composite (NASDAQ Composite), a broad market index, and the Standard & Poors (S&P) North Software-Software Index (S&P NSSI), a published industry index. We paid dividends of $.09 per share during 2013, $0.15 per share during 2012 and $0.12 per share during 2011, 2010, and 2009, respectively. The graph lines merely connect measurement dates and do not reflect fluctuations between those dates.

	12/31/2008	12/31/2009	12/31/2010	12/31/2011	12/31/2012	12/31/2013
Pegasystems Inc.	$100.00	$276.32	$298.75	$240.61	$186.39	$405.52
NASDAQ Composite	$100.00	$145.34	$171.70	$170.34	$200.57	$281.14
S&P NSSI	$100.00	$147.90	$185.10	$172.42	$202.46	$265.43

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ITEM 6. Selected Financial Data

The selected financial data presented below has been derived from our audited consolidated financial statements. This data should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations , the consolidated financial statements and accompanying notes.

	Year Ended December 31, (in thousands, except per share amounts)				
	2013	2012	2011	2010	2009
Consolidated Statements of Operations Data:					
Total revenue	$ 508,954	$ 461,710	$ 416,675	$ 336,599	$ 264,013
Income (loss) from operations	58,097	31,426	10,494	(2,580)	41,819
Income (loss) before provision (benefit) for income taxes	56,393	30,945	10,813	(6,197)	47,415
Net income (loss)	38,043	21,868	10,108	(5,891)	32,212
Earnings (loss) per share:					
Basic	$ 1.00	$ 0.58	$ 0.27	$ (0.16)	$ 0.89
Diluted	$ 0.98	$ 0.56	$ 0.26	$ (0.16)	$ 0.85
Cash dividends declared per common share	$ 0.12	$ 0.12	$ 0.12	$ 0.12	$ 0.12

	Year Ended December 31, (in thousands)				
	2013	2012	2011	2010	2009
Consolidated Balance Sheet Data:					
Total cash, cash equivalents, and marketable securities	$ 156,692	$ 122,985	$ 111,432	$ 87,251	$ 202,653
Working capital	159,772	123,885	89,716	73,606	188,552
Intangible assets, net of accumulated amortization	56,574	58,232	69,369	80,684	336
Goodwill	37,463	20,451	20,451	20,451	2,391
Total assets	533,662	439,492	381,711	337,475	279,585
Total stockholders equity	271,788	236,479	208,756	195,670	205,219

The following items impact the comparability of our consolidated financial data:

Our acquisition of Antenna in October 2013 and our acquisition of Chordiant in April 2010.

Foreign currency transaction (losses) gains of $(1.6) million, $0.8 million, $(0.9) million, $(5.6) million and $2.1 million, during the years ended December 31, 2013, 2012, 2011, 2010, and 2009, respectively. See Item 7A. Quantitative and Qualitative Disclosure about Market Risk for further discussion of our foreign currency exchange risk.

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ITEM 7. Management s Discussion and Analysis of Financial Condition and Results of Operations

Business overview

We develop, market, license, and support 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 PRPC software and related business solutions. PRPC is a comprehensive platform for building and managing 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 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 consulting services revenue.

Our acquisition of Antenna expands Pega s 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. Pega s 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. Total revenue attributable to Antenna included in our consolidated statements of operations in 2013 was $3.9 million. 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 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. In 2012, we began offering training online through PegaACADEMY, which 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.

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RESULTS OF OPERATIONS

2013 Compared to 2012

(Dollars in thousands)	Year Ended December 31, 2013	Year Ended December 31, 2012	Increase	
Total revenue	$ 508,954	$ 461,710	$ 47,244	10%
Gross profit	351,548	304,330	47,218	16%
Acquisition-related costs	1,306		1,306	n/m
Restructuring costs	1,731		1,731	n/m
Other operating expenses	290,414	272,904	17,510	6%
Total operating expenses	293,451	272,904	20,547	8%
Income from operations	58,097	31,426	26,671	85%
Income before provision for income taxes	56,393	30,945	25,448	82%

n/m not meaningful

Revenue

(Dollars in thousands)	Year Ended December 31, 2013		Year Ended December 31, 2012		Increase	
Software license revenue						
Perpetual licenses	$ 122,644	64%	$ 102,438	63%	$ 20,206	
Term licenses	62,711	33%	46,638	28%	16,073	
Subscription	6,521	3%	14,830	9%	(8,309)	
Total software license revenue	$ 191,876	100%	$ 163,906	100%	$ 27,970	17%

The aggregate value of new license arrangements executed in 2013 was higher than in 2012. The aggregate value of new license arrangements executed in the fourth quarter of 2013 was down slightly as compared to the fourth quarter of 2012.The aggregate value of new license arrangements executed fluctuates quarter to quarter. During 2013 and 2012, approximately 80% and 74%, 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. However, 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 increase in perpetual license revenue was primarily due to higher value perpetual arrangements executed during 2013 and the fourth quarter of 2012 than during 2012 and the fourth quarter of 2011.

The increase in term license revenue was primarily due to revenue recognized on term license arrangements executed in 2012 and 2011. The aggregate value of payments due under noncancellable term licenses increased to $233.6 million as of December 31, 2013 compared to $211.5 million as of December 31, 2012. See the table of future cash receipts from these term licenses on page 31.

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Subscription revenue primarily consists of the ratable recognition of license, maintenance and bundled services revenue on perpetual license arrangements that include a right to unspecified future products. Subscription revenue does not include revenue from our Pega Cloud® offerings, which is included in consulting services revenue. 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 in 2013 was primarily due to revenue recognized in the second quarter of 2012 for a large payment that became due.

(Dollars in thousands)	**Year Ended December 31,**		**Increase**	
	2013	**2012**		
Maintenance revenue				
Maintenance	$ 157,309	$ 133,527	$ 23,782	18%

The increase in maintenance revenue was 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 $0.8 million in 2013.

(Dollars in thousands)	**Year Ended December 31,**				**(Decrease)**	
	2013		**2012**			
Services revenue						
Consulting services	$ 154,500	97%	$ 157,792	96%	$ (3,292)	(2)%
Training	5,269	3%	6,485	4%	(1,216)	(19)%
Total Services	$ 159,769	100%	$ 164,277	100%	$ (4,508)	(3)%

Consulting services revenue includes revenue from our Pega Cloud® service offerings. Consulting services revenue decreased, partially offset by a $4.4 million revenue increase from our Pega Cloud® service offerings, of which $1.1 million was attributable to the acquired Antenna business. The decrease was primarily the result of more clients becoming enabled and our partners leading more implementation projects. If this trend continues, our consulting services revenue may continue to decrease in future periods. The decrease in our training revenue 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.

(Dollars in thousands)	**Year Ended December 31,**		**Increase (Decrease)**	
	2013	**2012**		
Gross Profit				
Software license	$ 185,595	$ 157,567	$ 28,028	18%
Maintenance	142,037	118,740	23,297	20%
Services	23,916	28,023	(4,107)	(15)%
Total gross profit	$ 351,548	$ 304,330	$ 47,218	16%
Total gross profit %	69%	66%		
Software license gross profit %	97%	96%		
Maintenance gross profit %	90%	89%		
Services gross profit %	15%	17%		

The increase in total gross profit was due to increases in license and maintenance revenue.

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The decrease in services gross profit percent was primarily due to lower consulting revenues, costs incurred on several projects for which the corresponding revenue will be recognized in future periods as revenue recognition criteria had not been met, and increased employee incentive expenses.

(Dollars in thousands)	Year Ended December 31, 2013	2012	Increase	
Amortization of intangibles:				
Cost of revenue	$ 6,443	$ 6,189	$ 254	4%
Selling and marketing	5,174	4,928	246	5%
General and administrative	396	20	376	1,880%
	$ 12,013	$ 11,137	$ 876	8%

The increase in amortization expense was due to the amortization associated with $10.4 million of intangibles acquired from Antenna.

Operating expenses

(Dollars in thousands)	Year Ended December 31, 2013	2012	Increase	
Selling and marketing				
Selling and marketing	$ 181,094	$ 167,263	$ 13,831	8%
As a percent of total revenue	36%	36%		
Selling and marketing headcount	598	520	78	15%

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 was primarily due to a $9.9 million increase in compensation and benefit expenses associated with higher headcount, a $1.7 million increase in marketing programs, a $1.2 million increase in commission expense, and a $1.3 million increase in partner commission expense.

(Dollars in thousands)	Year Ended December 31, 2013	2012	Increase	
Research and development				
Research and development	$ 79,726	$ 76,726	$ 3,000	4%
As a percent of total revenue	16%	17%		
Research and development headcount	913	727	186	26%

Research and development expenses include compensation, benefits, contracted services, and other headcount-related expenses associated with research and development. The increase in headcount reflects 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.

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The increase in research and development expenses was primarily due to a $7.4 million increase in compensation and benefit expenses associated with higher headcount, partially offset by a $2.3 million decrease in engineering contractor expenses and a decrease in rent and equipment-related expenses.

(Dollars in thousands)	**Year Ended December 31, 2013**	**2012**	**Increase**	
General and administrative				
General and administrative	$ 29,594	$ 28,915	$ 679	2%
As a percent of total revenue	6%	6%		
General and administrative headcount	271	251	20	8%

General and administrative expenses include compensation, benefits, and other headcount-related expenses associated with the finance, legal, corporate governance, and other administrative headcount. It also includes accounting, legal, and other professional consulting, and administrative fees.

The general and administrative headcount includes employees in human resources, information technology and corporate services departments whose costs are allocated to the rest of our functional departments.

The increase in general and administrative expenses was primarily due to increase in compensation and benefits associated with higher headcount.

Acquisition-related costs

Acquisition-related costs are expensed as incurred and include direct and incremental costs associated with an impending or completed acquisition. During 2013, the $1.3 million of acquisition-related costs were primarily professional fees associated with our acquisition of Antenna.

Restructuring costs

In 2013, restructuring costs include future lease payments and demising costs, net of estimated sublease income, for the elimination of space within one facility related to the integration of Antenna. See Note 12 Accrued Restructuring Costs in the notes to the accompanying consolidated financial statements for further detail.

Stock-based compensation

We recognize stock-based compensation expense associated with equity awards in our consolidated statements of operations based on the fair value of these awards at the date of grant.

(Dollars in thousands)	**Year Ended December 31, 2013**	**2012**	**Increase**	
Stock-based compensation:				
Cost of services	$ 4,085	$ 3,655	$ 430	12%
Operating expenses	8,784	7,851	933	12%
Total stock-based compensation before tax	12,869	11,506	$ 1,363	12%
Income tax benefit	(3,918)	(3,699)		

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The increase in stock-based compensation expense was primarily due to a full year of expense on the December 2012 annual employee equity grants. See Note 15 Stock-Based Compensation in the notes to the accompanying audited consolidated financial statements for further information on our stock-based awards.

Non-operating income and (expenses), net

(Dollars in thousands)	Year Ended December 31, 2013	2012	Change	
Foreign currency transaction (loss) gain	$ (1,593)	$ 780	$ (2,373)	(304)%
Interest income, net	524	419	105	25%
Other (expense) income, net	(635)	(1,680)	1,045	(62)%
	$ (1,704)	$ (481)	$ (1,223)	254%

We use 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 expense (income), net. The fluctuations in the value of these forward contracts recorded in other (expense) income, 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.

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 consolidated financial statements for discussion on our use of forward contracts.

The total change in the fair value of our foreign currency forward contracts recorded in other (expense) income, net, during 2013 and 2012 was a loss of $0.7 million and $1.7 million, respectively.

Provision for income taxes

The provision for income taxes represents current and future amounts owed for federal, state, and foreign taxes. During 2013 and 2012, we recorded an $18.4 million provision and a $9.1 million provision, respectively, which resulted in an effective tax rate of 32.5% and 29.3%, respectively

Our effective income tax rate for 2013 was below the statutory federal income tax rate due to a $2.1 million benefit related to the current period domestic production activities deduction, a $1.2 million benefit related to income generated in foreign jurisdictions that is subject to tax at a rate lower than the U.S. statutory tax rate, and a $1.6 million benefit related to the 2012 and 2013 federal research and experimentation (R&E) credit. These benefits were partially offset by $1.4 million of permanent differences related to nondeductible meals and entertainment expenses, foreign stock compensation, and transaction costs.

Our effective income tax rate for 2012 was below the statutory federal income tax rate due to a $1.2 million benefit related to the domestic production activities deduction and a $1.2 million benefit related to income generated in foreign jurisdictions that is subject to tax at a rate lower than the U.S. statutory rate. These benefits were partially offset by $1 million of permanent differences related to nondeductible meals and entertainment expenses and nondeductible foreign stock compensation.

The American Taxpayer Relief Act of 2012 (the Act) was signed into law by President Obama on January 2, 2013. Among other things, the Act retroactively extended the R&E credit through the end of 2013. Under ASC 740, *Income Taxes*, the effects of new legislation are recognized upon enactment, which means that both the retroactive tax effects for the 2012 R&E credit and the tax effects for the 2013 R&E are recognized in the 2013 financial statements. If we had recognized the effects of the 2012 R&E credit in the 2012 financial statements, the effective tax rate in 2012 would have been lowered by approximately 2.6%.

As of December 31, 2013, we had approximately $40.9 million of total unrecognized tax benefits, of which $25.2 million would decrease our effective tax rate if recognized. The remaining $15.7 million of unrecognized tax benefits relate to acquired net operating losses (NOLs) and R&E credits that are subject to limitations on their use. We expect that the changes in the unrecognized benefits within the next twelve months will be approximately $0.1 million, all of which would reduce our effective tax rate if realized.

2012 Compared to 2011

(Dollars in thousands)	**Year Ended December 31,**		**Increase**	
	2012	**2011**		
Total revenue	$ 461,710	$ 416,675	$ 45,035	11%
Gross profit	304,330	251,877	52,453	21%
Total operating expenses	272,904	241,383	31,521	13%
Income from operations	31,426	10,494	20,932	199%
Income before provision for income taxes	30,945	10,813	20,132	186%

The aggregate value of new license arrangements executed in 2012 was slightly higher than in 2011. The aggregate value of new license arrangements executed fluctuates quarter to quarter. During 2012 and 2011, approximately 74% and 58%, respectively, of new license arrangements were executed with existing clients. We believe the continued demand for our software products and related services is due to the strong value proposition, short implementation period, and variety of licensing models we offer our clients.

The increase in gross profit was primarily due to the increase in license revenue and to a lesser extent the increase in maintenance revenue.

The increase in operating expenses was primarily due to the increase in selling and marketing expenses and to a lesser extent the increase in research and development expenses, associated with higher headcount.

The increase in income from operations and income before provision for income taxes was primarily due to the higher increases in license and maintenance gross profit compared to the increase in operating expenses.

Revenue

(Dollars in thousands)	**Year Ended December 31,**				**Increase**	
	2012		**2011**			
License revenue						
Perpetual licenses	$ 102,438	63%	$ 94,129	68%	$ 8,309	9%
Term licenses	46,638	28%	34,453	25%	12,185	35%
Subscription	14,830	9%	10,225	7%	4,605	45%
Total license revenue	$ 163,906	100%	$ 138,807	100%	$ 25,099	18%

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In both 2011 and 2012, more than 50% of the aggregate value of new license arrangements for the fiscal year was executed in our fourth quarter. A large proportion of the value of these arrangements was term licenses that contributed very little to the increase in our term license revenue in 2012, but will be recognized as revenue in future periods. As a result, the aggregate value of future payments due under noncancellable term licenses increased significantly in both 2011 and 2012 from $90.9 million as of December 31, 2010 to $161.4 million as of December 31, 2011 and to $211.5 million as of December 31, 2012. The increase in term license revenue for 2012 is a result of the increase in the aggregate value of future payments due under noncancellable term licenses arrangements from prior years.

The increases in the aggregate value of term license arrangements executed in a certain period is not necessarily indicative of the volume level in future periods.

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 over time may cause our revenues to vary materially from period to period. The increase in perpetual license revenue was primarily due to the increase in the aggregate value of new perpetual license arrangements executed during the fourth quarter of 2012.

Subscription revenue primarily consists of the ratable recognition of license, maintenance and bundled services revenue on perpetual license arrangements that include a right to unspecified future products. Subscription revenue does not include revenue from our Pega Cloud® offerings. The timing of scheduled payments under client arrangements may limit the amount of revenue that can be recognized in a reporting period. Consequently, our subscription revenue may vary quarter to quarter. The increase in subscription revenue was primarily due to the full year of revenue recognized in 2012 on some arrangements for which we began recognizing revenue in the fourth quarter of 2011.

(Dollars in thousands)	**Year Ended December 31,**		**Increase**	
	2012	**2011**		
Maintenance revenue				
Maintenance	$ 133,527	$ 117,110	$ 16,417	14%

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

(Dollars in thousands)	**Year Ended December 31,**				**Increase (Decrease)**	
	2012		**2011**			
Services revenue						
Consulting services	$ 157,792	96%	$ 153,919	96%	$ 3,873	3%
Training	6,485	4%	6,839	4%	(354)	(5)%
Total Services	$ 164,277	100%	$ 160,758	100%	$ 3,519	2%

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Revenue from our Pega Cloud® offerings is included in consulting services revenue and was the primary driver for the increase in services revenue in 2012. In addition, our consulting services revenue increased due to higher realization rates in 2012 compared to 2011. As more of our clients are becoming enabled and our partners are leading the majority of implementation projects, our consulting services revenue may be lower in future periods.

(Dollars in thousands)	**Year Ended December 31,**		**Increase**
	2012	**2011**	