PEGASYSTEMS INC
Form 10-K/A
April 25, 2007
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K/A

Amendment No. 1

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

For the fiscal year ended December 31, 2005

¨ **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)

101 Main Street

Cambridge, MA **02142-1590**

(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:

None

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

Common Stock, $.01 par value per share

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

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchanged 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the Registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one): Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨

Indicate by check mark whether the Registrant is a shell company, as defined in Rule 12b-2 of the Securities Exchange Act of 1934. 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, 2005) was approximately $78 million.

There were 35,367,873 shares of the Registrant s common stock, $.01 par value per share, outstanding on April 16, 2007.

Documents Incorporated by Reference

Document Description	**10-K Part**
Portions of the Registrant s Proxy Statement for the Annual Meeting of Stockholders to be held May 30, 2006	III

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EXPLANATORY NOTE

On March 5, 2007, Pegasystems Inc. (the Company), issued a press release and filed a related Current Report on Form 8-K with the Securities and Exchange Commission (the SEC), announcing that it would be restating its previously issued financial statements and other financial information for the years 2005, 2004 and 2003, and financial information for the years 2002 and 2001, and for each of the quarters in the years 2005 and 2004.

The Company is restating the previously issued financial statements and other financial information referenced above to correct the timing of revenue recognition for certain arrangements which include fixed-price services. The Company is also restating the previously issued financial statements and other financial information referenced above to correct the timing of revenue recognition for time and materials services provided but not yet invoiced, and to correct certain other immaterial errors. This Amendment No. 1 (this Form 10-K/A) to the Company s Annual Report on Form 10-K for the year ended December 31, 2005 (the Original Form 10-K) is being filed to restate financial statements and other financial information for the years 2005, 2004 and 2003, and financial information for the years 2002 and 2001, and for each of the quarters in the years 2005, 2004 and 2003.

This Form 10-K/A also includes revisions and additional disclosures in response to comments from the SEC staff. Although the SEC staff did not require the Company to amend its previous filings with respect to these comments, the revisions and additional disclosures included in this Form 10-K/A reflect the Company s commitment to address these comments in future filings.

Specifically, this Form 10-K/A amends and restates the following portions of the Original Form 10-K:

Part I, Item 1. *Business;*

Part I, Item 1A. *Risk Factors;*

Part II, Item 6. *Selected Consolidated Financial Data;*

Part II, Item 7. *Management s Discussion and Analysis of Financial Condition and Results of Operations;*

Part II, Item 8. *Financial Statements and Supplementary Data;*

Part II, Item 9A. *Controls and Procedures;*

Part IV, Item 15. *Exhibits and Financial Statements Schedules;*

Schedule II, *Consent of Independent Registered Public Accounting Firm*; and

Exhibits 31.1, 31.2, 32.1 and 32.2.

Except as required to reflect the items described above, no other modifications or updates have been made to the Original Form 10-K. Information not affected by items described above remains unchanged and reflects the disclosures made at the time of, and as of the dates described in, the Original Form 10-K. This Form 10-K/A does not describe events occurring after the Original Form 10-K (including with respect to exhibits), or modify or update disclosures (including forward-looking statements) which may have been affected by events or changes in facts occurring after the date of the Original Form 10-K. Accordingly, this Form 10-K/A should be read in conjunction with the Company s filings made with the SEC subsequent to the filing of the Original Form 10-K, as information in such filings may update or supersede certain information contained in this Form 10K/A.

In light of the restatements referenced above, readers should not rely on our previously issued financial statements and other financial information for the years and each of the quarters in the years 2005, 2004, 2003, 2002 and 2001 or on the previously issued reports of our independent registered public accounting firm for those years.

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PART I

ITEM 1 BUSINESS

Pegasystems was incorporated in Massachusetts in 1983. Our stock is traded on the NASDAQ Global 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/A. Unless the context otherwise requires, references in this Annual Report on Form 10-K/A to the Company, registrant, we, us or our refer to Pegasystems Inc. and its subsidiaries.

Forward-looking statements

This Annual Report on Form 10-K/A 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. In addition, other written or oral statements that constitute forward-looking statements may be made by us or on our behalf. Words such as expect, anticipate, intend, plan, believe, seek, estimate, may, or variations of such words and similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions that are difficult to predict. We have identified certain risk factors in Item 1A on this Annual Report on Form 10-K/A 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.

SEC reports and our Code of Conduct

We make available free of charge through our website our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K, and amendments to these reports, as soon as reasonably practicable after we electronically file such material with, or furnish such material to, the Securities and Exchange Commission. 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, are also available on our website.

Overview

We develop, market, license and support software to manage complex, changing business processes. Our business process management (BPM) software, which is combined with a business rules engine (BRE), is used by companies to automate decision making and the processes implementing those decisions. Our technology allows customers to change processes rapidly in response to changing business objectives and requirements thus enhancing productivity and competitiveness. Our software utilizes standards-based technology that facilitates rapid solution deployment and allows our customers to leverage their existing technology investments.

We provide implementation, consulting, training and technical support services to help our customers increase the business value from the use of our software. We also maintain alliances with systems integrators and technology consulting firms to support our customers.

Business strategy

Our goal is to be the leader of the BPM software market by leveraging our patented technology unifying BPM and rules. We focus our sales efforts on target accounts, which are companies or divisions within companies, and are typically large organizations

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that are among the leaders in their industry. We frequently sell limited size initial licenses to these target accounts rather than selling large application licenses. This allows our customers to quickly realize business value from our software and limits their up-front investment. Once a customer has realized this initial value, we work with the customer to identify opportunities for follow-on sales. Follow-on sales are often larger than the initial sale, and the sales process for follow-on sales is often shorter as a result of the established relationship with the customer.

We have developed strategic partnerships with consultants and systems integrators who are important to our sales efforts because they influence buying decisions, help us to identify potential customer opportunities and complement our software with their technology and domain expertise. These partners may deliver strategic business planning, consulting, project management and implementation services to our customers. Currently, our partners include Cognizant Technology Solutions, IBM Corp., Kanbay International, Inc., Pinkerton Computer Consultants, Inc., Satyam Computer Services Ltd., Steria Group and Virtusa Corporation.

Pegasystems products

We provide a suite of rules-based BPM products intended to help our customers plan, build and manage business process management solutions.

PegaRULES®

Our PegaRULES rules engine is a key differentiator of our rules-based BPM software. It is an inference engine that automatically analyzes our customer s data, determines which business rules apply to that data, initiates the appropriate business processes and prompts users for any additional inputs required. Our rules engine uses change-aware declarative rules that automatically recognize changes in data, such as changes in age or account balance, and initiate the appropriate business processes for that change, such as a notification of eligibility for an account upgrade. This combination of rules and processing enables our customers to better align their business processes with their business objectives.

PegaRULES Process Commander®

PegaRULES Process Commander provides additional capabilities designed to model, simulate, execute, monitor and analyze results. Built on the PegaRULES engine, PegaRULES Process Commander offers a browser-based development environment, execution engine and management dashboard, with a graphical, rapid solution development environment. This platform helps solve a wide range of business process management problems and allows our customers to leverage existing technology investments by integrating software applications across a common platform.

Pegasystems SmartBPM Suite and Solution Frameworks

Pegasystems SmartBPM Suite adds process analysis, process simulation, enterprise integration, portal integration, content management and/or case management to the PegaRULES Process Commander capabilities.

We also offer purpose or industry specific solution frameworks built on the capabilities of our PegaRULES Process Commander software. PegaCARD Customer Process Manager, PegaHEALTH Customer Service Manager and Pega Customer Process Manager are solution frameworks that enable financial services, healthcare and other organizations to quickly implement new customer-facing practices and processes, bring new offerings to market, and provide specialized processing to meet the needs of different customers, departments or geographies. We offer frameworks that address exceptions management, which are transactions that are not

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automatically processed by existing systems. By automating not only research and decision making, but also the business processes necessary to execute the decisions, our exceptions management frameworks can reduce the costs and risks associated with manual processing, while improving quality and efficiency. These frameworks include PegaCARD Smart Dispute, Smart Investigate for Payments, Smart Investigate for Securities, Smart Adjust, and PegaHEALTH Claims Automation Suite. We also offer industry frameworks for retail banking and healthcare payers, and cross industry frameworks that assist our customers in gaining value from the use of our software.

Markets and representative customers

The market for BPM software is driven by businesses that seek to close the execution gap that may exist between their business objectives and their existing business processes. Our target customers are large, industry-leading organizations faced with managing complex and changing processes. Our traditional customers have been large companies in the financial services and healthcare markets. With PegaRULES Process Commander, we are also able to offer solutions to a broader range of companies as well as a broader range of industries.

Financial services

Financial services organizations continue to require software to improve the quality, accuracy and efficiency of customer interactions and transaction processing. Pegasystems customer process and exceptions management products provide flexibility and functionality to allow customers greater responsiveness to changing business requirements. Representative financial services customers of ours include: Bank of America Corporation, Barclays Bank PLC, Citigroup Inc., Credit Suisse Group, HSBC Holdings Plc, JPMorgan Chase & Co., National Australia Bank Limited, Rabobank Group, Société Générale Group and TD Bank Financial Group.

Healthcare

Healthcare organizations also continue to seek out products that integrate their front and back office initiatives and help improve customer service, efficiency and productivity. Representative healthcare customers of ours include: Aetna Inc., Wellpoint Inc., Blue Cross Blue Shield of Massachusetts, Inc., Blue Cross & Blue Shield of Rhode Island, Computer Sciences Corporation, Group Health Cooperative, HealthNow New York Inc., Hospitals Contribution Fund of Australia Ltd. and ViPS/WebMD Corporation.

Other industries

PegaRULES Process Commander offers solutions to a broad range of companies and industries. We sell rules-based BPM technology outside our traditional markets to customers in insurance, telecommunications, government, pharmaceuticals, manufacturing and travel services. Customers include: American National Insurance Company, American International Group (AIG), Amgen, The Allstate Corporation, Advanced Micro Devices (AMD), General Electric Company, RS Medical Corporation, Starwood Hotels & Resorts Worldwide Inc., VetCentric, Inc. and Vodafone Group, Plc.

Sales and marketing

We market our software and services primarily through a direct sales force. Strategic partnerships with consultants and systems integrators are important to our sales efforts because they influence buying decisions, help us to identify potential customer opportunities, and complement our software with their technology and domain expertise. Our partners include Cognizant Technology Solutions, IBM Corp., Kanbay International, Inc., Pinkerton Computer Consultants, Inc., Satyam Computer Services Ltd., Steria Group and Virtusa Corporation.

To support our sales efforts, we conduct a broad range of marketing programs, including industry trade shows, industry seminars, meetings with industry analysts, and other direct and indirect marketing efforts. Our consulting staff, business partners, and other third parties also generate sales leads. As of December 31, 2005, our sales and marketing staff consisted of 112 people worldwide.

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Sales by geography

In 2005, 2004, and 2003, sales to customers based outside of the United States represented 34%, 30% and 21%, respectively, of our total revenue. During 2005, 2004 and 2003, we derived our revenue from the following geographic areas:

(in thousands)	2005		2004		2003	
United States	**$ 66,459**	**66%**	$ 72,689	70%	$ 74,711	79%
United Kingdom	**18,161**	**18%**	11,930	12%	11,919	13%
Europe, other	**10,732**	**11%**	13,132	13%	6,891	7%
Other	**4,857**	**5%**	5,540	5%	1,509	1%
	$ 100,209	**100%**	$ 103,291	100%	$ 95,030	100%

In 2005, no customer accounted for 10% or more of our total revenue. In 2004, one customer accounted for approximately 10% of our total revenue. In 2003, three customers each accounted for approximately 16%, 14% and 12% of our total revenue, respectively. We currently operate in one operating segment rules-based business process management, or BPM, software. We derive substantially all of our operating revenue from the sale and support of one group of similar products and services. Substantially all of our assets are located within the United States.

Services and support

We offer services and support through three groups: our professional services group which provides market, business and technical knowledge to assist our customers throughout the sale and deployment of our products; our global customer support group which provides support and maintenance for our customers; and our education services group which offers training programs for our employees, customers and partners. As of December 31, 2005, our services and support groups consisted of 155 people located in our 10 offices.

Professional services

Our professional services group helps companies and partners implement and optimize our software. These projects enable us to guide our customers through deployment of our software, and allow our workflow architects and business process automation consultants to strengthen their industry specific knowledge that can benefit future product development. Many of our customers choose to engage our professional services group to expand their use of our software to additional business or product lines or automate additional processes within existing solutions. In addition, systems integrators and consulting firms, with which we have alliances, also help our customers deploy our products.

Global customer support

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

Education services

The success of our sales strategy for multiple follow-on sales to target customers depends on our ability to train a larger number of partners and customers to implement our technology. We offer training for our staff, customers and partners. Training is offered at our regional training facilities in Cambridge, Massachusetts,

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Reading, England, and Sydney, Australia, at a third party facility in San Francisco, California, or may be specially arranged at customer sites. Courses are designed to meet the specific role requirements of process architects, system architects and system administrators. Our customers are also granted access to our web-based self service portal. The password-protected site offers a portal for information important to the implementation and use of our products. This portal is available at any time of the day or night and users may access it to interact with us at their convenience and to view product information, sales and marketing support materials, Pegasystems news and event information.

Research and development

Our product development priority is to continue expanding the capabilities of our rules-based BPM technology. We intend to maintain and extend the support of our existing solution frameworks, and we may choose to invest in additional frameworks which incorporate the latest business innovations. We also intend to maintain and extend the support of popular hardware platforms, operating systems, databases and connectivity options to facilitate deployment. Our goal with all of our products is to enhance product capabilities, ease of use, ease of implementation, long-term flexibility and the ability to provide improved customer service.

We believe that the challenge of enhancing future performance and maintaining technology leadership will depend on our ability to anticipate changes, maintain and enhance our current products, develop new products and keep pace with the increasingly sophisticated requirements of our current and prospective customers. We must develop products that conform to our customers information technology standards, scale to meet the needs of large enterprises, operate globally and cost less than a comparable internal development effort. Our development organization is responsible for product architecture, core technology development, product testing and quality assurance.

As of December 31, 2005, our development group consisted of 96 people and has been significantly supplemented by the use of contracted resources. During 2005, 2004, and 2003, research and development expenses were approximately $19.5 million, $19.9 million, and $21.6 million, respectively. We expect that we will continue to commit significant resources to our product research and development in the future to maintain our leadership position.

Competition

The BPM software market is increasingly and intensely competitive, rapidly changing and highly fragmented, as current competitors expand their product offerings and new companies enter the market. Competitors vary in size and in the scope and breadth of the products and services offered. We encounter competition from:

- Enterprise content management-based vendors such as FileNet Corporation;
- Enterprise application integration vendors such as TIBCO Software Inc. and webMethods Inc.;
- Business process management vendors such as Fuego and Lombardi Software, Inc.;
- Business rules engine vendors such as Fair Isaac Corporation and ILOG Inc.;
- Companies that provide application specific business process management software for the financial services, healthcare, insurance and other specific markets such as Chordiant, DST Systems, Carreker Corporation, Oracle Corporation, SmartStream Technologies Ltd. and Trintech Group PLC;
- Current customers information technology departments, which may seek to modify existing systems or develop proprietary systems.

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We are one of the leading companies in the overall BPM software market, and have a strong presence in exceptions management in the financial services and healthcare markets. We have been most successful competing for customers whose businesses are characterized by a high degree of change, complexity and size. We believe that the principal competitive factors within our market include:

- Product adaptability, scalability, functionality and performance;
- Proven success in delivering costs-savings and efficiency improvements;
- Ease-of-use for developers, business units and end-users;
- Timely development and introduction of new products and product enhancements;
- Establishment of a significant base of reference customers;
- Ability to integrate with other products and technologies;
- Customer service and support;
- Product price;
- Vendor reputation; and
- Relationships with systems integrators.

Employees

As of December 31, 2005, we had 458 employees, of whom 370 were based in the United States, 15 were based in Canada, 63 were based in Europe, and 10 were based in Australia. Of the total, 112 were in sales and marketing, 155 performed consulting and customer support, 96 were in research and development, and 95 were in administration.

Backlog of license, maintenance and consulting revenues

As of December 31, 2005, we had software license and maintenance agreements and fixed fee professional services agreements with customers expected to result in approximately $47.5 million of revenue in 2006. As of December 31, 2004, we had software license and maintenance agreements and fixed fee professional services agreements with customers expected to result in approximately $30.0 million of revenue in 2005. Under such 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. We do not believe that backlog, as described above, is a meaningful indicator of future financial performance.

ITEM 1A RISK FACTORS

Factors that may affect future results

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/A or elsewhere by management from time to time.

Factors relating to our revenues

In recent years, we have typically licensed our software to new customers pursuant to perpetual licenses rather than term licenses, which has the effect of decreasing the amount of future term license renewal revenue and cash flow, and could reduce our overall future license revenue and cash flow if we are unable to increase the future volume of license transactions. In prior years, we typically licensed our software under term licenses requiring the customer to make monthly payments over the license term. More recently, we have typically been selling perpetual licenses to our software with a single license fee being payable at the commencement of the license (although our term license revenue exceeded our perpetual license revenue in 2005 due to a few large term licenses). We expect that perpetual licenses for new customers will continue to be a significant portion of

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total license signings, although we expect to enter into new term licenses in certain instances. Our use of perpetual licenses has the effect, with respect to such transactions, of increasing our license revenue and cash flow in the short term, but of decreasing the amount of renewal license revenue and cash flow in the future. If we are unable to increase the volume of new license transactions, given the anticipated decline in the renewal revenue from term license arrangements, our license revenue and cash flow will likely decline in future periods.

The volume of our license transactions began to increase in the second half of 2005, and we may not be able to sustain this increased volume of license transactions unless we can provide sufficient high quality professional services, training and maintenance resources to enable our customers to realize significant business value from our software. Our customers typically request professional services and training to assist them in implementing our products. Our customers also purchase maintenance on our products in almost all cases. As a result, an increase in the number of license transactions is likely to increase demand for professional services, training and maintenance relating to our products. Given that our volume of license transactions began to increase in the second half of 2005, we anticipate that we will need to provide our customers with more professional services, training and maintenance to enable our customers to realize significant business value from our software. Accordingly, we have been hiring additional personnel in these areas and improving our on-boarding process to ramp up new personnel in a shorter period of time. We have also been increasingly enabling our partners and our customers through training and the creation of centers of excellence to create an expanded universe of people that are skilled in the implementation of our products. However, if we are unable to provide sufficient high quality professional services, training or maintenance resources to our customers, our customers may not realize sufficient business value from our products to justify follow-on sales, which could impact our future financial performance.

We are increasingly entering into smaller initial licenses with new customers, which could adversely affect our financial performance if we are not successful in obtaining follow-on business from these customers. In 2005, we increasingly entered into small initial licenses with our new customers rather than selling large application licenses, to allow these new customers to realize business value from our software quickly and for a limited up-front investment. We expect this trend to continue in the near future. Once a customer has realized this initial value, we work with the customer to identify opportunities for follow-on sales, which are typically larger than the initial sale. However, we may not be successful in demonstrating this initial value to some customers, for reasons relating to the performance of our products, the quality of the services and support we provide for our products, or external reasons. For these customers, we may not obtain follow-on sales, and our license revenue will be limited to the smaller initial sale. This could lower average transaction size and adversely affect our financial performance.

Our term license revenue will decrease in the short term if we increasingly enter into term licenses with contract provisions that require the term license revenue to be recognized over the term of the agreement as license payments become due or ratably over the term of the license when paid in advance, or if existing customers do not renew their term licenses. A significant portion of our total revenue has been attributable to term licenses, including term license renewals. Historically, a significant portion of our term license revenue has been recognized as the present value of the committed future term license fees, as described in the Critical Accounting Policies contained in this Annual Report on Form 10-K/A. In the future, we expect to increasingly enter into term licenses with contract provisions that require the term license revenue to be recognized over the term of the agreement, as payments become due, or ratably over the term of the license when payments are made in advance. This would have the effect, with respect to a particular agreement, of reducing our term license revenue in the initial period but increasing the amount of recurring future term license revenue during the remainder of the license term, but would not change the expected cash flow. As a result, our term license revenue will decrease in the short term. In addition, while historically a majority of customers have renewed their term licenses, there can be no assurance that a majority of customers will continue to renew expiring term licenses. A decrease in term license renewal revenue absent offsetting revenue from other sources would have a material adverse effect on future financial performance.

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

Factors relating to fluctuations in our financial results

The timing of our license revenue is difficult to predict accurately, due to the uncertain timing of the completion of implementation services, product acceptance by the customer and closing of additional sales. Our quarterly revenue may fluctuate significantly, in part because a large portion of our revenue in any quarter is attributable to product acceptance or license renewal by a relatively small number of customers. Fluctuations also reflect our policy of recognizing revenue upon product acceptance or, in the case of term licenses, license renewal. In some cases, customers will not accept products until the end of a lengthy sales cycle and an implementation period, typically ranging from six to twelve months. Our PegaRULES products typically have a shorter sales cycle and implementation period than our historical application products. However, we may experience longer acceptance periods in some cases with respect to these products. Any increases in our sales or acceptance cycles may adversely affect our financial performance, due in part to the recognition of sales staff and commission costs in advance of revenue recognition. In addition, risks over which we have little or no control, including customers budgets, staffing allocation, and internal authorization reviews, can significantly affect the sales and acceptance cycles. Changes requested by customers may further delay product implementation and revenue recognition.

Our financial results may be adversely affected if we are required to change certain estimates, judgments and positions relative to our income taxes. In the ordinary course of conducting a global business enterprise, there are many transactions and calculations undertaken whose ultimate tax outcome cannot be certain. Some of these uncertainties arise as a consequence of positions we have taken regarding valuation of deferred tax assets, transactions and arrangements made among related parties, 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 for such outcomes. Although we believe our estimates are reasonable, no assurance can be given that the final tax outcome of these matters or our current estimates regarding these matters will not be different from what is reflected in our historical income tax provisions, returns and accruals. Such differences, 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. See further discussion on pages 23 and 24.

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

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We are investing heavily in sales and marketing and professional services in anticipation of increased license signings, and we may experience decreased profitability or losses if we are unsuccessful in increasing the value of license signings in the future. Demand for our products began to increase in the second half of 2005, which resulted in an increase in the value of new license signings in the second half of 2005 compared to the first half of 2005. We anticipate that the demand for our products will continue to increase in 2006 compared to 2005. Consequently, we have been increasing our investment in sales and marketing by hiring additional sales and marketing personnel. We also anticipate that we will need to provide our customers with more professional services, training and maintenance as a result of this anticipated increase in demand, and have been hiring additional personnel in these areas. These investments have resulted in increased fixed costs that do not vary with the level of revenue. If the anticipated demand for our products does not materialize, or if we are unsuccessful in increasing the value of new license signings, we could experience decreased profitability or losses as a result of these increased fixed costs, and our financial performance and results of operations could be adversely affected.

Factors relating to our products and markets

We will need to develop new products, evolve existing ones, and adapt to technology change. Technical developments, customer requirements, programming languages and industry standards change frequently in our markets. As a result, success in current markets and new markets will depend upon our ability to enhance current products, to develop and introduce new products that meet customer needs, keep pace with technology changes, respond to competitive products, and achieve market acceptance. Product development requires substantial investments for research, refinement and testing. There can be no assurance that we will have sufficient resources to make necessary product development investments. We may experience difficulties that will delay or prevent the successful development, introduction or implementation of new or enhanced products. Inability to introduce or implement new or enhanced products in a timely manner would adversely affect future financial performance. Our products are complex and may contain errors. Errors in products will require us to ship corrected products to customers. Errors in products could cause the loss of or delay in market acceptance or sales and revenue, the diversion of development resources, injury to our reputation, or increased service and warranty costs which would have an adverse effect on financial performance.

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

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

We rely on certain third-party relationships. We have a number of relationships with third parties that are significant to sales, marketing and support activities, and product development efforts. We rely on relational database management system applications and development tool vendors, software and hardware vendors, large system integrators and technology consulting firms to provide marketing and sales opportunities for the direct sales force and to strengthen our products through the use of industry-standard tools and utilities. 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 their relationships with or support of us.

We face risks from operations and customers based outside of the U.S. Sales to customers headquartered outside of the United States represented approximately 34% of our total revenue in 2005, 30% in 2004, and 21% in 2003. We, in part through our wholly-owned subsidiaries based in the

United Kingdom, Singapore, Canada, and Australia, market products and render consulting and training services to customers based in Canada, the United Kingdom, France, Germany, the Netherlands, Belgium, Switzerland, Austria,

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Ireland, Sweden, South Africa, Mexico, Australia, Hong Kong, and Singapore. We have established offices in Europe and Australia. We believe that growth will necessitate expanded international operations requiring a diversion of managerial attention and financial resources. We anticipate hiring additional personnel to accommodate international growth, and we may also enter into agreements with local distributors, representatives, or resellers. If we are unable to do one or more of these things in a timely manner, our growth, if any, in our foreign operations will be restricted, and our business, operating results, and financial condition could be materially and adversely affected.

In addition, there can be no assurance that we will be able to maintain or increase international market demand for our products. Many of our international sales are denominated in U.S. dollars. Accordingly, any appreciation of the value of the U.S. dollar relative to the currencies of those countries in which we sell our products may place us at a competitive disadvantage by effectively making our products more expensive as compared to those of our competitors. Additional risks inherent in our international business activities generally include unexpected changes in regulatory requirements, increased tariffs and other trade barriers, the costs of localizing products for local markets and complying with local business customs, longer accounts receivable patterns and difficulties in collecting foreign accounts receivable, difficulties in enforcing contractual and intellectual property rights, heightened risks of political and economic instability, the possibility of nationalization or expropriation of industries or properties, difficulties in managing international operations, potentially adverse tax consequences (including restrictions on repatriating earnings and the threat of double taxation), increased accounting and internal control expenses, and the burden of complying with a wide variety of foreign laws. There can be no assurance that one or more of these factors will not have a material adverse effect on our foreign operations, and, consequentially, our business, operating results, and financial condition.

Furthermore, we conduct a portion of our business in currencies other than the United States dollar. Our revenues and operating results are adversely affected when the dollar strengthens relative to other currencies and are positively affected when the dollar weakens. Changes in the value of major foreign currencies, particularly the British Pound and the Euro relative to the United States dollar, could adversely affect our revenues and operating results.

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

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

We face risks related to intellectual property claims or appropriation of our intellectual property rights. We rely primarily on a combination of copyright, trademark and trade secrets laws, as well as confidentiality agreements to protect our proprietary rights. We have obtained patents from the United States Patent and Trademark Office 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 United States. There can be no assurance that our means of protecting our proprietary rights will be adequate or that our competitors will not independently develop similar technology.

We are not aware that any of our products infringe the proprietary rights of third parties. There can be no assurance, however, that third parties will not claim infringement by us with respect to current or future products. Although we attempt to limit the amount and type of our contractual liability for infringement of the proprietary rights of third parties, these limitations often contain certain

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exclusions, and we cannot be assured that these limitations will be applicable and enforceable in all cases. Even if these limitations are found to be applicable and enforceable, our liability to our customers for these types of claims could be material in amount given the size of certain of our transactions. We expect that software product developers will increasingly be subject to infringement claims as the number of products and competitors in our industry segment grows and the functionality of products in different industry segments overlaps. Any such claims, with or without merit, could be time-consuming, result in costly litigation, cause product shipment delays, or require us to enter into royalty or licensing agreements. Such royalty or licensing agreements, if required, may not be available on terms acceptable to us or at all, which could have a material adverse effect upon our business, operating results, and financial condition.

Investor confidence and share value may be adversely impacted if our management is unable to provide an unqualified assessment regarding the effectiveness of our internal control over financial reporting, or if our independent registered public accounting firm is unable to provide us with an unqualified attestation regarding management s assessment, for our 2006 fiscal year or beyond, as required by Section 404 of the Sarbanes-OxleyAct of 2002. The Securities and Exchange Commission, as directed by Section 404 of the Sarbanes-Oxley Act of 2002, adopted rules requiring public companies to include a report of management on the company s internal control over financial reporting in its annual reports on Form 10-K that contains an assessment by management of the effectiveness of the company s internal control over financial reporting. In addition, the company s independent registered public accounting firm must attest to and report on management s assessment of the effectiveness of the company s internal control over financial reporting. For the year ended December 31, 2005, management s assessment is included on page 33 of this Annual Report on Form 10-K/A and our independent registered public accounting firm s attestation is included on page 34 of this Annual Report on Form 10-K/A. For 2005, management s assessment, and our registered public accounting firm s attestation, concluded that our internal control over financial reporting as of December 31, 2005 was not effective due to certain material weaknesses in our internal control over financial reporting, as described on page 33 of this Annual Report on Form 10K/A. For future periods, although we intend to diligently and regularly review and update our internal control over financial reporting in order to ensure compliance with the Section 404 requirements, our management may not be able to provide an unqualified assessment for our 2006 fiscal year or beyond, and our independent registered public accounting firm may not be able to provide unqualified opinions on management s assessment and on the effectiveness of the Company s internal control over financial reporting for any of these years. Any such event could result in an adverse reaction in the financial marketplace due to a loss of investor confidence in the reliability of our financial statements, which ultimately could negatively impact the market price of our shares.

ITEM 1B UNRESOLVED STAFF COMMENTS

Not applicable.

ITEM 2 PROPERTIES

Our principal administrative, sales, marketing, support, and research and development operations are located in an 85,228 square foot leased facility in Cambridge, Massachusetts. The lease for this facility expires in 2013, with the option to extend for two additional five-year periods. We also lease space for our other offices in the United States, Canada, Australia, France, and the United Kingdom. These leases expire at various dates through 2010. We believe that additional or alternative space will be available as needed in the future on commercially reasonable terms.

ITEM 3 LEGAL PROCEEDINGS

Not applicable.

ITEM 4 SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

During the fourth quarter of fiscal 2005, there were no matters submitted to a vote of security holders.

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EXECUTIVE OFFICERS OF THE REGISTRANT

The names of our executive officers and certain information about them are set forth below as of February 1, 2006:

Name	Age	Position(s) and Office(s) Held
Alan Trefler	49	Chief Executive Officer and Chairman
Douglas I. Kra	43	Vice President of Global Services
Michael Pyle	51	Senior Vice President of Product Development
Christopher J. Sullivan[1]	46	Senior Vice President, Chief Financial Officer and Treasurer

There are no family relationships among any of our executive officers or directors.

Alan Trefler, a founder of Pegasystems, serves as Chief Executive Officer and Chairman and has been a Director since we organized in 1983. Prior to 1983, he managed an electronic funds transfer product for TMI Systems Corporation, a software and services company. Mr. Trefler holds a B.A. degree in economics and computer science from Dartmouth College.

Douglas I. Kra joined Pegasystems in November 2004 as Vice President of Global Services. From 2002 to 2004, Mr. Kra served as Vice President at eLoyalty Corp., a consulting company specializing in customer relationship management. From 2000 to 2001, Mr. Kra served as President of Zefer Corp., an internet consulting firm. Prior to Zefer, Mr. Kra spent ten years at Cambridge Technology Partners Inc. in a variety of senior roles. He holds a B.A. in Computer Science from Brandeis University and an M.B.A. in finance from New York University Stern School of Business.

Michael Pyle joined Pegasystems in 1985 and has served as Senior Vice President of Product Development since August 2000. Including his positions with Pegasystems, Mr. Pyle s professional background encompasses almost thirty years of software development and managerial experience throughout Europe and the United States. Mr. Pyle completed his B.C.S. specializing in Computer Science and Systems Programming at the Civil Service College in London.

Christopher J. Sullivan joined Pegasystems in July 2001. In August 2001, he was appointed Senior Vice President, Chief Financial Officer and Treasurer. From August 2000 to July 2001, he served as CFO at Event Zero, an IT consulting company. From December 1998 to August 2000, he was the CFO and Executive Vice President of AMS Holding Group, a software and information services provider to the insurance industry. Previously, he served as Vice President of Finance at Compaq Computer Corporation, a computer company. His prior experience also includes service as Senior Vice President of Finance at Fisher Scientific International, Inc., a distributor of clinical and scientific laboratory equipment, and as Vice President of Finance at Digital Equipment Corporation. He holds a B.S.B.A. degree and an M.B.A. degree from Babson College.

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1 Mr. Sullivan resigned as Pegasystems Senior Vice President, Chief Financial Officer and Treasurer effective as of June 1, 2006. Craig Dynes joined the Company as Senior Vice President and Chief Financial Officer in September 2006.

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PART II

ITEM 5 MARKET FOR REGISTRANT S COMMON STOCK, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

The following table sets forth the range of high and low sales prices of our common stock on the NASDAQ Global Market for 2005 and 2004. Our common stock is traded under the NASDAQ Symbol PEGA . As of February 27, 2006, we had approximately 71 stockholders of record and approximately 16,990 beneficial owners of our common stock. On February 27, 2006, the closing sale price of our common stock was $8.15. We have never declared or paid any cash dividends on our common stock. We intend to retain our earnings to finance future growth, and therefore have not paid dividends, nor do we presently anticipate paying any dividends in the foreseeable future.

	High	Low
2005		
First Quarter	**$ 9.10**	**$ 5.20**
Second Quarter	**$ 6.11**	**$ 4.85**
Third Quarter	**$ 6.61**	**$ 5.55**
Fourth Quarter	**$ 7.59**	**$ 5.89**

	High	Low
2004		
First Quarter	**$ 11.74**	**$ 7.72**
Second Quarter	**$ 9.95**	**$ 7.72**
Third Quarter	**$ 8.78**	**$ 5.77**
Fourth Quarter	**$ 8.53**	**$ 6.55**

At the end of 2004, our Board of Directors authorized the repurchase of up to $10 million of our outstanding common stock. The purchases may be made from time to time on the open market or in privately negotiated transactions. Under the Share Repurchase Program , shares may be purchased in such amounts as market conditions warrant, subject to regulatory and other considerations. During 2005, we repurchased 957,112 shares for $5.9 million under the Share Repurchase Program, all in open market purchases. The Share Repurchase Program expires on June 30, 2006. The Share Repurchase Program may be suspended or discontinued at any time without prior notice. Our repurchase activity under the Share Repurchase Program through December 31, 2005 was as follows:

Period	Total Number of Shares Purchased[(1)]	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Share Repurchase Program	Approximate Dollar Value Of Shares That May Yet Be Purchased Under The Share Repurchase Program (in thousands)
March 2005	163,000	$ 5.71	163,000	$ 9,069
April 2005		$		$ 9,069
May 2005	148,439	$ 5.67	148,439	$ 8,228
June 2005	97,682	$ 5.94	97,682	$ 7,647
July 2005		$		$ 7,647
August 2005	213,248	$ 6.29	213,248	$ 6,305
September 2005	180,943	$ 6.06	180,943	$ 5,209
October 2005		$		$ 5,209
November 2005	98,900	$ 6.93	98,900	$ 4,524
December 2005	54,900	$ 7.30	54,900	$ 4,123
Total	957,112	$ 6.14	957,112	

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(1) All shares were purchased pursuant to the Share Repurchase Program.

In December 2005, we issued 27,766 shares of our common stock in connection with the exercise of warrants issued as part of the consideration for our acquisition of 1mind Corporation in 2002. These warrants were exercised by two former stockholders of 1mind. The consideration for these exercises was paid in the form of the surrender of 3,774 shares of our common stock under the warrants as a net exercise, which shares were valued at a total of $27 thousand, based on the average closing price of our common stock over the ten consecutive trading days ending on the third trading day prior to the date of exercise. We issued these 27,766 shares pursuant to the registration exemption under Section 4(2) of the Securities Act of 1933.

As of December 31, 2005, there were outstanding warrants to purchase 42,036 shares of our common stock with a weighted average fair value of $2.54 per share and a weighted average exercise price of $6.51 per share.

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ITEM 6 SELECTED CONSOLIDATED FINANCIAL DATA

The selected financial data has been restated to reflect the adjustments described in Note 8 to our Consolidated Financial Statements appearing in this Form 10-K/A. The following selected financial data should be read in conjunction with our restated Consolidated Financial Statements and accompanying notes.

	Year Ended December 31								
(in thousands except per share data)	2005 As Restated (1)	2004 As Restated (1)	2003 As Restated (1)	2002 As Previously Reported	2002 Adjustment	2002 As Restated (1)	2001 As Previously Reported	2001 Adjustment	2001 As Restated (1)
Consolidated Statements of Operations Data :									
Total revenue	**$ 100,209**	$ 103,291	$ 95,030	$ 97,408	$ 100	$ 97,508	$ 95,062	$ (1,136)	$ 93,926
Income from operations	**1,218**	5,771	14,735	11,476	1,945	13,421	6,534	(193)	6,341
Income before provision (benefit) for income taxes	**5,319**	11,156	21,892	17,197	1,945	19,142	13,534	(193)	13,341
Net income	**5,192**	8,211	16,679	15,297	1,945	17,242	12,534	(193)	12,341
Earnings per share:									
Basic	**$ 0.15**	$ 0.23	$ 0.48	0.45	0.06	$ 0.51	0.38		$ 0.38
Diluted	**$ 0.14**	$ 0.22	$ 0.47	0.43	0.05	$ 0.48	0.37		$ 0.37
Weighted average number of common shares outstanding									
Basic	**35,774**	35,691	34,518	33,835		33,835	32,677		32,677
Diluted	**36,462**	37,043	35,757	35,980		35,980	33,434		33,434

	Year Ended December 31										
(in thousands)	2005 As Restated (1)	2004 As Restated (1)	2003 As Previously Reported	2003 Adjustment	2003 As Restated (1)	2002 As Previously Reported	2002 Adjustment	2002 As Restated (1)	2001 As Previously Reported	2001 Adjustment	2001 As Restated (1)
Consolidated Balance Sheet Data :											
Total cash, cash equivalents and short term investments	**$ 114,735**	$ 97,360	$ 87,935	$	$ 87,935	$ 62,696	$	$ 62,696	$ 33,017	$	$ 33,017
Working capital	**133,440**	121,273	95,979	2,077	98,056	75,501	1,752	77,253	57,157	(193)	56,964
Long Term license installments, net of unearned interest income	**31,371**	44,344	53,666		53,666	48,667		48,667	43,155		43,155
Total assets	**209,654**	195,878	184,728	7,231	191,959	157,356	2,788	160,144	125,072	943	126,015
Capital Lease obligation, including current position	**166**	263							81		81
Stockholders equity	**167,682**	166,607	153,172	750	153,922	130,927	1,752	132,679	104,958	(193)	104,765

(1) As restated, see related discussion at Note 8 to the Consolidated Financial Statements.

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ITEM 7 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
Restatement of Financial Statements

The following *Management s Discussion and Analysis of Financial Condition and Results of Operations* gives the effects of the restatement discussed in Note 8 to the Consolidated Financial Statements.

Business Overview

Our business is comprised of developing and licensing business process management (BPM) software to our customers, and providing professional services, maintenance and training to those customers to maximize the business value from using our software. We focus our sales efforts on target accounts, which are companies or divisions within companies, and are typically large organizations that are among the leaders in their industry. We frequently sell limited size initial licenses to these target accounts rather than selling large application licenses. This allows our customers to quickly realize business value from our software and limits their up-front investment. Once a customer has realized this initial value, we work with the customer to identify opportunities for follow-on sales. Follow-on sales are often larger than the initial sale, and the sales process for follow-on sales is often shorter as a result of the established relationship with the customer.

Our customers typically request professional services and training to assist them in implementing our products. Our customers also purchase maintenance on our products in almost all situations, which is typically for annually renewable terms, and includes rights to upgrades and new releases, incident resolution and technical assistance. We provide maintenance and training services directly to most of our customers. Professional services are provided directly by us in some situations and through our network of partners in other cases. The amount of professional services provided by our partners has been increasing in recent years. By utilizing these partners, we have significantly increased the supply of skilled service consultants that can assist our customers. In certain situations, our partners are also able to offer lower rates to our customers due to the use of resources located in other countries, thereby reducing the overall cost. Some of our partners have more headcount dedicated to consulting services for our products than we have. We believe that this trend is good for our business because of the breadth of domain expertise that our partners can bring to solutions. We expect that our services revenue may grow more slowly over time than if we did not rely on our partners.

The percentage of our license revenue from our PegaRULES Process Commander software and related solution frameworks has been increasing. These products often require less implementation assistance than prior generations of our software products. In many cases this has enabled us to shorten the length of the sales process and the time required to receive customer acceptance of the software product. Significantly, PegaRULES Process Commander and solution frameworks can be used more broadly by customers within our traditional financial services and healthcare markets, as well as by customers outside of our traditional markets, enabling us to sell to expanded markets.

In recent years, we have typically licensed our software to new customers pursuant to perpetual licenses, under which a customer pays a single license fee at the commencement of the license, rather than term licenses. Under term licenses a customer pays a monthly fee during the license term and must renew the license for additional fees to continue to use the software after the original term. We expect that perpetual licenses for new customers will continue to be a significant portion of total license signings, although we expect to enter into new term licenses in certain instances. Our use of perpetual licenses rather than term licenses has the effect, with respect to a given transaction, of increasing our license revenue and cash flow in the short term, but of decreasing the amount of renewal revenue and cash flow in the future.

Generally, in prior periods, we have recognized the present value of committed future term license payments upon customer acceptance at the beginning of the license term. In the future, we expect to increasingly enter into term licenses with contract provisions that require the term license revenue to be recognized over the term of the agreement as payments become due, or ratably over the term of the license when payments are made in advance. This would have the effect, with respect to a particular agreement, of reducing our term license revenue in the initial period but increasing the amount of recurring future term license revenue during the remainder of the license term, but would not change the expected cash flow.

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Overview of Results of Operations

While the value of license signings in 2005 was only modestly higher than the value of license signings in 2004, license signings during the second half of 2005 improved significantly from the value of license signings in the first half of 2005. The increase in the value of license signings for the second half of 2005 was due to the increased success of our strategy of focusing on initial and follow-on sales to target accounts. Actual license signings are likely to fluctuate considerably quarter to quarter.

Total revenue in 2005 decreased 3% to $100.2 million from $103.3 million in 2004. License revenue decreased $0.7 million and services revenue decreased $2.4 million. Professional services and training revenue decreased $6.6 million to $39.1 million in 2005 from $45.7 million in 2004, while maintenance revenue increased $4.1 million to $20.2 million in 2005 from $16.1 million in 2004. Professional services and training revenue in 2004 benefited from the completion, during the year, of several large customer projects. The increase in maintenance revenue in 2005 was due to an expanded installed base of software and a higher proportion of perpetual licenses in the installed base, which yield greater maintenance revenue than term licenses. Gross margin decreased by $3.3 million from $70.2 million in 2004 to $66.9 million in 2005 primarily due to a decrease of $2.7 million in services gross margin.

Income before provision for income taxes decreased to $5.3 million in 2005 from $11.2 million in 2004, primarily due to a $2.7 million decrease in services gross margin, a $1.2 million increase in operating expenses, a $1.9 million unfavorable change in other income and expense related to foreign currency transactions, and a $0.7 million decrease in license margin, partially offset by a $1.2 million improvement in interest income. Net income for 2005 decreased to $5.2 million from $8.2 million in 2004, due to the decrease in income before provision for income taxes, partially offset by a lower effective tax rate in 2005.

We generated $25.3 million in cash flow from operations during 2005, and ended the period with $114.7 million in cash and short-term investments and $57.9 million in combined short and long-term license installment receivables.

Consistent with our strategy of working with accounts in target customer organizations to identify opportunities for follow-on sales, a majority of our revenue in 2005 was from existing customers who chose to add on to, renew or extend their use of our software. However, new customers (meaning companies or organizational divisions which are not current licensees of our software) accounted for $20.1 million, or 20%, of total 2005 revenue.

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Statements of Income Information

The following shows certain items reflected in our Statements of Income as a percentage of total revenue:

	Year ended December 31,		
	2005	**2004**	**2003**
Software license revenue	**40.8%**	40.2%	60.7%
Services revenue	**59.2**	59.8	39.3
Total revenue	**100.0**	100.0	100.0
Cost of software licenses	**0.3**	0.3	0.4
Cost of services	**32.9**	31.7	24.0
Total cost of revenue	**33.2**	32.0	24.4
Gross profit	**66.8**	68.0	75.6
Research and development	**19.4**	19.3	22.7
Selling and marketing	**34.0**	31.2	26.1
General and administrative	**12.2**	11.9	11.4
Total operating expenses	**65.5**	62.3	60.2
Income from operations	**1.3**	5.6	15.4
Installment receivable interest income	**2.5**	2.9	5.4
Other interest income, net	**3.0**	1.8	0.8
Other income (expense), net	**(1.4)**	0.5	1.3
Income before provision for income taxes	**5.4**	10.8	22.9
Provision for income taxes	**0.2**	2.9	5.5
Net income	**5.2%**	7.9%	17.4%

International Revenue

International revenue was 34%, 30% and 21% of total consolidated revenue in 2005, 2004 and 2003, respectively. Our international revenue may fluctuate in the future because such revenue is generally dependent upon a small number of sales and product acceptances by our customers during a given period. Historically, most of our contracts have been denominated in U.S. dollars. We expect, however, that in the future more of our contracts may be denominated in foreign currencies which may expose us to increased currency exchange risk.

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Year ended December 31, 2005 compared to year ended December 31, 2004

Revenue

Our total revenue for 2005 decreased 3% to $100.2 million from $103.3 million in 2004. This decrease was primarily due to a $2.4 million decrease in services revenue. The following table summarizes our revenue composition:

(in millions)	Year ended December 31, 2005	Year ended December 31, 2004
License revenue[1]		
Perpetual licenses	**$ 20.1**	$ 22.9
Term licenses	**20.8**	18.7
Total license revenue	**40.9**	41.6
Services revenue		
Professional services and training	**39.1**	45.6
Maintenance	**20.2**	16.1
Total services revenue	**59.3**	61.7
Total revenue	**$ 100.2**	$ 103.3

(1) License revenue composition amounts reported in a similar table in previous periods have been reformatted to the current presentation.

Total license revenue for 2005 decreased to $40.9 million from $41.6 million in 2004. The decrease in total license revenue was the result of a $2.8 million decrease in perpetual licenses partially offset by a $2.1 million increase in term licenses. The increase in term license revenue primarily reflected one large new term license transaction with an existing customer in the third quarter of 2005. The decrease in perpetual license revenue reflected our strategy of selling smaller initial perpetual licenses to our target accounts, with the potential of larger follow-on sales. Term license renewals scheduled for 2006 are modestly higher than actual term license renewals in 2005. While historically a majority of customers have renewed their term licenses, there can be no assurance that this will continue.

Maintenance revenue increased 26% to $20.2 million in 2005 from $16.1 million in 2004. The increase in maintenance revenue for 2005 was due to a larger installed base of software and a higher proportion of perpetual licenses in the installed base which yield greater maintenance revenue than term licenses. The $6.5 million decrease in professional services and training revenue in 2005 reflects the fact that 2004 benefited from $9.6 million of revenue associated with the completion of several unusually large fixed-price contracts partially offset by increased demand from our customers for these services in 2005. Typically, we derive substantial revenue from services provided in connection with the implementation of software licensed by new customers.

Deferred revenue consists primarily of amounts by which billed fees exceed revenue recognized on arrangements, and unearned portions of annual maintenance fees paid in advance. Deferred revenue balances increased to $20.5 million as of December 31, 2005, from $8.6 million as of December 31, 2004. The $11.9 million increase was due primarily to new license arrangements for which acceptance of the software or completion of services had not occurred and an increased value of unearned portions of annual maintenance fees paid in advance.

International revenue increased to 34% of total revenue for 2005 from 30% for 2004. This increase was primarily related to one large international license transaction in the third quarter of 2005. Our international revenue may fluctuate in the future because such revenue is generally dependent upon a small number of license transactions during a given period. We expect that due to competition from vendors who will do business in foreign currencies, more of our customer transactions may be denominated in foreign currencies in the future, which may expose us to increased currency exchange risk.

Cost of revenue

The cost of maintenance, professional services and training increased 1.0% to $33.0 million from $32.7 million in 2004. Cost of services as a percentage of services revenue increased to 56% for 2005 from 53% for 2004. Services gross margin was $26.3 million for 2005 compared to $29.0 million for 2004. The decrease in services gross margin reflects the increase in services costs, partially offset by growth in maintenance revenue and its associated higher margin. Such decrease also reflects the fact that 2004 benefited from $7.4 million of revenue and gross margin associated with several unusually large fixed-price contracts completed during that period. Services headcount was 155 at the end of 2005 compared to 123 at the end of 2004.

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Operating expenses

Research and development expenses for 2005 decreased to $19.5 million from $19.9 million for 2004 due to reduced use of contractors partially offset by costs associated with increased employee headcount. As a percentage of total revenue, research and development expenses remained constant at 19% in 2005 and 2004. Research and development headcount at the end of 2005 was 96 compared to 90 at the end of 2004.

Selling and marketing expenses for 2005 increased 6% to $34.1 million from $32.2 million for 2004. This increase was due to a $1.1 million increase in sales commissions, an increase in marketing program spending of $0.6 million, and increased wages and benefits expenses of $0.5 million due to higher headcount. As a percentage of total revenue, selling and marketing expenses increased to 34% in 2005 from 31% in 2004. Selling and marketing headcount at the end of 2005 was 112 compared to 108 at the end of 2004.

General and administrative expenses for 2005 decreased to $12.1 million from $12.3 million for 2004. As a percentage of total revenue, general and administrative expenses remained constant at 12% in 2005 and 2004. General and administrative headcount at the end of 2005 was 95 compared to 85 at the end of 2004. General and administrative expenses decreased in 2005 primarily due to reduced legal fees partially offset by costs associated with increased headcount.

Installment receivable interest income

Installment receivable interest income, which consists of the portion of all term license fees under software license agreements attributable to the time value of money, decreased to $2.5 million in 2005 from $3.0 million for 2004. The decrease was due primarily to a lower total value of that portfolio. A portion of the fee from each term license arrangement is initially deferred and recognized as installment receivable interest income over the remaining term of the license. For purposes of the present value calculations, the discount rates used are estimates of customers borrowing rates, typically below prime rate, and have varied between 3.25% and 5.8% during the past few years.

Other interest income, net

Other interest income increased to $3.0 million in 2005 from $1.8 million for 2004. The increase was primarily due to increased cash and investment balances and improved yields.

Other income (expense), net

Other income (expense), net, which consists primarily of currency exchange gains and losses, was ($1.4) million expense in 2005 compared to $0.5 million income in 2004. The unfavorable change in other expense, net, resulted primarily from the impact of foreign exchange rate changes on transactions recorded on our U.S. ledger valued in foreign currencies, consisting primarily of cash, investments, license installments, receivables, accounts payable and accruals. In particular, changes in the exchange rates of European currencies have unfavorably impacted foreign currency denominated assets.

Income before provision for income taxes

Income before provision for income taxes decreased to $5.3 million in 2005 from $11.2 million in 2004. This decrease was primarily due to a $2.7 million decrease in services gross margin, a $1.9 million decrease in other income and expense related to foreign currency transactions, a $1.2 million increase in operating expenses primarily due to investments in sales and marketing, and a $0.7 million decrease in license revenue, partially offset by a $1.2 million improvement in other interest income, net.

Provision for income taxes

The provision for income taxes in 2005 was $0.1 million compared to $2.9 million in 2004. The effective tax rate was 2% in 2005 compared to 26% in 2004.

During 2005, we engaged outside tax experts to review certain significant tax positions previously taken by the Company. In the fourth quarter of 2005, we completed a study of our extra-territorial income exclusions, which resulted in a decrease of our reserve for tax uncertainties related to this item. During the fourth quarter of 2005, we recorded a net income tax benefit of $1.3 million due primarily to changes in estimates upon completion of the study of benefits related to extra-territorial income exclusions, recording of tax refunds and overpayments, and changes in deferred tax items. These fourth quarter 2005 adjustments also significantly decreased the effective tax rate for 2005 compared to the statutory rate. Our effective income tax rate for 2005 was below the statutory federal income tax rate primarily because we recorded $1.0 million of benefits related to current period extra-territorial income exclusions, a $0.3 million reduction in reserve for tax uncertainties related to extra-territorial income exclusions, $0.2 million of estimated federal research and experimentation credit, a $0.2 million benefit from foreign activities, and $0.2 million of net benefit from state income taxes primarily due to state income tax credits. These factors were partially offset by $0.1 million of permanent differences primarily related to non-deductible meals and entertainment expenses.

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Judgment is required in determining our worldwide income tax expense provision. In the ordinary course of conducting a global business enterprise, there are many transactions and calculations undertaken whose ultimate tax outcome cannot be certain. Some of these uncertainties arise as a consequence of transactions and arrangements made among related parties, transfer pricing for transactions with our subsidiaries, and potential challenges to nexus and tax credit estimates. We estimate our exposure to unfavorable outcomes related to these uncertainties and estimate the probability for such outcomes. Although we believe our esti>per share

Balance at December 31, 2012	1,032,500	$0.29
Options granted	160,000	0.16
Options exercised, expired or forfeited	(10,000)	0.15
Balance at March 31, 2013	1,182,500	$0.28

	Number of shares	Weighted average price per share
Balance at December 31, 2011	1,003,000	$ 0.31
Options granted	65,000	0.15
Options exercised, expired or forfeited	(28,000)	0.36
Balance at March 31, 2012	1,040,000	$ 0.30

The following table summarizes information about options at March 31, 2013:

Options outstanding				Options exercisable			
Total shares	Weighted average exercise price	Weighted average remaining contractual life in years	Aggregate intrinsic value	Total shares	Weighted average exercise price	Weighted average remaining contractual life in years	Aggregate intrinsic value
1,182,500	$ 0.28	4.90	$ 1,770	960,250	$ 0.30	3.81	$ 1,770

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3. Stock-Based Compensation (continued)

Nonvested stock awards as of March 31, 2013 and changes during the three months ended March 31, 2013 were as follows:

	Nonvested	
	Number of shares	Weighted average g rant date fair value
Balance at December 31, 2012	112,250	$ 0.08
Granted	160,000	0.08
Vested	50,000	0.08
Balance at March 31, 2013	222,250	$ 0.08

As of March 31, 2013 and 2012, unrecognized compensation cost associated with non-vested share-based employee and non-employee compensation totaled $12,407 and $6,382, respectively, which are expected to be recognized over weighted average periods of 6 months and 5 months, respectively.

4. Loss Per Share

Basic loss per share excludes dilution and is computed by dividing loss available to common shareholders by the weighted-average number of shares outstanding for the period. Diluted loss per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock, except for periods when the Company reports a net loss because the inclusion of such items would be antidilutive.

The following is a reconciliation of the amounts used in calculating basic and diluted net loss per common share.

	Net Loss	Shares	Per Share Amount
Basic net loss per common share for the three months ended March 31, 2013:			
Loss available to common stockholders	$(52,141)	11,201,760	$0.00
Effect of dilutive stock options	--	--	--
Diluted net loss per common share for the three months ended March 31, 2013:	$(52,141)	11,201,760	$0.00
Basic net loss per common share for the three months ended March 31, 2012:			
Loss available to common stockholders	$(22,550)	11,196,760	$0.00
Effect of dilutive stock options	--	--	--
Diluted net loss per common share for the three months ended March 31, 2012:	$(22,550)	11,196,760	$0.00

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

Cautionary Statement Regarding Forward-Looking Statements

This Form 10-Q contains forward-looking statements regarding our business, customer prospects, or other factors that may affect future earnings or financial results that are subject to the safe harbor created by the Private Securities Litigation Reform Act of 1995. Such statements involve risks and uncertainties which could cause actual results to vary materially from those expressed in the forward-looking statements. Investors should read and understand the risk factors detailed in our Form 10-K for the fiscal year ended December 31, 2012 and in other filings with the Securities and Exchange Commission.

We operate in a rapidly changing environment that involves a number of risks, some of which are beyond our control. This list highlights some of the risks which may affect future operating results. These are the risks and uncertainties we believe are most important for you to consider. Additional risks and uncertainties, not presently known to us, which we currently deem immaterial or which are similar to those faced by other companies in our industry or business in general, may also impair our business operations. If any of the following risks or uncertainties actually occurs, our business, financial condition and operating results would likely suffer. These risks include, among others, the following:

changes in the funding priorities of the U.S. federal government;
changes in the way the U.S. federal government contracts with businesses;
terms specific to U.S. federal government contracts;
our failure to keep pace with a changing technological environment;
intense competition from other companies;
inaccuracy in our estimates of the cost of services and the timeline for completion of contracts;
non-performance by our subcontractors and suppliers;
our dependence on key personnel;
our dependence on third-party software and software maintenance suppliers;
our failure to adequately integrate businesses we may acquire;
fluctuations in our results of operations and the resulting impact on our stock price;
the exercise of outstanding options;
our failure to adequately protect our intellectual property;
the limited public market for our common stock; and
our forward-looking statements and projections may prove to be inaccurate.

In some cases, you can identify forward-looking statements by terms such as “may,” “will,” “should,” “could,” “would,” “expect,” “plans,” “anticipates,” “believes,” “estimates,” “projects,” “predicts,” “intends,” “potential” and similar expressions intended to identify forward-looking statements. These statements reflect our current views with respect to future events and are based on assumptions and subject to risks and uncertainties. Given these uncertainties, you should not place undue reliance on these forward-looking statements. We discuss many of these risks in greater detail under the heading “Risk Factors” in Item 1A. Also, these forward-looking statements represent our estimates and assumptions only as of the date of this report. Except as required by law, we assume no obligation to update any forward-looking statements after the date of this report.

Our Business

Founded in 1979, IAI is in the business of modernizing client information systems, developing and maintaining information technology systems, and performing consulting services to government and commercial organizations. We have performed software conversion projects for over 100 commercial and government customers, including Computer Sciences Corporation, IBM, Computer Associates, Sprint, Citibank, U.S. Department of Homeland Security, U.S. Treasury Department, U.S. Department of Agriculture, U.S. Department of Energy, U.S. Army, U.S. Air Force, U.S. Department of Veterans Affairs, and the Federal Deposit Insurance Corporation. Today, we primarily apply our technology, services and experience to legacy software migration and modernization for commercial companies and government agencies, and to developing web-based solutions for agencies of the U.S. federal government.

Three of our customers, one of which is a U.S. government agency with which we contract directly and two of which are companies with which we contract for services to U.S. government agencies represent material portions of our revenue. These customers accounted for 18.7% (direct) and 22.4% and 20.5% (under subcontract) of revenue in the first three months of 2013.

Three Months Ended March 31, 2013 versus Three Months Ended March 31, 2012

Revenue

Our revenues in the first quarter of 2013 were $1,317,049 compared to $1,513,990 in 2012, a decrease of 13.0%. Professional services revenue was $1,180,806 versus $1,165,249, an increase of 1.3%, and software product and maintenance revenue was $136,243 versus $348,741, a decrease of 60.9%. The decrease in our software product and maintenance revenue was primarily due to the expiration of one enterprise-wide U.S. federal government agency software maintenance contract, for which the bidding process for successive years was offered only under a type of U.S. federal government contract we do not have. Software product sales and associated margins are subject to considerable fluctuation from period to period, based on the product mix sold.

Gross Margins

Gross margin was $513,064, or 39.0% of sales in the first quarter of 2013 versus $532,687, or 35.2% of sales, in the first quarter of 2012. For the quarter ended March 31, 2013, $490,163 of the gross margin was attributable to professional services at a gross margin percentage of 41.5%, and $22,901 of the gross margin was attributable to software sales at a gross margin percentage of 16.8%. In the same quarter in 2012, we reported gross margins of $488,615, or 41.9% of sales for professional services and $44,072, or 12.6% of sales for software sales. Gross margin on professional services was consistent in terms of percentage of sales. Gross margin on software sales decreased in terms of dollars due to contract expirations but increased as a percentage of sales due to the addition of one maintenance contract for which there are no third-party costs. Software product sales and associated margins are subject to considerable fluctuation from period to period, based on the product mix sold.

Selling, General and Administrative Expenses

Selling, general and administrative expenses, exclusive of sales commissions, were $454,280, or 34.5% of revenues, in the first quarter of 2013 versus $408,079, or 27.0% of revenues, in the first quarter of 2012. These expenses increased $46,201, or 11.3%, due largely to increases in recruiting fees, additional sales staff, and costs related to financial reporting.

Commission expense was $112,306, or 8.5% of revenues, in the first quarter of 2013 versus $148,649, or 9.8% of revenues, in the first quarter of 2012. This decrease of $36,343, or 24.4%, is due to the decreases in gross margins and operating income on commissionable contracts, which drive commission earned at varying rates for each salesperson.

Net Loss

Net loss for the three months ended March 31, 2013, was $52,141, or 4.0% of revenue, versus net loss of $22,550, or 1.5 % of revenue, for the same period in 2012. The increase in net loss is due to decreases in software sales, and the absence related gross margin, as well as increases in recruiting fees and other selling, general and administrative expenses.

Liquidity and Capital Resources

Our cash and cash equivalents balance, when combined with our cash flow from operations during the first three months of 2013, were sufficient to provide financing for our operations. Our net cash used in the combination of our operating, investing, and financing activities in the first three months of 2013 was $293,609. Our net cash used, when subtracted from a beginning balance of $2,623,016 yielded cash and cash equivalents of $2,329,407 as of March 31, 2013. Our accounts receivable balances increased $159,196 and our current liabilities as a whole decreased $69,631. We had no non-current liabilities as of March 31, 2013.

We have a revolving line of credit with a bank providing for demand or short-term borrowings of up to $1,000,000. The line became effective December 20, 2005, and expires on December 1, 2013. As of March 31, 2013, no amounts were outstanding under this line of credit. At March 31, 2013, $703,000 was available under this line of credit based on our outstanding accounts receivable.

Given our current cash position and operating plan, we anticipate that we will be able to meet our cash requirements for the next twelve months and beyond.

We presently lease our corporate offices on a contractual basis with certain timeframe commitments and obligations. We believe that our existing offices will be sufficient to meet our foreseeable facility requirement. Should we need additional space to accommodate increased activities, management believes we can secure such additional space on reasonable terms.

We have no material commitments for capital expenditures.

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We have no off-balance sheet arrangements.

ITEM 4. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

Our management, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, and people performing similar functions, has evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act), as of March 31, 2013 (the "Evaluation Date"). Based upon this evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of the Evaluation Date, our disclosure controls and procedures are effective to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act (i) is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and (ii) is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosure.

Changes in Internal Controls over Financial Reporting

There were no changes in the Company's internal control over financial reporting during the quarter ended March 31, 2013 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Inherent Limitations on Effectiveness of Controls

Because of the inherent limitations in all control systems, no control system can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected. These inherent limitations include the realities that judgments in decision making can be faulty and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of a person, by collusion of two or more people or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and may not be detected. Notwithstanding these limitations, we believe that our disclosure controls and procedures are designed to provide reasonable assurance of achieving their objectives.

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PART II - OTHER INFORMATION

Item 1. Legal Proceedings

None.

Item 1A. Risk Factors

"Item 1A. Risk Factors" of our annual report on Form 10-K for the year ended December 31, 2012 includes a discussion of our risk factors. There have been no material changes from the risk factors described in our annual report on Form 10-K for the year ended December 31, 2012.

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

None.

Item 3. Defaults Upon Senior Securities

None.

Item 5. Other Information

None.

Item 6. Exhibits

31.1	Certification of Chief Executive Officer Pursuant to Rules 13a-14(a) and 15d-14(a) of the Securities Exchange Act of 1934
31.2	Certification of Chief Financial Officer Pursuant to Rules 13a-14(a) and 15d-14(a) of the Securities Exchange Act of 1934
32.1	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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SIGNATURES

In accordance with the requirements of the Exchange Act of 1934, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

	Information Analysis Incorporated (Registrant)
Date: May 14, 2013	By: /s/ Sandor Rosenberg Sandor Rosenberg, Chairman of the Board, Chief Executive Officer, and President
Date: May 14, 2013	By: /s/ Richard S. DeRose Richard S. DeRose, Executive Vice President, Treasurer, and Chief Financial Officer