

PEGASYSTEMS INC  
Form 10-Q  
November 02, 2016  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

**FORM 10-Q**

(Mark One)

☒ **Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
**For the quarterly period ended September 30, 2016**

**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**  
**(State or other jurisdiction of**  
**incorporation or organization)**

**04-2787865**  
**(IRS Employer**  
**Identification No.)**

**One Rogers Street Cambridge, MA**  
**(Address of principal executive offices)**

**02142-1209**  
**(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 ☒ 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 ☒ 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 ☒

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 ☒

There were 76,327,875 shares of the Registrant's common stock, \$.01 par value per share, outstanding on October 24, 2016.

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**PEGASYSTEMS INC.**

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Table of Contents**PEGASYSTEMS INC.****UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS****(in thousands)**

|                                                                    | <b>As of<br/>September 30,<br/>2016</b> | <b>As of<br/>December 31,<br/>2015</b> |
|--------------------------------------------------------------------|-----------------------------------------|----------------------------------------|
| <b><i>ASSETS</i></b>                                               |                                         |                                        |
| Current assets:                                                    |                                         |                                        |
| Cash and cash equivalents                                          | \$ 66,383                               | \$ 93,026                              |
| Marketable securities                                              | 63,347                                  | 126,052                                |
| Total cash, cash equivalents, and marketable securities            | 129,730                                 | 219,078                                |
| Trade accounts receivable, net of allowance of \$4,564 and \$4,631 | 208,562                                 | 211,846                                |
| Deferred income taxes                                              | 12,409                                  | 12,380                                 |
| Income taxes receivable                                            | 13,639                                  | 4,770                                  |
| Other current assets                                               | 14,319                                  | 10,791                                 |
| Total current assets                                               | 378,659                                 | 458,865                                |
| Property and equipment, net                                        | 39,343                                  | 31,319                                 |
| Long-term deferred income taxes                                    | 53,905                                  | 53,350                                 |
| Long-term other assets                                             | 3,755                                   | 4,030                                  |
| Intangible assets, net                                             | 47,462                                  | 33,418                                 |
| Goodwill                                                           | 73,871                                  | 46,776                                 |
| Total assets                                                       | \$ 596,995                              | \$ 627,758                             |
| <b><i>LIABILITIES AND STOCKHOLDERS' EQUITY</i></b>                 |                                         |                                        |
| Current liabilities:                                               |                                         |                                        |
| Accounts payable                                                   | \$ 8,824                                | \$ 12,675                              |
| Accrued expenses                                                   | 36,370                                  | 42,768                                 |
| Accrued compensation and related expenses                          | 52,070                                  | 55,872                                 |
| Deferred revenue                                                   | 140,458                                 | 155,873                                |
| Total current liabilities                                          | 237,722                                 | 267,188                                |
| Income taxes payable                                               | 5,253                                   | 5,618                                  |

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|                                                                                                 |            |            |
|-------------------------------------------------------------------------------------------------|------------|------------|
| Long-term deferred revenue                                                                      | 10,228     | 15,805     |
| Other long-term liabilities                                                                     | 16,372     | 16,288     |
| Total liabilities                                                                               | 269,575    | 304,899    |
| Stockholders' equity:                                                                           |            |            |
| Preferred stock, 1,000 shares authorized; no shares issued and outstanding                      |            |            |
| Common stock, 200,000 shares authorized; 76,284 shares and 76,488 shares issued and outstanding | 763        | 765        |
| Additional paid-in capital                                                                      | 143,020    | 145,418    |
| Retained earnings                                                                               | 188,376    | 180,183    |
| Accumulated other comprehensive loss                                                            | (4,739)    | (3,507)    |
| Total stockholders' equity                                                                      | 327,420    | 322,859    |
| Total liabilities and stockholders' equity                                                      | \$ 596,995 | \$ 627,758 |

See notes to unaudited condensed consolidated financial statements.

**Table of Contents****PEGASYSTEMS INC.****UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(in thousands, except per share amounts)**

|                                          | <b>Three Months Ended<br/>September 30,</b> |                | <b>Nine Months Ended<br/>September 30,</b> |                |
|------------------------------------------|---------------------------------------------|----------------|--------------------------------------------|----------------|
|                                          | <b>2016</b>                                 | <b>2015</b>    | <b>2016</b>                                | <b>2015</b>    |
| <b>Revenue:</b>                          |                                             |                |                                            |                |
| Software license                         | \$ 68,833                                   | \$ 58,948      | \$ 207,849                                 | \$ 180,420     |
| Maintenance                              | 55,038                                      | 52,285         | 163,174                                    | 150,366        |
| Services                                 | 58,931                                      | 51,170         | 179,633                                    | 147,554        |
| <b>Total revenue</b>                     | <b>182,802</b>                              | <b>162,403</b> | <b>550,656</b>                             | <b>478,340</b> |
| <b>Cost of revenue:</b>                  |                                             |                |                                            |                |
| Software license                         | 1,313                                       | 1,000          | 3,646                                      | 3,106          |
| Maintenance                              | 6,659                                       | 5,644          | 18,889                                     | 16,300         |
| Services                                 | 52,465                                      | 48,797         | 154,512                                    | 140,875        |
| <b>Total cost of revenue</b>             | <b>60,437</b>                               | <b>55,441</b>  | <b>177,047</b>                             | <b>160,281</b> |
| <b>Gross profit</b>                      | <b>122,365</b>                              | <b>106,962</b> | <b>373,609</b>                             | <b>318,059</b> |
| <b>Operating expenses:</b>               |                                             |                |                                            |                |
| Selling and marketing                    | 67,032                                      | 53,640         | 202,126                                    | 169,764        |
| Research and development                 | 38,036                                      | 33,032         | 108,530                                    | 94,248         |
| General and administrative               | 11,725                                      | 9,579          | 34,067                                     | 26,138         |
| Acquisition-related                      | 74                                          |                | 2,616                                      | 39             |
| Restructuring                            |                                             |                | 287                                        |                |
| <b>Total operating expenses</b>          | <b>116,867</b>                              | <b>96,251</b>  | <b>347,626</b>                             | <b>290,189</b> |
| <b>Income from operations</b>            | <b>5,498</b>                                | <b>10,711</b>  | <b>25,983</b>                              | <b>27,870</b>  |
| Foreign currency transaction gain (loss) | 1,082                                       | (412)          | 2,764                                      | (4,342)        |
| Interest income, net                     | 172                                         | 278            | 650                                        | 807            |
| Other expense, net                       | (1,237)                                     | (331)          | (4,891)                                    | (328)          |

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|                                                       |          |          |           |           |
|-------------------------------------------------------|----------|----------|-----------|-----------|
| Income before provision for income taxes              | 5,515    | 10,246   | 24,506    | 24,007    |
| Provision for income taxes                            | 3,097    | 3,921    | 9,436     | 8,643     |
| Net income                                            | \$ 2,418 | \$ 6,325 | \$ 15,070 | \$ 15,364 |
| Earnings per share:                                   |          |          |           |           |
| Basic                                                 | \$ 0.03  | \$ 0.08  | \$ 0.20   | \$ 0.20   |
| Diluted                                               | \$ 0.03  | \$ 0.08  | \$ 0.19   | \$ 0.19   |
| Weighted-average number of common shares outstanding: |          |          |           |           |
| Basic                                                 | 76,278   | 76,534   | 76,323    | 76,521    |
| Diluted                                               | 79,082   | 79,174   | 78,976    | 78,906    |
| Cash dividends declared per share                     | \$ 0.03  | \$ 0.03  | \$ 0.09   | \$ 0.09   |

See notes to unaudited condensed consolidated financial statements.

**Table of Contents****PEGASYSTEMS INC.****UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME****(in thousands)**

|                                                                                | <b>Three Months Ended<br/>September 30,</b> |             | <b>Nine Months Ended<br/>September 30,</b> |             |
|--------------------------------------------------------------------------------|---------------------------------------------|-------------|--------------------------------------------|-------------|
|                                                                                | <b>2016</b>                                 | <b>2015</b> | <b>2016</b>                                | <b>2015</b> |
| Net income                                                                     | \$ 2,418                                    | \$ 6,325    | \$ 15,070                                  | \$ 15,364   |
| Other comprehensive loss, net:                                                 |                                             |             |                                            |             |
| Unrealized (loss) gain on available-for-sale marketable securities, net of tax | (174)                                       | 162         | 168                                        | 167         |
| Foreign currency translation adjustments                                       | (169)                                       | (928)       | (1,400)                                    | (2,262)     |
| Total other comprehensive loss, net                                            | (343)                                       | (766)       | (1,232)                                    | (2,095)     |
| Comprehensive income                                                           | \$ 2,075                                    | \$ 5,559    | \$ 13,838                                  | \$ 13,269   |

See notes to unaudited condensed consolidated financial statements.

**Table of Contents****PEGASYSTEMS INC.****UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(in thousands)**

|                                                                                      | <b>Nine Months Ended<br/>September 30,</b> |                 |
|--------------------------------------------------------------------------------------|--------------------------------------------|-----------------|
|                                                                                      | <b>2016</b>                                | <b>2015</b>     |
| <b>Operating activities:</b>                                                         |                                            |                 |
| Net income                                                                           | \$ 15,070                                  | \$ 15,364       |
| <b>Adjustments to reconcile net income to cash provided by operating activities:</b> |                                            |                 |
| Excess tax benefits from exercise or vesting of equity awards                        | (3,160)                                    | (4,661)         |
| Deferred income taxes                                                                | (2,841)                                    | (2,889)         |
| Depreciation and amortization                                                        | 17,896                                     | 17,570          |
| Stock-based compensation expense                                                     | 30,634                                     | 23,005          |
| Foreign currency transaction (gain) loss                                             | (2,764)                                    | 4,342           |
| Other non-cash                                                                       | 153                                        | 1,129           |
| <b>Change in operating assets and liabilities:</b>                                   |                                            |                 |
| Trade accounts receivable                                                            | 3,940                                      | 21,969          |
| Income taxes receivable and other current assets                                     | (8,737)                                    | (8,670)         |
| Accounts payable and accrued expenses                                                | (16,678)                                   | (4,108)         |
| Deferred revenue                                                                     | (17,698)                                   | (6,925)         |
| Other long-term assets and liabilities                                               | 1,581                                      | (1,198)         |
| <b>Cash provided by operating activities</b>                                         | <b>17,396</b>                              | <b>54,928</b>   |
| <b>Investing activities:</b>                                                         |                                            |                 |
| Purchases of marketable securities                                                   | (22,614)                                   | (66,946)        |
| Proceeds from maturities and called marketable securities                            | 21,838                                     | 33,916          |
| Sales of marketable securities                                                       | 62,283                                     | 1,915           |
| Payments for acquisitions, net of cash acquired                                      | (49,113)                                   | (1,671)         |
| Investment in property and equipment                                                 | (15,253)                                   | (9,950)         |
| <b>Cash used in investing activities</b>                                             | <b>(2,859)</b>                             | <b>(42,736)</b> |
| <b>Financing activities:</b>                                                         |                                            |                 |

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|                                                                                   |           |           |
|-----------------------------------------------------------------------------------|-----------|-----------|
| Issuance of common stock for share-based compensation plans                       | 393       | 722       |
| Excess tax benefits from exercise or vesting of equity awards                     | 3,160     | 4,661     |
| Dividend payments to shareholders                                                 | (6,883)   | (6,896)   |
| Common stock repurchases for tax withholdings for net settlement of equity awards | (10,791)  | (7,149)   |
| Common stock repurchases under share repurchase programs                          | (25,750)  | (17,000)  |
| Cash used in financing activities                                                 | (39,871)  | (25,662)  |
| Effect of exchange rates on cash and cash equivalents                             | (1,309)   | (3,837)   |
| Net decrease in cash and cash equivalents                                         | (26,643)  | (17,307)  |
| Cash and cash equivalents, beginning of period                                    | 93,026    | 114,585   |
| Cash and cash equivalents, end of period                                          | \$ 66,383 | \$ 97,278 |

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, 2015.

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 2016.

**2. NEW ACCOUNTING PRONOUNCEMENTS**

***Measurement of Credit Losses on Financial Instruments:*** In June 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments, which requires measurement and recognition of expected credit losses for financial assets measured at amortized cost, including trade accounts receivable, upon initial recognition of that financial asset. Credit losses relating to available-for-sale debt securities should be recorded through an allowance for credit losses when the fair value is below the amortized cost of the asset, removing the concept of other-than-temporary impairments. The effective date for the Company will be January 1, 2020, with early adoption permitted. The Company is currently evaluating the effect this ASU will have on its consolidated financial statements and related disclosures.

***Improvements to Employee Share-Based Payment Accounting:*** In March 2016, the FASB issued ASU No. 2016-09, Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting, which is intended to simplify various aspects of the accounting for employee share-based payments transactions, including accounting for income taxes, forfeitures, and statutory tax withholding requirements, as well as classification in the statement of cash flows. The effective date for the Company will be January 1, 2017, with early adoption permitted. The Company is currently evaluating the effect this ASU will have on its consolidated financial statements and related disclosures.

***Leases:*** In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842), which requires lessees to record most leases on their balance sheets, recognizing a lease liability for the obligation to make lease payments and a right-of-use asset for the right to use the underlying asset for the lease term. The effective date for the Company will be January 1, 2019, with early adoption permitted. The Company currently expects that most of its operating lease commitments will be subject to this ASU and recognized as operating lease liabilities and right-of-use assets upon

adoption.

***Balance Sheet Classification of Deferred Taxes:*** In November 2015, the FASB issued ASU No. 2015-17, Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes. The guidance requires that deferred income tax liabilities and assets be classified as noncurrent in a classified balance sheet. The effective date for the Company will be January 1, 2017, with early adoption permitted. The Company does not expect this ASU to have a material impact on its consolidated financial statements and related disclosures.

***Revenue from Contracts with Customers:*** In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606) . This ASU amends the guidance for revenue recognition and implements a five-step process for customer contract revenue recognition that focuses on transfer of control, as opposed to transfer of risk and rewards. This ASU also requires enhanced disclosures regarding the nature, amount, timing and uncertainty of revenues and cash flows from contracts with customers. Other major provisions include ensuring the time value of money is considered in the transaction price, and allowing estimates of variable consideration to be recognized before contingencies are resolved in certain

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circumstances. This ASU originally had an effective date for the Company of January 1, 2017. In August 2015, the FASB issued ASU No. 2015-14, Revenue from Contracts with Customers (Topic 606) Deferral of the Effective Date, which defers the effective date by one year while providing the option to adopt the standard on the original effective date. In addition, the FASB issued ASU No. 2016-08, ASU No. 2016-10, and ASU No. 2016-12 in March 2016, April 2016, and May 2016, respectively, to help provide interpretive clarifications on the new guidance in ASC Topic 606. The effective date for these ASUs for the Company will be January 1, 2018. The Company has selected the full retrospective method and is currently evaluating its effect on its consolidated financial statements and related disclosures.

**3. MARKETABLE SECURITIES**

| (in thousands)          | September 30, 2016 |                  |                   |            |
|-------------------------|--------------------|------------------|-------------------|------------|
|                         | Amortized Cost     | Unrealized Gains | Unrealized Losses | Fair Value |
| Municipal bonds         | \$ 35,717          | \$ 34            | \$ (24)           | \$ 35,727  |
| Corporate bonds         | 26,655             | 30               | (16)              | 26,669     |
| Certificates of deposit | 950                | 1                |                   | 951        |
|                         | \$ 63,322          | \$ 65            | \$ (40)           | \$ 63,347  |

| (in thousands)          | December 31, 2015 |                  |                   |            |
|-------------------------|-------------------|------------------|-------------------|------------|
|                         | Amortized Cost    | Unrealized Gains | Unrealized Losses | Fair Value |
| Municipal bonds         | \$ 57,394         | \$ 7             | \$ (66)           | \$ 57,335  |
| Corporate bonds         | 66,960            | 2                | (147)             | 66,815     |
| Certificates of deposit | 1,903             |                  | (1)               | 1,902      |
|                         | \$ 126,257        | \$ 9             | \$ (214)          | \$ 126,052 |

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. Unrealized gains and losses considered to be temporary in nature are recorded as a component of accumulated other comprehensive loss, net of related income taxes. The Company reviews all investments for reductions in fair value that are other-than-temporary. When such reductions occur, the cost of the investment is adjusted to fair value through recording a loss on investments in the unaudited condensed consolidated statements of operations. Gains and losses on investments are calculated on the basis of specific identification. As of September 30, 2016, the Company did not hold any investments with unrealized losses that are considered to be other-than-temporary.

As of September 30, 2016, remaining maturities of marketable debt securities ranged from October 2016 to August 2019, with a weighted-average remaining maturity of approximately 16 months.

#### **4. DERIVATIVE INSTRUMENTS**

The Company uses foreign currency forward contracts ( forward contracts ) to hedge its exposure to fluctuations in foreign currency exchange rates associated with its foreign currency denominated cash, accounts receivable, and intercompany receivables and payables held by its U.S. parent company and United Kingdom ( U.K. ) subsidiary.

The Company is primarily exposed to foreign currency exchange rate fluctuations in the U.S. dollar, the Euro, and the Australian dollar relative to the British pound and the Euro and the Indian rupee relative to the U.S. dollar. At the end of June 2016, the U.K. held a referendum in which U.K. voters approved an exit from the European Union (the E.U. ), commonly referred to as Brexit . The announcement of Brexit resulted in a sharp decline in the value of the British pound, as compared to the U.S. dollar and other currencies. This decline primarily resulted in foreign currency transaction gains from the remeasurement of foreign currency denominated cash and accounts receivable held by the Company s U.K. subsidiary with corresponding losses on the Company s forward contracts included in other expense, net.

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The forward contracts are not designated as hedging instruments. As a result, the Company records the fair value of these contracts at the end of each reporting period in the accompanying unaudited condensed consolidated balance sheets 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 the accompanying unaudited condensed consolidated statements of operations. The cash flows related to these forward contracts are classified as operating activities in the accompanying unaudited condensed consolidated statements of cash flows. The Company does not enter into any forward contracts for trading or speculative purposes.

As of September 30, 2016 and December 31, 2015, the total notional amount of the Company's outstanding forward contracts was \$106.6 million and \$32.3 million, respectively.

The fair value of the Company's outstanding forward contracts was as follows:

| (in thousands)                     | September 30, 2016   |            | December 31, 2015    |            |
|------------------------------------|----------------------|------------|----------------------|------------|
|                                    | Recorded In:         | Fair Value | Recorded In:         | Fair Value |
| <b>Asset Derivatives</b>           |                      |            |                      |            |
| Foreign currency forward contracts | Other current assets | \$ 354     | Other current assets | \$ 48      |
| <b>Liability Derivatives</b>       |                      |            |                      |            |
| Foreign currency forward contracts | Accrued expenses     | \$ 393     | Accrued expenses     | \$ 1,052   |

The Company had forward contracts outstanding with total notional values as follows:

| Currency (in thousands) | As of September 30, |            |
|-------------------------|---------------------|------------|
|                         | 2016                | 2015       |
| Euro                    | 21,810              | 15,900     |
| British pound           | £ 5,919             | £ 1,300    |
| Australian dollar       | A\$ 19,515          | A\$ 11,500 |
| Indian rupee            | Rs                  | Rs 300,000 |
| United States dollar    | \$ 59,450           | \$ 23,300  |

| (in thousands)                                                                             | Three Months Ended |                    | Nine Months Ended  |                    |
|--------------------------------------------------------------------------------------------|--------------------|--------------------|--------------------|--------------------|
|                                                                                            | September 30, 2016 | September 30, 2015 | September 30, 2016 | September 30, 2015 |
| Loss from the change in the fair value of forward contracts included in other expense, net | \$ (1,237)         | \$ (319)           | \$ (4,955)         | \$ (319)           |
|                                                                                            | \$ 1,082           | \$ (412)           | \$ 2,764           | \$ (4,342)         |

Foreign currency transaction gain (loss) from the  
remeasurement of foreign currency assets and  
liabilities

## **5. FAIR VALUE MEASUREMENTS**

### **Assets and Liabilities Measured at Fair Value on a Recurring Basis**

The Company records its marketable securities and forward contracts 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 inputs that are observable either directly or indirectly; and (Level 3) significant unobservable inputs on which there is little or no market data, which require 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.

The Company's money market funds are classified within Level 1 of the fair value hierarchy. The Company's investments classified within Level 2 of the fair value hierarchy are valued based on a market approach using quoted prices, when

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available, or matrix pricing compiled by third party pricing vendors, using observable market inputs such as interest rates, yield curves, and credit risk. The Company's foreign currency forward contracts, which are all classified within Level 2 of the fair value hierarchy, are valued based on the notional amounts and rates under the contracts and observable market inputs such as currency exchange rates and credit risk. If applicable, the Company will recognize transfers into and out of levels within the fair value hierarchy at the end of the reporting period in which the actual event or change in circumstance occurs. There were no transfers between Level 1 and Level 2 during the nine months ended September 30, 2016.

The Company's assets and liabilities measured at fair value on a recurring basis consisted of the following:

| (in thousands)                     | Fair Value Measurements at<br>Reporting Date Using |           |                  |
|------------------------------------|----------------------------------------------------|-----------|------------------|
|                                    | September 30,<br>2016                              | Level 1   | Level 2          |
| <b>Fair Value Assets:</b>          |                                                    |           |                  |
| Money market funds                 | \$ 481                                             | \$ 481    | \$               |
| <b>Marketable securities:</b>      |                                                    |           |                  |
| Municipal bonds                    | \$ 35,727                                          | \$        | \$ 35,727        |
| Corporate bonds                    | 26,669                                             |           | 26,669           |
| Certificates of deposit            | 951                                                |           | 951              |
| <b>Total marketable securities</b> | <b>\$ 63,347</b>                                   | <b>\$</b> | <b>\$ 63,347</b> |
| Foreign currency forward contracts | \$ 354                                             | \$        | \$ 354           |
| <b>Fair Value Liabilities:</b>     |                                                    |           |                  |
| Foreign currency forward contracts | \$ 393                                             | \$        | \$ 393           |

| (in thousands)                | Fair Value Measurements at<br>Reporting Date Using |         |           |
|-------------------------------|----------------------------------------------------|---------|-----------|
|                               | December 31,<br>2015                               | Level 1 | Level 2   |
| <b>Fair Value Assets:</b>     |                                                    |         |           |
| Money market funds            | \$ 573                                             | \$ 573  | \$        |
| <b>Marketable securities:</b> |                                                    |         |           |
| Municipal bonds               | \$ 57,335                                          | \$      | \$ 57,335 |
| Corporate bonds               | 66,815                                             |         | 66,815    |
| Certificates of deposit       | 1,902                                              |         | 1,902     |

|                                    |    |         |    |    |         |
|------------------------------------|----|---------|----|----|---------|
| Total marketable securities        | \$ | 126,052 | \$ | \$ | 126,052 |
| Foreign currency forward contracts | \$ | 48      | \$ | \$ | 48      |
| Fair Value Liabilities:            |    |         |    |    |         |
| Foreign currency forward contracts | \$ | 1,052   | \$ | \$ | 1,052   |

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 nine months of 2016 and 2015, the Company did not recognize any impairments on its assets measured at fair value on a nonrecurring basis.

**Table of Contents****6. TRADE ACCOUNTS RECEIVABLE, NET OF ALLOWANCE**

Unbilled trade accounts receivable primarily relate to services earned under time and materials arrangements and to license, maintenance, and cloud arrangements that have commenced or been delivered in excess of scheduled invoicing.

| (in thousands)                     | September 30, December 31, |            |
|------------------------------------|----------------------------|------------|
|                                    | 2016                       | 2015       |
| Trade accounts receivable          | \$ 178,846                 | \$ 190,820 |
| Unbilled trade accounts receivable | 34,280                     | 25,657     |
| Total accounts receivable          | 213,126                    | 216,477    |
| Allowance for sales credit memos   | (4,564)                    | (4,631)    |
|                                    | \$ 208,562                 | \$ 211,846 |

**7. GOODWILL AND OTHER INTANGIBLE ASSETS**

The following table presents the changes in the carrying amount of goodwill:

| (in thousands)                    | 2016      |
|-----------------------------------|-----------|
| Balance as of January 1,          | \$ 46,776 |
| Goodwill acquired during the year | 27,311    |
| Currency translation adjustments  | (216)     |
| Balance as of September 30,       | \$ 73,871 |

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 |
|---------------------------------|-----------------------|-----------|--------------------------|----------------|
| <b>As of September 30, 2016</b> |                       |           |                          |                |
| Customer related intangibles    | 4-10 years            | \$ 63,134 | \$ (35,714)              | \$ 27,420      |

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|                   |            |            |             |           |
|-------------------|------------|------------|-------------|-----------|
| Technology        | 3-10 years | 58,942     | (38,908)    | 20,034    |
| Other intangibles | 3 years    | 5,361      | (5,353)     | 8         |
| Total             |            | \$ 127,437 | \$ (79,975) | \$ 47,462 |

**As of December 31, 2015**

|                              |           |            |             |           |
|------------------------------|-----------|------------|-------------|-----------|
| Customer related intangibles | 4-9 years | \$ 49,546  | \$ (30,465) | \$ 19,081 |
| Technology                   | 3-9 years | 48,342     | (34,282)    | 14,060    |
| Other intangibles            | 3 years   | 5,361      | (5,084)     | 277       |
| Total                        |           | \$ 103,249 | \$ (69,831) | \$ 33,418 |

Amortization expense of acquired intangibles is reflected in the Company's unaudited condensed consolidated statements of operations as follows:

| (in thousands)             | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |          |
|----------------------------|-------------------------------------|----------|------------------------------------|----------|
|                            | 2016                                | 2015     | 2016                               | 2015     |
| Cost of revenue            | \$ 1,642                            | \$ 1,351 | \$ 4,626                           | \$ 4,041 |
| Selling and marketing      | 1,867                               | 1,537    | 5,274                              | 4,602    |
| General and administrative | 90                                  | 91       | 268                                | 593      |
| Total amortization expense | \$ 3,599                            | \$ 2,979 | \$ 10,168                          | \$ 9,236 |

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

| <b>(in thousands) as of September 30, 2016</b> | <b>Future estimated<br/>amortization<br/>expense</b> |
|------------------------------------------------|------------------------------------------------------|
| Remainder of 2016                              | \$ 3,267                                             |
| 2017                                           | 12,335                                               |
| 2018                                           | 11,335                                               |
| 2019                                           | 5,543                                                |
| 2020                                           | 2,647                                                |
| 2021 and thereafter                            | 12,335                                               |
|                                                | <b>\$ 47,462</b>                                     |

**8. ACQUISITION**

On April 11, 2016, the Company acquired OpenSpan, Inc. ( OpenSpan ), a privately held software provider of robotic process automation and workforce analytics software for \$48.8 million in cash, net of \$1.8 million in cash acquired. As of September 30, 2016, \$7.4 million of the cash consideration remains in escrow and will remain for up to an 18-month period after the acquisition as security for the indemnification obligations of the selling shareholders.

During the third quarter and nine months of 2016, the Company incurred \$0.1 million and \$2.6 million, respectively, of direct and incremental expenses that were primarily legal and advisory fees and due diligence costs to affect the acquisition.

In allocating the total purchase consideration based on estimated fair values, the Company recorded \$27.3 million of goodwill, which is nondeductible for income tax purposes, and \$24.3 million of intangible assets with a weighted-average amortization period of 9.7 years. The estimated fair values of assets acquired and liabilities assumed may be subject to change as additional information is received and certain tax returns are finalized. The Company expects to finalize the valuation no later than one year from the acquisition date.

**9. ACCRUED EXPENSES**

| <b>(in thousands)</b> | <b>September 30,<br/>2016</b> | <b>December 31,<br/>2015</b> |
|-----------------------|-------------------------------|------------------------------|
| Partner commissions   | \$ 2,661                      | \$ 3,319                     |
| Other taxes           | 7,544                         | 10,070                       |

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|                                                       |           |           |
|-------------------------------------------------------|-----------|-----------|
| Employee reimbursable expenses                        | 2,312     | 1,426     |
| Dividends payable                                     | 2,291     | 2,297     |
| Professional services contractor fees                 | 4,723     | 4,580     |
| Self-insurance health and dental claims               | 2,428     | 2,129     |
| Professional fees                                     | 2,679     | 2,937     |
| Short-term deferred rent                              | 1,752     | 1,600     |
| Income taxes payable                                  | 1,268     | 5,464     |
| Acquisition-related expenses and merger consideration | 362       | 834       |
| Restructuring                                         | 132       | 394       |
| Marketing and sales program expenses                  | 1,242     | 1,397     |
| Cloud hosting expenses                                | 858       | 1,370     |
| Foreign currency forward contracts                    | 393       | 1,052     |
| Fixed assets in progress                              | 2,981     | 1,632     |
| Other                                                 | 2,744     | 2,267     |
|                                                       | \$ 36,370 | \$ 42,768 |

**Table of Contents****10. DEFERRED REVENUE**

| <b>(in thousands)</b>      | <b>September 30, 2016</b> |         | <b>December 31, 2015</b> |         |
|----------------------------|---------------------------|---------|--------------------------|---------|
| Software license           | \$                        | 28,630  | \$                       | 40,886  |
| Maintenance                |                           | 95,378  |                          | 95,262  |
| Cloud                      |                           | 10,123  |                          | 8,948   |
| Services                   |                           | 6,327   |                          | 10,777  |
| Current deferred revenue   |                           | 140,458 |                          | 155,873 |
| Software license           |                           | 6,929   |                          | 12,389  |
| Maintenance                |                           | 1,701   |                          | 2,227   |
| Cloud                      |                           | 1,598   |                          | 1,189   |
| Long-term deferred revenue |                           | 10,228  |                          | 15,805  |
|                            | \$                        | 150,686 | \$                       | 171,678 |

**11. STOCK-BASED COMPENSATION**

The following table presents the stock-based compensation expense included in the Company's unaudited condensed consolidated statements of operations:

| <b>(in thousands)</b>                     | <b>Three Months Ended<br/>September 30,</b> |             | <b>Nine Months Ended<br/>September 30,</b> |             |
|-------------------------------------------|---------------------------------------------|-------------|--------------------------------------------|-------------|
|                                           | <b>2016</b>                                 | <b>2015</b> | <b>2016</b>                                | <b>2015</b> |
| Cost of revenues                          | \$ 3,117                                    | \$ 2,285    | \$ 8,711                                   | \$ 6,519    |
| Operating expenses                        | 7,701                                       | 5,806       | 21,923                                     | 16,486      |
| Total stock-based compensation before tax | \$ 10,818                                   | \$ 8,091    | \$ 30,634                                  | \$ 23,005   |
| Income tax benefit                        | \$ (3,227)                                  | \$ (2,326)  | \$ (8,917)                                 | \$ (6,437)  |

During the nine months of 2016, the Company issued approximately 812,000 shares of common stock to its employees and 18,000 shares of common stock to its non-employee directors under the Company's share-based compensation plans.

During the nine months of 2016, the Company granted approximately 1,802,000 restricted stock units ( RSUs ) and 2,567,000 non-qualified stock options to its employees with total fair values of approximately \$45.5 million and \$21.2

million, respectively. This includes approximately 225,000 RSUs which were granted in connection with the election by employees to receive 50% of their 2016 target incentive compensation under the Company's Corporate Incentive Compensation Plan in the form of RSUs instead of cash. Stock-based compensation of approximately \$5.6 million associated with this RSU grant will be recognized over a one-year period beginning on the grant date. During the nine months of 2016, the Company also granted approximately 36,000 RSUs to its non-employee directors with a total fair value of \$1 million, which primarily vested 25% on the grant date and will vest 25% quarterly thereafter.

The Company recognizes stock based compensation on the accelerated recognition method, treating each vesting tranche as if it were an individual grant. As of September 30, 2016, the Company had approximately \$51.1 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.

**Table of Contents****12. 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 and RSUs, 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 anti-dilutive in the periods presented, but could be dilutive in the future.

| (in thousands, except per share amounts)                               | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |           |
|------------------------------------------------------------------------|-------------------------------------|----------|------------------------------------|-----------|
|                                                                        | 2016                                | 2015     | 2016                               | 2015      |
| <b>Basic</b>                                                           |                                     |          |                                    |           |
| Net income                                                             | \$ 2,418                            | \$ 6,325 | \$ 15,070                          | \$ 15,364 |
| Weighted-average common shares outstanding                             | 76,278                              | 76,534   | 76,323                             | 76,521    |
| Earnings per share, basic                                              | \$ 0.03                             | \$ 0.08  | \$ 0.20                            | \$ 0.20   |
| <b>Diluted</b>                                                         |                                     |          |                                    |           |
| Net income                                                             | \$ 2,418                            | \$ 6,325 | \$ 15,070                          | \$ 15,364 |
| Weighted-average common shares outstanding, basic                      | 76,278                              | 76,534   | 76,323                             | 76,521    |
| Weighted-average effect of dilutive securities:                        |                                     |          |                                    |           |
| Stock options                                                          | 1,613                               | 1,603    | 1,556                              | 1,546     |
| RSUs                                                                   | 1,191                               | 1,037    | 1,097                              | 839       |
| Effect of assumed exercise of stock options and RSUs                   | 2,804                               | 2,640    | 2,653                              | 2,385     |
| Weighted-average common shares outstanding, assuming dilution          | 79,082                              | 79,174   | 78,976                             | 78,906    |
| Earnings per share, diluted                                            | \$ 0.03                             | \$ 0.08  | \$ 0.19                            | \$ 0.19   |
| Outstanding options and RSUs excluded as impact would be anti-dilutive | 296                                 | 320      | 368                                | 201       |



**Table of Contents****13. GEOGRAPHIC INFORMATION AND MAJOR CLIENTS**

Operating segments are defined as components of an enterprise, about which separate financial information is available that is evaluated regularly by the chief operating decision maker ( CODM ) in deciding how to allocate resources and in assessing performance.

The Company develops and licenses software applications for customer engagement and its Pega® 7 Platform, and provides consulting services, maintenance, and training related to its offerings. The Company derives substantially all of its revenue from the sale and support of one group of similar products and services software that provides case management, business process management, and real-time decisioning solutions to improve customer engagement and operational excellence in the enterprise applications market. To assess performance, the Company's CODM, who is the chief executive officer, reviews financial information on a consolidated basis. Therefore, the Company determined it has one reportable segment Customer Engagement Solutions and one reporting unit.

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

| (Dollars in thousands)    | Three Months Ended<br>September 30, |      |            |      | Nine Months Ended<br>September 30, |      |            |      |
|---------------------------|-------------------------------------|------|------------|------|------------------------------------|------|------------|------|
|                           | 2016                                |      | 2015       |      | 2016                               |      | 2015       |      |
| U.S.                      | \$ 111,274                          | 61%  | \$ 89,640  | 55%  | \$ 308,049                         | 56%  | \$ 267,671 | 56%  |
| Other Americas            | 7,952                               | 4%   | 6,602      | 4%   | 49,494                             | 9%   | 46,278     | 10%  |
| U.K.                      | 21,490                              | 12%  | 19,491     | 12%  | 77,181                             | 14%  | 60,867     | 13%  |
| Other EMEA <sup>(1)</sup> | 23,656                              | 13%  | 20,672     | 13%  | 67,314                             | 12%  | 55,376     | 11%  |
| Asia Pacific              | 18,430                              | 10%  | 25,998     | 16%  | 48,618                             | 9%   | 48,148     | 10%  |
|                           | \$ 182,802                          | 100% | \$ 162,403 | 100% | \$ 550,656                         | 100% | \$ 478,340 | 100% |

<sup>(1)</sup> Includes Europe, the Middle East and Africa ( Other EMEA ).

There were no clients accounting for 10% or more of the Company's total revenue during the third quarter and nine months of 2016 and 2015.

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

| (Dollars in thousands)               | As of<br>September 30,<br>2016 | As of<br>December 31,<br>2015 |
|--------------------------------------|--------------------------------|-------------------------------|
| Trade receivables, net of allowances | \$ 208,562                     | \$ 211,846                    |

Client A

%

10%

## 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, the timing of recognizing revenue under existing license and cloud arrangements. 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, strateg project, guidance, 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. 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 consolidation in the financial services, insurance, healthcare, and communications markets; reliance on third party relationships; the potential loss of vendor specific objective evidence ( VSOE ) for our consulting services; the inherent risks associated with international operations and the continued weakness in international economies; foreign currency

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exchange rates; the financial impact of the Company's past acquisitions, including the recent OpenSpan acquisition, and any future acquisitions; 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, 2015. We do not intend to update or revise any forward-looking statements publicly, whether as a result of new information, future events, or otherwise.

## **Business overview**

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

Our clients include Global 3000 companies and government agencies that seek to manage complex enterprise systems and customer service issues with greater agility and cost-effectiveness. Our strategy is to sell a client a series of licenses, each focused on a specific purpose or area of operations in support of longer term enterprise-wide digital transformation initiatives.

Our license revenue is primarily derived from sales of our applications and our Pega® 7 Platform. Our consulting services revenue is primarily related to new license implementations. We offer training for our staff, clients, and partners at our regional training facilities and at third-party facilities, including client sites. Our online training through Pega® Academy provides an alternative way to learn our software in a virtual environment. We believe that this online training will continue to expand the number of trained experts at a faster pace.

In the third quarter of 2016 and 2015, sales to clients based outside of the United States of America ( U.S. ) represented approximately 39% and 45% of our total revenue, respectively. For each of the nine month periods of 2016 and 2015, sales to clients based outside of the U.S. represented approximately 44% of our total revenue.

At the end of June 2016, the United Kingdom (the U.K. ) held a referendum in which U.K. voters approved an exit from the European Union (the E.U. ), commonly referred to as Brexit . While Brexit has not had a meaningful impact on our business momentum, it has resulted in a sharp decline in the value of the British pound, slightly reducing revenue during the three and nine months ended September 30, 2016, but with no material impact on our results of operations. Prolonged weakening of the British pound relative to the U.S. dollar may adversely affect our revenue and results of operations in future periods.

We continue to expand our sales and marketing capacity to achieve broader market coverage, with sales and marketing costs representing 37% and 35% of revenue during the nine months of 2016 and 2015, respectively. We are investing heavily in research and development to expand and improve our software offerings, with research and development costs representing 20% of revenue during each of the nine months of 2016 and 2015.

Also, in evaluating the financial condition and operating performance of our business, management focuses on the following key financial metrics:

**Increase (Decrease)**

**Increase (Decrease)**

| (Dollars in thousands, except per share amounts) | Three Months Ended<br>September 30, |            |           |       | Nine Months Ended<br>September 30, |            |           |       |
|--------------------------------------------------|-------------------------------------|------------|-----------|-------|------------------------------------|------------|-----------|-------|
|                                                  | 2016                                | 2015       |           |       | 2016                               | 2015       |           |       |
| Total revenue                                    | \$ 182,802                          | \$ 162,403 | \$ 20,399 | 13%   | \$ 550,656                         | \$ 478,340 | \$ 72,316 | 15%   |
| License revenue                                  | \$ 68,833                           | \$ 58,948  | \$ 9,885  | 17%   | \$ 207,849                         | \$ 180,420 | \$ 27,429 | 15%   |
| Recurring revenue <sup>(1)</sup>                 | \$ 94,830                           | \$ 79,022  | \$ 15,808 | 20%   | 295,929                            | 248,939    | \$ 46,990 | 19%   |
| Diluted earnings per share                       | \$ 0.03                             | \$ 0.08    | \$ (0.05) | (63)% | \$ 0.19                            | \$ 0.19    | \$        | %     |
| Cash flow provided by operating activities       |                                     |            |           |       | 17,396                             | 54,928     | (37,532)  | (68)% |

- (1) Recurring revenue includes maintenance, cloud, and term license revenue and is derived from the amounts reported within the Results of Operations Revenue tables.

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In addition to the key financial metrics listed above, management also focuses on new license signings and backlog:

During the nine months of 2016 and 2015, approximately 81% and 62%, respectively, of the value of new license arrangements were executed with existing clients.

We compute license and cloud backlog by adding deferred license and cloud revenue as recorded on the balance sheet and license and cloud commitments, which are not yet billed and not recorded on our balance sheet. License and cloud backlog may vary in any given period depending on the amount and timing of when arrangements are executed, as well as the mix between perpetual, term, and cloud license arrangements, which is dependent on our clients' needs.

| (Dollars in thousands)                                       | As of September 30, |            | % Change |
|--------------------------------------------------------------|---------------------|------------|----------|
|                                                              | 2016                | 2015       |          |
| Total deferred license and cloud revenue                     | \$ 47,280           | \$ 55,370  | (15)%    |
| Total license and cloud commitments not on the balance sheet | 372,532             | 324,340    | 15%      |
| Total license and cloud backlog                              | \$ 419,812          | \$ 379,710 | 11%      |

We also regularly evaluate acquisitions or investment opportunities in complementary businesses, services and technologies, and intellectual property rights in an effort to expand and enhance our product offerings. On April 11, 2016, we acquired OpenSpan, Inc. ( "OpenSpan" ), a privately held software provider of robotic process automation and workforce analytics software for \$48.8 million in cash, net of \$1.8 million in cash acquired. Subsequent to the acquisition we unified the Pega Robotic Automation with our Pega® 7 Platform for Case and Business Process Management and our portfolio of CRM applications. We believe this will enable clients to intelligently optimize how work gets done across the enterprise and more effectively automate tasks, streamline processes, increase employee productivity, and ultimately deliver better customer experiences.

**Critical accounting policies**

Management's Discussion and Analysis of Financial Condition and Results of Operations is based upon our unaudited condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the U.S. 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 the 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, 2015. For more information regarding our critical accounting policies, we encourage you to read the discussion contained in Item 7 under the heading "Critical Accounting Estimates and Significant Judgments" 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, 2015.

**Results of Operations**

| (Dollars in thousands)                   | Three Months Ended<br>September 30, |            |                     |       | Nine Months Ended<br>September 30, |            |                     |      |
|------------------------------------------|-------------------------------------|------------|---------------------|-------|------------------------------------|------------|---------------------|------|
|                                          | 2016                                | 2015       | Increase (Decrease) |       | 2016                               | 2015       | Increase (Decrease) |      |
| Total revenue                            | \$ 182,802                          | \$ 162,403 | \$ 20,399           | 13%   | \$ 550,656                         | \$ 478,340 | \$ 72,316           | 15%  |
| Gross profit                             | \$ 122,365                          | \$ 106,962 | \$ 15,403           | 14%   | \$ 373,609                         | \$ 318,059 | \$ 55,550           | 17%  |
| Total operating expenses                 | \$ 116,867                          | \$ 96,251  | \$ 20,616           | 21%   | \$ 347,626                         | \$ 290,189 | \$ 57,437           | 20%  |
| Income from operations                   | \$ 5,498                            | \$ 10,711  | \$ (5,213)          | (49)% | \$ 25,983                          | \$ 27,870  | \$ (1,887)          | (7)% |
| Income before provision for income taxes | \$ 5,515                            | \$ 10,246  | \$ (4,731)          | (46)% | \$ 24,506                          | \$ 24,007  | \$ 499              | 2%   |

**Table of Contents*****Revenue******Software license revenue***

| (Dollars in thousands) | Three Months Ended<br>September 30, |      |           |      | Increase<br>(Decrease) |      | Nine Months Ended<br>September 30, |      |            |      | Increase  |     |
|------------------------|-------------------------------------|------|-----------|------|------------------------|------|------------------------------------|------|------------|------|-----------|-----|
|                        | 2016                                |      | 2015      |      |                        |      | 2016                               |      | 2015       |      |           |     |
| Perpetual licenses     | \$ 39,914                           | 58%  | \$ 40,455 | 69%  | \$ (541)               | (1)% | \$ 105,734                         | 51%  | \$ 103,547 | 57%  | \$ 2,187  | 2%  |
| Term licenses          | 28,919                              | 42%  | 18,493    | 31%  | 10,426                 | 56%  | 102,115                            | 49%  | 76,873     | 43%  | 25,242    | 33% |
| Total license revenue  | \$ 68,833                           | 100% | \$ 58,948 | 100% | \$ 9,885               | 17%  | \$ 207,849                         | 100% | \$ 180,420 | 100% | \$ 27,429 | 15% |

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

The increase in perpetual license revenue during the nine months of 2016 compared to the same period in 2015 was primarily due to the higher percentage of perpetual arrangements executed and recognized in revenue during the nine months of 2016 compared to the same period in 2015. The aggregate value of future payments due under noncancellable perpetual licenses was \$19.7 million as of September 30, 2016 compared to \$36.5 million as of September 30, 2015. We expect to recognize \$3.9 million of the \$19.7 million as revenue during the fourth quarter of 2016.

The increase in term license revenue during the third quarter of 2016 compared to the same period in 2015 was primarily due to a large term license renewal for which the second year of the term was recognized as revenue in the third quarter of 2016. The increase in term license revenue during the nine months of 2016 compared to the same period in 2015 was primarily due to a term license arrangement greater than \$10 million for which the license fee for the three year license term was paid and recognized in full in the first quarter of 2016. The aggregate value of future payments due under noncancellable term licenses and our cloud arrangements grew to \$352.8 million as of September 30, 2016 compared to \$287.9 million as of September 30, 2015. We expect to recognize \$26.7 million of the \$352.8 million as revenue during the fourth quarter of 2016 in addition to new term license and Pega Cloud arrangements we may complete or prepayments we may receive from existing term license agreements. See the table of future cash receipts in Liquidity and Capital Resources Cash Provided by Operating Activities.

***Maintenance revenue***

| (Dollars in thousands) | Three Months Ended |           |          |    | Nine Months Ended |            |           |    |
|------------------------|--------------------|-----------|----------|----|-------------------|------------|-----------|----|
|                        | September 30,      |           | Increase |    | September 30,     |            | Increase  |    |
|                        | 2016               | 2015      |          |    | 2016              | 2015       |           |    |
| Maintenance            | \$ 55,038          | \$ 52,285 | \$ 2,753 | 5% | \$ 163,174        | \$ 150,366 | \$ 12,808 | 9% |

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

#### *Services revenue*

| (Dollars in thousands) | Three Months Ended |      |           |      | Increase (Decrease) |       |            |      | Nine Months Ended |      |           |     | Increase |  |
|------------------------|--------------------|------|-----------|------|---------------------|-------|------------|------|-------------------|------|-----------|-----|----------|--|
|                        | September 30,      |      |           |      |                     |       |            |      | September 30,     |      |           |     |          |  |
|                        | 2016               |      | 2015      |      |                     |       | 2016       |      | 2015              |      |           |     |          |  |
| Consulting services    | \$ 46,829          | 80%  | \$ 41,472 | 81%  | \$ 5,357            | 13%   | \$ 144,263 | 80%  | \$ 121,810        | 83%  | \$ 22,453 | 18% |          |  |
| Cloud                  | 10,873             | 18%  | 8,244     | 16%  | 2,629               | 32%   | 30,640     | 17%  | 21,700            | 15%  | 8,940     | 41% |          |  |
| Training               | 1,229              | 2%   | 1,454     | 3%   | (225)               | (15)% | 4,730      | 3%   | 4,044             | 2%   | 686       | 17% |          |  |
| Total services         | \$ 58,931          | 100% | \$ 51,170 | 100% | \$ 7,761            | 15%   | \$ 179,633 | 100% | \$ 147,554        | 100% | \$ 32,079 | 22% |          |  |

Consulting services revenue represents revenue primarily from new license implementations. Our consulting services revenue may fluctuate in future periods depending on the mix of new implementation projects we perform as compared to those performed by our enabled clients or led by our partners. The increase in consulting services revenue during the third quarter of 2016 compared to the same period of 2015 was primarily due to higher realization rates and revenue from two large projects. The increase in consulting services revenue during the nine months of 2016 compared to the same period in 2015 was due to the higher realization rates and revenue from the large projects discussed above, as well as unusually low demand in the first quarter of 2015 and revenue recognized on another two large projects in the first quarter of 2016, which had been delayed from 2015.

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Cloud revenue represents revenue from our Pega Cloud offerings. The increases in cloud revenue were primarily due to growth of our cloud client base.

**Gross profit**

| (Dollars in thousands)          | Three Months Ended<br>September 30, |            |           |      | Nine Months Ended<br>September 30, |            |           |      |
|---------------------------------|-------------------------------------|------------|-----------|------|------------------------------------|------------|-----------|------|
|                                 | 2016                                | 2015       | Increase  |      | 2016                               | 2015       | Increase  |      |
| Software license                | \$ 67,520                           | \$ 57,948  | \$ 9,572  | 17%  | \$ 204,203                         | \$ 177,314 | \$ 26,889 | 15%  |
| Maintenance                     | 48,379                              | 46,641     | 1,738     | 4%   | 144,285                            | 134,066    | 10,219    | 8%   |
| Services                        | 6,466                               | 2,373      | 4,093     | 172% | 25,121                             | 6,679      | 18,442    | 276% |
| Total gross profit              | \$ 122,365                          | \$ 106,962 | \$ 15,403 | 14%  | \$ 373,609                         | \$ 318,059 | \$ 55,550 | 17%  |
| Total gross profit %            | 67%                                 | 66%        |           |      | 68%                                | 66%        |           |      |
| Software license gross profit % | 98%                                 | 98%        |           |      | 98%                                | 98%        |           |      |
| Maintenance gross profit %      | 88%                                 | 89%        |           |      | 88%                                | 89%        |           |      |
| Services gross profit %         | 11%                                 | 5%         |           |      | 14%                                | 5%         |           |      |

The increases in services gross profit percent were primarily due to the recognition of revenue in the first quarter of 2016 related to two large projects which had been delayed from prior periods, for which the majority of the associated costs had already been recognized in the third quarter and nine months of 2015.

**Operating expenses****Amortization of intangibles**

| (Dollars in thousands)     | Three Months Ended<br>September 30, |          |                     |      | Nine Months Ended<br>September 30, |          |                     |       |
|----------------------------|-------------------------------------|----------|---------------------|------|------------------------------------|----------|---------------------|-------|
|                            | 2016                                | 2015     | Increase (Decrease) |      | 2016                               | 2015     | Increase (Decrease) |       |
| Cost of revenue            | \$ 1,642                            | \$ 1,351 | \$ 291              | 22%  | \$ 4,626                           | \$ 4,041 | \$ 585              | 14%   |
| Selling and marketing      | 1,867                               | 1,537    | 330                 | 21%  | 5,274                              | 4,602    | 672                 | 15%   |
| General and administrative | 90                                  | 91       | (1)                 | (1)% | 268                                | 593      | (325)               | (55)% |
|                            | \$ 3,599                            | \$ 2,979 | \$ 620              | 21%  | \$ 10,168                          | \$ 9,236 | \$ 932              | 10%   |

The increases were primarily due to the amortization associated with \$24.3 million of intangible assets acquired from OpenSpan in April 2016.

***Selling and marketing***

| (Dollars in thousands)                           | Three Months Ended    |                       | Increase  |     | Nine Months Ended     |                       | Increase  |     |
|--------------------------------------------------|-----------------------|-----------------------|-----------|-----|-----------------------|-----------------------|-----------|-----|
|                                                  | September 30,<br>2016 | September 30,<br>2015 |           |     | September 30,<br>2016 | September 30,<br>2015 |           |     |
| Selling and marketing                            | \$ 67,032             | \$ 53,640             | \$ 13,392 | 25% | \$ 202,126            | \$ 169,764            | \$ 32,362 | 19% |
| As a percent of total revenue                    | 37%                   | 33%                   |           |     | 37%                   | 35%                   |           |     |
| Selling and marketing headcount at September 30, |                       |                       |           |     | 875                   | 707                   | 168       | 24% |

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 the third quarter of 2016 compared to the same period in 2015 was primarily due to a \$7.9 million increase in compensation, benefits, and employee travel expenses associated with higher headcount and a \$3.8 million increase in sales commissions associated with the higher value of new license arrangements executed during the third quarter of 2016 compared to the same period in 2015.

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The increase in the nine months of 2016 compared to the same period in 2015 was primarily due to a \$23.8 million increase in compensation, benefits, and employee travel expenses associated with higher headcount and a \$2.5 million increase in sales and marketing program expenses primarily related to our digital advertising and brand awareness campaigns.

The increase in headcount reflects our efforts to increase our sales capacity to target new accounts in existing industries, as well as to expand coverage in new industries and geographies and to increase the number of our sales opportunities.

***Research and development***

| (Dollars in thousands)                              | Three Months Ended |                    | Increase |     | Nine Months Ended  |                    | Increase  |     |
|-----------------------------------------------------|--------------------|--------------------|----------|-----|--------------------|--------------------|-----------|-----|
|                                                     | September 30, 2016 | September 30, 2015 |          |     | September 30, 2016 | September 30, 2015 |           |     |
| Research and development                            | \$ 38,036          | \$ 33,032          | \$ 5,004 | 15% | \$ 108,530         | \$ 94,248          | \$ 14,282 | 15% |
| As a percent of total revenue                       | 21%                | 20%                |          |     | 20%                | 20%                |           |     |
| Research and development headcount at September 30, |                    |                    |          |     | 1,437              | 1,189              | 248       | 21% |

Research and development expenses include compensation, benefits, contracted services, and other headcount-related expenses associated with the creation and development of our products, as well as enhancements and design changes to existing products and integration of acquired technologies.

The increases in the third quarter and nine months of 2016 compared to the same periods in 2015 were primarily due to a \$4.1 million and \$12.3 million increase, respectively, in compensation and benefit expenses associated with higher headcount.

The increase in headcount primarily reflects the growth in our India research facility which usually lowers our average compensation expense per employee.

***General and administrative***

| (Dollars in thousands)                                | Three Months Ended |                    | Increase |     | Nine Months Ended  |                    | Increase |     |
|-------------------------------------------------------|--------------------|--------------------|----------|-----|--------------------|--------------------|----------|-----|
|                                                       | September 30, 2016 | September 30, 2015 |          |     | September 30, 2016 | September 30, 2015 |          |     |
| General and administrative                            | \$ 11,725          | \$ 9,579           | \$ 2,146 | 22% | \$ 34,067          | \$ 26,138          | \$ 7,929 | 30% |
| As a percent of total revenue                         | 6%                 | 6%                 |          |     | 6%                 | 5%                 |          |     |
| General and administrative headcount at September 30, |                    |                    |          |     | 371                | 327                | 44       | 13% |

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

employees in human resources, information technology, and corporate services departments whose costs are allocated to our other functional departments.

The increase in the third quarter of 2016 compared to the same period in 2015 was primarily due to a \$1.7 million increase in compensation and benefits expenses associated with higher headcount.

The increase in the nine months of 2016 compared to the same period in 2015 was primarily due to the fact that the first quarter of 2016 did not include a \$1.8 million benefit from the settlement of our indemnification claims against the former Antenna, Inc. shareholders and a \$1.6 million benefit from the settlement of certain indirect tax liabilities, which reduced our general and administrative expenses in the first quarter of 2015. The increase was also due to a \$2.6 million increase in compensation and benefits expenses associated with higher headcount and a \$1.2 million increase in legal expenses in the nine months of 2016 compared to the same period in 2015.

**Table of Contents*****Stock-based compensation***

The following table summarizes stock-based compensation expense included in our unaudited condensed consolidated statements of operations:

| (Dollars in thousands)                    | Three Months Ended |                    | Increase |     | Nine Months Ended  |                    | Increase |     |
|-------------------------------------------|--------------------|--------------------|----------|-----|--------------------|--------------------|----------|-----|
|                                           | September 30, 2016 | September 30, 2015 |          |     | September 30, 2016 | September 30, 2015 |          |     |
| Cost of revenues                          | \$ 3,117           | \$ 2,285           | \$ 832   | 36% | \$ 8,711           | \$ 6,519           | \$ 2,192 | 34% |
| Operating expenses                        | 7,701              | 5,806              | 1,895    | 33% | 21,923             | 16,486             | 5,437    | 33% |
| Total stock-based compensation before tax | \$ 10,818          | \$ 8,091           | \$ 2,727 | 34% | \$ 30,634          | \$ 23,005          | \$ 7,629 | 33% |
| Income tax benefit                        | \$ (3,227)         | \$ (2,326)         |          |     | \$ (8,917)         | \$ (6,437)         |          |     |

The increases were primarily due to the increased value of our annual periodic equity awards granted in March 2015 and 2016. These awards generally have a five-year vesting schedule.

***Non-operating income and expenses, net***

| (Dollars in thousands)                   | Three Months Ended |                    | Increase (Decrease) |        | Nine Months Ended  |                    | Increase (Decrease) |       |
|------------------------------------------|--------------------|--------------------|---------------------|--------|--------------------|--------------------|---------------------|-------|
|                                          | September 30, 2016 | September 30, 2015 |                     |        | September 30, 2016 | September 30, 2015 |                     |       |
| Foreign currency transaction gain (loss) | \$ 1,082           | \$ (412)           | \$ 1,494            | n/m    | \$ 2,764           | \$ (4,342)         | \$ 7,106            | n/m   |
| Interest income, net                     | 172                | 278                | (106)               | (38)%  | 650                | 807                | (157)               | (19)% |
| Other expense, net                       | (1,237)            | (331)              | (906)               | 274%   | (4,891)            | (328)              | (4,563)             | n/m   |
| Non-operating loss                       | \$ 17              | \$ (465)           | \$ 482              | (104)% | \$ (1,477)         | \$ (3,863)         | \$ 2,386            | (62)% |

n/m - not meaningful

We use foreign currency forward contracts ( forward contracts ) to hedge our exposure to fluctuations in foreign currency exchange rates associated with our foreign currency denominated cash, accounts receivable, and intercompany receivables and payables held by our U.S. parent company in currencies other than the U.S. dollar and by our U.K. subsidiary in currencies other than the British pound.

These forward contracts are not designated as hedging instruments. As a result, we record the fair value of the outstanding contracts at the end of the reporting period in our consolidated balance sheet, with any fluctuations in the value of these contracts recognized in other expense, net.

See Note 4 – Derivative Instruments in the notes to the accompanying unaudited condensed consolidated financial statements for discussion of our use of forward contracts.

***Provision for income taxes***

We account for income taxes at each interim period using our estimated annual effective tax rate and adjust for discrete tax items recorded in the same period. The provision for income taxes represents current and future amounts owed for federal, state, and foreign taxes. During the third quarter of 2016 and 2015, we recorded tax provisions of \$3.1 million and \$3.9 million, respectively, which resulted in an effective tax rate of 56.2% and 38.3%, respectively. During the nine months of 2016 and 2015, we recorded tax provisions of \$9.4 million and \$8.6 million, respectively, which resulted in an effective tax rate of 38.5% and 36.0%, respectively. The slight increase in our effective tax rate for the nine months of 2016 compared to the same period in 2015 was due to the lower amount of favorable discrete items recognized in the third quarter of 2016. The quarterly effective tax rate may fluctuate depending on quarterly pre-tax income levels, the impact of discrete items, and changes in our estimated annual effective tax rate.

**Table of Contents****Liquidity and capital resources**

| (in thousands)                                          | Nine Months Ended<br>September 30, |                            |
|---------------------------------------------------------|------------------------------------|----------------------------|
|                                                         | 2016                               | 2015                       |
| Cash provided by (used in):                             |                                    |                            |
| Operating activities                                    | \$ 17,396                          | \$ 54,928                  |
| Investing activities                                    | (2,859)                            | (42,736)                   |
| Financing activities                                    | (39,871)                           | (25,662)                   |
| Effect of exchange rate on cash                         | (1,309)                            | (3,837)                    |
| Net (decrease) in cash and cash equivalents             | \$ (26,643)                        | \$ (17,307)                |
|                                                         | As of<br>September 30, 2016        | As of<br>December 31, 2015 |
| Total cash, cash equivalents, and marketable securities | \$ 129,730                         | \$ 219,078                 |

The decrease in cash and cash equivalents during the nine months of 2016 was primarily due to cash used in financing activities for share repurchases under our current common stock repurchase program. We believe that our current cash, cash equivalents, marketable securities, and cash flow from operations will be sufficient to fund our operations, our dividend payments, and our share repurchase program for at least the next 12 months.

We evaluate acquisition opportunities from time to time, which if pursued, could require use of our funds. On April 11, 2016, we acquired OpenSpan for \$48.8 million in cash, net of cash acquired. \$7.4 million of the cash consideration remains in escrow for up to an 18-month period after the acquisition as security for the indemnification obligations of the selling shareholders. During the nine months of 2016, we incurred direct and incremental expenses associated with the transaction of \$2.6 million that are primarily professional fees to affect the acquisition. In addition, during the nine months of 2016 and 2015, we paid \$0.3 million and \$0.5 million, respectively, representing additional cash consideration to the selling shareholders of one of the three companies acquired in 2014 based on the achievement of certain performance milestones. We may be required to pay an additional \$0.4 million in cash to the same selling shareholders based on the achievement of additional performance milestones through the end of 2016.

As of September 30, 2016, approximately \$46.5 million of our cash and cash equivalents was held in our foreign subsidiaries. If it becomes necessary to repatriate these funds, we may be required to pay U.S. tax, net of any applicable foreign tax credits, upon repatriation. We consider the earnings of our foreign subsidiaries to be permanently reinvested and, as a result, U.S. taxes on such earnings are not provided. It is impractical to estimate the amount of U.S. tax we could have to pay upon repatriation due to the complexity of the foreign tax credit calculations. There can be no assurance that changes in our plans or other events affecting our operations will not result in materially accelerated or unexpected expenditures.

**Cash provided by operating activities**

The primary driver during the nine months of 2016 was net income of \$15.1 million.

The primary drivers during the nine months of 2015 were net income of \$15.4 million and a \$21.4 million decrease in trade accounts receivable as a result of an increase in collections.

**Table of Contents****Future Cash Receipts from License and Cloud Arrangements**

The timing of cash receipts may not coincide with the timing of future revenue recognition.

| (in thousands) as of September 30, 2016 | Contractual<br>payments for<br>term<br>licenses and<br>cloud<br>arrangements<br>not recorded<br>on the balance sheet <sup>(1)</sup> | Other contractual<br>license payments not<br>recorded on the<br>balance<br>sheet <sup>(2)</sup> | Total      |
|-----------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------|------------|
| Remainder of 2016                       | \$ 26,737                                                                                                                           | \$ 3,871                                                                                        | \$ 30,608  |
| 2017                                    | 110,341                                                                                                                             | 9,040                                                                                           | 119,381    |
| 2018                                    | 96,155                                                                                                                              | 4,598                                                                                           | 100,753    |
| 2019                                    | 66,165                                                                                                                              | 1,440                                                                                           | 67,605     |
| 2020 and thereafter                     | 53,406                                                                                                                              | 779                                                                                             | 54,185     |
| Total                                   | \$ 352,804                                                                                                                          | \$ 19,728                                                                                       | \$ 372,532 |

(1) These amounts are for our on-premises term licenses and hosted Pega Cloud service offerings. The timing of future revenue recognition may not coincide with the timing of the cash receipts.

(2) These amounts are for perpetual licenses with extended payment terms and/or additional rights of use.

Total contractual future cash receipts due from our existing license and cloud arrangements were approximately \$324.3 million as of September 30, 2015.

**Cash used in investing activities**

During the nine months of 2016, we acquired OpenSpan for \$48.8 million, net of cash acquired, and invested \$15.3 million primarily in internally developed software and leasehold improvements at our corporate headquarters, partially offset by proceeds received from the sales of marketable debt securities of \$62.3 million.

During the nine months of 2015, we purchased marketable debt securities of \$66.9 million and invested \$10 million primarily in leasehold improvements to our office in Hyderabad, India, partially offset by proceeds received from the maturities of marketable debt securities of \$33.9 million.

**Cash used in financing activities**

We used cash primarily for repurchases of our common stock, share repurchases for tax withholdings for the net settlement of our equity awards, and the payment of our quarterly dividend.

Since 2004, our Board of Directors has approved annual stock repurchase programs that have authorized the repurchase in the aggregate of up to \$195 million of our common stock. Purchases under these programs have been made on the open market.

The following table is a summary of our repurchase activity under all of our repurchase programs during the nine months of 2016 and 2015:

| (Dollars in thousands)                      | Nine Months Ended<br>September 30, |           |         |           |
|---------------------------------------------|------------------------------------|-----------|---------|-----------|
|                                             | 2016                               |           | 2015    |           |
|                                             | Shares                             | Amount    | Shares  | Amount    |
| Prior year authorization as of January 1,   |                                    | \$ 40,534 |         | \$ 13,284 |
| Authorizations                              |                                    | 25,879    |         | 50,000    |
| Repurchases paid                            | 1,028,101                          | (25,530)  | 727,591 | (16,705)  |
| Repurchases unsettled                       | 6,000                              | (177)     | 20,946  | (510)     |
| Authorization remaining as of September 30, |                                    | \$ 40,706 |         | \$ 46,069 |

In addition to the share repurchases made under our repurchase programs, we net settled the majority of our employee stock option exercises and RSU vestings, which resulted in the withholding of shares to cover the option exercise price and the minimum statutory tax withholding obligations.

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During the nine months of 2016 and 2015, option and RSU holders net settled a total of 1,569,000 shares and 1,422,000 shares, respectively, of which only 775,000 shares and 745,000 shares, respectively, were issued to the option and RSU holders. The balance of the shares were surrendered to us to pay for the exercise price with respect to options and the applicable taxes for both options and RSUs. During the nine months of 2016 and 2015, instead of receiving cash from the equity holders, we withheld shares with a value of \$10.8 million and \$7.1 million, respectively, for withholding taxes, and \$10.1 million and \$8.5 million, respectively, for the exercise price of options.

**Dividends**

We declared a cash dividend of \$0.09 per share and paid cash dividends of \$6.9 million in each of the nine months of 2016 and 2015. It is our current intention to pay a quarterly cash dividend of \$0.03 per share, however, the Board of Directors may terminate or modify this dividend program at any time without notice.

**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

Market risk represents the risk of loss that may affect us due to adverse changes in financial market prices and rates. Our market risk exposure is primarily related to fluctuations in foreign exchange rates.

We use foreign currency forward contracts to hedge our exposures to fluctuations in non-functional currency exchange rates. See Note 4 Derivative Instruments in the notes to the accompanying unaudited condensed consolidated financial statements for further discussion.

There were no significant changes to our quantitative and qualitative disclosures about market risk during the nine months of 2016. Please refer to Part II, Item 7A. Quantitative and Qualitative Disclosures about Market Risk included in our Annual Report on Form 10-K for the year ended December 31, 2015 for a more complete discussion of our market risk exposure.

**Item 4. Controls and Procedures**

***(a) Evaluation of Disclosure Controls and Procedures***

Our management, with the participation of our Chief Executive Officer, or CEO, and Chief Financial Officer, or CFO, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act) as of September 30, 2016. In designing and evaluating our disclosure controls and procedures, our management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives, and our management necessarily applied its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on this evaluation, our CEO and CFO concluded that our disclosure controls and procedures were effective as of September 30, 2016.

***(b) Changes in Internal Control over Financial Reporting***

There have been no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act) during the quarter ended September 30, 2016 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.



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**Part II Other Information:**

**Item 1A. Risk Factors**

We encourage you to carefully consider the risk factors identified in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2015. These risk factors could materially affect our business, financial condition, and future results and could cause our actual business and financial results to differ materially from those contained in forward-looking statements made in this Quarterly Report on Form 10-Q or elsewhere by management from time to time. Except for the information presented below, which updates, and should be read in conjunction with, the risk factors and information disclosed in our Form 10-K, there have been no material changes during the nine months of 2016 to the risk factors disclosed in our Annual Report on Form 10-K for the year ended December 31, 2015.

**Factors relating to our products and markets**

*We face risks from operations and clients based outside of the U.S.* Sales to clients based outside of the U.S. represented approximately 45% of our total revenue in the last three fiscal years and approximately 44% of our total revenue in the nine months of 2016. We market products and render consulting and training services to clients based outside of the U.S. including clients based in Canada, Europe, Latin America, Asia, and Australia. We have established offices in North America, Europe (including Russia and Turkey), Asia (including India), and Australia. We believe that growth will necessitate expanded international operations, requiring a diversion of managerial attention and increased costs. We anticipate hiring additional personnel to accommodate international growth, and we may also enter into agreements with local distributors, representatives, or resellers. If we are unable to do one or more of these things in a timely manner, our growth, if any, in our foreign operations may be restricted, and our business, operating results, and financial condition could be materially and adversely affected.

In addition, we may not be able to maintain or increase international market demand for our products. Additional risks inherent in our international business activities generally include:

laws and business practices favoring local competitors;

compliance with multiple, conflicting and changing governmental laws and regulations, including employment, tax, privacy and data privacy and protection laws and regulations, increased tariffs and other trade barriers;

the costs of localizing products for local markets, including translation into foreign languages and associated expenses;

longer payment cycles and credit and collectability risk on our foreign trade receivables;

difficulties in enforcing contractual and intellectual property rights;

heightened fraud and anti-bribery awareness risks;

treatment of revenue from international sources and changes to tax codes, including being subject to foreign tax laws, being liable for paying withholding income or other taxes in foreign jurisdictions, and other potentially adverse tax consequences (including restrictions on repatriating earnings and the threat of double taxation );

managing our international operations, including increased accounting and internal control expenses;

heightened risks of political and economic instability; and

foreign currency exchange rate fluctuations and controls.

One or more of these factors may have a material adverse effect on our foreign operations, and, consequently, on our business, operating results, and financial condition.

On June 23, 2016, the U.K. held a referendum in which U.K. voters approved an exit from the E.U., commonly referred to as "Brexit". As a result of the referendum, it is expected that the British government will begin negotiating the future terms of the U.K.'s relationship with the E.U., including the terms of trade between the U.K. and the E.U. The announcement of Brexit caused significant volatility in global stock markets and currency exchange rate fluctuations that resulted in the strengthening of the U.S. dollar against foreign currencies in which we conduct business. The future effects of Brexit will depend on any agreements the U.K. makes to retain access to E.U. markets either during a transitional period or more permanently. The measures could potentially disrupt the markets we serve and may cause our customers to closely monitor their costs and reduce their spending budget on our products and services. In addition, Brexit could lead to legal uncertainty and potentially divergent national laws and regulations as the U.K. determines which E.U. laws to replace or replicate. Given the lack of comparable precedent, it is unclear what financial, trade and legal implications the withdrawal of the U.K. from the E.U. would have and how such withdrawal would affect us. Adverse consequences such as deterioration in economic conditions, volatility in currency exchange rates, and prohibitive laws and regulations could have a negative impact on our business, operating results, and financial condition.

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***We are exposed to fluctuations in currency exchange rates that could negatively impact our financial results and cash flows.*** Because a significant portion of our business is conducted outside the U.S., we face exposure to adverse movements in foreign currency exchange rates. Our international sales are usually denominated in foreign currencies. The operating expenses of our foreign operations are also primarily denominated in foreign currencies, which partially offset our foreign currency exposure on our international sales. Our results of operations and cash flows are subject to fluctuations due to changes in foreign currency exchange rates, particularly changes in the U.S. dollar, the Euro, and the Australian dollar relative to the British pound and the Euro and Indian rupee relative to the U.S. dollar. These exposures may change over time as business practices evolve, and they could have a material adverse impact on our financial results and cash flows. We use foreign currency forward contracts ( forward contracts ) to hedge our exposure to changes in foreign currency exchange rates associated with our foreign currency denominated cash, accounts receivable, and intercompany receivables and payables held by our U.S. parent company and Pegasystems Limited, its U.K. subsidiary. These forward contracts have terms not greater than six months and are intended to partially mitigate exposure to the foreign currency transaction gains and losses. We do not enter into any hedging contracts for trading or speculative purposes. Our realized gain or loss with respect to foreign currency fluctuations will generally depend on the size and type of cross-currency exposures that we enter into; the currency exchange rates associated with these exposures and changes in those rates; whether we have entered into forward contracts to offset these exposures; and other factors. All of these factors could materially impact our operating results, financial condition, and cash flows.

The announcement of Brexit adversely impacted global markets, including currencies, and resulted in a sharp decline in the value of the British pound, as compared to the U.S. dollar and other currencies. Volatility in exchange rates is expected to continue in the short term as the U.K. negotiates its exit from the E.U. A weaker British pound compared to the U.S. dollar during a reporting period causes our international revenue to be translated into fewer U.S. dollars. Continued weakening of the British pound relative to the U.S. dollar may adversely affect our results of operations.

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

The following table sets forth information regarding our repurchases of our common stock during the third quarter of 2016:

| Period               | Total Number<br>of Shares<br>Purchased | Average Price<br>Paid per<br>Share | Total Number of Shares Purchased as Part of Publicly Announced Share Repurchase Programs <sup>(1)</sup> |                                                | Approximate Dollar Value of Shares That May Yet Be Purchased Under Publicly Announced Share Repurchase Programs <sup>(1)</sup> |                |
|----------------------|----------------------------------------|------------------------------------|---------------------------------------------------------------------------------------------------------|------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------|----------------|
|                      |                                        |                                    | of Publicly<br>Announced<br>Share<br>Repurchase<br>Programs <sup>(1)</sup>                              | Share<br>Repurchase<br>Programs <sup>(1)</sup> | Under Publicly<br>Announced<br>Share<br>Repurchase<br>Programs <sup>(1)</sup>                                                  | (in thousands) |
| 7/1/2016 - 7/31/2016 | 64,328                                 | \$ 27.61                           | 64,328                                                                                                  | \$                                             | 45,335                                                                                                                         |                |
| 8/1/2016 - 8/31/2016 | 109,870                                | \$ 25.87                           | 109,870                                                                                                 | \$                                             | 42,493                                                                                                                         |                |
| 9/1/2016 - 9/30/2016 | 65,100                                 | \$ 27.45                           | 65,100                                                                                                  | \$                                             | 40,706                                                                                                                         |                |
| Total                | 239,298                                | \$ 26.77                           |                                                                                                         |                                                |                                                                                                                                |                |

- (1) Since 2004, our Board of Directors has approved stock repurchase programs that have authorized the repurchase, in the aggregate, of up to \$195 million of our common stock. On May 20, 2016, we announced that our Board of Directors extended the expiration date of the current stock repurchase program to June 30, 2017 and increased the amount of stock the Company is authorized to repurchase to \$50 million between May 18, 2016 and June 30, 2017 (the Current Program ). Under the Current Program, purchases may be made from time to time on the open market or in privately negotiated transactions. Shares may be repurchased in such amounts as market conditions warrant, subject to regulatory and other considerations. We have established a pre-arranged stock repurchase plan, intended to comply with the requirements of Rule 10b5-1 under the Securities Exchange Act of 1934, as amended (the Exchange Act ), and Rule 10b-18 under the Exchange Act (the 10b5-1 Plan ). All share repurchases under the Current Program during closed trading window periods will be made pursuant to the 10b5-1 Plan.

**Item 6. Exhibits**

The exhibits listed in the Exhibit Index immediately preceding such exhibits are filed or furnished, as the case may be, as part of this report and such Exhibit Index is incorporated herein by reference.

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**SIGNATURE**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**Pegasystems Inc.**

Date: November 2, 2016

By:           /s/   KENNETH STILLWELL  
**Kenneth Stillwell**

**Chief Financial Officer and Chief Administrative  
Officer**

**(Principal Financial Officer)**

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**PEGASYSTEMS INC.**

**Exhibit Index**

| <b>Exhibit<br/>No.</b> | <b>Description</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |
|------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 31.1                   | Certification pursuant to Exchange Act Rules 13a-14 and 15d-14 of the Chief Executive Officer.                                                                                                                                                                                                                                                                                                                                                                                                                                                 |
| 31.2                   | Certification pursuant to Exchange Act Rules 13a-14 and 15d-14 of the Chief Financial Officer.                                                                                                                                                                                                                                                                                                                                                                                                                                                 |
| 32                     | Certification pursuant to 18 U.S.C. Section 1350 of the Chief Executive Officer and the Chief Financial Officer.                                                                                                                                                                                                                                                                                                                                                                                                                               |
| 101                    | The following materials from Pegasystems Inc. s Quarterly Report on Form 10-Q for the quarter ended September 30, 2016 formatted in XBRL (Extensible Business Reporting Language): (i) the Unaudited Condensed Consolidated Balance Sheets, (ii) the Unaudited Condensed Consolidated Statements of Operations, (iii) the Unaudited Condensed Consolidated Statements of Comprehensive Income, (iv) the Unaudited Condensed Consolidated Statements of Cash Flows, and (v) the Notes to Unaudited Condensed Consolidated Financial Statements. |