PEGASYSTEMS INC
Form 10-K
February 26, 2015
Table of Contents

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, 2014

¨ **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 x No ¨

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. x

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, 2014) was approximately $747 million.

There were 76,342,028 shares of the Registrant s common stock, $0.01 par value per share, outstanding on February 5, 2015.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant s definitive proxy statement related to its 2015 annual meeting of stockholders to be filed subsequently are incorporated by reference into Part III of this report.

Table of Contents

TABLE OF CONTENTS

Table of Contents

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, strategy, is intended to, project, guidance, or variations of such words and similar expressio 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. 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: Applications Engineered for Evolution

We believe business success requires that organizations become digital, and that a new generation of strategic applications can accelerate how organizations become modern digital enterprises. We power the digital enterprise with strategic applications built on Pega 7, our unified on-Cloud and on-premises platform (Pega 7 or Pega 7 platform). Pega 7 is designed to allow business and information technology to collaborate by using a comprehensive set of visual models to build applications: process models, predictive analytics, user experience (UX) designs, decision logic, etc. This visual, model-based approach is designed to be faster in building, deploying, and evolving strategic applications than traditional programming, and to empower our clients to better engage their customers, simplify processes, and turn the power of change into a competitive advantage.

We develop, market, license, and support strategic software applications for marketing, sales and onboarding, customer service, and operations, in addition to licensing our Pega 7 platform for clients that wish to build and extend their own applications. Our software is designed to assist clients in building, deploying, and evolving strategic enterprise applications, creating an environment in which business and IT can collaborate to manage back-office operations, front office sales, marketing, and/or customer service needs.

Our applications and platform intersect with and encompass 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 industry solutions and packaged applications.

We also provide consulting services and implementation support, training, and technical support services to help clients maximize the business value from our software. Our clients include Global 500 companies and government agencies that seek to manage complex enterprise systems and customer service issues more nimbly and cost-effectively. Our strategy is to sell a client a series of licenses, each focused on a specific purpose or area of operations. As we have found meaningful interest from smaller companies, we are expanding our sales force to extend coverage beyond our traditional Global 500 focus.

Table of Contents

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., Atos SE, Capgemini SA, Cognizant Technology Solutions Inc., Ernst & Young LLP, Infosys Technologies Limited, Mahindra Satyam, PricewaterhouseCoopers LLP, Tata Consultancy Services Limited, Virtusa Corporation, and Wipro Ltd.

Our products

Pega s applications streamline business operations, connect enterprises to their customers in real-time across channels, and adapt to meet changing requirements. Our applications can be deployed in the Cloud or on-premises, providing our clients with the flexibility to operate the software according to their own preferences.

Pega 7

Pega 7 is a unified platform that enables clients to build enterprise applications in a fraction of the time it would take using traditional programming technologies. Pega 7 is engineered to support complex global enterprises, allowing for application development and deployment on a patented layered architecture that supports reuse across lines of business, geographies, and customer segments. Our platform features a model-driven, visual code-free approach to application development that enables business and IT to collaborate, using a visual language that models the requirements and design of the application through readily understandable metaphors. This agile approach facilitates continuous improvement methodologies, such as Lean Six Sigma, to effectively manage individual projects or drive a complete enterprise transformation. All aspects of the application are captured in the model, including business strategy mapping, business processes, data models, case definitions, rules, decisions, reporting, interfaces, intelligent work management capabilities, business activity monitoring, and the UX across both web and mobile devices.

Once defined this way, the finished application and 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, helping to close the costly gap between vision and execution. Changes to the code are made by changing the model, and application documentation is generated directly from the model as well. The Pega 7 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. Pega 7 was previously marketed as PegaRULES Process Commander and the Build for Change platform.

Strategic Applications

Pegasystems also offers purpose or industry-specific software applications built on the Pega 7 platform. These applications for Marketing, Sales and Onboarding, Customer Service and Support, and Operations provide a best-practice starting point as well as industry-specific business processes. As they are built on the Pega 7 foundation, these applications deliver flexibility beyond traditional commercial off the shelf products. We believe our applications allow our clients to offer differentiated service and value to their customers. Pega 7 enables organizations to quickly implement new processes, refine customer experiences, bring new offerings to market, and provide customized or specialized processing to help meet the needs of different customers, departments, geographies, or regulatory requirements.

Table of Contents

Pega Customer Relationship Management Applications

Pega s Customer Relationship Management Applications are designed to evolve to meet changing business needs. Our applications offer process-driven, customer-centric CRM software that maximizes the lifetime value of customers and helps reduce the costs of serving customers. We provide marketing, sales, and service applications to optimize sales processes and customer service interactions.

Pega Marketing helps enterprises manage customer relationships across inbound and outbound channels. It incorporates predictive and adaptive analytics and business rules in real time to evaluate the context of each customer interaction and dynamically recommends the most relevant action, offer, content, and channel.

Pega Customer Service provides a contact center desktop, case management for customer service, mobile field service, self-service, and industry specific processes and data models. It allows enterprises to deliver consistent interactions across channels, improves employee productivity, and allows organizations to adapt to changing business requirements.

Pega Sales Automation automates and manages the sales process from prospecting to product fulfillment. Our software allows enterprises to capture best practices and guides sales teams through the sales and customer onboarding processes.

Pega provides *Operations Applications* to support a variety of business needs including risk, fraud, and compliance management; exceptions and investigations; order fulfillment; claims processing; insurance underwriting; and product development.

These applications incorporate and leverage many common technical capabilities. Our case management and business process technology facilitates 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 applications to guide actions and optimize process outcomes based on business objectives. Capabilities for cross-sell/up-sell, retention, service recommendations, and collections that can be changed with model-driven tools help businesses deploy automated decision-making quickly. The predictive and adaptive analytics incorporated into these applications support the creation and refinement of decision models to improve outcomes.

Social listening, text analytics, and natural language processing capabilities are also available in our Pega Customer Relationship Management Applications. This allows our clients to collect social content in tweets, blogs, and posts on Facebook or in other social communities, and enrich it by detecting language, topic, taxonomy, and sentiment. Using this capability, our clients are able to monitor, triage, and respond to social content across multiple channels, and turn it into actionable social intelligence.

Our Pega Co-Browse collaboration technology enables contact center users to provide fast service by simultaneously co-browsing Web pages with their customers. The technology is designed to allow our clients to engage customers in real time, and can also be used to enable employees to collaborate on work across physical locations.

The Pega Mobile capabilities in our Pega 7 platform are designed to help clients efficiently build, manage, and deploy mobile applications as part of a unified Omni-channel experience. By using Pega Mobile, enterprises can deploy Pega applications as packaged, branded mobile applications and manage the complex elements of the mobile application lifecycle including security, integration, testing, and management of mobile applications and devices. Our mobile application development solutions help businesses to reduce the development time, deployment cost, and complexity associated with run-the-business mobile applications.

Table of Contents

Pega Cloud®

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

Our services and support

We offer services and support through our global customer success group, our global customer support group, and our PegaACADEMY training services group. We also utilize third party contractors to assist us in providing these services.

Global Customer Success

Our Global Customer Success group combines our sales and Pega consulting groups and provides guidance and implementation services to our clients and partners on how to best apply our technology and develop strong implementation expertise.

Global Customer Support

Our Global Customer Support group is responsible for technical support. Support services include problem tracking, prioritization and escalation procedures, periodic preventive maintenance, documentation updates, and new software releases.

PegaACADEMY 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. Instructor-led training is offered at our regional training facilities in North America, the United Kingdom, India, Australia, and at third-party facilities in numerous other locations including client sites. Online training is 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 that require strategic applications to differentiate them in the markets they serve by increasing business agility, driving growth, improving productivity, attracting and retaining customers, and reducing risk. We deliver applications tailored to our clients specific industry needs as well as an application development platform for a multi-channel environment that can adapt to changing customer needs. We also enable enterprise transformation initiatives by providing an application development platform that digitizes end-to-end processes and allows for multi-channel customer interactions, all enhanced by Next-Best-Action analytics.

Our clients have typically been large companies in the financial services, healthcare, insurance, communications and media, public sector, manufacturing, and life sciences markets. We are expanding our client base to a broader range of companies in the Global 2000 within those markets as well as to additional industries.

Financial Services

Financial services organizations rely on software to market, onboard, cross-sell, retain, and service their customers as well as automate the operations that support these customer interactions. Our customer service and support, sales and new account onboarding, Know Your Customer (KYC), marketing, collections, and dispute management applications allow clients to be responsive to changing business requirements.

Table of Contents

Healthcare

Healthcare organizations seek software that integrates their front and back-offices and helps them deliver personalized care and customer service while reducing cost, automating processes, and increasing operational efficiency. Our applications allow healthcare clients to address sales, service, operations, 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. Insurers are also becoming increasingly sensitive to ways to improve customer service and the overall customer experience. Our applications for insurance carriers help increase business value by delivering customer-focused experiences and personalized interactions that help drive higher sales, lower expense ratios, and mitigate risk.

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 applications enable organizations to reshape the way they market and sell to customers, streamline onboarding and fulfillment operations, and bring new services and products to market.

Public Sector

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. Pega delivers advanced capabilities to streamline operations and optimize service delivery through an agile, multi-channel approach.

Manufacturing

Manufacturers worldwide are transforming their businesses to better engage customers and suppliers, as well as directly manage the performance of their products from the earliest designs throughout the product life-cycle. Our manufacturing applications address field service, reduce supplier risk, manage warranties, recalls, repairs, and returns as well as extend existing enterprise resource planning system capabilities.

Life Sciences

Life sciences organizations are looking for solutions to improve customer engagement as well as increase efficiencies and transparency across the product development lifecycle. Our customer engagement, clinical, and pharmacovigilance applications are designed to deliver customer engagement, safety and risk management, and regulatory transparency.

Other Industries

We offer software to a broad range of other types of companies and industries. For example, we sell our applications and platform to clients in transportation, retail, travel, energy, utilities, and other services.

Competition

We compete in the CRM (which includes marketing, sales, and customer service), BPM, Case Management, Decision Management, co-browsing, social engagement, and mobile application development platform software markets, as well as markets for the vertical applications we provide (e.g. KYC for Financial

Services, Pharmacovigilance for Life Sciences). 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 they offer. 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 and RightNow divisions of Oracle, the Microsoft Dynamics CRM division of Microsoft, and IBM s Unica Marketing product;
- Decision Management vendors including Business Rules Engine vendors such as the Operational Decision Management 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 division of Cognizant;
- 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;
- Co-browsing software providers, including the Oracle s RightNow Cobrowse Cloud Service;
- Social listening, text analytics, and natural language processing vendors, including Attensity, Visible Technologies, and Salesforce.com;
- Professional service organizations that develop their own products or create 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, or 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;

Proven success in enabling improved customer interactions;

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.

We believe we are competitively differentiated as our unified Pega 7 platform is designed to allow 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. In addition, our applications, built on the Pega 7 platform, provide the same level of flexibility and ability to adapt to our clients needs. 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.

Intellectual Property

We rely primarily on a combination of copyright, patent, trademark, and trade secrets laws, as well as confidentiality agreements to protect our proprietary rights. We have obtained patents relating to our system architecture and products in strategic global markets. We enter into confidentiality and license agreements with our employees, partners, clients, and other third parties and control access to and ownership of software, services, documentation, and other proprietary information as means to protect our proprietary rights.

Sales and marketing

We market our software and services primarily through a direct sales force. In addition, strategic partnerships with management consulting firms and major systems integrators are important to our sales efforts because they influence buying decisions, help us identify sales opportunities, and complement our software and services with their domain expertise and professional services capabilities. We also partner with technology providers and application developers.

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

Sales to clients based outside of the United States of America (U.S.) represented approximately 45% of our total revenue during each of the last three fiscal years. We have derived substantially all of our operating revenue from the sale and support of one group of similar products and services during each of the last three fiscal years. The majority of our long-lived assets were located within the U.S. at the end of each of the last three fiscal years. See Note 18, Geographic Information and Major Clients, included in the Notes to Consolidated Financial Statements included in Item 8 of this Annual Report on Form 10-K. 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 technology. We intend to maintain and extend the support of our existing strategic applications, and we

Table of Contents

may choose to invest in additional strategic applications 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 2014, 2013, and 2012, research and development expenses were approximately $108.6 million, $79.7 million, and $76.7 million, respectively. See Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operations of this Annual Report on Form 10-K for further discussion. 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, 2015, we had 2,970 employees worldwide, of which 1,313 were based in North America, 617 were based in Europe, and 1,040 were based in Asia Pacific.

Backlog of license, maintenance, and services

As of December 31, 2014, we had software license, maintenance, Cloud, and services agreements with clients expected to result in approximately $540.3 million of future revenue, of which we expect approximately $315.3 million to be recognized in 2015. As of December 31, 2013, we had approximately $505.9 million in backlog of client software license, maintenance, Cloud, and services agreements. 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. Backlog may vary in any given period depending on the amount and timing of when arrangements are executed, as well as the mix between perpetual and term license arrangements. Business conditions could change and, therefore, backlog may not be a reliable indicator of future financial performance. See Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operations of this Annual Report on Form 10-K for more detail regarding backlog.

Available Information

We make available 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, free of charge through our Website (www.pega.com/about-us/investors) 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.

Table of Contents

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. In the event that our clients choose term licenses or Pega Cloud® subscriptions, we recognize the revenue over the license term or Pega Cloud subscription term, which 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. Other factors which may influence the predictability of our license revenue include: changes in customer budgets and decision making processes that could affect both the timing and size of transactions, the deferral of license revenue to future periods due to the timing of the execution of an agreement or our ability to deliver the products or services, changes in our business model, and/or our ability to execute on our marketing and sales strategies.

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. If our revenues and operating results do not meet the expectations of our investors or securities analysts or fall below guidance we may provide to the market, or due to other factors discussed elsewhere in this section, the price of our common stock may decline.

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. Also, certain of our smaller clients may have limited additional sales opportunities available. For any of 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.

Table of Contents

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 consulting services revenue.

If we are unable to maintain vendor-specific objective evidence (VSOE) of fair value of our time and materials (T&M) 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 T&M 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 T&M consulting services pricing or otherwise introduce variability in our T&M consulting services arrangements to attract or retain clients, this could lead to an insufficient number of consistently priced T&M consulting services arrangements for us to maintain VSOE. If we do not have VSOE of fair value of our T&M consulting services, we may be required to recognize all revenue for these consulting services arrangements, including any bundled license, maintenance, and other services revenue, 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/or positions relative to our income and other taxes. In the ordinary course of conducting our global business enterprise, we cannot be certain of the ultimate tax outcome related to many transactions and calculations. 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 also subject to non-income taxes such as payroll, sales, use, value-added, net worth, property and goods and services taxes in the U.S. and in various foreign jurisdictions. We are regularly under audit by tax authorities with respect to these non-income taxes and may have exposure to additional non-income tax liabilities which could have an adverse effect on our results of operations and financial condition.

If it became necessary to repatriate any of our foreign cash balances to the United States, we may be subject to increased income taxes, other restrictions, and limitations. As of December 31, 2014, approximately $46.8 million of our cash and cash equivalents is held in our foreign subsidiaries. If we are unable to reinvest this cash outside of the U.S., we may have to repatriate some of our foreign cash to the U.S. which would increase our income tax liability. If it became 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 have not been 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 other factors.

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 to balance our growth in expenses. 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 also 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, address any defects or errors, 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, address any product defects or errors, 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. We may not have sufficient resources to make necessary product development investments. We may experience technical or other difficulties that will delay or prevent the successful development, introduction, or implementation of new or enhanced products. We may also experience technical or other difficulties in the integration of acquired technologies into our existing platform and applications. Inability to introduce or implement new or enhanced products in a timely manner could result in loss of market share if competitors are able to provide solutions to meet customer needs before we do, give rise to unanticipated expenses related to further development or modification of acquired technologies as a result of integration issues, and adversely affect future financial performance.

The market for our offerings is intensely and increasingly competitive, rapidly changing, and highly fragmented. We compete in the CRM, which includes marketing, sales, and customer service, BPM, Case Management, Decision Management, co-browsing, social engagement, and mobile application development platform software markets, as well as markets for the vertical applications we provide (e.g. KYC for Financial Services, Pharmacovigilance for Life Sciences). 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, co-browsing, social engagement, 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 to 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 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. In the past few years, the regions which we serve 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

Table of Contents

financial services and insurance clients, and possibly our clients in other industries, to make investments in technology, which in turn may delay or reduce the number 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 and may result in longer sales cycles, increased price competition, and reductions in sales of our products and services. 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, healthcare, and communications 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, healthcare, and communications 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 and communications markets. 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.

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 to product development efforts, including Cloud hosting facilities. 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. Further, the use of third-party hosting facilities requires us to rely on data security as it is provided by such third parties, which despite our due diligence may be less than adequate.

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 the last three fiscal years. 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, the Middle East, Latin America, Asia, and Australia. We have established offices in North America, Europe (including Russia and Turkey), 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, we may not 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 privacy and protection laws and regulations, increased tariffs and other trade barriers;

12

Table of Contents

- the costs of localizing products for local markets, including translation into foreign languages and associated expenses;
- longer payment cycles and credit and collectability risk on our foreign trade receivables;
- difficulties in enforcing contractual and intellectual property rights;
- heightened fraud and anti-bribery awareness risks;
- treatment of revenue from international sources and changes to tax codes, including being subject to foreign tax laws, being liable for paying withholding income or other taxes in foreign jurisdictions, and other potentially adverse tax consequences (including restrictions on repatriating earnings and the threat of double taxation);
- managing our international operations, including increased accounting and internal control expenses;
- heightened risks of political and economic instability; and
- foreign currency exchange rate fluctuations and controls.

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 their local currencies, so it holds cash and accounts receivable denominated in these foreign currencies, which are subject to foreign currency transaction gains or losses. We have historically 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 is intended to partially mitigate the exposure to the foreign currency transaction gains and losses. We are in the process of reassessing our hedging strategy and have not entered into any foreign currency forward contracts since February 2014. Although we may resume the use of foreign currency forward contracts in the future, amounts denominated in foreign currencies, particularly the British pound, Euro, Australian dollar, and Indian rupee relative to the U.S. dollar, may fluctuate in value and 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 who is also our founder and majority stockholder. 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, and rapidly replace and ramp up new management. 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.

Table of Contents

We may not be able to achieve the key elements of our strategy and grow our business as anticipated. We currently intend to grow our business by pursuing strategic initiatives. Key elements of our strategy include utilizing our network of partner alliances to support our growth strategies and developing the talent and organizational structure capable of supporting our growth targets. We may not be able to achieve one or more of our key initiatives. Our success depends on our ability to appropriately manage our expenses as we grow our organization; successfully execute our marketing and sales strategies; successfully incorporate acquired technologies into our unified Pega 7 platform; and develop new products or product enhancements. If we are not able to execute on these actions, our business may not grow as we anticipated, and our operating results could be adversely affected.

We may experience significant errors or security flaws in our product and services, and could face privacy, product liability, and/or warranty claims as a result. Despite quality 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. Additionally, 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/or warranty claims as well as harm our reputation, which could impact our future sales of products and services. Typically, we enter into license agreements that 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.

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 in strategically important global markets 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, including clients, 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, and also assert ownership of work product and intellectual property rights as appropriate, there are often exceptions, and we cannot be assured that limitations will be applicable and enforceable in all cases. Even if 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 and delivery 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 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. Data privacy laws and regulations in Europe, Australia, Latin America and elsewhere are undergoing rapid transformation towards increased restrictions. We have developed and implemented a compliance program based on what we believe are current best practices, including the background checking of our major vendor and distribution partners and the creation of a data privacy center of excellence, 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, which could be significant.

Security of our systems and of global customer data is a growing challenge on many fronts. Security breaches may expose us to significant legal and financial liabilities. Our security measures, and those of our clients, may be breached as a result of third-party action, or that of employees, consultants, or others, including intentional misconduct by computer hackers, system error, human error, technical flaws in our products, 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 systems, and our clients data, to reduce these risks, there can be no assurance that our efforts will prevent breaches. 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, though this may prove insufficient in the event of a major breach.

Additionally, our Cloud computing service offering allows clients to create and deploy Pega 7-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 and technology including encryption, virtualized infrastructure, and support. Because we do not control the transmissions between our clients and our third-party technology 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. 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 acquisitions and we continue to evaluate and consider other potential strategic transactions, including domestic and international 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 and/or legal requirements, new third-party intellectual property infringement claims related to the acquired technology and/or services, dilution of shareholder value, cross border legal issues, 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.

See Note 13 Commitments and Contingencies, in the Notes to Consolidated Financial Statements included in Item 8 of this Annual Report on Form 10-K for more information about our lease commitments. 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.

Table of Contents

PART II

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

Stock Split

On March 6, 2014, our Board of Directors approved a two-for-one stock split of our common stock, effected in the form of a common stock dividend (the Stock Split). 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 $0.01, for each share of common stock held on the Record Date. The number of common shares and per share amounts for all prior periods presented in this Annual Report on Form 10-K have been retroactively restated to reflect the Stock Split, except as otherwise noted.

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 (1)			
	2014		2013	
	High	Low	High	Low
First Quarter	$ 24.85	$ 17.07	$ 15.18	$ 11.39
Second Quarter	$ 21.79	$ 15.51	$ 16.78	$ 12.23
Third Quarter	$ 23.38	$ 19.10	$ 20.28	$ 16.29
Fourth Quarter	$ 21.95	$ 18.46	$ 25.77	$ 18.40

(1) The historical per share amounts presented above reflect the impact of the Stock Split. See Stock Split above.

Holders

As of February 5, 2015, we had approximately 25 stockholders of record and approximately 10,650 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. This represents $0.015 per share of common stock on a post-split basis. On May 27, 2014, we announced an increase in our quarterly common stock cash dividend to $0.03 per share. 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.

Table of Contents

Issuer Purchases of Equity Securities

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

Period		Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Share Repurchase Program (1)	Approximate Dollar Value of Shares That May Yet Be Purchased at Period End Under Publicly Announced Share Repurchased Programs (1) (in thousands)
10/1/2014	10/31/2014	59,692	$ 19.16	59,692	$ 980
11/1/2014	11/30/2014	29,433	$ 20.22	29,433	$ 14,795
12/1/2014	12/31/2014	72,603	$ 20.81	72,603	$ 13,284
Total		161,728	$ 20.09		

(1) Since 2004, our Board of Directors has approved stock repurchase programs that have authorized the repurchase, in the aggregate, of up to $119 million of our common stock. On November 24, 2014, we announced that our Board of Directors extended the expiration date of the current stock repurchase program (the Current Program) to December 31, 2015 and authorized us to repurchase up to $15 million of our stock between November 18, 2014 and December 31, 2015. 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 to pay in cash to the applicable taxing authorities on behalf of our employees. We do not consider these transactions to be common stock repurchases.

Table of Contents

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, 2009 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 $0.09 per share during 2014, $0.045 per share during 2013, $0.075 per share during 2012 and $0.06 per share during 2011 and 2010, respectively. The graph lines merely connect measurement dates and do not reflect fluctuations between those dates.

	12/31/2009	12/31/2010	12/31/2011	12/31/2012	12/31/2013	12/31/2014
Pegasystems Inc.	$100.00	$108.15	$87.08	$67.46	$146.76	$124.60
NASDAQ Composite	$100.00	$118.02	$117.04	$137.47	$192.62	$221.02
S&P NSSI	$100.00	$125.15	$116.57	$136.89	$179.47	$204.38

Table of Contents

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)	**2014**	**2013**	**2012**	**2011**	**2010**
Consolidated Statements of Operations Data:					
Total revenue	$ 590,004	$ 508,954	$ 461,710	$ 416,675	$ 336,599
Income (loss) from operations	51,539	58,097	31,426	10,494	(2,580)
Income (loss) before provision (benefit) for income taxes	47,994	56,393	30,945	10,813	(6,197)
Net income (loss)	33,255	38,043	21,868	10,108	(5,891)
Earnings (loss) per share:					
Basic (1)	$ 0.44	$ 0.50	$ 0.29	$ 0.13	$ (0.08)
Diluted (1)	$ 0.42	$ 0.49	$ 0.28	$ 0.13	$ (0.08)
Cash dividends declared per common share	$ 0.105	$ 0.06	$ 0.06	$ 0.06	$ 0.06

(1) The number of common shares and per share amounts have been retroactively restated for all prior periods presented to reflect the two-for-one common stock split effected in the form of a common stock dividend distributed on April 1, 2014. See Item 5 Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities Stock Split of this Annual Report on Form 10-K for further discussion of the Stock Split.

	Year Ended December 31,				
(in thousands)	**2014**	**2013**	**2012**	**2011**	**2010**
Consolidated Balance Sheet Data:					
Total cash, cash equivalents, and marketable securities	$ 211,216	$ 156,692	$ 122,985	$ 111,432	$ 87,251
Working capital	163,448	157,823	123,885	89,716	73,606
Intangible assets, net of accumulated amortization	45,664	56,574	58,232	69,369	80,684
Goodwill	46,860	43,469	20,451	20,451	20,451
Total assets	587,801	536,480	439,492	381,711	337,475
Total stockholders equity	294,705	271,788	236,479	208,756	195,670

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 \$(3.8) million, \$(1.6) million, \$0.8 million, \$(0.9) million, and \$(5.6) million, during the years ended December 31, 2014, 2013, 2012, 2011, and 2010, respectively. See Item 7A Quantitative and Qualitative Disclosure about Market Risk for further discussion of our foreign currency exchange risk.

Table of Contents

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

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

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

Our clients include Global 500 companies and government agencies that seek to manage complex enterprise systems and customer service issues more nimbly and cost-effectively. Our strategy is to sell a client a series of licenses, each focused on a specific purpose or area of operations. As we have found meaningful interest from smaller companies, we are expanding our sales force to extend coverage beyond our traditional Global 500 focus. We license our products and render consulting and training services to clients domestically and internationally, including in Canada, Europe, the Middle East, Latin America, Asia, and Australia. In 2014, 2013, and 2012, sales to clients based outside of the United States of America (U.S.) represented approximately 45%, of our total revenue. See Note 18, Geographic Information and Major Clients, included in the Notes to Consolidated Financial Statements included in Item 8 of this Annual Report on Form 10-K for further detail on our geographic revenues.

Our license revenue is primarily derived from sales of our applications in the areas of marketing, sales and onboarding, customer service and support, and operations, as well our Pega 7 platform. Our consulting services revenue is primarily related to new license implementations. Our consulting services revenue may be lower in future periods as our clients become enabled and our partners lead more projects. We offer training for our staff, clients, and partners at our regional training facilities and at third-party facilities, including client sites. Our online training through PegaACADEMY provides an alternative way to learn our software in a virtual environment. We believe that this online training will continue to expand the number of trained experts at a faster pace.

We continue to invest heavily in research and development to improve our software. Our research and development operations are primarily located in the U.S. and India. We also regularly evaluate acquisitions or investment opportunities in complementary businesses, services and technologies, and intellectual property rights in an effort to expand and enhance our product offerings.

The Pega Mobile capabilities in our Pega 7 platform are designed to help clients efficiently build, manage, and deploy mobile applications as part of a unified Omni-channel experience. By using Pega Mobile, enterprises can deploy Pega applications as packaged, branded mobile applications and manage the complex elements of the mobile application lifecycle including security, integration, testing, and management of mobile applications and devices. Our mobile application development solutions help businesses to reduce the development time, deployment cost, and complexity associated with run-the-business mobile applications.

We acquired Antenna Software, Inc. and its subsidiaries (Antenna) in October 2013. The operations of Antenna are included in our operating results from the date of acquisition. Due to the integration of the products, sales force, and operations of Antenna, as of the third quarter of 2014, it is no longer feasible for us to identify the impact of Antenna on our consolidated results of operations.

Table of Contents

For 2014, we recorded total revenue of $590 million, an increase of 16% over 2013. License revenue was $232.3 million, an increase of 21% over 2013. Diluted earnings per share for 2014 was $0.42 as compared to $0.49 for 2013, a decrease of 14%. We generated cash flow from operations of $99.9 million during 2014, an increase of 24% over 2013. The increase in cash flow from operations was primarily driven by increased net income and our strong accounts receivable collections in 2014.

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

	As of December 31,			% Change	
(Dollars in thousands)	**2014**	**2013**	**2012**	**2014 vs. 2013**	**2013 vs. 2012**
Total billed deferred license and Cloud revenue	$ 63,048	$ 64,267	$ 40,262	(2)%	60%
Total off-balance sheet license and Cloud commitments	301,409	283,099	265,222	6%	7%
Total license and Cloud Backlog	$ 364,457	$ 347,366	$ 305,484	5%	14%

To grow our business, we intend to:

- execute sales and support models for the needs of our expanding target market;
- employ a digital marketing program in support of customer buying;
- utilize our network of partner alliances to support our growth strategies; and
- develop talent and an organizational structure capable of supporting our growth targets.

Whether or not we are successful depends on our ability to:

- successfully execute our marketing and sales strategies;
- appropriately manage our expenses as we grow our organization;
- develop new products or product enhancements; and
- successfully incorporate acquired technologies into our applications and unified Pega 7 platform.

Table of Contents

RESULTS OF OPERATIONS

(Dollars in thousands)	Year Ended December 31,			% Change	
	2014	2013	2012	2014 vs. 2013	2013 vs. 2012
Total revenue	$ 590,004	$ 508,954	$ 461,710	16%	10%
Gross profit	404,910	351,548	304,330	15%	16%
Total operating expenses	353,371	293,451	272,904	20%	8%
Income from operations	51,539	58,097	31,426	(11)%	85%
Income before provision for income taxes	47,994	56,393	30,945	(15)%	82%

Revenue

(Dollars in thousands)	Year Ended December 31,						% Change	
	2014		2013		2012		2014 vs. 2013	2013 vs. 2012
Software license revenue								
Perpetual licenses	$ 136,154	59%	$ 122,644	64%	$ 102,438	63%	11%	20%
Term licenses	88,813	38%	62,711	33%	46,638	28%	42%	34%
Subscription	7,369	3%	6,521	3%	14,830	9%	13%	(56)%
Total software license revenue	$ 232,336	100%	$ 191,876	100%	$ 163,906	100%	21%	17%

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. Additionally, some of our perpetual license arrangements include extended payment terms or additional rights of use, which also result in the recognition of revenue over longer periods. The aggregate value of new license agreements executed also fluctuates quarter to quarter.

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 client scheduled payments under subscription arrangements may limit the amount of revenue recognized in a reporting period. Consequently, our subscription revenue may vary materially quarter to quarter.

2014 Compared to 2013

The aggregate value of new license arrangements executed during 2014 increased compared to 2013 due to a higher number of license arrangements executed in 2014. The increase in the aggregate value of license arrangements executed was primarily due to one perpetual license arrangement executed in the second quarter of 2014 for more than $10 million, partially offset by a decrease in the value of new license arrangements executed in the fourth quarter of 2014. During 2014 and 2013, approximately 82% and 80%, respectively, of the value of new license arrangements were executed with existing clients.

The increase in perpetual license revenue was primarily due to the higher number and total value of license arrangements executed in 2014. The aggregate value of payments due under noncancellable perpetual licenses was $31.3 million as of December 31, 2014 compared to $30.7 million as of December 31, 2013.

The increase in term license revenue was primarily due to term license arrangements executed in 2014 and the second half of 2013. The aggregate value of payments due under noncancellable term licenses and Pega Cloud arrangements grew to $270.1 million as of December 31, 2014 compared to $252.4 million as of December 31, 2013. See the table of future cash receipts in Liquidity and Capital Resources Cash Provided by Operating Activities.

Table of Contents

The increase in subscription revenue in 2014 compared to 2013 was primarily due to the timing of payments for a client arrangement.

2013 Compared to 2012

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 increase in perpetual license revenue was primarily due to higher number and total value of 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 and our Pega Cloud arrangements increased to $252.4 million as of December 31, 2013 compared to $221.7 million as of December 31, 2012.

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,			% Change	
	2014	**2013**	**2012**	**2014 vs. 2013**	**2013 vs. 2012**
Maintenance revenue					
Maintenance	$ 186,239	$ 157,309	$ 133,527	18%	18%

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 attributable to recognition of the fair value of the acquired Antenna deferred maintenance revenue was $0.8 million in 2014 and 2013.

(Dollars in thousands)	Year Ended December 31,						% Change	
	2014		**2013**		**2012**		**2014 vs. 2013**	**2013 vs. 2012**
Services revenue								
Consulting services	$ 149,628	87%	$ 145,780	91%	$ 153,432	93%	3%	(5)%
Cloud	16,614	10%	8,720	6%	4,360	3%	91%	100%
Training	5,187	3%	5,269	3%	6,485	4%	(2)%	(19)%
Total services	$ 171,429	100%	$ 159,769	100%	$ 164,277	100%	7%	(3)%

2014 Compared to 2013

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

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

Training revenue decreased slightly as a result of a higher number of clients taking courses through our PegaACADEMY self-service online training, which has a significantly lower average price per student as compared to our traditional instructor-led training.

Table of Contents

2013 Compared to 2012

The decrease in consulting services revenue was primarily the result of more clients becoming enabled and our partners leading more implementation projects.

The increase in Cloud revenue was primarily due to growth of our Cloud client base and $1.1 million of revenue attributable to Antenna.

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,**			**% Change**	
	2014	**2013**	**2012**	**2014 vs. 2013**	**2013 vs. 2012**
Gross Profit					
Software license	$ 227,377	$ 185,595	$ 157,567	23%	18%
Maintenance	166,225	142,037	118,740	17%	20%
Services	11,308	23,916	28,023	(53)%	(15)%
Total gross profit	$ 404,910	$ 351,548	$ 304,330	15%	16%
Total gross profit %	69%	69%	66%		
Software license gross profit %	98%	97%	96%		
Maintenance gross profit %	89%	90%	89%		
Services gross profit %	7%	15%	17%		

2014 Compared to 2013

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

The decrease in services gross profit percent was primarily due to increased subcontractor and employee-related costs associated with higher headcount, primarily related to Antenna. It was also due to two large implementation projects for which more revenue without any associated expenses was recognized in 2013 than in 2014. The associated expenses were incurred in prior periods. In addition, European professional services utilization rates declined 8% in 2014 compared to 2013, primarily due to the weakening overall economic conditions in Europe and the completion of a large project.

2013 Compared to 2012

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

The decrease in services gross profit percent was primarily due to lower consulting revenues, costs incurred on several projects in 2013 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,**			**% Change**	
	2014	**2013**	**2012**	**2014 vs. 2013**	**2013 vs. 2012**
Amortization of intangibles:					
Cost of revenue	$ 6,017	$ 6,443	$ 6,189	(7)%	4%
Selling and marketing	6,022	5,174	4,928	16%	5%
General and administrative	1,770	396	20	347%	1,880%
	$ 13,809	$ 12,013	$ 11,137	15%	8%

2014 Compared to 2013 and 2013 Compared to 2012

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

Operating expenses

(Dollars in thousands)	Year Ended December 31,			% Change	
	2014	2013	2012	2014 vs. 2013	2013 vs. 2012
Selling and marketing					
Selling and marketing	$ 206,658	$ 181,094	$ 167,263	14%	8%
As a percent of total revenue	35%	36%	36%		
Selling and marketing headcount	661	598	520	11%	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 increases in headcount reflect our efforts to increase our sales capacity to target new accounts in existing industries as well as to expand coverage in new industries and geographies, and execute on our marketing strategies to continue to generate pipeline opportunities.

2014 Compared to 2013

The increase was primarily due to a $14.2 million increase in compensation and benefit expenses associated with higher headcount, partially due to Antenna, a $5.6 million increase in marketing and sales program expenses primarily related to PegaWORLD, our annual user conference, a $2.6 million increase in travel associated with the higher number of sales employees, and a $0.8 million increase in amortization associated with our Antenna customer related intangibles.

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 2014 compared to 2013.

2013 Compared to 2012

The increase 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,			% Change	
	2014	2013	2012	2014 vs. 2013	2013 vs. 2012
Research and development					
Research and development	$ 108,591	$ 79,726	$ 76,726	36%	4%
As a percent of total revenue	18%	16%	17%		
Research and development headcount	1,085	913	727	19%	26%

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 and integration of acquired technologies.

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

2014 Compared to 2013

The increase was primarily due to a $20.9 million increase in compensation and benefit expenses associated with higher headcount, inclusive of the compensation and benefit expenses associated with Antenna and with our product management and design group now included in research and development, a $2.3 million increase in computer and computer-related costs, and a $1.8 million increase in contracted professional services.

2013 Compared to 2012

The increase 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,**			**% Change**	
	2014	**2013**	**2012**	**2014 vs. 2013**	**2013 vs. 2012**
General and administrative					
General and administrative	$ 37,442	$ 29,594	$ 28,915	27%	2%
As a percent of total revenue	6%	6%	6%		
General and administrative headcount	310	271	251	14%	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.

2014 Compared to 2013

The increase was primarily due to a $2.6 million increase in compensation and benefits associated with higher headcount, a $2 million increase in professional fees primarily associated with legal and audit costs, and a $1.4 million increase in amortization associated with our trademark and non-compete intangible assets.

2013 Compared to 2012

The increase was primarily due to compensation and benefits associated with higher headcount.

Acquisition-related

Acquisition-related costs are expensed as incurred and include direct and incremental costs associated with an impending or completed acquisition. During 2014 and 2013, the $0.5 million and $1.3 million of acquisition-related costs were primarily professional fees associated with our acquisition of Antenna.

Table of Contents

Restructuring

The restructuring expenses represent future lease payments and demising costs, net of estimated sublease income, for space acquired in connection with the Antenna acquisition. During the fourth quarter of 2013, we ceased use of some of this space as part of our integration of Antenna and recognized $1.7 million in expenses. During the third quarter of 2014, we restructured the remaining space and revised our estimate of sublease income for the previously restructured space, recognizing $0.2 million in restructuring expenses. See Note 12 Accrued Restructuring in the Notes to Consolidated Financial Statements included in Item 8 of this Annual Report on Form 10-K for further discussion.

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 using the accelerated recognition method with each vesting tranche treated as if it were an individual grant.

(Dollars in thousands)	**Year Ended December 31,**			**% Change**	
	2014	**2013**	**2012**	**2014 vs. 2013**	**2013 vs. 2012**
Stock-based compensation:					
Cost of revenues	$ 5,335	$ 4,085	$ 3,655	31%	12%
Operating expenses	13,870	8,784	7,851	58%	12%
Total stock-based compensation before tax	19,205	12,869	11,506	49%	12%
Income tax benefit	(5,563)	(3,918)	(3,699)		

2014 Compared to 2013

The increase was primarily due to the timing of the 2013 and 2012 annual equity grants, which occurred in March 2014 and December 2012, respectively, as well as the higher value of the 2013 annual equity grant, executive new hire grants made since September 30, 2013, and awards granted in connection with the 2014 acquisitions.

2013 Compared to 2012

The increase was primarily due to a full year of expense on the December 2012 annual equity grant.

See Note 15 Stock-Based Compensation in the Notes to Consolidated Financial Statements included in Item 8 of this Annual Report on Form 10-K for further information on our stock-based awards.

Non-operating income and (expenses), net

(Dollars in thousands)	**Year Ended December 31,**			**% Change**	
	2014	**2013**	**2012**	**2014 vs. 2013**	**2013 vs. 2012**
Foreign currency transaction (loss) gain	$ (3,769)	$ (1,593)	$ 780	137%	(304)%
Interest income, net	683	524	419	30%	25%
Other expense, net	(459)	(635)	(1,680)	(28)%	(62)%
	$ (3,545)	$ (1,704)	$ (481)	108%	254%

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

28

Table of Contents

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, net, partially offset in net income, the gains and losses from the remeasurement or settlement of the foreign currency denominated accounts receivable, intercompany payables, and cash held by the U.S. operating company recorded in foreign currency transaction (loss) gain.

We are primarily exposed to the fluctuation in the British pound, Euro, Australian dollar, and Indian rupee relative to the U.S. dollar. See Note 4 Derivative Instruments in the Notes to Consolidated Financial Statements included in Item 8 of this Annual Report on Form 10-K for discussion on our use of forward contracts.

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

The total change in the fair value of our foreign currency forward contracts recorded in other expense, net, during 2014, 2013, and 2012 was a loss of $0.5 million, $0.7 million, and $1.7 million, respectively.

Provision for income taxes

2014 Compared to 2013

The provision for income taxes represents current and future amounts owed for federal, state, and foreign taxes. During 2014 and 2013, we recorded a $14.7 million and an $18.4 million provision, respectively, which resulted in an effective tax rate of 30.7% and 32.5%, respectively.

Our effective income tax rate for 2014 was below the statutory rate primarily due to a $2.4 million benefit related to the current period domestic production activities deduction, a $1.8 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 $0.8 million benefit related to the 2014 federal research and experimentation (R&E) credit discussed below. These benefits were partially offset by $1.8 million of permanent differences related to nondeductible meals and entertainment expenses and foreign stock compensation.

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 R&E credit discussed below. 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.

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, such that both the retroactive tax effects for the 2012 R&E credit and the tax effects for the 2013 R&E were 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%. On December 19, 2014, President Obama signed the Tax Increase Prevention Act of 2014, which included an extension of the R&E credit through the end of 2014.

As of December 31, 2014, we had approximately $43.4 million of total unrecognized tax benefits, of which $23.4 million would decrease our effective tax rate if recognized. The remaining $20 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 $0.5 million, all of which relate to the expiration of applicable statute of limitations and would reduce our effective tax rate if realized.

Table of Contents

2013 Compared to 2012

During 2013 and 2012, we recorded an $18.4 million 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 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.

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 NOLs and R&E credits that are subject to limitations on their use.

LIQUIDITY AND CAPITAL RESOURCES

(in thousands)	Year Ended December 31,		
	2014	**2013**	**2012**
Cash provided by (used in):			
Operating activities	$ 99,889	$ 80,703	$ 43,579
Investing activities	(37,657)	(63,997)	(19,238)
Financing activities	(24,032)	(14,567)	(8,091)
Effect of exchange rate on cash	(3,846)	567	922
Net increase in cash and cash equivalents	$ 34,354	$ 2,706	$ 17,172

	As of December 31,		
	2014	**2013**	**2012**
Total cash, cash equivalents, and marketable securities	$ 211,216	$ 156,692	$ 122,985

The increase in cash and cash equivalents over the three years ended December 31, 2014, 2013, and 2012 was driven by the increases in cash provided by operating activities, the primary source of our liquidity. We use this source of liquidity to fund our capital expenditures and acquisitions, investments, dividend payments, and share repurchase program. We believe that our current cash, cash equivalents, and cash flow from operations will be sufficient to fund our operations and our share repurchase program for at least the next 12 months. There can be no assurance that changes in our plans or other events affecting our operations will not result in materially accelerated or unexpected cash requirements.

We evaluate acquisition opportunities from time to time, which if pursued, could require use of our funds. In October, 2013, we acquired Antenna for $27.1 million in cash, inclusive of cash acquired, and in the first quarter of 2014, we paid $0.8 million of the remaining merger consideration related to the final working capital adjustment.

During 2014, we completed three acquisitions for $6.3 million in cash, inclusive of $2.1 million in cash acquired, and $1.1 million in additional cash consideration to be paid by us in 2015. In addition, up to $1.5 million in additional cash consideration may be payable to the selling shareholders of one of the three acquired companies based on the achievement of certain performance milestones through the end of 2016.

During 2014 and 2013, we incurred $0.5 million and $1.3 million of direct and incremental expenses associated with these transactions, which were primarily professional fees.

As of December 31, 2014, approximately $46.8 million of our cash and cash equivalents was held in our foreign subsidiaries. If it became necessary to repatriate these funds, we may be required to pay U.S. tax, net of

30

Table of Contents

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.

Cash provided by operating activities

The primary drivers during 2014 were net income of $33.3 million, a $13.4 million increase in accounts payable and accrued expenses primarily due to the timing of income tax payments, and an $11.2 million increase in deferred revenue primarily resulting from the difference in timing of billings and revenue recognition for annual maintenance.

The primary drivers during 2013 were net income of $38 million and the $18.2 million in net inflows from operating asset and liability changes primarily due to the timing of payments for certain accrued expenses and additional tax liabilities associated with Antenna.

The primary driver during 2012 was net income of $21.9 million.

Future Cash Receipts from License Arrangements

Total contractual future cash receipts due from our existing license agreements was approximately $301.4 million as of December 31, 2014, $283.1 million as of December 31, 2013, and $265.2 million as of December 31, 2012. The approximate timing of future cash receipts due as of December 31, 2014 are summarized as follows:

As of December 31, *(in thousands)*	**Contractual payments for term licenses not recorded on the balance sheet (1)**	**Other contractual license payments not recorded on the balance sheet (2)**	**Total**
2015	$ 89,261	$ 19,017	$ 108,278
2016	83,165	12,290	95,455
2017	47,188		47,188
2018	25,070		25,070
2019	25,418		25,418
Total	$ 270,102	$ 31,307	$ 301,409

(1) These amounts include contractual future cash receipts related to our on-premises term licenses and hosted Pega Cloud service offerings. The amounts related to our on-premises 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 revenue associated with our Pega Cloud arrangements will be recognized ratably as Cloud revenue within services revenue over the term of the agreement. The timing of future revenue recognition and future cash receipts may not coincide.

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

Cash used in investing activities

During 2014, cash used in investing activities was primarily for purchases of marketable debt securities for $55.5 million, partially offset by the proceeds received from the maturities and called marketable debt securities of $33.2 million. We paid $3.9 million for acquisitions in 2014, net of cash acquired. We also invested $11.5 million primarily in leasehold improvements and computer equipment for the build-out of our new office in India.

Table of Contents

During 2013, cash used in investing activities was primarily for purchases of marketable debt securities for $60.6 million, partially offset by the proceeds received from the maturities and called marketable debt securities of $27.8 million. We paid $25.6 million to acquire Antenna, net of cash acquired and a preliminary working capital adjustment. We also invested $5.6 million primarily in leasehold improvements and computer equipment for the build-out of our U.S. and India offices.

During 2012, we invested $23.6 million primarily in leasehold improvements, furniture and fixtures and equipment for the build-out of our U.S. and India offices.

Cash used in financing activities

Net cash used in financing activities during 2014, 2013, and 2012, was primarily for repurchases of our common stock and the payment of our quarterly dividend. Since 2004, our Board of Directors has approved annual stock repurchase programs that have authorized the repurchase of up to $119 million of our common stock. As of December 31, 2014, approximately $99.3 million had been repurchased, $13.3 million remained available for repurchase and $6.4 million had expired. Purchases under these programs have been made on the open market.

Common stock repurchases

The following table is a summary of our repurchase activity under all of our stock repurchase programs:

(Dollars in thousands)	Year ended December 31, 2014		2013		2012	
	Shares (1)	**Amount**	**Shares (1)**	**Amount**	**Shares (1)**	**Amount**
Prior year authorizations at January 1,		$ 14,433		$ 14,793		$ 13,963
Authorizations		14,410		12,164		6,036
Repurchases paid	756,143	(15,264)	773,258	(12,370)	363,606	(5,130)
Repurchases unsettled	13,983	(295)	6,282	(154)	6,798	(76)
Authorized dollars remaining as of December 31,		$ 13,284		$ 14,433		$ 14,793

(1) 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. See Item 5 Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities of this Annual Report on Form 10-K for further discussion of the Stock Split.

In addition to the share repurchases made under our repurchase programs, we net settled the majority of our employee stock options exercised and RSUs vested. During 2014 and 2013, option and RSU holders net settled stock options and vested RSUs representing the right to purchase a total of 1,193,000 shares and 861,000 shares, respectively, of which only 641,000 shares and 432,000 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 with respect to stock options and the applicable taxes for both options and RSUs. During 2014 and 2013, instead of receiving cash from the equity holders, we withheld shares with a value of $6.1 million and $7.4 million, respectively, for withholding taxes, and $6.4 million and $9 million, respectively, for the exercise price.

Dividends

On May 27, 2014, we announced an increase in our quarterly cash dividend from $0.015 to $0.03 per share. We declared quarterly dividends totaling $0.105 per share, $0.06 per share, and $0.06 per share for the years ended December 31, 2014, 2013, and 2012, respectively. Our Board of Directors authorized the acceleration of the payment of the dividend declared in the fourth quarter 2012, otherwise payable in January 2013, to December 2012. Therefore, there was no dividend payment in the first quarter of 2013. For the years ended December 31, 2014, 2013, and 2012, we paid cash dividends of $6.9 million, $3.4 million, and $5.7 million, respectively. 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.

Contractual obligations

As of December 31, 2014, we had purchase obligations for customer support and marketing programs and payments under operating leases. Our lease arrangement for our new office headquarters expires in 2023, subject to our option to extend for two additional five-year periods. We also lease space for our other offices under noncancellable operating leases that expire at various dates through 2021.

	Payments due by period					
(in thousands)	**Total**	**2015**	**2016 & 2017**	**2018 & 2019**	**2020 & Thereafter**	**Other**
Purchase obligations (1)	$ 2,123	$ 2,123	$	$	$	$
Liability for uncertain tax positions (2)	22,921					22,921
Operating lease obligations (3)	100,005	12,645	26,517	24,468	36,375	
Total	$ 125,049	$ 14,768	$ 26,517	$ 24,468	$ 36,375	$ 22,921

(1) Represents the fixed or minimum amounts due under purchase obligations for customer support and marketing programs.

(2) As of December 31, 2014, our recorded liability for uncertain tax positions was approximately $22.9 million. We are unable to reasonably estimate the timing of the cash outflow due to uncertainties in the timing of the effective settlement of tax positions.

(3) Includes deferred rent of approximately $1.4 million included in accrued expenses and approximately $10 million in other long-term liabilities in the accompanying audited consolidated balance sheet as of December 31, 2014.

CRITICAL ACCOUNTING ESTIMATES AND SIGNIFICANT JUDGMENTS

Management s discussion and analysis of the financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the U.S. and the rules and regulations of the SEC for annual 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.

We believe that, of our significant accounting policies, which are described in Note 2, Significant Accounting Policies, in the Notes to Consolidated Financial Statements included in Item 8 of this Annual Report on Form 10-K, the following accounting policies are most important to the portrayal of our financial condition and require the most subjective judgment. Accordingly, these are the policies we believe are the most critical to aid in fully understanding and evaluating our consolidated financial condition and results of operations. If actual results differ significantly from management s estimates and projections, there could be a material effect on our financial statements.

Revenue recognition

Our revenue is derived primarily from software licenses, maintenance fees related to our software licenses, and consulting services. Our license arrangements, whether involving a perpetual license or a term license, generally contain multiple elements, including consulting services, training, and software maintenance services.

33

Table of Contents

Software revenue recognition requires judgment, including whether a software arrangement includes multiple elements, and if so, whether vendor-specific objective evidence (VSOE) of fair value exists for those elements. The amount of arrangement consideration allocated to undelivered elements is based on the VSOE of fair value for those elements and recognized as those elements are delivered. Any remaining portion of the total arrangement fee is allocated to the software license, the first delivered element. Revenue is recognized for each element when all of the revenue recognition criteria have been met.

Changes in the mix of the elements in a software arrangement, the ability to identify VSOE for those elements, the fair value of the respective elements, and changes to a product s estimated life cycle could materially impact the amount of earned and unearned revenue.

Before we can recognize revenue, the following four basic criteria must be met:

Persuasive evidence of an arrangement As evidence of the existence of an arrangement, we use a contract or purchase order signed by the client for software and maintenance and a statement of work for consulting services. In the event the client is a reseller, we ensure a binding agreement exists between the reseller and end user of the software.

Delivery of product and services Software is delivered electronically or shipped via disk media. Services are considered delivered as the work is performed or, in the case of maintenance, over the contractual service period.

Fee is fixed or determinable We assess whether a fee is fixed or determinable at the onset of the arrangement. In addition, we assess whether contract modifications to an existing arrangement constitute a concession. Our agreements do not include a right of return.

Collection of fee is probable We assess the probability of collecting from each client at the onset of the arrangement based on a number of factors, including the client s payment history, its current creditworthiness, economic conditions in the client s industry and geographic location, and general economic conditions. If, in our judgment, collection of a fee is not probable, revenue is recognized as cash is collected, provided all other conditions for revenue recognition have been met.

Software license revenues

Perpetual software license fees are recognized as revenue when the software is delivered, any acceptance required by contract that is not perfunctory is obtained, no significant obligations or contingencies exist related to the software, other than maintenance, and all other revenue recognition criteria are met.

Term software license fees are payable on a monthly, quarterly, or annual basis under license agreements that typically have a three to five-year term and may be renewed for additional terms at the client s option.

As a result of our focus on frequent sales to our targeted clients, our strategy to sell initial term licensing agreements to those clients with the goal to generate follow-on sales, and as a result of extended payment terms and other factors, such as the risk of concessions, we recognize term license revenue over the term of the agreement as payments become due or earlier if prepaid, provided all other criteria for revenue recognition have been met.

Subscription revenue primarily consists of license, maintenance, and bundled services revenue recognized on our license arrangements that include a right to unspecified future products, which is recognized ratably over the term of the subscription period.

Maintenance revenues

First-year maintenance typically is sold with the related software license and renewed on an annual basis thereafter. Maintenance revenue is deferred and recognized ratably over the term of the support period, which is generally one year and subject to annual renewals. Perpetual license maintenance obligations are based on separately stated renewal rates in the arrangement that are substantive and therefore represent VSOE of fair value. Term license arrangements include separately stated maintenance fees and we use separate sales to determine VSOE of fair value.

Services revenues

Our services revenue is comprised of fees for consulting services, including software implementation, training, reimbursable expenses and sales of our Pega Cloud® as-a-platform offering (Pega Cloud®). Consulting services may be provided on a stand-alone basis or bundled with a license and software maintenance services.

Revenue from training services and consulting services under time and materials contracts is recognized as services are performed. We have VSOE of fair value for our training services and consulting services under time and materials contracts in North America, Australia, and Europe.

Consulting services may occasionally be provided on a fixed-price basis. We do not have VSOE of fair value for fixed-price services or time and materials services in certain geographical regions. When these services are part of a multiple element arrangement, and the services are not essential to the functionality of the software, and when services, including maintenance, are the only undelivered element, we recognize the revenue from the total arrangement ratably over the longer of the software maintenance period or the service period. Revenue from fixed-price services that are not bundled with a software license is generally recognized ratably over the service period, which is typically less than four months.

Revenue from stand-alone sales of Pega Cloud® is recognized ratably over the term of the service. When implementation services are sold together with our Pega Cloud® offering and these services have stand-alone value to the client, we account for these services separately from our Pega Cloud® offering as described earlier. Stand-alone value is established through the client s ability to buy these services from many trained partner system integrators and from transactions sold independently from the sale of Pega Cloud®. Since these multiple-element arrangements are not software license sales, we apply a selling price hierarchy. Under the selling price hierarchy, third-party evidence of selling price (TPE) will be considered if VSOE does not exist, and estimated selling price (ESP) will be used if neither VSOE nor TPE is available. Generally, we are not able to determine TPE as our sales strategy is customized to the needs of our clients and our products or services are dissimilar to comparable products or services in the marketplace. In determining ESP, we apply significant judgment as we weigh a variety of factors, based on the facts and circumstances of the arrangement. We typically arrive at an ESP for a service that is not sold separately by considering company-specific factors such as geographies, competitive landscape, and pricing practices used to establish bundled pricing and discounting.

Deferred revenue

Deferred software license revenue typically results from client billings for which all of the criteria to recognize revenue have not been met. Deferred maintenance revenue represents software license updates and product support contracts that are typically billed in advance and are recognized ratably over the support periods. Deferred services revenue represents advanced billings for consulting, hosting, and training services that are recognized as the services are performed. The amount of revenue to defer and subsequently recognize involves judgments based on revenue recognition rules discussed above.

Goodwill and Intangible Assets Impairment

Our goodwill and intangibles assets result from our business acquisitions. Goodwill and intangible assets with indefinite useful lives are not amortized, but are tested for impairment at least annually or as circumstances indicate their value may no longer be recoverable. We do not carry any intangible assets with indefinite useful lives other than goodwill. We perform our annual goodwill impairment as of November 30th of each fiscal year.

To assess if goodwill is impaired, we first perform a qualitative assessment to determine whether further impairment testing is necessary. If, as a result of the qualitative assessment, we consider it more-likely-than-not that the fair value of our reporting unit is less than its carrying amount, we perform a quantitative impairment test in a two-step process. For the first step, we screen for impairment, and if any possible impairment exists, we undertake a second step of measuring such impairment by performing discounted cash flow analysis. This analysis is based on cash flow assumptions that are consistent with the plans and estimates being used to manage our business. In the first step, we review the carrying amount of our reporting unit compared to the fair value of the reporting unit. An excess carrying value to fair value would indicate that goodwill may be impaired. If we determined that goodwill may be impaired, then we would compare the implied fair value to the carrying value of the goodwill. We periodically re-evaluate our business and have determined that we have one operating segment and one reporting unit after completing the integration of Antenna s operations. If our assumptions change in the future, we may be required to record impairment charges to reduce the carrying value of our goodwill. Changes in the valuation of goodwill could materially impact our operating results and financial position. We evaluate our intangible assets for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. In evaluating potential impairment of these assets, we specifically consider whether any indicators of impairment are present, including, but not limited to:

- whether there has been a significant adverse change in the business climate that affects the value of an asset;

- whether there has been a significant change in the extent or manner in which an asset is used; and

- whether there is an expectation that the asset will be sold or disposed of before the end of its originally estimated useful life.

If indicators of impairment are present, we compare the estimated undiscounted cash flows that the specific asset is expected to generate to its carrying value. The key assumptions of the cash flow model involve significant subjectivity. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the asset exceeds its fair value.

As of December 31, 2014, we had $46.9 million of goodwill and $45.7 million of acquired intangible assets. If our estimates or the related assumptions change in the future, we may be required to record impairment charges to reduce the carrying value of these assets. Changes in the valuation of long-lived assets could materially impact our operating results and financial position. To date, there have been no impairments of goodwill or intangibles assets.

Accounting for Income Taxes

We use the asset and liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are determined based on temporary differences between the financial statement and tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse.

We regularly assess the need for a valuation allowance against our deferred tax assets. Future realization of our deferred tax assets ultimately depends on the existence of sufficient taxable income within the available carryback or carryforward periods. Sources of taxable income include taxable income in prior carryback years, future reversals of existing taxable temporary differences, tax planning strategies, and future taxable income. We record a valuation allowance to reduce our deferred tax assets to an amount we believe is more likely than not to be realized. Changes in our valuation allowance impact income tax expense in the period of adjustment. Our deferred tax valuation allowance requires significant judgment and uncertainties, including assumptions about future taxable income that are based on historical and projected information.

As of December 31, 2014, we had approximately $115.8 million of acquired Chordiant federal NOLs that are subject to annual use limitations under section 382 of the Internal Revenue Code. Based on those limitations we anticipate using $90 million of the remaining NOLs by 2029. In addition, we had $0.7 million of deferred tax assets related to state NOLs as of December 31, 2014.

We acquired approximately $39.6 million and $58.1 million of federal and foreign NOLs, respectively, in the Antenna transaction. We anticipate that we may utilize $7.5 million of the acquired Antenna federal NOLs under the applicable section 382 limitation, and these losses are scheduled to expire in 2031. A valuation allowance is recorded on the deferred tax assets in excess of the federal NOLs that are deemed recoverable under the preliminary limitation. With regard to the acquired foreign NOLs, a full valuation allowance has been recorded as of December 31, 2014 due to uncertainty regarding the availability of these NOLs to offset future income generated by the related foreign businesses due to limitations under local country change in control provisions. As of December 31, 2014, the Company had approximately $39.3 million of acquired Antenna federal NOLs, which are subject to annual use limitations under section 382. Based on those limitations, the Company anticipates using $7.1 million of the remaining NOLs by 2031.

We assess our income tax positions and record tax benefits based upon management s evaluation of the facts, circumstances, and information available at the reporting date. For those tax positions where it is more-likely-than-not that a tax benefit will be sustained, we record the largest amount of tax benefit with a greater than 50 percent likelihood of being realized upon ultimate settlement with a taxing authority having full knowledge of all relevant information. For those income tax positions where it is not more-likely-than-not that a tax benefit will be sustained, no tax benefit is recognized in the financial statements. We classify liabilities for uncertain tax positions as non-current liabilities unless the uncertainty is expected to be resolved within one year. We classify interest and penalties on uncertain tax positions as income tax expense.

As a global company, we use significant judgment to calculate and provide for income taxes in each of the tax jurisdictions in which we operate. In the ordinary course of our business, there are transactions and calculations undertaken whose ultimate tax outcome cannot be certain. Some of these uncertainties arise as a consequence of transfer pricing for transactions with our subsidiaries and nexus and tax credit estimates. In addition, the calculation of acquired tax attributes and the associated limitations are complex. We estimate our exposure to unfavorable outcomes related to these uncertainties and estimate the probability of such outcomes.

Although we believe our estimates are reasonable, no assurance can be given that the final tax outcome 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 on our income tax provision and operating results in the period in which such a determination is made.

See Note 16 Income Taxes in the Notes to Consolidated Financial Statements included in Item 8 of this Annual Report on Form 10-K for further information.

NEW ACCOUNTING PRONOUNCEMENTS

New Accounting Pronouncements are detailed in Note 2, Significant Accounting Policies, in the Notes to Consolidated Financial Statements included in Item 8 of this Annual Report on Form 10-K.

ITEM 7A. Quantitative and Qualitative Disclosure 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 and interest rates.

Foreign currency exposure

Approximately 45% of our total revenue was derived from sales to clients based outside of the U.S. in the last three fiscal years. Our international sales are usually denominated in foreign currencies. However, the operating expenses of our foreign operations are also primarily denominated in foreign currencies, which partially offset our foreign currency exposure. A decrease in the value of foreign currencies, particularly the British pound, Euro, Australian dollar, and Indian rupee relative to the U.S. dollar, could adversely impact our revenues and operating results.

Table of Contents

Our U.S. operating company invoices most of our foreign clients in foreign currencies, so it holds cash and receivables denominated in these foreign currencies. Our U.S. operating company s functional currency is the U.S. dollar. Therefore, when there are changes in the foreign currency exchange rates versus the U.S. dollar, we recognize a foreign currency transaction gain or (loss) in our consolidated statements of operations. In addition, we have intercompany accounts that are eliminated in consolidation, but that expose us to foreign currency exchange rate fluctuation, which are recorded as foreign currency transaction gains or (losses) in our consolidated statements of operations.

We have historically used forward contracts to manage our exposure to changes in foreign currency exchange rates affecting foreign currency denominated accounts receivable, intercompany payables, and cash primarily held by our U.S. operating company. We are in the process of reassessing our hedging strategy and have not entered into any forward contracts since February 2014. As of December 31, 2014 and 2013, we did not have any forward contracts outstanding.

These forward contracts were not designated as hedging instruments and as a result, we record their fair value at the end of each reporting period in our 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, net, in our consolidated statements of operations. Generally, we enter into contracts with terms of 90 days or less.

The fluctuations in the value of these forward contracts partially offset the gains and losses from the remeasurement or settlement of the foreign currency denominated accounts receivable, intercompany payables, and cash held by the U.S. operating company recorded in foreign currency transaction (loss) gain, thus partially mitigating the volatility.

We entered into forward contracts with notional values as follows:

	Twelve Months Ended December 31,					
Foreign currency *(in thousands)*		**2014**		**2013**		**2012**
Euro		21,900		102,300		49,700
British pound	£	26,500	£	85,400	£	52,000
Australian dollar	A$	12,900	A$	26,300	A$	
Indian rupee	Rs	204,000	Rs	690,000	Rs	

The total change in the fair value of our forward contracts recorded in other expense, net, was as follows:

	Change in Fair Value in USD Twelve Months Ended December 31,		
(in thousands)	**2014**	**2013**	**2012**
Loss included in other expense, net	$ (532)	$ (747)	$ (1,738)

The impact on net income of the gains and losses recorded on the foreign currency forward contracts, which is included in other expense, net, in the accompanying consolidated statements of operations, and the foreign currency transaction gains and losses recorded on the remeasurement and settlement of the foreign currency denominated assets, which is included in foreign currency transaction (loss) gain in the accompanying consolidated statements of operations, was a net loss of approximately $4.3 million, $2.3 million and $1 million for the years ended December 31, 2014, 2013 and 2012, respectively.

Interest rate exposure

As of December 31, 2014, we had $96.6 million of marketable debt securities, which consisted primarily of corporate and municipal bonds, with a weighted-average remaining maturity of 13 months. Due to the overall short-term remaining maturities of our marketable debt securities, our interest rate exposure is not significant. As of December 31, 2014, a 200 basis point increase in market interest rates would have reduced the fair value of our fixed rate marketable debt securities by approximately $2.1 million.

Table of Contents

ITEM 8. Financial Statements and Supplementary Data

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of Pegasystems Inc.

Cambridge, Massachusetts

We have audited the accompanying consolidated balance sheets of Pegasystems Inc. and subsidiaries (the Company) as of December 31, 2014 and 2013, and the related consolidated statements of operations, comprehensive income (loss), stockholders equity, and cash flows for each of the three years in the period ended December 31, 2014. We also have audited the Company s internal control over financial reporting as of December 31, 2014, based on criteria established in *Internal Control Integrated Framework* (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company s management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management s Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on these financial statements and an opinion on the Company s internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company s internal control over financial reporting is a process designed by, or under the supervision of, the company s principal executive and principal financial officers, or persons performing similar functions, and effected by the company s board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Pegasystems Inc. and subsidiaries as of December 31, 2014 and 2013, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2014, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2014, based on the criteria established in *Internal Control Integrated Framework* (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission.

/s/ DELOITTE & TOUCHE LLP

Boston, Massachusetts

February 26, 2015

40

Table of Contents

PEGASYSTEMS INC.

CONSOLIDATED BALANCE SHEETS

(in thousands, except per share amounts)

	As of December 31, 2014	As of December 31, 2013
ASSETS		
Current assets:		
Cash and cash equivalents	$ 114,585	$ 80,231
Marketable securities	96,631	76,461
Total cash, cash equivalents, and marketable securities	211,216	156,692
Trade accounts receivable, net of allowance of $1,540 and $1,997	154,844	165,641
Deferred income taxes	12,974	12,336
Income taxes receivable	4,502	4,392
Other current assets	9,544	9,148
Total current assets	393,080	348,209
Property and equipment, net	30,156	28,957
Long-term deferred income taxes	69,258	56,745
Long-term other assets	2,783	2,526
Intangible assets, net	45,664	56,574
Goodwill	46,860	43,469
Total assets	$ 587,801	$ 536,480
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 4,752	$ 3,671
Accrued expenses	42,958	31,624
Accrued compensation and related expenses	47,250	44,401
Deferred revenue	134,672	110,690
Total current liabilities	229,632	190,386
Income taxes payable	24,896	21,269
Long-term deferred revenue	20,859	34,196
Other long-term liabilities	17,709	18,841
Total liabilities	293,096	264,692
Commitments and contingencies (Note 13)		
Stockholders equity (1):		
Preferred stock, $0.01 par value, 1,000 shares authorized; no shares issued and outstanding		
Common stock, $0.01 par value, 200,000 shares and 100,000 shares authorized; 76,357 shares and 76,324 shares issued and outstanding	764	764
Additional paid-in capital	141,495	139,565
Retained earnings	153,058	127,826
Accumulated other comprehensive (loss) income:		
Net unrealized (loss) gain on available-for-sale marketable securities	(65)	77
Foreign currency translation adjustments	(547)	3,556
Total stockholders equity	294,705	271,788

Total liabilities and stockholders equity	$ 587,801	$ 536,480

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

See notes to consolidated financial statements.

41

Table of Contents

PEGASYSTEMS INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share amounts)

	Year ended December 31, 2014	2013	2012
Revenue:			
Software license	$ 232,336	$ 191,876	$ 163,906
Maintenance	186,239	157,309	133,527
Services	171,429	159,769	164,277
Total revenue	590,004	508,954	461,710
Cost of revenue:			
Software license	4,959	6,281	6,339
Maintenance	20,014	15,272	14,787
Services	160,121	135,853	136,254
Total cost of revenue	185,094	157,406	157,380
Gross profit	404,910	351,548	304,330
Operating expenses:			
Selling and marketing	206,658	181,094	167,263
Research and development	108,591	79,726	76,726
General and administrative	37,442	29,594	28,915
Acquisition-related	488	1,306	
Restructuring	192	1,731	
Total operating expenses	353,371	293,451	272,904
Income from operations	51,539	58,097	31,426
Foreign currency transaction (loss) gain	(3,769)	(1,593)	780
Interest income, net	683	524	419
Other expense, net	(459)	(635)	(1,680)
Income before provision for income taxes	47,994	56,393	30,945
Provision for income taxes	14,739	18,350	9,077
Net income	$ 33,255	$ 38,043	$ 21,868
Earnings per share (1):			
Basic	$ 0.44	$ 0.50	$ 0.29
Diluted	$ 0.42	$ 0.49	$ 0.28
Weighted-average number of common shares outstanding			
Basic	76,327	75,946	75,706
Diluted	78,531	77,974	77,718

(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 consolidated financial statements.

Table of Contents

PEGASYSTEMS INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(in thousands)

	Year ended December 31, 2014	2013	2012
Net income	$ 33,255	$ 38,043	$ 21,868
Other comprehensive (loss) income:			
Unrealized (loss) gain on securities, net of tax	(142)	(11)	31
Foreign currency translation adjustments	(4,103)	469	1,495
Total other comprehensive (loss) income	(4,245)	458	1,526
Comprehensive income	$ 29,010	$ 38,501	$ 23,394

See notes to consolidated financial statements.

Table of Contents

PEGASYSTEMS INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

(in thousands, except per share amounts)

	Common Stock		Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive (Loss) Income	Total Stockholders Equity
	Number of Shares	Amount				
Balance at January 1, 2012	75,424	$ 754	$ 129,324	$ 77,029	$ 1,649	$ 208,756
Repurchase of common stock	(370)	(4)	(5,202)			