PEGASYSTEMS INC
Form 10-K
March 10, 2008
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2007

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

Commission File No. 1-11859

PEGASYSTEMS INC.

(Exact name of Registrant as specified in its charter)

Massachusetts

(State or other jurisdiction of incorporation or organization)

(IRS Employer Identification No. 04-2787865)

101 Main Street	
Cambridge, MA	**02142-1590**
(Address of principal executive offices)	**(zip code)**

(617) 374-9600

(Registrant s telephone number, including area code)

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

None

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

Common Stock, $0.01 par value per share

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

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

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

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

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

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨ Smaller reporting company ¨

Indicate by check mark whether the Registrant is a shell company, as defined in Rule 12b-2 of the Securities Exchange Act of 1934. Yes ¨ No x

The aggregate market value of the Registrant s common stock held by non-affiliates of the Registrant based on the closing price (as reported by NASDAQ) of such common stock on the last business day of the Registrant s most recently completed second fiscal quarter (June 30, 2007) was approximately $155 million.

There were 36,077,682 shares of the Registrant s common stock, $0.01 par value per share, outstanding on February 29, 2008.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant s Proxy Statement for the Annual Meeting of Stockholders to be held May 29, 2008 are incorporated by reference into Part III of this report.

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PART I

ITEM 1 BUSINESS

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

Forward-looking statements

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

SEC reports and our Code of Conduct

We make available free of charge through our website our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K, and amendments to these reports, as soon as reasonably practicable after we electronically file such material with, or furnish such material to, the Securities and Exchange Commission. We make available on our website reports filed by our executive officers and Directors on Forms 3, 4, and 5 regarding their ownership of our securities. Our Code of Conduct, and any amendments to our Code of Conduct, are also available on our website.

Overview

We develop, market, license, and support software to automate complex, changing business processes. Our software enables organizations to build, deploy, and change enterprise applications easily and quickly by directly capturing business objectives, automating programming, and automating work. Our software also allows organizations to avoid the time and expense required to create lengthy policy manuals and system specifications by unifying business rules with business processes in the software and automating the creation of system documentation. Our software is standards-based and can leverage existing technology investments to reduce implementation time. Our customers use our software to improve their customer service, reach new markets, and boost operational effectiveness.

Our SmartBPM® Suite is complemented by software solutions that we refer to as frameworks. These frameworks provide purpose or industry-specific functionality that allows our customers to quickly implement our software.

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

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Business strategy

Our goal is to be the leader of the Business Process Management (BPM) software market by leveraging our patented technology that unifies business processes and business rules. To demonstrate the many business problems customers can address using our software, we have created solution frameworks for industry-specific requirements and processes, new product development, and collaboration across the enterprise that customers can use with our software. We focus our sales efforts on accounts within target customer organizations, which are typically large organizations that are among the leaders in their industry. We frequently sell limited size initial licenses to these target accounts rather than selling large application licenses. This allows our customers to quickly realize business value from our software and limits their initial investment. Once a customer has realized this initial value, we work with the customer to identify opportunities for follow-on sales. The sales process for follow-on sales is often shorter as a result of our established relationship with the customer. We invest resources in professional services, customer support, and customer and partner enablement to help our customers achieve success.

Strategic partnerships with consultants and systems integrators are important to our sales efforts because they influence buying decisions, help us to identify engagements, and complement our software with their technology and domain expertise. These partners may deliver strategic business planning, consulting, project management, and implementation services to our customers. Currently, our partners include Accenture Ltd., Capgemini SA, Computer Sciences Corporation, Cognizant Technology Solutions Inc., International Business Machines Corporation, Satyam Computer Services Ltd., Steria Group, and Virtusa Corporation.

Pegasystems products

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

PegaRULES Process Commander®

PegaRULES Process Commander provides capabilities designed to model, execute, monitor, and analyze results. PegaRULES Process Commander includes an application profiler that allows a business process application to be defined based on business goals and objectives, with simplified fill in the blank entry. The product also simplifies process modeling, allowing business users to graphically describe and test an intended business process within the system itself. The software uses the results of the application profiler and the process modeling to create the new business solution, including the user interface and executable business models. PegaRULES Process Commander also provides a browser-based graphical development environment, execution engine, and management dashboard for rapid business application and solution development. This product helps solve a wide range of BPM problems, including acquiring new business, providing customer service, creating a servicing backbone for enterprise-wide processing, and managing risk, fraud and compliance with regulatory requirements. PegaRULES Process Commander also allows our customers to leverage previous technology investments by integrating software applications across a common platform.

Pegasystems SmartBPM Suite and Solution Frameworks

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

Pegasystems also offers purpose- or industry -specific solution frameworks built on the capabilities of our PegaRULES Process Commander software. These frameworks allow organizations to quickly implement new customer-facing practices and processes, bring new offerings to market, and provide customized or specialized processing to meet the needs of different customers, departments, geographies or regulatory requirements. These include:

- Customer Process Manager

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- Product Configuration
- Retail Banking Industry Framework
- Fraud Investigation and Case Management
- Healthcare Member and Provider Services
- Healthcare Payer Industry Framework
- Customer Process Manager for Insurance
- Insurance Industry Framework
- Control and Compliance Framework

We also offer other frameworks that address exceptions management transactions that are not automatically processed by existing systems. By automating not only research and decision making, but also the business processes necessary to execute the decisions, our exceptions management frameworks can reduce the costs and risks associated with manual processing, while improving quality and efficiency. These frameworks include PegaCARD Smart Dispute, Smart Investigate for Payments, Smart Investigate for Securities, Smart Adjust, and PegaHEALTH Claims Automation Suite.

Markets and representative customers

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

Financial services

Financial services organizations require software to improve the quality, accuracy, and efficiency of customer interactions and transactions processing. Pegasystems customer process and exceptions management products allow customers to be responsive to changing business requirements. Representative financial services customers of ours include: Bank of America Corporation, Barclays Bank PLC, Citigroup Inc., Credit Suisse Group, HSBC Holdings Plc, JPMorgan Chase & Co., National Australia Bank Limited, the Royal Bank of Scotland plc, and TD Bank Financial Group.

Healthcare

Healthcare organizations seek products that integrate their front and back office initiatives and help drive customer service, efficiency, and productivity. Representative healthcare customers of ours include: Aetna Inc., Blue Cross Blue Shield of Massachusetts, Blue Cross & Blue Shield of Minnesota, Computer Sciences Corporation, Group Health Cooperative, HealthNow New York Inc., and Wellpoint Inc.

Insurance

Insurance companies, whether competing globally or nationally for customers and channels, need software to automate the key activities of policy rating, quoting, customization, underwriting, and servicing as well as products that improve customer service and the overall customer experience. Representative insurance industry customers of ours include: American National Insurance Group, American International Group, Inc. (AIG), The Allstate Corporation, John Hancock, Farmers Insurance Group, and Nationwide Mutual Insurance Company.

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Other industries

PegaRULES Process Commander offers solutions to a broad range of companies and industries. We sell rules-based BPM technology to customers in telecommunications, government, life sciences, manufacturing, and travel services. Customers include: Amgen Inc., Advanced Micro Devices, Inc. (AMD), General Electric Company, Novartis Pharmaceuticals Corp., Starwood Hotels & Resorts Worldwide Inc., The ServiceMaster Company and Vodafone Group Plc.

Services and support

We offer services and support through three groups: our professional services group which provides market, business and technical knowledge to assist our customers throughout the sale and deployment of our products; our customer support group which provides support and maintenance for our customers; and our education services group which offers training programs for our employees, customers and partners. As of December 31, 2007, our services and support groups consisted of 276 people located in our 11 offices. We also utilize third party subcontractors to assist us in providing services.

Professional services

Our professional services group helps companies and partners implement and optimize our software. This enables us to guide our customers through deployment of our software. Many of our customers choose to engage our professional services group to expand their use of our software to additional business or product lines or automate additional processes within existing solutions. In addition, systems integrators and consulting firms, with which we have alliances, help our customers deploy our products.

Our implementation procedures are developed through field experience and facilitate implementation of our software through project management that establishes standards for project activities and provides a basis for governance and accountability. By adopting a phased approach to deployment, our customers can engage in smaller, more easily managed projects that are more likely to result in a successful solution.

Customer support

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

Education services

The success of our sales strategy for multiple follow-on sales to target customers depends on our ability to train a larger number of partners and customers to implement our technology. We offer training for our staff, customers, and partners. Training is offered at our regional training facilities in Cambridge, Massachusetts, London, England, and Sydney, Australia, at third party facilities in numerous other locations, or may be specially arranged at customer sites. Courses are designed to meet the specific requirements of process architects, system architects, and system administrators.

Sales and marketing

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

To support our sales efforts, we conduct a broad range of marketing programs, including industry trade shows, industry seminars, meetings with industry analysts, and other direct and indirect marketing efforts. Our consulting staff, business partners, and other third parties also generate sales leads. As of December 31, 2007, our sales and marketing group consisted of 153 people worldwide.

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Sales by geography

In 2007, 2006, and 2005, sales to customers based outside of the United States of America (U.S.) represented 35%, 37%, and 34%, respectively, of our total revenue. During 2007, 2006, and 2005, we derived our revenue from the following geographic areas:

(Dollars in thousands)	2007		2006		2005	
U.S.	$ 104,952	65%	$ 79,903	63%	$ 66,459	66%
United Kingdom	34,278	21%	19,741	16%	18,161	18%
Europe, other	8,755	5%	11,606	9%	10,732	11%
Other	13,964	9%	14,773	12%	4,857	5%
	$ 161,949	100%	$ 126,023	100%	$ 100,209	100%

In 2007, 2006, and 2005, no customer accounted for 10% or more of our total revenue. We currently operate in one operating segment rules-based BPM software. We derive substantially all of our operating revenue from the sale and support of one group of similar products and services. Substantially all of our assets are located within the U.S.

Research and development

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

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

As of December 31, 2007, our development group consisted of 119 people and has been significantly supplemented by the use of contracted resources. During 2007, 2006, and 2005, research and development expenses were approximately $26.2 million, $22.7 million, and $19.5 million, respectively. We expect that we will continue to commit significant resources to our product research and development in the future to maintain our leadership position.

Competition

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

- Enterprise content management-based vendors such as the FileNet division of International Business Machines Corporation;

- Enterprise application integration vendors such as TIBCO Software Inc.;

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- BPM vendors such as the Fuego division of BEA Systems, Inc. and Lombardi Software, Inc.;
- Business rules engine vendors such as Fair Isaac Corporation and ILOG, Inc.;
- Companies that provide application specific BPM software for the financial services, healthcare, insurance and other specific markets such as Chordiant Software, Inc., DST Systems, Inc., Oracle Corporation, and SmartStream Technologies Ltd.;
- Current customers information technology departments, which may seek to modify existing systems or develop proprietary systems.

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

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

Employees

As of December 31, 2007, we had 657 employees, of whom 494 were based in the U.S., 35 were based in Canada, 105 were based in Europe, 12 were based in Australia, and 11 were based in Asia. Our total headcount includes 153 sales and marketing employees, 276 consulting and customer support employees, 119 research and development employees, and 109 administrative employees. In addition, we supplement our research and development and services employees with contractors.

Backlog of license, maintenance and consulting revenues

As of December 31, 2007, we had software license and maintenance agreements and fixed fee professional services agreements with customers expected to result in approximately $132 million of future revenue, of which we expect approximately $82 million to be recognized as revenue in 2008. As of December 31, 2006, we had software license and maintenance agreements and fixed fee professional services agreements with customers expected to result in approximately $59 million of future revenue, of which we expected approximately $49 million to be recognized as revenue in 2007. Under some of these agreements, we must fulfill certain conditions prior to recognizing revenue, and there can be no assurance when, if ever, we will be able to satisfy all such conditions in each instance. Business conditions could change and, therefore, backlog may not be a reliable indicator of future financial performance.

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ITEM 1A RISK FACTORS

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

Factors relating to our revenues

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

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

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

Factors relating to fluctuations in our financial results

The timing of our license revenue is difficult to predict accurately, which may cause our quarterly operating results to vary considerably. Our quarterly revenue may fluctuate significantly, in part because our revenue in any quarter is attributable to a relatively small number of transactions. Our decision to increasingly enter into term licenses with contract provisions that require the term license revenue to be recognized over the license term as payments become due or earlier if paid in advance may adversely affect our profitability in any period due to sales commissions being paid at the time of signing and the corresponding revenue being recognized over time. The mix of perpetual license and term license signings in a quarter may cause a fluctuation in the timing of recognized license revenue, because we recognize revenue from term licenses over the term as payments become due. We plan selling and marketing expenses, product development, and other expenses based on anticipated future revenue. If revenue falls below expectations, financial performance is likely to be adversely affected because only small portions of expenses vary with revenue. As a result, period-to-period comparisons of operating results are not necessarily meaningful and should not be relied upon to predict future performance.

Our financial results may be adversely affected if we are required to change certain estimates, judgments, and positions relative to our income taxes. In the ordinary course of conducting a global business enterprise, there are many transactions and calculations undertaken whose ultimate tax outcome cannot be certain. Some of these uncertainties arise as a consequence of positions we have taken regarding valuation of deferred tax assets, transfer pricing for transactions with our subsidiaries, and potential challenges to nexus and tax credit estimates. We estimate our exposure to unfavorable outcomes related to these uncertainties and estimate the probability for such outcomes. Although we believe our estimates are reasonable, no assurance can be given that the final tax outcome of these matters or our current estimates regarding these matters will not be different from what is reflected in our historical income tax provisions, returns, and accruals. Such differences, or changes in estimates relating to potential differences, could have a material impact, unfavorable or favorable, on our income tax provisions, require us to change the recorded value of deferred tax assets, and adversely affect our financial results.

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

Factors relating to our products and markets

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

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

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

The recent credit market turmoil may impact our sales to our financial services customers. Recently, many financial services institutions have been forced to record massive write-offs on their financial statements to reflect the reduced value of their portfolios of sub-prime mortgage loans and/or securities derived from these loans. Additionally, financial institutions that are in the business of mortgage lending have seen a dramatic reduction in the number of loan transactions. The reduction in loan transactions has also affected the overall amount of borrowing and liquidity in the market, thereby impacting other companies such as credit card issuers. All of this turmoil could impact the ability and willingness of our financial services customers to make investments in technology, which may delay or reduce the amount of purchases of our software and professional services by these customers.

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

We face risks from operations and customers based outside of the U.S. Sales to customers headquartered outside of the U.S. represented approximately 35% of our total revenue in 2007, 37% in 2006 and 34% in 2005. We, in part through our wholly-owned subsidiaries based in the United Kingdom, Canada, and Australia, market products and render consulting and training services to customers based in Canada, the United Kingdom, France, Germany, Spain, the Netherlands, Belgium, Switzerland, Austria, Ireland, Sweden, South Africa, Mexico, Australia, Hong Kong, and Singapore. We have established offices in Canada, Europe, and Australia. We believe that growth will necessitate expanded international operations, requiring a diversion of managerial attention and increased costs. We anticipate hiring additional personnel to accommodate international growth, and we may also enter into agreements with local distributors, representatives, or resellers. If we are unable to do one or more of these things in a timely manner, our growth, if any, in our foreign operations may be restricted, and our business, operating results, and financial condition could be materially and adversely affected.

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

Furthermore, our international sales may be denominated in U.S. dollars or foreign currencies depending on the customer and transaction. However, the operating expenses of our foreign operations are primarily denominated in foreign currencies. To the extent our international sales are also denominated in the foreign currency, our foreign currency exposure is largely offset. An increase in the value of foreign currencies, particularly the British pound and the Euro relative to the U.S. dollar, could adversely impact our revenues and operating results.

Factors relating to our internal operations and potential liabilities

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

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

We face risks related to intellectual property claims or appropriation of our intellectual property rights. We rely primarily on a combination of copyright, trademark and trade secrets laws, as well as confidentiality

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agreements to protect our proprietary rights. We have obtained patents from the U.S. Patent and Trademark Office relating to the architecture of our systems. We cannot assure that such patents will not be invalidated or circumvented or that rights granted thereunder or the claims contained therein will provide us with competitive advantages. Moreover, despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or to obtain the use of information that we regard as proprietary. In addition, the laws of some foreign countries do not protect our proprietary rights to as great an extent as do the laws of the U.S. There can be no assurance that our means of protecting our proprietary rights will be adequate or that our competitors will not independently develop similar technology.

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

ITEM 1B UNRESOLVED STAFF COMMENTS

Not applicable.

ITEM 2 PROPERTIES

Our principal administrative, sales, marketing, support, and research and development operations are located at 101 Main Street, Cambridge, Massachusetts in an approximately 100,000 square foot leased facility. The lease for this facility expires in 2013, subject to our option to extend for two additional five-year periods. We also lease space for our other offices in the U.S., Canada, Australia, France, and the United Kingdom. These leases expire at various dates through 2010. We believe that additional or alternative space will be available as needed in the future on commercially reasonable terms.

ITEM 3 LEGAL PROCEEDINGS

Not applicable.

ITEM 4 SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

During the fourth quarter of 2007, there were no matters submitted to a vote of security holders.

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EXECUTIVE OFFICERS OF THE REGISTRANT

The names of our executive officers and certain information about them are set forth below as of February 1, 2008:

Name	Age	Position(s) and Office(s) Held
Alan Trefler	51	Chief Executive Officer and Chairman
Craig Dynes	52	Chief Financial Officer and Senior Vice President
Edward Hughes	56	Senior Vice President, Global Sales
Douglas Kra	45	Vice President of Global Services
Michael Pyle	53	Senior Vice President of Product Development

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

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

Craig Dynes joined Pegasystems in September 2006 as Chief Financial Officer and Senior Vice President. Mr. Dynes assumed the role of principal accounting officer following the resignation of the Company s former Vice President of Finance in November 2007. From 2004 to 2006, Mr. Dynes served as Chief Financial Officer at Demandware, a venture-backed enterprise software firm. From 2003 to 2004, Mr. Dynes served as President and CEO of Narad Networks, a manufacturer of equipment for the cable television industry. From 1997 to 2002, Mr. Dynes served as Chief Financial Officer of SilverStream Software, Inc., an application development software company. Prior to SilverStream, Mr. Dynes held senior financial positions at Sybase Inc. and Powersoft Corp. Mr. Dynes is a graduate of the Richard Ivey School of Business Administration, the University of Western Ontario and is a Canadian Chartered Accountant.

Edward Hughes joined Pegasystems in February 2006 as Senior Vice President, Global Sales. From 2003 to 2005, Mr. Hughes served as Vice President of Sales in the Americas for the Software Development group of International Business Machines Corporation. From 2000 to 2003, Mr. Hughes served as Vice President of Sales for Rational Software, Inc. Prior to Rational, Mr. Hughes held senior management positions at Compuware Corporation. Mr. Hughes is a graduate of Catholic University and the Potomac School of Law.

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

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

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PART II

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

The following table sets forth the range of high and low sales prices of our common stock on the NASDAQ Global Select Market for 2007 and 2006. Our common stock is traded under the NASDAQ Symbol PEGA . As of February 29, 2008, we had approximately 64 stockholders of record and approximately 29,006 beneficial owners of our common stock. On February 29, 2008, the closing sale price of our common stock was $9.40. In July 2006, we began paying a quarterly cash dividend of $0.03 per share of common stock. Prior to July 2006, we had never declared or paid any cash dividends on our common stock. Quarterly cash dividends are expected to continue at $0.03 per share, subject to change or elimination at anytime by our Board of Directors, to stockholders of record as of the first trading day of each quarter.

	High	Low
2007		
First Quarter	$ 10.04	$ 8.07
Second Quarter	$ 11.17	$ 8.85
Third Quarter	$ 12.67	$ 10.10
Fourth Quarter	$ 13.10	$ 10.70

	High	Low
2006		
First Quarter	$ 8.37	$ 6.91
Second Quarter	$ 8.37	$ 6.19
Third Quarter	$ 8.88	$ 6.20
Fourth Quarter	$ 10.61	$ 8.52

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COMPARISON OF CUMULATIVE TOTAL STOCKHOLDER RETURN

The following performance graph represents a comparison of the cumulative total return (assuming the reinvestment of dividends) for a $100 investment on December 31, 2002 in each of our common stock, the Total Return Index for the NASDAQ Composite (NASDAQ Composite) (a broad market index) and the Standard & Poors (S&P) Goldman Sachs Technology Software Index (S&P GSTI Software Index) (a published industry index). We paid dividends of $0.06 per share during 2006 and $0.12 per share during 2007. The graph lines merely connect measurement dates and do not reflect fluctuations between those dates.

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ISSUER PURCHASES OF EQUITY SECURITIES

On June 4, 2007, we publicly announced that our Board of Directors approved a new $10.0 million stock repurchase program beginning July 1, 2007 and ending June 30, 2008 (the Third Program). Under the Third Program, shares may be purchased in such amounts as market conditions warrant, subject to regulatory and other considerations. Purchases under the Third Program may be made from time to time on the open market or in privately negotiated transactions.

The following table sets forth information regarding our repurchases of our common stock, under the Third Program, during the fourth quarter of 2007.

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Share Repurchase Program	Approximate Dollar Value of Shares That May Yet Be Purchased Under The Third Program (in thousands)
10/1/07-10/31/07	87,690	$ 11.74	87,690	$ 4,242
11/1/07-11/30/07	77,082	12.09	77,082	3,310
12/1/07-12/31/07	176,057	11.93	176,057	1,210
Total	340,829	$ 11.92		

In November 2007, a former stockholder of 1mind Corporation (1mind) exercised a warrant to purchase 1,408 shares of our common stock, which was originally issued as part of the consideration for our acquisition of 1mind in 2002. In accordance with the net exercise provisions of this warrant, we withheld 102 shares of our common stock to cover the exercise price of the warrant, which shares were valued at approximately $1,200, based on the average closing price of our common stock over the ten consecutive trading days ending on the third trading day prior to the exercise date and issued 1,306 shares of our common stock. The issuance of these shares was made in reliance on the exemption from registration provided by Regulation D under the Securities Act of 1933.

In November 2007, International Business Machines Corporation (IBM) exercised a warrant to purchase 26,738 shares of our common stock, which was previously issued in 2004 in connection with our agreement with IBM. In accordance with the net exercise provisions of this warrant, we withheld 20,923 shares of our common stock to cover the exercise price, which shares were valued at approximately $0.3 million, based on the average closing price of our common stock over the five consecutive trading days ending on the day prior to the exercise date and issued 5,815 shares of our common stock. The issuance of these shares was made in reliance on the exemptions from registration provided by Section 4(2) of the Securities Act of 1933.

For information concerning securities authorized for issuance under equity compensation plans, see Part III, Item 12 SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS.

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ITEM 6 SELECTED CONSOLIDATED FINANCIAL DATA

The selected consolidated financial data presented below has been derived from our consolidated financial statements. This data may not be indicative of our future condition or results of operations and should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations , the consolidated financial statements and accompanying notes.

	Year Ended December 31,				
	2007	2006	2005	2004	2003
	(in thousands, except per share data)				
Consolidated Statements of Operations Data:					
Total revenue	$ 161,949	$ 126,023	$ 100,209	$ 103,291	$ 95,030
Income (loss) from operations	1,951	(7,114)	1,218	5,771	14,735
Income before provision for income taxes	9,942	1,187	5,319	11,156	21,892
Net income	6,595	1,842	5,192	8,211	16,679
Earnings per share:					
Basic	$ 0.18	$ 0.05	$ 0.15	$ 0.23	$ 0.48
Diluted	$ 0.18	$ 0.05	$ 0.14	$ 0.22	$ 0.47
Cash dividends declared per common shares	$ 0.12	$ 0.09	$	$	$
Weighted-average number of common shares outstanding:					
Basic	35,875	35,229	35,774	35,691	34,518
Diluted	37,433	37,134	36,462	37,043	35,757

	Year Ended December 31,				
	2007	2006	2005	2004	2003
	(in thousands)				
Consolidated Balance Sheet Data:					
Total cash, cash equivalents and short-term investments	$ 149,981	$ 127,758	$ 114,735	$ 97,360	$ 87,935
Working capital	159,547	147,229	133,440	121,273	98,056
Long-term license installments, net of unearned interest income	8,267	17,458	31,371	44,344	53,666
Total assets	243,307	214,008	209,654	195,878	191,959
Capital lease obligation, including current portion		63	166	263	
Stockholders equity	172,944	166,158	167,682	166,607	153,922

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ITEM 7 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

BUSINESS OVERVIEW

We develop and license rules-based BPM software and provide professional services, maintenance, and training related to our software. We focus our sales efforts on target accounts, which are companies or divisions within companies, and are typically large organizations that are among the leaders in their industry. Our strategy is to sell limited size initial licenses to these target accounts rather than selling large application licenses, with the goal to generate follow-on sales. This strategy allows our customers to quickly realize business value from our software and reduces their initial investment.

Our customers typically request professional services and training to assist them in implementing our products. Almost all of our customers also purchase maintenance on our products, which includes rights to upgrades and new releases, incident resolution and technical assistance. Professional services are provided directly by us in some situations and through our network of partners in other cases. The amount of professional services provided by our partners has been increasing in recent years. By utilizing these partners, we have significantly increased the supply of skilled service consultants that can assist our customers.

Our license revenue from new license signings is primarily derived from our PegaRULES Process Commander software and related solution frameworks. PegaRULES Process Commander is a comprehensive platform for building and managing BPM applications that unifies business rules and business processes. Our solution frameworks are built on the capabilities of PegaRULES Process Commander and are purpose- or industry -specific collections of best practice functionality to allow organizations to quickly implement new customer-facing practices and processes, bring new offerings to market, and provide customized or specialized processing. These products often require less implementation assistance than prior generations of our software products. In many cases this has resulted in a shorter sales process and implementation period. PegaRULES Process Commander and related solution frameworks can be used more broadly by customers within our traditional financial services, insurance and healthcare markets, as well as by a broader range of customers within other markets, such as life sciences and government. We license our software to new customers pursuant to perpetual and term license agreements, depending on customer circumstances.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Management s discussion and analysis of the financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the U.S. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. We base our estimates and judgments on historical experience, knowledge of current conditions and beliefs of what could occur in the future given available information. We consider the following accounting policies to be both those most important to the portrayal of our financial condition and those that require the most subjective judgment. If actual results differ significantly from management s estimates and projections, there could be a material effect on our financial statements.

Revenue recognition

Our revenue is derived from two primary sources: software license fees and service fees. Our license arrangements, whether involving a perpetual license or a term license, generally contain multiple elements. In addition to the license, these elements generally include professional consulting services, training, and software maintenance services. Revenue from arrangements in which the fair value of one or more undelivered elements is unknown is deferred until the fair value of those elements is known and the residual value of the license can be determined.

Software License Revenues

Perpetual software license fees are recognized as revenue when the software is delivered, any acceptance required by contract is obtained, no significant obligations or contingencies exist related to the software, other than maintenance support, and all other revenue recognition criteria are met.

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

As a result of our focus on frequent sales to our targeted customers, our strategy to sell limited size initial term licensing agreements to those customers with the goal to generate follow-on sales, and as a result of certain contract provisions, we recognize term license revenue over the term of the agreement as payments become due or earlier if prepaid, provided all other criteria for revenue recognition have been met.

Historically, the majority of our term license arrangements were larger agreements with extended payment terms and therefore, did not typically result in follow-on license agreements. We have a history of successfully collecting payments under the original payment terms, therefore for these arrangements, we have recognized the present value of the future term license payments upon customer acceptance, provided that no significant obligations or contingencies exist related to the software, other than maintenance support, and provided all other criteria for revenue recognition have been met. A portion of the license fees payable under these agreements (equal to the difference between the total license payments and the discounted present value of those payments) was initially deferred and recognized as installment receivable interest income (and is not part of total revenue) over the license term. For purposes of the present value calculations, the discount rates used were estimates of customers borrowing rates at the time of recognition, typically below prime rate, and have varied between 3.25% and 6.9% for the past few years. As of December 31, 2007, the remaining balance of these installment receivables totaled approximately $27.5 million as summarized in the table on page 33.

For licensing arrangements that include a right to unspecified future products, fees are accounted for as subscriptions and the revenue is recognized ratably over the economic life or term of the arrangement.

Services Revenues

Our services revenue is comprised of fees for software maintenance, training, and consulting services including software implementation. Consulting services may be provided on a stand-alone basis or bundled with a license and software maintenance services.

Software maintenance revenue is recognized over the term of the related maintenance agreement, which is generally one year. Revenue from training services and consulting services under time and materials contracts is recognized as services are performed. We have vendor specific objective evidence of fair value for our software maintenance, training services, and consulting services under time and materials contracts.

Services may be provided on a fixed-price basis. We do not have vendor specific objective evidence of fair value for fixed-price services prior to completion of the services. When fixed-price services are part of a multiple element arrangement, and the services are not essential to the functionality of the other elements of the arrangement, and when services are the only undelivered element, we recognize the revenue from the total arrangement ratably over the longer of the software maintenance period or the service period. In a limited number of our arrangements, the fixed-price services are essential to the arrangement because we make significant alterations to the functionality of the software or build complex interfaces necessary for the software to be functional in the customer s environment. We have not been able to make reasonably dependable estimates for the purpose of determining our progress to completion, as we have limited experience with these types of unique and complex arrangements. Accordingly, when the fixed-price services are essential to the arrangement, all revenue and costs are deferred until the completion of the fixed-price services under the completed contract method. Revenue from fixed-price services that are not bundled with a software license is generally recognized as performed during the service period, which is typically less than four months.

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We warrant to our customers that our software products will conform to documented specifications. We have not experienced significant claims related to software warranties beyond the scope of maintenance support, which we are already obligated to provide, and consequently we have not established reserves for warranty obligations.

Our agreements with customers generally require us to indemnify the customer against claims that our software infringes third party patent, copyright, trademark or other proprietary rights. Such indemnification obligations are generally limited in a variety of industry-standard respects, including our right to replace an infringing product. As of December 31, 2007, we had not experienced any material losses related to these indemnification obligations and no claims with respect thereto were outstanding. We do not expect significant claims related to these indemnification obligations, and consequently, we have not established any related reserves.

Deferred project costs

We defer direct costs when a project is being accounted for under the completed contract method or for certain arrangements where all of the required revenue recognition criteria have not been met. We report these deferred project costs in other current assets.

Deferred revenue

Deferred revenue consists primarily of billed fees that exceed revenue recognized on arrangements and advance payment of maintenance fees.

Allowance for doubtful accounts and allowance for sales credit memos

We maintain an allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. Our estimates are based on the composition of the accounts receivable aging, historical bad debts, changes in payment patterns, customer creditworthiness and current economic trends. If we used different assumptions, or if the financial condition of customers were to deteriorate that resulted in their inability to make required payments, additional provisions for doubtful accounts would be required and would increase bad debt expense.

We record allowances for estimates of potential sales credit memos. We base these estimates on historical analyses of sales credit memos and assumptions about future events and experience with customer disputes. If we used different assumptions in calculating the allowance, adjustments would be reflected as changes to revenue.

Stock-based compensation

As a result of the adoption of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 123R, Share-Based Payment (SFAS 123(R)) on January 1, 2006, we recognize stock-based compensation expense associated with equity awards in our consolidated statements of income based on the fair value of these awards at the date of grant. Pro forma disclosure is no longer an alternative. We adopted the provisions of SFAS 123(R) using the modified prospective method, and, accordingly prior period amounts were not restated. Stock-based compensation is recognized over the requisite service period, which is generally the vesting period of the equity award, and adjusted each period for anticipated forfeitures. We recognize stock-based compensation under the ratable method, which treats each vesting tranche as if it were an individual grant.

During the fourth quarter of 2007, our Board of Directors approved changes to our equity compensation program, including the granting of restricted stock units (RSUs) in addition to stock options, for periodic equity compensation grants. RSUs deliver to the recipient a right to receive a specified number of shares of our

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common stock upon vesting. Unlike stock options, there is no cost to the employee at share issuance. We value our RSUs at the fair value of our common stock on the grant date, which is the closing price of our common stock on the grant date, less the present value of expected dividends as the employee is not entitled to dividends during the requisite service period. We periodically grant stock options and RSUs for a fixed number of shares to employees and non-employee Directors. The exercise price for stock options is greater than or equal to the fair market value of the shares at the date of the grant.

We estimate the fair value of stock options using the Black-Scholes option valuation model, which requires us to make estimates of key assumptions including the expected term of the option, the expected volatility of our stock price over the option s expected term, the risk-free interest rate over the option s expected term, and our expected annual dividend yield. The expected term of options granted is derived from historical data on employee exercises and post-vesting employment termination behavior. The expected volatility is based on the historical volatility of our stock price. The expected annual dividend yield is based on the expected annual dividend of $0.12 per share divided by the average stock price. If factors change and we employ different assumptions in the application of SFAS 123(R) in future periods, the compensation expense that we record under SFAS 123(R) may differ significantly from what we have recorded in the current period.

The following table summarizes the estimated impact on the fair value of our stock options granted during the years ended December 31, 2007 and 2006, respectively, had we applied different weighted-average assumptions in the Black-Scholes option valuation model as follows:

SFAS 123(R) Assumption	Year ended December 31, 2007	Hypothetical Change	Estimated Impact on Stock-Based Compensation
Expected volatility	53%	10%	15%
Expected term in years	5.6	1	8%
Risk-free interest rate	4.02%	2%	6%
Expected annual dividend yield	1.19%	1%	9%

SFAS 123(R) Assumption	Year ended December 31, 2006	Hypothetical Change	Estimated Impact on Stock-Based Compensation
Expected volatility	75%	10%	9%
Expected term in years	6.1	1	6%
Risk-free interest rate	4.81%	2%	3%
Expected annual dividend yield	.97%	1%	8%

The amount of stock-based compensation recognized during a period is based on the value of the portion of the awards that are ultimately expected to vest. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Based on the review of historical forfeiture data for our employees, we have applied an annual forfeiture rate of 18% and re-evaluate and adjust the forfeiture rate as necessary. Ultimately, we recognize the actual expense over the vesting period only for the shares that vest.

The choice of a valuation model, and the underlying assumptions used in applying that model, involves significant judgment. Our judgment reflects our assessment of the most accurate method of valuing the stock options we issue based on our historical experience, knowledge of current conditions and beliefs of what could occur in the future given available information. Our judgment could change over time as additional information becomes available to us, or the facts underlying our assumptions change over time, and any change in our judgments could have a material effect on our financial statements.

Prior to January 1, 2006, we accounted for stock option grants to employees and Directors using the intrinsic value method in accordance with Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, (APB 25). Under the intrinsic value method, compensation associated with stock awards to

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employees and Directors was determined as the difference, if any, between the current fair value of the underlying common stock on the date compensation was measured and the exercise price of the award. In accordance with the provisions of APB 25, since the exercise price of our employee stock options equaled the market price of the underlying stock on the date of the grant, no compensation expense was recorded in the financial statements. However, we disclosed in the notes to our consolidated financial statements the pro forma effect on our consolidated statements of income had we employed the fair value method of accounting for stock option grants in accordance with SFAS No. 123 Accounting for Stock-Based Compensation (SFAS 123). For purposes of that disclosure, we used the Black-Scholes option valuation model to value the options granted, which required us to make certain assumptions similar to those required by SFAS 123(R) and as described above, except the dividend yield was equal to zero, as no dividends had been declared through December 31, 2005.

See Note 4 STOCK-BASED COMPENSATION in the notes to the accompanying consolidated financial statements for further information on the impact of SFAS 123(R) to our consolidated financial statements.

Accounting for Income Taxes

As a global company, we use significant judgment to calculate and provide for income taxes in each of the tax jurisdictions in which we operate. In the ordinary course of our business, there are transactions and calculations undertaken whose ultimate tax outcome cannot be certain. Some of these uncertainties arise as a consequence of transfer pricing for transactions with our subsidiaries and potential challenges to nexus and credit estimates. We estimate our exposure to unfavorable outcomes related to these uncertainties and estimate the probability for such outcomes in accordance with the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48), which we adopted on January 1, 2007. As a result of the implementation of FIN 48, we recorded a $1.5 million reduction to January 1, 2007 retained earnings. In accordance with FIN 48, as of December 31, 2007, the amount of unrecognized tax benefits totaled approximately $9.8 million, of which $3.9 million, if recognized would favorably affect our effective tax rate in any future period. We do not expect the changes in the unrecognized benefits within the next twelve months to be material.

We account for income taxes in accordance with SFAS No. 109, Accounting for Income Taxes (SFAS 109), which requires that deferred tax assets and liabilities be recognized using enacted tax rates for the effect of temporary differences between the book and tax bases of recorded assets and liabilities. We record a valuation allowance to reduce our deferred taxes to an amount we believe is more likely than not to be realized. We consider future taxable income and prudent and feasible tax planning strategies in assessing the need for a valuation allowance.

Although we believe our estimates are reasonable, no assurance can be given that the final tax outcome will not be different from what is reflected in our historical income tax provisions, returns, and accruals. Such differences, or changes in estimates relating to potential differences, could have a material impact on our income tax provision and operating results in the period in which such a determination is made.

RESULTS OF OPERATIONS

2007 Compared to 2006

(Dollars in millions)	**Year Ended December 31,**		**Increase (Decrease)**	
	2007	**2006**		
Total revenue	$ 161.9	$ 126.0	$ 35.9	29%
Gross profit	96.7	72.3	24.4	34%
Total operating expenses	94.8	79.4	15.4	19%
Income before provision (benefit) for income taxes	$ 9.9	$ 1.2	$ 8.8	n/m

n/m = not meaningful

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The increase in total revenue in 2007 compared to 2006 consisted of a $15.7 million increase in license revenue, a $14.3 million increase in professional services and training revenue and a $5.9 million increase in maintenance revenue, in each case due to an increase in the overall demand for our software, related professional services, and maintenance. Our international revenue was 35% of total revenue in 2007 compared to 37% in 2006.

The increase in gross profit for 2007 compared to 2006 was due to the increase in license revenue and an increase of $8.7 million in services gross profit.

Total operating expenses increased in 2007 compared to 2006 due to our continued investment in expanding the number of sales and marketing personnel, increased spending in research and development, and higher accounting fees as a result of restating our previously issued financial statements.

The increase in income before provision (benefit) for income taxes was primarily due to the $24.4 million increase in our gross profit, which was partially offset by a $15.4 million increase in operating expenses as discussed above.

Revenue

(Dollars in millions)	**Year Ended December 31,**				**Increase**	
	2007		**2006**		**(Decrease)**	
License revenue						
Perpetual licenses	$ 37.9	74%	$ 27.2	77%	$ 10.7	39%
Term licenses	13.2	26	8.2	23	5.0	61%
Total license revenue	$ 51.1	100%	$ 35.4	100%	$ 15.7	44%

The mix between perpetual and term license signings fluctuates based on customer circumstances. Our license revenue growth in 2007 was primarily driven by increased demand for perpetual licenses of our software. Both the number and the average value of perpetual license arrangements increased in 2007 compared to 2006.

We recognize revenue for our term license arrangements over the term of the agreement as payments become due or earlier if prepaid. While the number of term license signings decreased, the average value of term license arrangements increased in 2007 compared to 2006. The aggregate value of payments for these term licenses, which will be recognized in future periods as revenue, totaled $71.4 million as of December 31, 2007 as compared to $14.2 million as of December 31, 2006. The aggregate value of these non-cancellable term license arrangements as of December 31, 2007 includes $21.3 million of term license payments that we expect to recognize as revenue in 2008, which represents a 61% increase compared to $13.2 million of term license revenue in 2007. We expect our term license revenue could be higher than $21.3 million in 2008 as we complete new term license agreements in 2008. See the table of expected cash receipts from these term licenses on page 33 for an analysis of future receipts by year.

(Dollars in millions)	**Year Ended December 31,**				**Increase**	
	2007		**2006**		**(Decrease)**	
Services revenue						
Professional services and training	$ 79.7	72%	$ 65.4	72%	$ 14.3	22%
Maintenance	31.1	28	25.2	28	5.9	23%
Total services revenue	$ 110.8	100%	$ 90.6	100%	$ 20.2	22%

Professional services are primarily consulting services related to new license implementations. We continue to experience strong demand for these services as our installed license base continues to grow. As a result of the

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demand for these services, we have increased employee headcount in the professional services organization by 42% to 233 employees as of December 31, 2007 from 164 employees as of December 31, 2006. In addition to our own employees, we use contractors to provide these services.

The increase in maintenance revenue in 2007 compared to 2006 is a result of the continued increase in the installed base of our software.

(Dollars in millions)	**Year Ended December 31,**		**Increase (Decrease)**	
	2007	**2006**		
Gross Profit				
License gross profit	$ 51.1	$ 35.4	$ 15.7	44%
Services gross profit	45.6	36.9	8.7	24%
Total gross profit	$ 96.7	$ 72.3	$ 24.4	34%
Services gross margin	41%	41%		

There are no significant direct costs associated with license revenue, therefore, increases in license gross profit are due to increases in license revenue.

Our professional services and training gross margin was unchanged in 2007 compared to 2006. While we increased the professional services headcount by 42% in 2007, and 80% of those new employees were hired in the second half of the year, contractor costs as a percentage of professional services and training revenue decreased to 14%, or $11.2 million, in 2007 compared to 17%, or $11.3 million, in 2006. We expect to continue to increase the number of professional services employees to meet the demand for professional services related to new license implementations and we will continue to utilize subcontractors while we recruit, hire and train professional services employees. Our margin on maintenance in 2007 was also unchanged in 2007 compared to 2006.

Operating expenses

(Dollars in millions)	**Year Ended December 31,**		**Increase (Decrease)**	
	2007	**2006**		
Selling and marketing				
Selling and marketing	$ 51.7	$ 43.9	$ 7.8	18%
As a percent of total revenue	32%	35%		
Selling and marketing headcount	153	138	15	11%

Selling and marketing expenses include payroll, employee benefits, stock-based compensation expense, and other headcount-related costs associated with selling and marketing personnel as well as advertising, promotions, trade shows, seminars, and other programs. The increase in selling and marketing expenses was primarily due to an increase in employee related costs associated with increased headcount in 2007 compared to 2006. Payroll, compensation and benefit expenses increased approximately $4.5 million and travel expenses increased approximately $0.8 million a result of the higher headcount.

(Dollars in millions)	**Year Ended December 31,**		**Increase (Decrease)**	
	2007	**2006**		
Research and development				
Research and development	$ 26.2	$ 22.7	$ 3.5	15%
As a percent of total revenue	16%	18%		
Research and development headcount	119	108	11	10%

Research and development expenses include payroll, employee benefits, stock-based compensation expense, contracted services, and other labor-related costs associated with research and development. The increase in

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research and development costs during 2007 was primarily due to $1.1 million of higher headcount costs and $1.2 million of higher offshore contractor costs. We are in the process of establishing a research and development center in India. The associated start-up costs are included in general and administrative expenses until the new center is operational, at which time, the costs associated with the new center will be included in research and development expenses.

(Dollars in millions)	**Year Ended December 31,**		**Increase**	
	2007	**2006**	**(Decrease)**	
General and administrative				
General and administrative	$ 16.9	$ 12.7	$ 4.2	32%
As a percent of total revenue	10%	10%		
General and administrative headcount	109	103	6	6%

General and administrative costs include payroll, employee benefits, stock-based compensation expense and other headcount-related costs associated with finance, legal, corporate governance, other administrative headcount, and accounting, legal, and other administrative fees as well as certain start-up costs associated with our new research and development center in India. The increase in general and administrative costs during 2007 was primarily due to $1.4 million of higher compensation and benefit costs relating to increased headcount and $1.3 million of higher accounting fees associated with the restatement of our previously issued financial statements. We expect to incur additional start-up costs in 2008 associated with the establishment of a research and development center in India.

Stock-based compensation

In accordance with SFAS 123(R) and beginning on January 1, 2006, we recognize stock-based compensation expense associated with equity awards in our consolidated statements of income based on the fair value of these awards at the date of grant. The following table summarizes stock-based compensation expense included in our consolidated statements of income in 2007 and 2006:

	Year Ended December 31,		**Increase**	
(in thousands, except per share amounts)	**2007**	**2006**	**(Decrease)**	
Stock-based compensation expense:				
Cost of services	$ 490	$ 286	$ 204	71%
Selling and marketing	427	520	(93)	(18)%
Research and development	139	135	4	3%
General and administrative	562	527	35	7%
Total stock-based compensation before tax	$ 1,618	$ 1,468	$ 150	10%
Income tax benefit	(430)	(520)		
Net stock-based compensation expense	$ 1,188	$ 948		
Effect on earnings (loss) per share:				
Basic	$ (0.03)	$ (0.03)		
Diluted	$ (0.03)	$ (0.03)		

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In December 2007, we granted approximately 408,000 stock options and approximately 204,000 RSUs to certain employees. The associated stock-based compensation expense for these grants was insignificant in 2007, due to the awards being granted near the end of the year. As of December 31, 2007, we had approximately $2.5 million of unrecognized stock-based compensation expense related to the unvested portion of all our stock options that is expected to be recognized as expense over a weighted-average period of approximately 2.0 years and we had approximately $1.4 million of unrecognized stock-based compensation expense related to the RSUs that is expected to be recognized as expense over a weighted-average period of 2.7 years.

(Dollars in millions)	**Year Ended December 31,**		**Increase**	
	2007	**2006**	**(Decrease)**	
Interest income, Other income and Income taxes				
Installment receivable interest income	$ 1.3	$ 1.9	$ (0.6)	(34)%
Other interest income, net	6.7	5.4	1.3	25%
Other income, net		1.0	(1.0)	(97)%
Interest income and other	$ 8.0	$ 8.3	$ (0.3)	(4)%

The increase in interest income was primarily due to larger balances of cash and investments, partially offset by the decrease in interest rates and an expected reduction in interest income from installment receivables reflecting the declining balance of term licenses on which revenue had been recognized in advance of payments.

Other income, net, consists primarily of currency exchange gains and losses and realized gains and losses on the sale of our investments.

Provision (benefit) for income taxes

The provision for income taxes represents current and future amounts owed for federal, state, and foreign taxes. In 2007, we recorded a $3.3 million provision compared to a benefit of $0.7 million in 2006, which resulted in an effective tax rate of 34% in 2007 compared to (55%) in 2006.

Our effective income tax rate for 2007 was below the statutory federal income tax rate due to approximately $0.3 million of benefits related to the current period domestic production activities, approximately $0.5 million of estimated federal income tax credits, and approximately $0.2 million of state income tax credits. These benefits were partially offset by $0.3 million of permanent differences primarily related to nondeductible meals and entertainment expenses and approximately $0.2 million of prior year provision to return adjustments.

Our effective tax rate for 2006 differed from the statutory federal income tax rate due to approximately $0.7 million of benefits related to current period extra-territorial income exclusions, approximately $0.2 million of estimated federal income tax credits, a $0.3 million benefit from foreign activities, and approximately $0.3 million of net benefit from state income taxes primarily due to state income tax credits. These factors were partially offset by $0.2 million of permanent differences primarily related to nondeductible meals and entertainment expenses and a $0.2 million increase in reserve for tax uncertainties related to international activity.

We adopted the provisions of FIN 48 on January 1, 2007. As a result, we recorded the cumulative effect of applying the provisions of FIN 48 and recorded a $1.5 million reduction to our January 1, 2007 retained earnings. As of December 31, 2007, the amount of unrecognized tax benefits totaled approximately $9.8 million, of which $3.9 million, if recognized would impact our effective tax rate. We do not expect the changes in the unrecognized benefits within the next twelve months to be material.

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2006 Compared to 2005

Revenue

Our total revenue for 2006 increased 26% to $126.0 million from $100.2 million in 2005. This increase was primarily due to a $31.3 million increase in services revenue. The following table summarizes our revenue composition:

(in millions)	Year ended December 31, 2006	Year ended December 31, 2005
License revenue		
Perpetual licenses	$ 27.2	$ 20.1
Term licenses	8.2	20.8
Total license revenue	35.4	40.9
Services revenue		
Professional services and training	65.4	39.1
Maintenance	25.2	20.2
Total services revenue	90.6	59.3
Total revenue	$ 126.0	$ 100.2

Total license revenue for 2006 decreased 13% to $35.4 million from $40.9 million in 2005. The decrease in total license revenue was the result of a $12.6 million decrease in term license revenue partially offset by a $7.1 million increase in perpetual license revenue. The decrease in term license revenue was primarily due to our decision to increasingly enter into term licenses with contract provisions that require the term license to be recognized over the license term as payments become due or earlier if prepaid. A summary of expected payments for these term licenses is provided on page 33. These payments, which will be recognized as revenue in future periods, as they become due or earlier if prepaid, have increased in total from $3.5 million at December 31, 2005 to $14.2 million at December 31, 2006.

Professional services and training revenue increased 67% to $65.4 million in 2006 from $39.1 million in 2005. The increase was primarily the result of an increase in demand from our customers for professional services. Other components of the increase in professional services and training revenue include $4.0 million in revenue from three large fixed fee contracts which were completed in 2006, a $2.9 million increase in billed expenses and $1.4 million increase in training revenue. Typically, we derive substantial revenue from services provided in connection with the implementation of software licensed by new customers. Maintenance revenue increased 25% to $25.2 million in 2006 from $20.2 million in 2005. The increase in maintenance revenue for 2006 was due to a larger installed base of software and a higher proportion of perpetual licenses in the installed base which yield greater maintenance revenue than term licenses.

Deferred revenue at December 31, 2006 consisted primarily of amounts by which billed fees exceed revenue recognized on arrangements, and unearned portions of annual maintenance fees paid in advance. Deferred revenue decreased to $17.1 million as of December 31, 2006, from $20.5 million as of December 31, 2005. The $3.5 million decrease was due primarily to a $5.6 million decrease in the deferred revenue associated with agreements containing customer acceptances or completion of fixed-price services engagements, partially offset by a $2.0 million increase in the unearned portions of annual maintenance fees paid in advance.

International revenue increased to 37% of total revenue for 2006 from 34% for 2005. This increase was primarily related to one large international license transaction in the third quarter of 2006. Our international revenue may fluctuate in the future because such revenue is generally dependent upon a small number of license transactions during a given period. We expect that due to competition from vendors who will do business in

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foreign currencies, more of our customer transactions may be denominated in foreign currencies in the future, which may expose us to increased currency exchange risk.

Cost of revenue

The cost of maintenance, professional services and training increased 63% to $53.7 million in 2006 from $33.0 million in 2005. Cost of services as a percentage of services revenue increased to 59% for 2006 from 56% for 2005. Such increases were due primarily to increases in compensation costs, contracted services and travel costs. These increases reflect an investment in expanding the pool of trained service personnel, including new professional services employees and partners, to support an increase in the number of license implementation projects and in anticipation of increased demand resulting from new license signings. Services gross margin was $36.9 million for 2006 compared to $26.3 million for 2005. Services gross margin as a percentage of services revenue decreased to 41% for 2006 from 44% for 2005. The decrease in services gross margin percentage reflects the increase in services costs, partially offset by growth in maintenance revenue and its associated higher margin. Maintenance revenue increased 25% to $25.2 million in 2006 from $20.2 million in 2005 although it decreased as a percentage of services revenue to 28% in 2006 from 34% in 2005. Services headcount was 198 at the end of 2006 compared to 155 at the end of 2005. In addition, contracted services increased 82% from $6.2 million in 2005 to $11.3 million in 2006.

Operating expenses

Research and development expenses for 2006 increased to $22.7 million from $19.5 million for 2005 due to increased use of contractors and costs related to increased employee headcount. As a percentage of total revenue, research and development expenses decreased to 18% in 2006 from 19% in 2005, primarily due to increased revenue. Research and development headcount at the end of 2006 was 108 compared to 96 at the end of 2005.

Selling and marketing expenses for 2006 increased 29% to $43.9 million from $34.1 million for 2005. This increase was primarily due to a $2.5 million increase in sales commissions, increased compensation and benefits expenses of $4.5 million and increased travel expenses of $1.6 million due to higher headcount. As a percentage of total revenue, selling and marketing expenses increased to 35% in 2006 from 34% in 2005, primarily due to increased spending. Selling and marketing headcount at the end of 2006 was 138 compared to 112 at the end of 2005.

General and administrative expenses for 2006 increased 5% to $12.7 million from $12.1 million in 2005. The increase was primarily attributed to costs related to increased headcount. As a percentage of total revenue, general and administrative expenses decreased to 10% in 2006 from 12% in 2005, as revenue grew faster than general and administrative spending. General and administrative headcount at the end of 2006 was 103 compared to 95 at the end of 2005.

Installment receivable interest income

Installment receivable interest income, which consists of the portion of all term license fees recognized under the net present value method attributable to the time value of money, decreased to $1.9 million in 2006 from $2.5 million in 2005. The decrease was due primarily to a lower total value of that portfolio. A portion of the fee from each term license arrangement is initially deferred and recognized as installment receivable interest income over the remaining term of the license. For purposes of the present value calculations, the discount rates used are estimates of customers borrowing rates, typically below prime rate, and have varied between 3.25% and 6.9% during the past few years.

Other interest income, net

Other interest income increased to $5.4 million in 2006 from $3.0 million for 2005. The increase was primarily due to increased cash and investment balances and improved yields.

Other income (expense), net

Other income (expense), net, which consists primarily of currency exchange gains and losses, was $1.0 million income in 2006 compared to ($1.4) million expense in 2005. The favorable change in other income (expense), net, resulted primarily from the impact of foreign exchange rate changes on transactions recorded on our U.S. ledger valued in foreign currencies, consisting primarily of cash, investments, license installments, receivables, accounts payable and accruals.

Income before provision for income taxes

Income before provision for income taxes decreased to $1.2 million in 2006 from $5.3 million in 2005. This decrease was primarily due to a $5.2 million decrease in license gross margin, a $13.7 million increase in operating expenses primarily due to investments in sales and marketing, partially offset by a $10.5 million increase in services gross margin, a $1.8 million improvement in installment receivable interest income and other interest income, net, and a $2.4 million increase in other income and expense related to foreign currency transactions.

Provision for income taxes

The provision for income taxes was a benefit of $0.7 million in 2006 compared to $0.1 million provision in 2005. The effective tax rate was (55%) in 2006 compared to 2% in 2005.

Our effective income tax rate for 2006 differed from the statutory federal income tax rate primarily because we recorded $0.7 million of benefits related to current period extra-territorial income exclusions, $0.2 million of estimated federal income tax credits, a $0.3 million benefit from foreign activities, and $0.3 million of net benefit from state income taxes primarily due to state income tax credits. These factors were partially offset by $0.2 million of permanent differences primarily related to nondeductible meals and entertainment expenses and $0.2 million increase in reserve for tax uncertainties related to international activity.

We have provided reserves for certain tax matters, both domestic and foreign, which we believe could result in additional tax being due. Any additional assessment or reduction of these contingent liabilities will be reflected in the Company s effective tax rate in the period that additional facts become known. The reserve for tax uncertainties totaled approximately $2.0 million as of December 31, 2006 and 2005.

LIQUIDITY AND CAPITAL RESOURCES

(in thousands)	Year Ended December 31,		
	2007	**2006**	**2005**
Cash flows provided by (used in)			
Operating activities	$ 25,347	$ 19,844	$ 25,295
Investing activities	(24,847)	(10,771)	(20,188)
Financing activities	(251)	(4,902)	(4,126)
Effect of exchange rate on cash	453	523	(572)
Net increase in cash and cash equivalents	$ 702	$ 4,694	$ 409
Total cash and cash equivalents and short-term investments	$ 149,981	$ 127,758	$ 114,735

We have funded our operations primarily from cash flows provided by operations. As of December 31, 2007, we had cash and equivalents and short-term investments of $150.0 million, a $22.2 million increase from $127.8 million as of December 31, 2006. This increase was primarily due to $25.3 million of cash flow provided by operations and $10.7 million from the exercise of stock options, partially offset by $9.1 million used to repurchase shares of our common stock and $4.3 million used for dividend payments to our shareholders.

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Working capital was $159.5 million as of December 31, 2007, a $12.3 million increase from $147.2 million at December 31, 2006. The increase in working capital was primarily due to a $22.2 million increase in cash and short-term investments and a $13.9 million increase in trade accounts receivable, partially offset by a $16.1 million increase in our deferred revenue. The increase in trade accounts receivable is a result of the growth in our business. Despite the increase in trade accounts receivables, our days billing outstanding decreased from 70 days as of December 31, 2006 to 48 days as of December 31, 2007. The reduction in our days billing outstanding was due to the increase in billings and our collection efforts.

Working capital was $147.2 million as of December 31, 2006, a $13.8 million increase from $133.4 million as of December 31, 2005. The increase in working capital in 2006 was primarily due to a $13.1 million increase in cash and investments and a $5.0 million increase in trade accounts receivable, partially offset by a $7.3 million increase in accounts payable and accrued expenses. The increase in accounts payable and accrued expenses was primarily due to increases in commissions, vacation and other expenses. The increase in trade accounts receivable was due to the growth in our business. Despite the increase in trade accounts receivables, our days billing outstanding decreased from 73 days as of December 31, 2005 to 70 days as of December 31, 2006.

Cash flows provided by operating activities

Cash flows provided by operating activities for 2007 increased $5.5 million in 2007 compared to 2006. The increase was primarily due to the $16.1 million increase in deferred revenue, which consists of billed fees that exceed revenue recognized on arrangements and advance payment of maintenance fees, and the $11.8 million reduction in license installments, partially offset by the $13.9 million increase in trade accounts receivable and higher income taxes paid.

During 2006, cash flows provided by operating activities benefited from an $18.7 million reduction in license installments. The decrease in license installments reflects the lower average remaining life of our term licenses recorded on the balance sheet.

Cash flows used in investing activities

Net cash flows used in investing activities in 2007, 2006, and 2005 was primarily for purchases of marketable debt securities of $109.3 million, $94.0 million, and $44.4 million, respectively, partially offset by the proceeds received from the sales, maturities and called marketable debt securities of $87.2 million, $85.7 million, and $26.5 million, respectively. In addition, we invested $2.7 million, $2.4 million, and $2.2 million in equipment and software in 2007, 2006, and 2005, respectively.

Cash flows used in financing activities

Net cash flows used in financing activities in 2007, 2006, and 2005 was primarily for repurchases of our common stock. Since 2004, our Board of Directors has approved three stock repurchase programs that authorized us to repurchase in the aggregate up to $30.0 million of our common stock. Purchases under these programs were made on the open market.

The following table is a summary of our repurchase activity under all of our repurchase programs for 2007, 2006, and 2005:

(Dollars in thousands)	**2007**		**2006**		**2005**	
	Shares	**Amount**	**Shares**	**Amount**	**Shares**	**Amount**
Prior year authorizations at January 1,		$ 6,872		$ 4,123		$ 10,000
Authorizations		10,000		10,000		
Repurchases paid	799,347	(9,135)	962,420	(6,819)	957,112	(5,877)
Repurchases unsettled	48,015	(569)				
Expirations		(5,958)		(432)		
Authorized dollars remaining as of December 31,		$ 1,210		$ 6,872		$ 4,123

Between January 1, 2005 and December 31, 2007, we repurchased approximately 2,767,000 shares of our common stock for approximately $22.4 million under three separate programs, including $0.6 million of repurchases that settled in January 2008. These share repurchases partially offset the shares issued and proceeds received under our various share-based compensation plans in 2007, and more than offset these amounts in 2006 and 2005. Under these share-based compensation plans, we received proceeds for shares issued of $10.9 million, $3.7 million, and $1.8 million in 2007, 2006, and 2005, respectively.

On May 30, 2006, our Board of Directors approved an ongoing quarterly cash dividend of $0.03 per share, beginning with the second quarter ended June 30, 2006. Accordingly, the Company declared $0.12 per share and $0.09 per share for the years ended December 31, 2007 and 2006, respectively, and paid cash dividends of $4.3 million and $2.1 million in 2007 and 2006, respectively. It is our current intention to pay a quarterly cash dividend of $0.03 per share to shareholders of record as of the first trading day of each quarter, however, the Board of Directors may terminate or modify this dividend program at any time without notice.

We believe that our current cash, cash equivalents, and cash flow from operations will be sufficient to fund our business for at least the next twelve months. Material risks to cash flow from operations include delayed or reduced cash payments accompanying sales of new licenses or a decline in our services business. 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.

As of December 31, 2007, we had material commitments for purchases of customer support and consulting services, and payments under operating leases. Our principal administrative, sales, marketing, support, and research and development operations are located in an approximate 100,000 square foot leased facility in Cambridge, Massachusetts. The lease for this facility expires in 2013, subject to our option to extend for two additional five-year periods. We also lease space for our other offices in the U.S., Canada, Australia, France, and the United Kingdom. These leases expire at various dates through 2010. Rent expense under operating leases is recognized on a straight-line basis to account for scheduled rent increases. The excess of expense over current payments is recorded as deferred rent and included in other long-term liabilities.

In July 2006, the Company entered into an agreement to lease additional space in its Cambridge, Massachusetts facility. The lease for this additional space expires in 2013, subject to our option to extend for two additional five-year periods. Under a tenant improvement allowance, the agreement allows us to collect reimbursement from the landlord, up to approximately $0.9 million of the costs associated with the build-out of this space. As of December 31, 2007, we had incurred and had been reimbursed for approximately $0.9 million of improvement costs, which were recorded as leasehold improvements with a corresponding credit to deferred rent expense to be amortized to rent expense over the lease term.

As of December 31, 2007, our known contractual obligations, including future minimum rental payments required under operating leases with non-cancelable terms in excess of one year were as follows:

			Payment due by period			
Contractual obligations: (in thousands)	**Total (1)**	**2008**	**2009 & 20010**	**2011 & 2012**	**2013 and after**	**Other (1)**
Purchase commitments	$ 690	$ 690	$	$	$	$
FIN 48 liability	9,825					9,825
Operating lease obligations (2)	22,264	4,215	8,191	8,415	1,443	
Total	$ 32,779	$ 4,905	$ 8,191	$ 8,415	$ 1,443	$ 9,825

(1) Total contractual obligations include our FIN 48 liability of approximately $9.8 million, but we are unable to reasonably estimate the timing in individual years beyond 12 months due to uncertainties in the timing of the effective settlement of tax positions.

(2) Includes deferred rent of approximately $0.2 million included in accounts payable and accrued expenses and approximately $1.8 million in other long-term liabilities.

The following table summarizes the cash receipts due in connection with our existing term license agreements:

Year ended December 31, (in thousands)	Installment payments for term licenses recorded on the balance sheet (1)	Installment payments for term licenses not recorded on the balance sheet (2)
2008	$ 19,183	$ 21,338
2009	3,500	19,197
2010	2,780	14,087
2011	2,176	10,616
2012	1,267	6,202
Total	28,906	$ 71,440
Unearned installment interest income	(1,456)	
Total license installments receivable, net	$ 27,450	

(1) These amounts have previously been recognized as license revenue, net of unearned installment interest income and consist of approximately $19.2 million of short-term license installments and approximately $8.3 million of long-term license installments included in the accompanying consolidated balance sheet as of December 31, 2007. For these agreements, we recognized the present value of future term license payments upon customer acceptance, provided that no significant obligations or contingencies exist related to the software, other than maintenance support, and provided all other criteria for revenue recognition have been met.

(2) These amounts will be recognized as revenue in the future over the term of the agreement as payments become due or earlier if prepaid. The aggregate installment payments for these term licenses increased $57.2 million in 2007 from $14.2 million as of December 31, 2006.

Inflation

Inflation has not had a significant impact on our operating results to date, and we do not expect it to have a significant impact in the future. Our unbilled license and maintenance fees are typically subject to annual increases based on recognized inflation indices.

Significant customers

No customer accounted for 10% or more of our total revenue in 2007, 2006, or 2005.

New Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS 157). SFAS 157 defines fair values, establishes a framework for measuring fair value, and expands the disclosure requirements about fair value measurements. In February 2008, the FASB issued Staff Position No. FAS 157-2 (FSP 157-2) that defers the effective date of applying the provisions of SFAS 157 to the fair value measurement of nonfinancial assets and nonfinancial liabilities until fiscal years beginning after November 15, 2008. We were required to adopt the provisions of SFAS 157 that pertain to financial assets and liabilities on January 1, 2008. The adoption of SFAS 157 did not have a material impact on our consolidated financial position or results of operations. We are currently evaluating the effect FSP 157-2 will have on our consolidated financial position and results of operations.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115, (SFAS 159). SFAS 159 allows entities to voluntarily choose, at specified election dates, to measure many financial assets and financial liabilities (as well as certain nonfinancial instruments that are similar to financial instruments) at fair value. The election is made on an instrument-by-instrument basis and is irrevocable. If the fair value option is elected for an instrument, SFAS 159 specifies that all subsequent changes in fair value for that instrument shall be reported in earnings. We were required to adopt SFAS 159 on January 1, 2008. The adoption of SFAS 159 did not have a material effect on our consolidated financial position or results of operations.

In December 2007, the FASB issued SFAS No. 141 (revised), Business Combinations (SFAS 141(R)). SFAS 141(R) changes the accounting for business combinations including the measurement of acquirer shares issued in consideration for a business combination, the recognition of contingent consideration, the accounting for preacquisition gain and loss contingencies, the recognition of capitalized in-process research and development, the accounting for acquisition-related restructuring cost accruals, the treatment of acquisition related transaction costs and the recognition of changes in the acquirer s income tax valuation allowance. SFAS 141(R) applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008, except for certain tax adjustments for prior business combinations. Accordingly, we will adopt this statement on January 1, 2009. We are evaluating the effect SFAS 141(R) will have on our consolidated financial position and results of operations.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51 (SFAS 160). SFAS 160 changes the accounting for noncontrolling (minority) interests in consolidated financial statements including the requirements to classify noncontrolling interests as a component of consolidated stockholders equity, and the elimination of minority interest accounting in results of operations with earnings attributable to noncontrolling interests reported as part of consolidated earnings. Additionally, SFAS 160 revises the accounting for both increases and decreases in a parent s controlling ownership interest. SFAS 160 is effective for fiscal years beginning after December 15, 2008, with early adoption prohibited. Accordingly, we will adopt this statement on January 1, 2009. We do not expect the adoption of SFAS 160 to have a material impact on our consolidated financial position or results of operations.

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ITEM 7A QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

Market risk represents the risk of loss that may affect us due to adverse changes in financial market prices and rates. Our market risk exposure is primarily fluctuations in foreign exchange rates and interest rates. We have not entered into derivative or hedging transactions to manage risk in connection with such fluctuations.

Foreign currency exposure

We derived approximately 35%, 37%, and 34% of our total revenue from sales to customers based outside of the U.S. in 2007, 2006, and 2005, respectively. Our international sales may be denominated in U.S. dollars or foreign currencies depending on the customer and transaction. However, the operating expenses of our foreign operations are primarily denominated in foreign currencies. To the extent the international sales are also denominated in the foreign currency, our foreign currency exposure is largely offset. An increase in the value of foreign currencies, particularly the British pound and the Euro relative to the U.S. dollar, could adversely impact our revenues and operating results. There can be no assurance that sales denominated in foreign currencies will not be material in the future.

Most of our transactions with customers are invoiced from our offices in the U.S. For those transactions that are denominated in currencies other than the U.S. dollar, we have receivables and license installments that are valued in foreign currencies. In addition, our U.S. operating company holds cash and investments in foreign currencies in order to support our foreign operations. Our functional currency is the U.S. dollar, therefore, when there are changes in the foreign currency exchange rates versus the U.S. dollar, we recognize a foreign currency transaction gain or (loss) in other income (expense), net in our consolidated statements of income. We had net assets valued in foreign currencies, consisting primarily of cash, investments, license installments, and receivables, partially offset by accounts payable and accruals, with a carrying value of approximately $28.4 million as of December 31, 2007. As of December 31, 2007, a ten percent change in foreign currency exchange rates would have changed the carrying value of our net assets by approximately $2.8 million as of that date with a corresponding currency gain (loss) recognized in our consolidated statement of income.

Interest rate exposure

Our balance sheet contains interest bearing assets which have fixed rates of interest. These assets include license installments receivable generated in the normal course of business through transactions with customers and our investments in marketable debt securities.

License installments receivable bear interest at the rate in effect when the license revenue was recognized, which does not vary throughout the life of the contractual cash flow stream. We believe that at current market interest rates, the fair value of license installments receivable approximates the carrying value as reported on our balance sheets. However, there can be no assurance that the fair market value will approximate the carrying value in the future. Factors such as increasing interest rates can reduce the fair market value of the license installments receivable. Changes in market rates do not affect net earnings as the license installments receivable are carried at cost and, since they are not financial instruments and are held until maturity, are not marked to market to reflect changes in the fair value of the portfolio. The carrying value of our total license installment receivables was $27.5 million as of December 31, 2007, and reflects the weighted-average of historic discount rates used to record each term license arrangement. The average rate changes with market rates as new license installments receivable are added to the portfolio, which mitigates exposure to market interest rate risk. A 200 basis point increase in market interest rates would have decreased the fair value of our license installments receivable by approximately $0.6 million as of December 31, 2007.

We invest primarily in government sponsored enterprises and corporate bonds that are fixed rate marketable debt securities. A 200 basis point increase in market interest rates would have reduced the fair value of our marketable debt securities by approximately $2.2 million as of December 31, 2007. Changes in market rates and

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the related impact on fair value of the investments do not generally affect net earnings as our investments are fixed rate securities and are classified as available-for-sale and as such, unrealized gains and losses, net of tax effect, are recorded in accumulated other comprehensive income in our accompanying consolidated balance sheets. However, when the investments are sold, the unrealized gains and losses are recorded as realized gains and losses and included in net income in the accompanying consolidated statements of income.

In November 2005, the FASB issued FASB Staff Position (FSP) FAS 115-1 and FAS 124-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments (FSP 115-1), which provides guidance on determining when investments in certain debt and equity securities are considered impaired, whether that impairment is other-than-temporary, and on measuring such impairment loss. FSP 115-1 also includes accounting considerations subsequent to the recognition of an other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. We analyze our investments for impairments on an ongoing basis. Factors considered in determining whether a loss is temporary include the length of time and extent to which the securities have been in an unrealized loss position and our ability and intent to hold the investment for a period of time sufficient to allow for any anticipated market recovery. As of December 31, 2007, we held investments that had aggregate gross unrealized losses of approximately $0.2 million. All such securities have been in an unrealized loss position for less than 12 months, except for approximately $18.9 million of corporate bonds that had an unrealized loss of $20,000 and mature in 2008. We believe that the impairments to these investments are not other-than-temporary at this time as these securities are all highly rated investments which have been subject to routine market changes that have not been significant to date and we have the ability and intent to hold these investments for a period of time sufficient to allow for the anticipated market recovery.

As of December 31, 2007, we did not directly hold any auction-rate securities or mortgage-backed securities. As a result, any investment exposure related to the recent sub-prime mortgage crisis is indirect and limited to our investments in corporate bonds of financial institutions that could be impacted by the sub-prime mortgage crisis. As of the date of this filing, we are not aware of any downgrades, losses, or other significant deterioration in the fair value of our cash equivalents or short-term investments.

ITEM 8 FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of Pegasystems Inc.

Cambridge, Massachusetts

We have audited Pegasystems Inc. and subsidiaries (the Company) internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management s Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on that risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

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

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

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the Company s annual or interim financial statements will not be prevented or detected on a timely basis. The following material weakness has been identified and included in management s assessment:

Material Weakness in Accounting for Certain Complex Software Revenue Recognition Transactions

The Company did not have effective design or operational controls over accounting for software revenue recognition, specifically; the Company s ability to apply generally accepted accounting principles as they relate to the recognition of revenue on transactions containing complex and non-standard terms. This material weakness resulted in post-closing adjustments proposed to the Company s consolidated financial statements

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effecting revenue, accounts receivable and deferred revenue. These adjustments, some of which are reflected in the accompanying consolidated financial statements for the year ended December 31, 2007, were not individually or collectively material; however there is a reasonable possibility that a material misstatement of the annual or interim financial statements could occur and not be prevented or detected on a timely basis.

This material weakness was considered in determining the nature, timing, and extent of audit tests applied in our audit of the consolidated financial statements as of and for the year ended December 31, 2007, of the Company and this report does not affect our report on such financial statements.

In our opinion, because of the effect of the material weakness identified above on the achievement of the objectives of the control criteria, the Company has not maintained effective internal control over financial reporting as of December 31, 2007, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements as of and for the year ended December 31, 2007, of the Company and our report dated March 10, 2008 expressed an unqualified opinion on those financial statements (which includes an explanatory paragraph relating to the adoption of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No.109*, effective January 1, 2007 and the adoption of Financial Accounting Standards No. 123R, *Share-Based Payment*, effective January 1, 2006).

/s/ Deloitte & Touche LLP

Boston, Massachusetts

March 10, 2008

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of Pegasystems Inc.

Cambridge, Massachusetts

We have audited the accompanying consolidated balance sheets of Pegasystems Inc. and subsidiaries (the Company) as of December 31, 2007 and 2006, and the related consolidated statements of income, stockholders equity and comprehensive income, and cash flows for each of the three years in the period ended December 31, 2007. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.