UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x **Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended September 30, 2013

or

¨ **Transition Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the transition period from ________ to ________

Commission File Number: 1-11859

PEGASYSTEMS INC.

(Exact name of Registrant as specified in its charter)

Massachusetts	**04-2787865**
(State or other jurisdiction of incorporation or organization)	***(IRS Employer Identification No.)***
One Rogers Street Cambridge, MA	**02142-1209**
(Address of principal executive offices)	***(Zip Code)***

(617) 374-9600

(Registrant s telephone number including area code)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

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

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

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

There were 37,961,290 shares of the Registrant s common stock, $.01 par value per share, outstanding on November 1, 2013.

PEGASYSTEMS INC.

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PEGASYSTEMS INC.

UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands)

	As of September 30, 2013	As of December 31, 2012
ASSETS		
Current assets:		
Cash and cash equivalents	$ 108,827	$ 77,525
Marketable securities	79,618	45,460
Total cash, cash equivalents, and marketable securities	188,445	122,985
Trade accounts receivable, net of allowance of $772 and $963	90,583	134,066
Deferred income taxes	10,152	10,202
Income taxes receivable	4,199	6,261
Other current assets	6,929	5,496
Total current assets	300,308	279,010
Property and equipment, net	28,977	30,827
Long-term deferred income taxes	49,693	49,292
Long-term other assets	1,657	1,680
Intangible assets, net	49,910	58,232
Goodwill	20,451	20,451
Total assets	$ 450,996	$ 439,492
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 2,347	$ 3,330
Accrued expenses	20,741	15,534
Accrued compensation and related expenses	31,925	40,715
Deferred revenue	91,758	95,546
Total current liabilities	146,771	155,125
Income taxes payable	13,748	13,551
Long-term deferred revenue	17,954	18,719
Other long-term liabilities	17,466	15,618
Total liabilities	195,939	203,013

Stockholders equity:

Preferred stock, 1,000 shares authorized; no shares issued and outstanding				
Common stock, 100,000 shares authorized; 37,989 shares and 37,945 shares issued and outstanding		380		379
Additional paid-in capital		138,271		138,576
Retained earnings		113,410		94,349
Accumulated other comprehensive income		2,996		3,175
Total stockholders equity		255,057		236,479
Total liabilities and stockholders equity	$	450,996	$	439,492

See notes to unaudited condensed consolidated financial statements.

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PEGASYSTEMS INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	**2012**	**2013**	**2012**
Revenue:				
Software license	$ 44,802	$ 28,575	$ 128,217	$ 95,517
Maintenance	37,979	32,317	112,238	97,657
Professional services	39,230	40,765	115,117	124,706
Total revenue	122,011	101,657	355,572	317,880
Cost of revenue:				
Software license	1,592	1,585	4,751	4,763
Maintenance	3,599	3,745	11,106	11,072
Professional services	32,907	32,335	97,772	103,351
Total cost of revenue	38,098	37,665	113,629	119,186
Gross profit	83,913	63,992	241,943	198,694
Operating expenses:				
Selling and marketing	42,663	36,893	127,279	116,476
Research and development	19,786	19,506	59,123	57,411
General and administrative	7,130	7,192	21,203	21,171
Acquisition-related costs	545		545	
Total operating expenses	70,124	63,591	208,150	195,058
Income from operations	13,789	401	33,793	3,636
Foreign currency transaction gain (loss)	661	438	(1,666)	337
Interest income, net	123	113	376	318
Other expense, net	(1,163)	(920)	(418)	(1,496)
Income before provision for income taxes	13,410	32	32,085	2,795
Provision for income taxes	4,700	363	9,603	1,336
Net income (loss)	$ 8,710	$ (331)	$ 22,482	$ 1,459
Earnings (loss) per share:				
Basic	$ 0.23	$ (0.01)	$ 0.59	$ 0.04

Diluted	$	0.22	$	(0.01)	$	0.58	$	0.04
Weighted-average number of common shares outstanding								
Basic		37,955		37,881		37,950		37,834
Diluted		39,079		37,881		38,872		38,897
Cash dividends declared per share	$	0.03	$	0.03	$	0.09	$	0.09

See notes to unaudited condensed consolidated financial statements.

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PEGASYSTEMS INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	**2012**	**2013**	**2012**
Net income (loss)	$ 8,710	$ (331)	$ 22,482	$ 1,459
Other comprehensive income (loss):				
Unrealized gain (loss) on securities, net of tax	113	33	(32)	80
Foreign currency translation adjustments	2,340	1,315	(147)	1,248
Total other comprehensive income (loss)	2,453	1,348	(179)	1,328
Comprehensive income	$ 11,163	$ 1,017	$ 22,303	$ 2,787

See notes to unaudited condensed consolidated financial statements.

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PEGASYSTEMS INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	Nine Months Ended September 30, 2013	Nine Months Ended September 30, 2012
Operating activities:		
Net income	$ 22,482	$ 1,459
Adjustments to reconcile net income to cash provided by operating activities:		
Excess tax benefits from exercise or vesting of equity awards	(2,670)	(3,161)
Deferred income taxes	(537)	(511)
Depreciation and amortization	14,173	13,986
Stock-based compensation expense	9,713	8,622
Foreign currency transaction loss (gain)	1,666	(337)
Other non-cash items	2,736	4,021
Change in operating assets and liabilities:		
Trade accounts receivable	42,611	18,938
Income taxes receivable and other current assets	2,599	(1,468)
Accounts payable and accrued expenses	(5,762)	(20,491)
Deferred revenue	(3,836)	2,747
Other long-term assets and liabilities	260	5,279
Cash provided by operating activities	83,435	29,084
Investing activities:		
Purchase of marketable securities	(56,645)	(13,336)
Matured and called marketable securities	21,129	18,465
Investment in property and equipment	(4,158)	(21,875)
Cash used in investing activities	(39,674)	(16,746)
Financing activities:		
Issuance of common stock for share-based compensation plans	970	753
Excess tax benefits from exercise or vesting of equity awards	2,670	3,161
Dividend payments to shareholders	(2,281)	(3,404)
Common stock repurchases for tax withholdings for net settlement of equity awards	(4,123)	(3,650)
Common stock repurchases under share repurchase programs	(9,178)	(3,910)
Cash used in financing activities	(11,942)	(7,050)
Effect of exchange rate on cash and cash equivalents	(517)	596

Net increase in cash and cash equivalents	31,302	5,884
Cash and cash equivalents, beginning of period	77,525	60,353
Cash and cash equivalents, end of period	$ 108,827	$ 66,237

See notes to unaudited condensed consolidated financial statements.

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PEGASYSTEMS INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. ACCOUNTING POLICIES

Basis of Presentation

Pegasystems Inc. (together with its subsidiaries, the Company) has prepared the accompanying unaudited condensed consolidated financial statements pursuant to the rules and regulations of the U.S. Securities and Exchange Commission (SEC) regarding interim financial reporting. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America (U.S.) for complete financial statements and should be read in conjunction with the Company s audited financial statements included in the Annual Report on Form 10-K for the year ended December 31, 2012.

In the opinion of management, the Company has prepared the accompanying unaudited condensed consolidated financial statements on the same basis as its audited financial statements, and these financial statements include all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the results of the interim periods presented. The operating results for the interim periods presented are not necessarily indicative of the results expected for the full year 2013.

Acquisition-related costs

Acquisition-related costs are expensed as incurred and include costs to affect an impending or completed acquisition and direct and incremental costs associated with an acquisition. During the third quarter of 2013, acquisition-related costs of $0.5 million were primarily legal and advisory fees and due diligence costs associated with the Company s acquisition of Antenna Software, Inc. (Antenna). See Note 12 Subsequent Event .

2. MARKETABLE SECURITIES

(in thousands)	**September 30, 2013**			
	Amortized Cost	**Unrealized Gains**	**Unrealized Losses**	**Fair Value**
Municipal bonds	$ 47,325	60	(28)	$ 47,357
Corporate bonds	29,776	56	(9)	29,823
Certificates of deposit	2,442	1	(5)	2,438
	$ 79,543	117	(42)	$ 79,618

(in thousands)	**December 31, 2012**			
	Amortized Cost	**Unrealized Gains**	**Unrealized Losses**	**Fair Value**

Municipal bonds	$	30,488	48	(10)	$	30,526
Corporate bonds		14,853	83	(2)		14,934
	$	45,341	131	(12)	$	45,460

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

As of September 30, 2013, remaining maturities of marketable debt securities ranged from October 2013 to February 2016, with a weighted-average remaining maturity of approximately 14 months.

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3. DERIVATIVE INSTRUMENTS

The Company uses foreign currency forward contracts (forward contracts) to manage its exposure to changes in foreign currency denominated accounts receivable, intercompany payables and cash primarily held by the U.S. operating company. The Company has been primarily exposed to the fluctuation in the British pound and Euro relative to the U.S. dollar. More recently, the Company has experienced increased levels of exposure to the Australian dollar and Indian rupee, for which it began to use forward contracts in the third quarter of 2013.

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

As of September 30, 2013 and December 31, 2012, the Company did not have any forward contracts outstanding.

During the third quarter and first nine months of 2013 and 2012, the Company entered into forward contracts with notional values as follows:

	Notional Amount							
	Three Months Ended September 30,				Nine Months Ended September 30,			
Foreign currency (in thousands)		**2013**		**2012**		**2013**		**2012**
Euro		28,500		21,700		61,000		48,900
British pound	£	26,000	£	16,000	£	59,500	£	39,000
Australian dollar	A$	15,500	A$		A$	15,500	A$	
Indian rupee	Rs	460,000	Rs		Rs	460,000	Rs	

During the third quarter and first nine months of 2013 and 2012, the total change in the fair value of the Company s forward contracts recorded in other expense, net, was as follows:

	Change in Fair Value in USD							
	Three Months Ended September 30,				Nine Months Ended September 30,			
(in thousands)		**2013**		**2012**		**2013**		**2012**
Loss included in other expense, net	$	(1,173)	$	(926)	$	(430)	$	(1,522)

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4. FAIR VALUE MEASUREMENTS

Assets Measured at Fair Value on a Recurring Basis

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

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

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

(in thousands)	September 30, 2013	Fair Value Measurements at Reporting Date Using: Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Money market funds	$ 3,070	$ 3,070	$
Marketable securities:			
Municipal bonds	$ 47,357	$ 13,289	$ 34,068
Corporate bonds	29,823	29,823	
Certificates of deposit	2,438		2,438
Total marketable securities	$ 79,618	$ 43,112	$ 36,506

(in thousands)	December 31,	Fair Value Measurements at Reporting Date Using: Quoted Prices	Significant

	2012	in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)
Money market funds	$ 2,873	$ 2,873	$
Marketable securities:			
Municipal bonds	$ 30,526	$ 11,966	$ 18,560
Corporate bonds	14,934	14,934	
Total marketable securities	$ 45,460	$ 26,900	$ 18,560

Assets Measured at Fair Value on a Nonrecurring Basis

Assets recorded at fair value on a nonrecurring basis, such as property and equipment, and intangible assets, are recognized at fair value when they are impaired. During the first nine months of 2013 and 2012, the Company did not recognize any impairments on its assets measured at fair value on a nonrecurring basis.

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5. TRADE ACCOUNTS RECEIVABLE, NET OF ALLOWANCE

(in thousands)	September 30, 2013	December 31, 2012
Trade accounts receivable	$ 58,037	$ 112,106
Unbilled trade accounts receivable	33,318	22,923
Total accounts receivable	91,355	135,029
Allowance for sales credit memos	(772)	(963)
	$ 90,583	$ 134,066

Unbilled trade accounts receivable relate to services earned under time and material arrangements, and maintenance and license arrangements that had not been invoiced as of September 30, 2013 and December 31, 2012, respectively.

6. GOODWILL AND OTHER INTANGIBLE ASSETS

There were no changes in the carrying amount of goodwill during the first nine months of 2013.

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

(in thousands)	Range of Useful Lives	Cost	Accumulated Amortization	Net Book Value
As of September 30, 2013				
Customer related intangibles	9 years	$ 44,355	$ (16,838)	$ 27,517
Technology	4-9 years	43,446	(21,053)	22,393
Other intangibles	1-5 years	2,238	(2,238)	
Total		$ 90,039	$ (40,129)	$ 49,910

		Cost	Accumulated Amortization	Net Book Value
As of December 31, 2012				
Customer related intangibles	9 years	$ 44,355	$ (13,142)	$ 31,213
Technology	4-9 years	43,446	(16,431)	27,015
Other intangibles	1-5 years	2,238	(2,234)	4
Total		$ 90,039	$ (31,807)	$ 58,232

For the third quarter and first nine months of 2013 and 2012, amortization of intangibles was reflected in the Company s unaudited condensed consolidated statements of operations as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(in thousands)	**2013**	**2012**	**2013**	**2012**
Cost of software license	$ 1,540	$ 1,541	$ 4,622	$ 4,649
Selling and marketing	1,232	1,232	3,696	3,696
General and administrative		5	4	15
Total amortization expense	$ 2,772	$ 2,778	$ 8,322	$ 8,360

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

(in thousands) September 30, 2013	Future estimated amortization expense
Remainder of 2013	$ 2,773
2014	9,489
2015	8,688
2016	8,688
2017	8,688
2018 & thereafter	11,584
	$ 49,910

7. ACCRUED EXPENSES

(in thousands)	September 30, 2013	December 31, 2012
Partner commissions	$ 4,349	$ 1,723
Other taxes	3,120	2,711
Employee reimbursable expenses	2,255	879
Dividends payable	1,140	
Professional services contractor fees	1,660	602
Self-insurance health and dental claims	977	1,707
Professional fees	930	811
Short-term deferred rent	783	1,111
Foreign income taxes payable	649	1,167
Acquisition-related costs	482	
Restructuring	113	441
Other	4,283	4,382
	$ 20,741	$ 15,534

8. DEFERRED REVENUE

(in thousands)	September 30, 2013	December 31, 2012
Software license	$ 17,206	$ 24,303
Maintenance	63,342	62,144
Professional services and other	11,210	9,099

Current deferred revenue		91,758		95,546
Software license		16,690		15,407
Maintenance and professional services		1,264		3,312
Long-term deferred revenue		17,954		18,719
	$	109,712	$	114,265

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9. STOCK-BASED COMPENSATION

For the third quarter and first nine months of 2013 and 2012, stock-based compensation expense was reflected in the Company s unaudited condensed consolidated statements of operations as follows:

(in thousands)	Three Months Ended September 30, 2013	Three Months Ended September 30, 2012	Nine Months Ended September 30, 2013	Nine Months Ended September 30, 2012
Cost of services	$ 947	$ 849	$ 3,134	$ 2,710
Operating expenses	2,053	1,935	6,579	5,912
Total stock-based compensation before tax	$ 3,000	$ 2,784	$ 9,713	$ 8,622
Income tax benefit	(893)	(915)	(2,941)	(2,781)

During the first nine months of 2013, the Company issued approximately 344,000 shares to its employees and 14,000 shares to its non-employee directors under the Company s share-based compensation plans.

During the first nine months of 2013, the Company granted approximately 114,000 restricted stock units (RSUs) with a total fair value of approximately $3.3 million. Approximately 59,000 RSUs were issued in connection with the election by employees to receive 50% of their 2013 target incentive compensation under the Company s Corporate Incentive Compensation Plan (the CICP) in the form of RSUs instead of cash. Stock-based compensation of approximately $1.7 million associated with this RSU grant will be recognized over a one-year period beginning on the grant date.

As of September 30, 2013, the Company had approximately $12.2 million of unrecognized stock-based compensation expense, net of estimated forfeitures, related to all unvested RSUs and unvested stock options that is expected to be recognized over a weighted-average period of 2.1 years.

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10. EARNINGS PER SHARE

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
(in thousands, except per share amounts)	**2013**	**2012**	**2013**	**2012**
Basic				
Net income (loss)	$ 8,710	$ (331)	$ 22,482	$ 1,459
Weighted-average common shares outstanding	37,955	37,881	37,950	37,834
Earnings (loss) per share, basic	$ 0.23	$ (0.01)	$ 0.59	$ 0.04
Diluted				
Net income (loss)	$ 8,710	$ (331)	$ 22,482	$ 1,459
Weighted-average common shares outstanding, basic	37,955	37,881	37,950	37,834
Weighted-average effect of dilutive securities:				
Stock options and warrants	913		729	817
RSUs	211		193	246
Effect of assumed exercise of stock options, warrants and RSUs	1,124		922	1,063
Weighted-average common shares outstanding, diluted	39,079	37,881	38,872	38,897
Earnings (loss) per share, diluted	$ 0.22	$ (0.01)	$ 0.58	$ 0.04
Outstanding options and RSUs excluded as impact would be antidilutive	33	1,865	146	55

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11. GEOGRAPHIC INFORMATION AND MAJOR CLIENTS

The Company develops and licenses its rules-based software solutions and provides professional and cloud services, maintenance, and training related to its software. The Company derives substantially all of its revenue from the sale and support of one group of similar products and services software that provides business process solutions in the enterprise applications market. To assess performance, the Company s chief operating decision maker primarily reviews financial information on a consolidated basis. Therefore, the Company has determined it operates in one segment Business Process Solutions.

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

(Dollars in thousands)	**Three Months Ended September 30,**						**Nine Months Ended September 30,**					
	2013			**2012**			**2013**			**2012**		
U.S.	$	59,034	49%	$	56,475	56%	$	189,489	53%	$	173,406	55%
United Kingdom		22,115	18%		18,862	18%		58,782	17%		55,329	17%
Europe, other		24,748	20%		12,836	13%		66,012	18%		45,051	14%
Other		16,114	13%		13,484	13%		41,289	12%		44,094	14%
	$	122,011	100%	$	101,657	100%	$	355,572	100%	$	317,880	100%

Clients accounting for 10% or more of the Company s total revenue or outstanding trade receivables, net, were as follows:

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
(Dollars in thousands)	**2013**	**2012**	**2013**	**2012**
Total revenue	**$ 122,011**	**$ 101,657**	**$ 355,572**	**$ 317,880**
Client A	10%	%	%	%

(Dollars in thousands)	**As of September 30, 2013**	**As of December 31, 2012**
Trade receivables, net of allowance	**$ 90,583**	**$ 134,066**

Client A	13%	10%

12. SUBSEQUENT EVENT

On October 9, 2013, the Company acquired Antenna, a leading provider of mobile application development platforms. The Company acquired all of the outstanding capital stock of Antenna in a merger for $26.3 million in cash. The Company is in the process of preparing an allocation of the purchase price to the fair value of assets acquired and liabilities assumed, but currently expects that a substantial portion of the Antenna purchase price will ultimately be allocated to intangible assets, and that such assets are likely to include acquired core technology, customer related assets and goodwill. During the third quarter of 2013, the Company incurred direct and incremental expenses associated with the transaction of $0.5 million and expects to incur an additional estimated $2.2 million of such expenses that are primarily professional fees to affect the acquisition.

The Company believes the acquisition will offer its collective clients faster time-to-market and increased flexibility in end-to-end mobile application development, powerful device management and cloud-based mobile Backend-as-a-Service.

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

Forward-Looking Statements

This Quarterly Report on Form 10-Q contains or incorporates forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements include, but are not limited to, statements about our future financial performance and business plans, the adequacy of our liquidity and capital resources, the continued payment of quarterly dividends by the Company, and the timing of recognizing revenue under existing term license agreements. These forward-looking statements are based on current expectations, estimates, forecasts and projections about the industry and markets in which we operate and management s beliefs and assumptions. In addition, other written or oral statements that constitute forward-looking statements may be made by us or on our behalf. Words such as expect, anticipate, intend, plan, believe, could, estimate, may, target, project, or variations of s similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions that are difficult to predict. Important factors that could cause actual future activities and results to differ include, among others, variation in demand for our products and services and the difficulty in predicting the completion of product acceptance and other factors affecting the timing of license revenue recognition, the ongoing uncertainty and volatility in the global financial markets, the ongoing consolidation in the financial services and healthcare markets, reliance on third party relationships, the potential loss of vendor specific objective evidence for our professional services, and management of the Company s growth. These risks are described more completely in Item 1A of Part I of our Annual Report on Form 10-K for the year ended December 31, 2012 and in Item 1A of Part II of this Quarterly Report on Form 10-Q. We do not intend to update publicly any forward-looking statements, whether as a result of new information, future events or otherwise.

Business overview

We develop, market, license, and support software, which allows organizations to build, deploy, and change enterprise applications easily and quickly. Our unified software platform enables our clients to build enterprise applications in a fraction of the time it would take with competitive disjointed architectures, by directly capturing business objectives, automating programming, and automating work. We also provide consulting services, cloud service offerings, maintenance, and training related to our software.

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

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

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

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

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

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On October 9, 2013, we acquired Antenna Software, Inc. (Antenna), a leading provider of mobile application development platforms for $26.3 million in cash. We believe the acquisition will offer our collective clients faster time-to-market and increased flexibility in end-to-end mobile application development, powerful device management and cloud-based mobile Backend-as-a-Service.

Critical accounting policies

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

There have been no changes in our critical accounting policies as disclosed in our Annual Report on Form 10-K for the year ended December 31, 2012. For more information regarding our critical accounting policies, we encourage you to read the discussion contained in Item 7 under the heading Critical Accounting Policies, Significant Judgments and Estimates and Note 2 Significant Accounting Policies included in the notes to the Consolidated Financial Statements contained in our Annual Report on Form 10-K for the year ended December 31, 2012.

Results of Operations

(Dollars in thousands)	Three Months Ended September 30, 2013	Three Months Ended September 30, 2012	Increase		Nine Months Ended September 30, 2013	Nine Months Ended September 30, 2012	Increase	
Total revenue	$ 122,011	$ 101,657	$ 20,354	20%	$ 355,572	$ 317,880	$ 37,692	12%
Gross profit	$ 83,913	$ 63,992	$ 19,921	31%	$ 241,943	$ 198,694	$ 43,249	22%
Total operating expenses	$ 70,124	$ 63,591	$ 6,533	10%	$ 208,150	$ 195,058	$ 13,092	7%
Income from operations	$ 13,789	$ 401	$ 13,388	n/m	$ 33,793	$ 3,636	$ 30,157	829%
Income before provision for income taxes	$ 13,410	$ 32	$ 13,378	n/m	$ 32,085	$ 2,795	$ 29,290	n/m

n/m - not meaningful

Revenue

Three Months Ended September 30,	Increase (Decrease)	Nine Months Ended September 30,	Increase (Decrease)

llars in sands)	**2013**		**2012**				**2013**		**2012**			
nse nue												
petual nses	$ 28,971	65%	$ 16,999	60%	$ 11,972		$ 79,978	62%	$ 50,448	53%	$ 29,530	
m nses	14,077	31%	9,742	34%	4,335		42,987	34%	32,650	34%	10,337	
scription	1,754	4%	1,834	6%	(80)		5,252	4%	12,419	13%	(7,167)	
al license nue	$ 44,802	100%	$ 28,575	100%	$ 16,227	57%	$ 128,217	100%	$ 95,517	100%	$ 32,700	34

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The aggregate value of new license arrangements executed during the third quarter of 2013 nearly doubled as compared to the third quarter of 2012 due to a higher average value of license arrangements executed in the third quarter of 2013. The aggregate value of new license arrangements executed during the first nine months of 2013 was higher than in the same period in 2012 due to both a larger number and higher average value of license arrangements executed in the first nine months of 2013. The aggregate value of new license arrangements executed fluctuates quarter to quarter. During the first nine months of 2013 and 2012, approximately 72% and 68%, respectively, of the value of new license arrangements were executed with existing clients.

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

The increase in perpetual license revenue during the third quarter of 2013 compared to the same period in 2012 was primarily due to larger value perpetual arrangements executed during the third quarter of 2013 than in the third quarter of 2012. The increase in perpetual license revenue during the first nine months of 2013 compared to the same period in 2012 was primarily due to higher value perpetual arrangements executed during the first nine months of 2013 and the fourth quarter of 2012 than during the first nine months of 2012 and the fourth quarter of 2011.

The increases in term license revenue were primarily due to revenue recognized on term license arrangements executed in 2012 and 2011. The aggregate value of payments due under noncancellable term licenses grew to $203.6 million as of September 30, 2013 compared to $155.9 million as of September 30, 2012. We expect to recognize $16 million of the $203.6 million as revenue during the remainder of 2013 in addition to new term license agreements we may complete or prepayments we may receive from existing term license agreements. See the table of future cash receipts on page 22.

Subscription revenue primarily consists of the ratable recognition of license, maintenance and bundled services revenue on perpetual license arrangements that include a right to unspecified future products. Subscription revenue does not include revenue from our Pega Cloud offerings, which is included in consulting services. The timing of scheduled payments under client arrangements may limit the amount of revenue recognized in a reporting period. Consequently, our subscription revenue may vary quarter to quarter. The decrease in subscription revenue during the first nine months of 2013 compared to the same period in 2012 was primarily due to revenue recognized in the second quarter of 2012 for a large payment that became due.

	Three Months Ended September 30,		**Increase**		**Nine Months Ended September 30,**		**Increase**	
(Dollars in thousands)	**2013**	**2012**			**2013**	**2012**		
Maintenance revenue								
Maintenance	$ 37,979	$ 32,317	$ 5,662	18%	$ 112,238	$ 97,657	$ 14,581	15%

The increases in maintenance revenue were primarily due to the growth in the aggregate value of the installed base of our software.

(Dollars in thousands)	Three Months Ended September 30,				(Decrease)		Nine Months Ended September 30,				(Decrease)	
	2013		2012				2013		2012			
Professional services revenue												
Consulting services	$ 38,097	97%	$ 39,549	97%	$ (1,452)	(4)%	$ 111,272	97%	$ 119,825	96%	$ (8,553)	(7
Training	1,133	3%	1,216	3%	(83)	(7)%	3,845	3%	4,881	4%	(1,036)	(21
Total Professional services	$ 39,230	100%	$ 40,765	100%	$ (1,535)	(4)%	$ 115,117	100%	$ 124,706	100%	$ (9,589)	(8

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Consulting services includes revenue from our Pega Cloud offerings. The decreases in consulting services revenue were primarily the result of more clients becoming enabled and our partners leading more implementation projects. If this trend continues, our consulting services revenue may continue to decrease in future periods. The decrease in our training revenue during the first nine months of 2013 compared to the same period in 2012 was primarily due to the increased adoption of our Pega Academy self-service online training by our partners, which has a lower average price per student.

Gross profit

	Three Months Ended September 30,		Increase (Decrease)		Nine Months Ended September 30,		Increase (Decrease)	
(Dollars in thousands)	**2013**	**2012**			**2013**	**2012**		
Gross Profit								
Software license	$ 43,210	$ 26,990	$ 16,220	60%	$ 123,466	$ 90,754	$ 32,712	36%
Maintenance	34,380	28,572	5,808	20%	101,132	86,585	14,547	17%
Professional services	6,323	8,430	(2,107)	(25)%	17,345	21,355	(4,010)	(19)%
Total gross profit	$ 83,913	$ 63,992	$ 19,921	31%	$ 241,943	$ 198,694	$ 43,249	22%
Total gross profit %	69%	63%			68%	63%		
Software license gross profit %	96%	94%			96%	95%		
Maintenance gross profit %	91%	88%			90%	89%		
Professional services gross profit %	16%	21%			15%	17%		

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

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

Operating expenses

	Three Months Ended September 30,		Increase		Nine Months Ended September 30,		Increase	
(Dollars in thousands)	**2013**	**2012**			**2013**	**2012**		
Selling and marketing								
Selling and marketing	$ 42,663	$ 36,893	$ 5,770	16%	$ 127,279	$ 116,476	$ 10,803	9%
As a percent of total revenue	35%	36%			36%	37%		
Selling and marketing headcount at September 30,					538	524	14	3%

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

The increase in selling and marketing expenses during the third quarter of 2013 compared to the same period in 2012 was primarily due to a $2.2 million increase in compensation expenses, a $1.4 million increase in commission expense associated with the higher value of new license arrangements executed, and a $2.7 million increase in partner commission expense.

The increase in selling and marketing expenses during the first nine months of 2013 compared to the same period in 2012 was primarily due to a $5.5 million increase in compensation expenses, a $2.2 million increase in commission expense associated with the higher value of new license arrangements executed and a $2.8 million increase in partner commission expense.

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	Three Months Ended September 30,		Increase	Nine Months Ended September 30,		Increase
(Dollars in thousands)	**2013**	**2012**		**2013**	&	