

MAGIC SOFTWARE ENTERPRISES LTD  
Form 20-F  
April 21, 2015

**SECURITIES AND EXCHANGE COMMISSION**

**Washington D.C. 20549**

**FORM 20-F**

**OR**

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

**For the fiscal year ended December 31, 2014**

**OR**

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**OR**

**..SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES**  
**EXCHANGE ACT OF 1934**

**Date of event requiring this shell company report**

**Commission file number: 0-19415**

**MAGIC SOFTWARE ENTERPRISES LTD.**

(Exact name of Registrant as specified in its charter  
and translation of Registrant's name into English)

**Israel**

(Jurisdiction of incorporation or organization)

**5 Haplada Street, Or Yehuda 6021805, Israel**

(Address of principal executive offices)

**Amit Birk; +972 (3) 538 9322; abirk@magicsoftware.com**

**5 Haplada Street, Or Yehuda 6021805, Israel**

(Name, Telephone, E-mail and/or Facsimile number and Address of Company Contact Person)

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

| Title of each class                       | Name of each exchange on which registered |
|-------------------------------------------|-------------------------------------------|
| <b>Ordinary Shares, NIS 0.1 Par Value</b> | <b>NASDAQ Global Select Market</b>        |

Securities registered or to be registered pursuant to Section 12(g) of the Act: **None**

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act: **None**

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report:

**Ordinary Shares, par value NIS 0. 1 per share.....44,174,217** (as of December 31, 2014)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes ☐ No ☒

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

Yes ☐ No ☒

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes ☒ No ☐

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes ☒ No ☐

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

Large accelerated filer ☐ Accelerated filer ☒ Non-accelerated filer ☐

Indicate by check mark which basis of accounting the registrant has used to prepare the financial statements included in this filing:

U.S. GAAP ☒ International Financial Reporting Standards as issued by the International Accounting Standards Board ☐ Other ☐

If "Other" has been checked in response to the previous question, indicate by check mark which financial statement item the registrant has elected to follow:

Item 17 ☐ Item 18 ☐

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ☐ No ☒

This annual report on Form 20-F is incorporated by reference into the registrant's Registration Statement on Form F-3, File No. 333-192241 and into the registrant's Registration Statements on Form S-8, File Nos. 333-13270, 333-113552, 333-132221 and 333-149553.



## INTRODUCTION

We are a global provider of proprietary application development, business process integration and selected vertical complete software solutions and related professional services, and a vendor of IT outsourcing services. Our software is used by customers to develop, deploy and integrate on-premise, mobile and cloud-based business applications quickly and cost effectively. In addition, our technology enables enterprises to accelerate the process of delivering business solutions that meet current and future needs and allow customers to dramatically improve their business performance and return on investment. With respect to IT outsourcing services, we offer a vast portfolio of professional services in the areas of infrastructure design and delivery, application development, technology consulting planning and implementation services, support services and supplemental staffing services. In addition, we offer a variety of proprietary comprehensive packaged software solutions through certain of our subsidiaries for (i) revenue management and monetization solutions in mobile, wireline, broadband and MVNO/E, (ii) management systems of both hubs and traditional air cargo ground handling operations from physical handling and cargo documentation through customs, seamless EDI communications, dangerous goods, special handling, track and trace, security to billing (iii) human capital management, or HCM, solutions, to facilitate the collection, analysis and interpretation of quality data about people, their jobs and their performance, to enhance HCM decision making and (iv) comprehensive systems for managing broadcast channels in the area of TV broadcast management through cloud-based on demand service or on premise solutions. Based on our technological capabilities, our software solutions enable customers to respond to rapidly-evolving market needs and regulatory changes, while improving the efficiency of their core operations. We have approximately 1,200 employees and operate through a network of over 3,000 independent software vendors, who we refer to as Magic Software Providers, or MSPs, and hundreds of system integrators, distributors, resellers, and consulting and OEM partners. Thousands of enterprises in approximately 50 countries use our products and services.

Our product portfolio consists of:

- **Magic xpa** – a proprietary application platform for developing and deploying business applications.
- **Appbuilder** – a proprietary application platform for building, deploying, and maintaining high-end, mainframe-grade business applications.
- **Magic xpi** – a proprietary platform for application integration.

These products enable our customers to improve their business performance and return on investment by supporting the affordable and rapid delivery and integration of business applications, systems and databases. Using our products, enterprises and MSPs can achieve fast time-to-market by rapidly building integrated solutions, deploy them in multiple environments while leveraging existing IT resources. In addition, our products are scalable and platform-agnostic, enabling our customers to build solutions by specifying their business logic requirements in a high-level language rather than in computer code, and to benefit from seamless platform upgrades and cross-platform functionality without the need to re-write their applications. Our technology also supports the development of mobile applications that can be deployed on a variety of smartphones and tablets, and in a cloud environment.

We sell our products globally through a broad channel network, including our own direct sales representatives and offices, independent country distributors, MSPs that use our technology to develop and sell solutions to their customers, and system integrators. We also offer software maintenance, support, training and consulting services in connection with our products, thus aiding in the successful implementation of Magic xpa, Magic xpi and AppBuilder projects, and assuring successful operation of the platforms once installed.

Our vertical packaged software solutions include:

**Leap™** – a proprietary comprehensive core software solution for Business Support Systems, or BSS, including convergent charging, billing, customer management, policy control and payment software solutions for the telecommunications, content, Machine to Machine/Internet of Things or M2M/IoT, payment and other industries.

**Hermes Solution** – a proprietary comprehensive core software solution for both hubs and traditional air cargo ground handling operations supporting operations from physical handling and cargo documentation through customs, seamless EDI communications, dangerous goods, special handling, track and trace and security to billing.

**HR Pulse** – a customized SaaS and on premise solution for HCM that provides a menu of templates that can be used to affordably and expeditiously create customized HCM solutions for companies and promote the building and implementation of solutions that address broader business challenges.

**MBS Solution** – a proprietary comprehensive core system for TV broadcast management for use in managing broadcast channels.

In addition, we provide a broad range of IT services in the areas of infrastructure design and delivery, application development, technology planning and implementation services, as well as supplemental staffing services to a wide variety of companies, including Fortune 1000 companies. The technical personnel we provide generally supplements in-house capabilities of our customers. We have worked extensively with virtually all types of telecom infrastructure technologies in wireless and wire-line as well as in the areas of infrastructure design and delivery, application development, project management, technology planning and implementation services.

As used in this annual report, the terms “we,” “us,” “our,” and Magic mean Magic Software Enterprises Ltd. and its subsidiaries, unless otherwise indicated.

Our consolidated financial statements appearing in this annual report are prepared in U.S. dollars and in accordance with United States generally accepted accounting principles, or U.S. GAAP. All references in this annual report to “dollars” or “\$” are to U.S. dollars and all references in this annual report to “NIS” are to New Israeli Shekels.

We have obtained trademark registrations for Magic® in the United States, Canada, Israel, the Netherlands (Benelux), Switzerland, Thailand and the United Kingdom. All other trademarks and trade names appearing in this annual report are owned by their respective holders.

Statements made in this annual report concerning the contents of any contract, agreement or other document are summaries of such contracts, agreements or documents and are not complete descriptions of all of their terms. If we filed any of these documents as an exhibit to this annual report or to any previous filing with the Securities and Exchange Commission, or the SEC, you may read the document itself for a complete recitation of its terms.

This annual report on Form 20-F contains various “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act, and the Private Securities Litigation Reform Act of 1995, as amended, with respect to our business, financial condition and results of operations. Such forward-looking statements reflect our current view with respect to future events and financial results. Statements which use the terms “anticipate,” “believe,” “expect,” “plan,” “intend,” “estimate” and similar expressions are intended to identify forward looking statements. We remind readers that forward-looking statements are merely predictions and therefore inherently subject to uncertainties and other factors and involve known and unknown risks that could cause the actual results, performance, levels of activity, or our achievements, or

industry results, to be materially different from any future results, performance, levels of activity, or our achievements expressed or implied by such forward-looking statements. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. Except as required by applicable law, including the securities laws of the United States, we undertake no obligation to publicly release any update or revision to any forward looking statements to reflect new information, future events or circumstances, or otherwise after the date hereof. We have attempted to identify significant uncertainties and other factors affecting forward-looking statements in the Risk Factors section that appears in Item 3D “Key Information - Risk Factors.”

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PART I

ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS

Not applicable.

ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

ITEM 3. KEY INFORMATION

A. SELECTED FINANCIAL DATA

The following table presents selected consolidated financial data as of the dates and for each of the periods indicated. The selected consolidated financial data set forth below should be read in conjunction with and are qualified entirely by reference to Item 5. "Operating and Financial Review and Prospects" and our consolidated financial statements and notes thereto included elsewhere in this annual report.

We have derived the following consolidated income statement data for the years ended December 31, 2012, 2013 and 2014 and the consolidated balance sheet data as of December 31, 2013 and 2014 from our audited consolidated financial statements and notes included elsewhere in this annual report. We have derived the consolidated income statement data for the year ended December 31, 2010 and 2011 and the consolidated balance sheet data as of December 31, 2010, 2011 and 2012 from our audited consolidated financial statements that are not included in this annual report.

Income Statement Data:

|           | <b>Year ended December 31,</b>                                      |             |             |             |             |
|-----------|---------------------------------------------------------------------|-------------|-------------|-------------|-------------|
|           | <b>2010</b>                                                         | <b>2011</b> | <b>2012</b> | <b>2013</b> | <b>2014</b> |
|           | <b>(U.S. dollars in thousands, except share and per share data)</b> |             |             |             |             |
| Revenues: |                                                                     |             |             |             |             |
| Software  | \$20,111                                                            | \$23,110    | \$23,684    | \$23,254    | \$25,351    |

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|                                                      |         |          |          |          |          |
|------------------------------------------------------|---------|----------|----------|----------|----------|
| Maintenance and technical support                    | 14,407  | 16,751   | 22,384   | 22,685   | 22,780   |
| Consulting services                                  | 54,060  | 73,467   | 80,312   | 99,019   | 116,173  |
| Total revenues                                       | 88,578  | 113,328  | 126,380  | 144,958  | 164,304  |
| Cost of revenues:                                    |         |          |          |          |          |
| Software                                             | 5,320   | 5,771    | 7,439    | 6,648    | 7,646    |
| Maintenance and technical support                    | 2,070   | 2,250    | 3,238    | 2,949    | 2,921    |
| Consulting services                                  | 44,058  | 59,237   | 62,716   | 76,296   | 89,160   |
| Total cost of revenues                               | 51,448  | 67,258   | 73,393   | 85,893   | 99,727   |
| Gross profit                                         | 37,130  | 46,070   | 52,987   | 59,065   | 64,577   |
| Operating costs and expenses:                        |         |          |          |          |          |
| Research and development, net                        | 2,072   | 2,047    | 2,947    | 3,706    | 4,750    |
| Selling and marketing                                | 17,526  | 20,147   | 22,990   | 23,066   | 24,580   |
| General and administrative                           | 8,194   | 9,159    | 10,642   | 13,166   | 14,521   |
| Other income, net                                    | -       | -        | -        | -        | -        |
| Operating income                                     | 9,338   | 14,717   | 16,408   | 19,127   | 20,726   |
| Financial income (expense), net                      | (224 )  | 221      | 10       | (684 )   | (1,786 ) |
| Other income (expense), net                          | 159     | 125      | 136      | (12 )    | (67 )    |
| Income before taxes on income                        | 9,273   | 15,063   | 16,554   | 18,431   | 18,873   |
| Tax benefit (taxes on income)                        | 102     | 203      | (94 )    | (1,575 ) | (2,307 ) |
| Income after taxes on income                         | 9,375   | 15,266   | 16,460   | 16,856   | 16,566   |
| Net income                                           | \$9,375 | \$15,266 | \$16,460 | \$16,856 | \$16,566 |
| Change in redeemable non-controlling interests       | -       | -        | 184      | 546      | 542      |
| Net income attributable to non-controlling interests | -       | 222      | 93       | 430      | 621      |
| Net income attributable to Magic's Shareholders      | 9,375   | 15,044   | 16,183   | 15,880   | 15,403   |
| Basic earnings per share                             | \$0.29  | \$0.41   | \$0.44   | \$0.43   | 0.36     |
| Diluted earnings per share                           | \$0.29  | \$0.41   | \$0.44   | \$0.43   | \$0.36   |
| Shares used to compute basic earnings per share      | 32,140  | 36,268   | 36,502   | 36,835   | 44,172   |
| Shares used to compute diluted earnings per share    | 32,731  | 37,046   | 37,108   | 37,294   | 43,305   |
| Dividends                                            | -       | -        | 3,661    | 7,723    | 8,681    |
| Cash dividend declared per ordinary share            | \$0.50  | -        | \$0.10   | \$0.21   | \$0.22   |

## Balance Sheet Data:

|                                                                       | December 31,                |          |          |          |           |
|-----------------------------------------------------------------------|-----------------------------|----------|----------|----------|-----------|
|                                                                       | 2010                        | 2011     | 2012     | 2013     | 2014      |
|                                                                       | (U.S. dollars in thousands) |          |          |          |           |
| Working capital                                                       | \$48,815                    | \$36,304 | \$44,205 | \$45,171 | \$102,843 |
| Cash, cash equivalents, short term deposits and marketable securities | 46,542                      | 32,122   | 38,634   | 35,988   | 84,430    |
| Total assets                                                          | 111,950                     | 135,971  | 152,954  | 167,003  | 224,184   |
| Total equity                                                          | 88,865                      | 105,625  | 118,361  | 129,131  | 187,724   |

## Dividend Policy

## Dividends:

In December 2009, we declared a cash dividend of \$0.5 per share (\$16.0 million in the aggregate) to our shareholders of record on January 11, 2010, that was payable on January 25, 2010.

In September 2012, we declared a cash dividend of \$0.10 per share (\$3.7 million in the aggregate) to our shareholders of record on October 2, 2012, that was payable on October 17, 2012.

In February 2013 we declared a cash dividend of \$0.12 per share (\$4.4 million in the aggregate) to our shareholders of record on February 25, 2013 that was payable on March 14, 2013.

In August 2013, we declared an additional cash dividend of \$0.09 per share (\$3.4 million in the aggregate) to our shareholders of record on August 21, 2013 that was payable on September 3, 2013.

In February 2014, we declared paid a cash dividend of \$0.12 per share (\$4.5 million in the aggregate) to our shareholders of record on February 27, 2014, that was payable on March 14, 2014.

In September 2014, we declared a cash dividend in the amount of US \$0.095 per share (\$4.2 million in the aggregate) to shareholders of record on August 19, 2014, that was payable on September 4, 2014.

During 2014, we distributed cash dividends totaling \$8.7 million (or \$0.215 per share), providing a dividend yield of approximately 3.2%.

In February 2015, we declared a cash dividend in the amount of US \$0.081 per share (\$3.6 million in the aggregate) to our shareholders of record on February 23, 2015, that was payable on March 11, 2015.

The distributed amounts were consistent with our Board of Directors' dividend policy to distribute a dividend of up to 50% of our annual distributable profits each year, subject to any law. Our Board of Directors may at its discretion and at any time, change, whether as a result of a one-time decision or a change in policy, change the rate of dividend distributions or decide not to distribute a dividend. For information about our dividend policy and distributions see Item 8A. "Financial Information - Consolidated Statements and Other Financial Information."

B. CAPITALIZATION AND INDEBTEDNESS

Not applicable.

C. REASONS FOR THE OFFER AND USE OF PROCEEDS

Not applicable.

D. RISK FACTORS

*Investing in our ordinary shares involves a high degree of risk and uncertainty. You should carefully consider the risks and uncertainties described below before investing in our ordinary shares. Our business, prospects, financial condition and results of operations could be adversely affected due to any of the following risks. In that case, the value of our ordinary shares could decline, and you could lose all or part of your investment.*

**Risks Related to Our Business and Our Industry**

***We are dependent on a limited number of core product families and services and a decrease in revenues from these products and services would adversely affect our business, results of operations and financial condition; our future success will be largely dependent on the acceptance of future releases of our core product families and if we are unsuccessful with these efforts, our business, results of operations and financial condition will be adversely affected.***

We derive a significant portion of our revenues from sales of application platforms, integration products and vertical software solutions and from related professional services, software maintenance and technical support as well as from other IT professional services, which include IT consulting and staffing services. Our future growth depends heavily on our ability to effectively develop and sell new products developed by us or acquired from third parties as well as

add new features to existing products. A decrease in revenues from our principal products and services would adversely affect our business, results of operations and financial condition.

Our future success will mainly be dependent on the continued acceptance of our application platforms and integration products primarily under our Magic xpa, Magic xpi and Appbuilder brands. The continued acceptance of these products will be dependent in part on the continued acceptance and growth of the cloud market, including rich internet applications, or RIAs, mobile and software as a service, or SaaS, for which they are particularly useful and advantageous. We will need to continue to enhance our products to meet evolving requirements and if new versions of such products are not accepted, our business, results of operations and financial condition may be adversely affected.

***Rapid technological changes may adversely affect the market acceptance of our products and services, and our business, results of operations and financial condition could be adversely affected.***

We compete in a market that is characterized by rapid technological changes. Other companies are also seeking to offer software solutions, enterprise mobility solutions and Internet-related solutions, such as cloud computing, to generate growth. These companies may develop technological or business model innovations in the markets that we seek to address that are, or are perceived to be, equivalent or superior to our products. In addition, our customers' business models may change in ways that we do not anticipate and these changes could reduce or eliminate our customers' needs for our products and services. Our operating results depend on our ability to adapt to market changes and develop and introduce new products and services into existing and emerging markets.

The introduction of new technologies and devices could render existing products and services obsolete and unmarketable and could exert price pressures on our products and services. Our future success will depend upon our ability to address the increasingly sophisticated needs of our customers by:

Supporting existing and emerging hardware, software, databases and networking platforms; and

Developing and introducing new and enhanced software development technology and applications that keep pace with such technological developments, emerging new product markets and changing customer requirements.

In addition, if release dates of any future products or enhancements are delayed or if they fail to achieve market acceptance when released, our business, financial condition and results of operations could be adversely affected.

***Adapting to evolving technologies can require substantial financial investments, distract management and adversely affect the demand for our existing products and services.***

Adapting to evolving technologies may require us to invest a significant amount of resources into the development, integration, support and marketing of those technologies. The acceptance and growth of cloud computing and enterprise mobility are examples of rapidly changing technologies which we have adapted into our products and packaged software solution. This required us to make a substantial financial investment to develop and implement cloud computing and enterprise mobility into our software solution models and has required significant attention from our management to refine our business strategies to include the delivery of these solutions. As the market continues to adopt these new technologies, we expect to continue to make substantial investments in our service solutions and system integrations related to these changing technologies. Even if we succeed in adapting to a new technology by developing attractive products and services and successfully bringing them to market, there is no assurance that the new product or service will have a positive impact on our financial performance and could even result in lower revenue, lower margins and higher costs and therefore could negatively impact our financial performance.

***We are exposed to general global economic and market conditions, particularly those impacting the communications industry.***

We provide packaged software and IT services to service providers in the communications industry, and our business may therefore be highly dependent upon conditions in that industry. Developments in the communications industry, such as the impact of global economic conditions, industry consolidation, emergence of new competitors, commoditization of voice, video and data services and changes in the regulatory environment, at times have had, and could continue to have, a material adverse effect on our existing or potential customers. In the past, these conditions reduced the high growth rates that the communications industry had previously experienced and caused the market value, financial results and prospects and capital spending levels of many communications companies to decline or degrade. Industry consolidation involving our customers may place us at risk of losing business to the incumbent provider to one of the parties to the consolidation or to new competitors. During previous economic downturns, the communications industry experienced significant financial pressures that caused many in the industry to cut expenses and limit investment in capital intensive projects and, in some cases, led to restructurings and bankruptcies. Continuing uncertainty as to economic recovery in recent years may have adverse consequences for our customers and

our business.

Downturns in the business climate for communications companies have in the past resulted in slower customer buying decisions and price pressures that adversely affected our ability to generate revenue. Adverse market conditions may have a negative impact on our business by decreasing our new customer engagements and the size of initial spending commitments under those engagements, as well as decreasing the level of discretionary spending by existing customers. In addition, a slowdown in buying decisions may extend our sales cycle period and may limit our ability to forecast our flow of new contracts. If such adverse business conditions arise in the future, our business may be harmed.

The revenues of one of our principal IT professional services subsidiaries is dependent upon Ericsson Inc., or Ericsson, which is currently our largest customer, accounting for 19%, 13% and 10% of our total revenues for the years ended December 31, 2012, 2013 and 2014, respectively. The decline in the percentage of our total revenues attributable to Ericsson is the result of an increase in our total revenues and the completion of a number projects for Ericsson. We do not know if, or for how much longer, Ericsson will continue to utilize our IT professional services. Under a recently entered master services agreement, Ericsson may terminate its agreement with us upon 30 days' notice without any penalty. The termination of our agreement with Ericsson, or a significant decrease in revenues from them, may adversely affect our business, results of operations and financial condition.

***If our customers terminate contracted projects or choose not to retain us for additional projects, our revenues and profitability may be negatively affected.***

Our IT professional services customers typically retain us on a non-exclusive basis. Many of our customer contracts, including those that are on a fixed price and timeframe basis, can be terminated by the customer with or without cause upon 90 days' notice or less, and generally without termination-related penalties. Additionally, our contracts with customers are typically limited to discrete projects without any commitment to a specific volume of business or future work and may involve multiple stages. In addition, the increased breadth of our service offerings may result in larger and more complex projects for our customers that require us to devote resources to more thoroughly understand their operations. Despite these efforts, our customers may choose not to retain us for additional stages or may cancel or delay planned or existing engagements due to any number of factors, including:

- a customer's financial difficulties;
- a change in a customer's strategic priorities;
- a customer's demand for price reductions; and
- a decision by a customer to utilize its in-house IT capacity or work with our competitors.

These potential terminations, cancellations or delays in planned or existing engagements could make it difficult for us to use our personnel efficiently and may negatively impact our revenues and profitability.

***We enter from time to time into fixed-price contracts that could subject us to losses in the event we fail to properly estimate our costs.***

We enter from time to time into a number of firm fixed-price contracts. If our initial cost estimates are incorrect, we can lose money on these contracts. Because many of these contracts involve new technologies and applications, unforeseen events, such as technological difficulties and other cost overruns, can result in the contract pricing becoming less favorable or even unprofitable to us and have an adverse impact on our financial results.

***If we fail to meet our customers' performance expectations, our reputation may be harmed, causing us to lose customers or exposing us to legal liability.***

Our ability to attract and retain customers depends to a large extent on our relationships with our customers and our reputation for high quality solutions, professional services and integrity. As a result, if a customer is not satisfied with our services or solutions, including those of subcontractors we engage, our reputation may be damaged. Our failure to meet these goals or a customer's expectations may result in a less profitable or an unprofitable engagement. Moreover, if we fail to meet our customers' expectations, we may lose customers and be subject to legal liability, particularly if such failure adversely impacts our customers' businesses.

In addition, a portion of our projects may be considered critical to the operations of our customers' businesses. Our exposure to legal liability may be increased in the case of outsourcing contracts in which we become more involved in our customers' operations. While we typically strive to include provisions designed to limit our exposure to legal claims relating to our services and the solutions we develop, these provisions may not adequately protect us or may not be enforceable in all cases. The general liability insurance coverage that we maintain, including coverage for errors and omissions, is subject to important exclusions and limitations. We cannot be certain that this coverage will continue to be available on reasonable terms or will be available in sufficient amounts to cover one or more large claims, or that the insurer will not disclaim coverage as to any future claim. A successful assertion of one or more large claims against us that exceeds our available insurance coverage or changes in our insurance policies, including premium increases or the imposition of large deductible or co-insurance requirements, could adversely affect our profitability.

***If our technical support or professional services are not satisfactory to our customers, they may not renew their maintenance and support agreements or buy future products, which could adversely affect our future results of operations.***

Our business relies on our customers' satisfaction with the technical support and professional services we provide to support our products. If we fail to provide technical support services that are responsive, satisfy our customers' expectations and resolve issues that they encounter with our products and services, then they may elect not to purchase or renew annual maintenance and support contracts and they may choose not to purchase additional products and services from us. Accordingly, our failure to provide satisfactory technical support or professional services could lead our customers not to renew their agreements with us or renew on terms less favorable to us, and therefore have a material and adverse effect on our business and results of operations.

***We face intense competition in the markets in which we operate. This competition could adversely affect our business, results of operations and financial condition.***

We compete with other companies in the areas of application platforms, business integration and business process management, or BPM, tools, and in the applications, mobile solutions, vertical solutions and services markets in which we operate. The growth of the cloud computing market has increased the competition in these areas. We expect that such competition will increase in the future, both with respect to our technology, applications and services which we currently offer and applications and services which we and other vendors are developing. Increased competition, direct and indirect, could adversely affect our business, financial condition and results of operations.

We also compete with other companies in the technical IT consulting and staffing services industry. This industry is highly competitive and fragmented and has low entry barriers. We, through four of our subsidiaries in the United States and three of our subsidiaries in Israel, compete for potential customers with providers of outsourcing services, systems integrators, computer systems consultants, other providers of technical IT consulting services and, to a lesser extent, temporary personnel agencies. We expect competition to increase, and we may not be able to remain competitive.

Some of our existing and potential competitors are larger companies, have substantially greater resources than us, including financial, technological, marketing, skilled human resources and distribution capabilities, and enjoy greater market recognition than us. We may not be able to differentiate our products and services from those of our competitors, offer our products as part of integrated systems or solutions to the same extent as our competitors, or successfully develop or introduce new products that are more cost-effective, or offer better performance than our competitors. Failure to do so could adversely affect our business, financial condition and results of operations.

***As we derive a portion of our revenues from the Israeli government sector, a reduction of government spending in Israel on IT services may reduce our revenues and profitability; and any delay in its annual budget approval process may negatively impact our cash flows.***

We perform work for a wide range of Israeli governmental agencies and related subcontractors. Any reduction in total Israeli government spending for political or economic reasons, such as occurred in the Israeli recession ending in 2004 or the recent worldwide recession, may reduce our revenues and profitability. In addition, the government of Israel has experienced significant delays in the approval of its annual budget in recent years. Such delays in the future could negatively affect our cash flows by delaying receipt of payment from the government of Israel for services performed.

***We may encounter difficulties in realizing the potential financial or strategic benefits of recent business acquisitions. We expect to make additional acquisitions in the future that could disrupt our operations and harm our operating results.***

It is a part of our business strategy to pursue acquisitions and other initiatives in order to expand our product offerings or services or otherwise enhance our market position and strategic strengths. In the past five years we made a number of acquisitions, including: (i) our distributor in South Africa, Magix Integration (Proprietary) Ltd., or Magix Integration, which specializes in the software integration and application development of our platforms as well as the support of large-scale and complex systems in the public and financial sectors in South Africa; (ii) the AppBuilder activity of BluePhoenix Solutions Ltd., or AppBuilder, a development platform for managing, maintaining, and reusing business applications required by large-scale enterprises; (iii) Complete Business Solutions Ltd., a software solution integrator and a Business Partner of SAP; (iv) Comm-IT Group, a software and systems development house that specializes in providing advanced IT and communications services and solutions, project and product consultation, installation and implementation of databases and software integration; (v) Dario Solutions IT Ltd., a provider of software integration and software solutions for large and mid-range customers in Israel and Microsoft Gold Level Partner; (vi) Valinor Ltd., a Microsoft Certified Partner and a Oracle Gold Level Partner that specializes in project and product consultation, and the installation and implementation of databases; (vii) the enterprise division of Allstates Technical Services, LLC, a U.S.-based full-service provider of consulting and staffing solutions for IT, engineering and telecom personnel; (viii) Datamind, a software solutions integrator of user-driven Business Intelligence (“BI”) solutions (mainly QlikView and Qlik Sense) that enable customers to make better, faster and more informed business decisions, wherever they are. QlikView and Qlik Sense are self-service data visualization and analysis applications/tools built using market-proven data indexing engine, delivering the ease-of-use business users require to create personalized visualizations, reports and dashboards through simple drag-and-drop techniques, while ensuring centralized data security and governance. These BI tools are designed to expand the focus of filling the gap between visualization or dashboard solutions and complex BI platforms tied to report-centric ways of doing business. As Data Discovery is being adopted as an alternative BI platform, these BI tools are designed to give users the immediate insights they need and IT professionals the enterprise manageability and governance they require. It supports the way human curiosity naturally searches, filters, questions and finds associations in data to find meaning in information more easily, revealing insights and enabling decisions in the process; (ix) Formula Telecom Solutions Ltd., an Israeli based global proprietary software vendor, specializes in the development, sale, service and support of Business Support Systems, or BSS, including convergent charging, billing, customer management, policy control and payment software solutions for the telecommunications, content, Machine to Machine/Internet of Things, or M2M/IoT, payment and other industries; and (x) our most recent announcement of February 25, 2015 regarding our entry into a definitive agreement to acquire a 70% stake, with an option to increase our holdings to 100%, in an Israeli-based company specializing in software professional services for mainframes and complex large-scale environments. The acquisition is subject to the fulfillment of certain conditions defined in the acquisition agreement. Mergers and acquisitions of companies are inherently risky and subject to many factors outside of our control and no assurance can be given that our future acquisitions will be successful and will not adversely affect our business, operating results, or financial condition. In the future, we may seek to acquire or make strategic investments in complementary businesses, technologies, services or products, or enter into strategic partnerships or alliances with third parties in the future in order to expand our business. Failure to manage and successfully integrate acquisitions

could materially harm our business and operating results. Prior acquisitions have resulted in a wide range of outcomes, from successful introduction of new products and technologies to a failure to do so. Even when an acquired company has previously developed and marketed products, there can be no assurance that new product enhancements will be made in a timely manner or that pre-acquisition due diligence will have identified all possible issues that might arise with respect to such products. If we acquire other businesses, we may face difficulties, including:

Difficulties in integrating the operations, systems, technologies, products, and personnel of the acquired businesses or enterprises;

Diversion of management's attention from normal daily operations of the business and the challenges of managing larger and more widespread operations resulting from acquisitions;

- Potential difficulties in completing projects associated with in-process research and development;

Difficulties in entering markets in which we have no or limited direct prior experience and where competitors in such markets have stronger market positions;

- Insufficient revenue to offset increased expenses associated with acquisitions; and

The potential loss of key employees, customers, distributors, vendors and other business partners of the companies we acquire following and continuing after announcement of acquisition plans.

***If we fail to manage our growth, our business could be disrupted and our profitability will likely decline.***

We have experienced rapid growth during the last six years, through both acquisitions and organic growth. The number of our employees increased from 397 as of December 31, 2009 to approximately 1,181 as of December 31, 2014 and may increase further as we aim to enhance our businesses. This increase may significantly strain our management and other operational and financial resources. In particular, continued headcount growth increases the integration challenges involved in:

- recruiting, training and retaining skilled technical, marketing and management personnel;

- maintaining high quality standards;

- preserving our corporate culture, values and entrepreneurial environment;

- developing and improving our internal administrative infrastructure, particularly our financial, operational, communications and other internal controls; and

- maintaining high levels of customer satisfaction.

The rapid execution necessary to exploit the market for our business model requires an effective planning and management process. Our systems, procedures or controls may not be adequate to support the growth in our operations, and our management may not be able to achieve the rapid execution necessary to exploit the market for our business model. Our future operating results will also depend on our ability to expand our development, sales and marketing organizations. If we are unable to manage growth effectively, our profitability will likely decline.

*We have a history of quarterly fluctuations in our results of operations and expect these fluctuations to continue.*

We have experienced, and in the future may continue to experience, significant fluctuations in our quarterly results of operations. Factors that may contribute to fluctuations in our quarterly results of operations include:

- The size and timing of orders;

- The high level of competition that we encounter;

- The timing of our products introductions or enhancements or those of our competitors or of providers of complementary products;

- Market acceptance of our new products, applications and services;

- The purchasing patterns and budget cycles of our customers and end-users;

- The mix of product sales;

Exchange rate fluctuations;

General economic conditions; and

The integration of newly acquired businesses.

Our customers ordinarily require the delivery of our products promptly after we accept their orders. With the exception of contracts for services and packaged software solution projects, we usually do not have a backlog of orders for our products. Consequently, revenues from our products in any quarter depend on orders received and products provided by us and accepted by the customers in that quarter. A deferral in the placement and acceptance of any large order from one quarter to another could adversely affect our results of operations for the prior quarter. Our customers sometimes require an acceptance test for services and packaged software solutions projects we provide and as a result, we may have a significant backlog of orders arising from those services and projects. Our revenues from services depend on orders received and services provided by us and accepted by our customers in that quarter. If sales in any quarter do not increase correspondingly or if we do not reduce our expenses in response to level or declining revenues in a timely fashion, our financial results for that quarter may be adversely affected. For these reasons, quarter-to-quarter comparisons of our results of operations are not necessarily meaningful and you should not rely on the results of our operations in any particular quarter as an indication of future performance.

***The revenues in one of our principal IT professional services subsidiaries are dependent upon one key customer and a significant decrease in revenues from such customer could adversely affect our business, results of operations and financial condition.***

The revenues of one of our principal IT professional services subsidiaries is dependent upon Ericsson, which is currently our largest customer, accounting for 19%, 13% and 10% of our total revenues for the years ended December 31, 2012, 2013 and 2014, respectively. The decline in the percentage of our total revenues attributable to Ericsson is the result of an increase in our total revenues and the completion of a number projects for Ericsson. We do not know if, or for how much longer, Ericsson will continue to utilize our IT professional services. Under a recently entered master services agreement, Ericsson may terminate its agreement with us upon 30 days' notice without any penalty. The termination of our agreement with Ericsson, or a significant decrease in revenues from them, may adversely affect our business, results of operations and financial condition

***The increasing amount of intangible assets and goodwill recorded on our balance sheet may lead to significant impairment charges in the future.***

We regularly review our long-lived assets, including identifiable intangible assets and goodwill, for impairment. Goodwill and indefinite life intangible assets are subject to impairment review at least annually. Other long-lived assets are reviewed when there is an indication that impairment may have occurred. The amount of goodwill and identifiable intangible assets on our consolidated balance sheet has increased significantly from \$26.9 million as of December 31, 2009 to approximately \$88 million as of December 31, 2014 as a result of our acquisitions, and may increase further following future acquisitions. Impairment testing under U.S. GAAP may lead to further impairment charges in the future. Any significant impairment charges could have a material adverse effect on our results of operations.

***If we fail to attract and retain highly skilled IT professionals, we may not have the necessary resources to properly staff projects and competition for such professionals may adversely affect our business, results of operations and financial condition.***

Our success depends largely on the contributions of our employees and our ability to attract and retain qualified personnel, including technology, consulting, engineering, marketing and management professionals and also upon our ability to attract and retain qualified computer professionals to serve as temporary IT personnel. Competition for the limited number of qualified professionals with a working knowledge of certain sophisticated computer languages is intense. We compete for technical personnel with other providers of technical IT consulting and staffing services, systems integrators, providers of outsourcing services, computer systems consultants, customers and, to a lesser extent, temporary personnel agencies. A shortage of, and significant competition for software professionals with the skills and experience necessary to perform the required services, may require us to forego projects for lack of resources and may adversely affect our business, results of operations and financial condition. In addition, our ability to maintain and renew existing engagements and obtain new business for our contract IT professional services operations depends, in large part, on our ability to hire and retain technical personnel with the IT skills that keep pace with continuing changes in software evolution, industry standards and technologies, and customer preferences. Demand for qualified professionals conversant with certain technologies may exceed supply as new and additional skills are required to keep pace with evolving computer technology or as competition for technical personnel increases. Increasing demand for qualified personnel could also result in increased expenses to hire and retain qualified technical personnel and could adversely affect our profit margins.

***We derive a significant portion of our revenues from independent distributors who are under no obligation to purchase our products and the loss of such independent distributors could adversely affect our business, results of operations and financial condition.***

We sell our products and packaged software solutions through our own direct sales representatives and offices, as well as through third parties that use our technology to develop and sell solutions to their customers (ISVs) and also through system integrators. The ISVs then sell the applications they develop on the Magic xpa or AppBuilder application platforms to end-users. In some regions, especially in Asia and Asia-Pacific, Central and Eastern Europe, Spain, Italy, South America, Africa and a few countries in the Mediterranean area, we also sell our products and packaged software solutions through a broad distribution and sales network, including independent regional distributors. We are dependent upon the acceptance of our products by our ISVs and independent distributors and their active marketing and sales efforts. Typically, our arrangements with our independent distributors do not require them to purchase specified amounts of products or prevent them from selling competitive products. Our ISVs may stop using our technology to develop and sell solutions to end-users. Similarly, our independent distributors may not continue, or may not give a high priority to, marketing and supporting our products. Our results of operations could be adversely affected by a decline in the number of ISVs utilizing our technology and by changes in the financial condition, business, marketing strategies, local and global economic conditions, or results of our independent distributors. If any of our distribution relationships are terminated, we may not be successful in replacing them on a timely basis, or at all. In addition, we will need to develop new sales channels for new products, and we may not succeed in doing so. Any changes in our distribution and sales channels, or our inability to establish effective distribution and sales channels for new markets, could adversely impact our ability to sell our products and result in a loss of revenues and profits.

***Unfavorable national and global economic conditions could adversely affect our business, operating results and financial condition.***

During periods of slowing economic activity our customers may reduce their demand for our products, technology and professional services, which would reduce our sales, and our business, operating results and financial condition may be adversely affected. Economies throughout the world currently face a number of challenges, including threatened sovereign defaults, credit downgrades, restricted credit for businesses and consumers and potentially falling demand for a variety of products and services. Notwithstanding the improving economic conditions in some of our markets, many companies are still cutting back expenditures or delaying plans to add additional personnel or systems. Any further worsening of the global economic condition could result in longer sales cycles, slower adoption of new technologies and increased price competition for our products and services. We could also be exposed to credit risk and payment delinquencies on our accounts receivable, which are not covered by collateral. Any of these events would likely harm our business, operating results and financial condition.

***Changes in the ratio of our revenues generated from different revenue elements may adversely affect our gross profit margins.***

We derive our revenues from the sale of software licenses, related professional services, maintenance and technical support as well as from other IT professional services. Our gross margin is affected by the proportion of our revenues generated from the sale of each of those elements of our revenues. Our revenues from the sale of our software licenses, related professional services, maintenance and technical support have higher gross margins than our revenues from IT professional services. Our software licenses revenues also include the sale of third party software licenses, which have a lower gross margin than sales of our proprietary software products. Any increase in the portion of third party software license sales out of total license sales will decrease our gross profit margin. If the relative proportion of our revenues from the sale of IT professional services increases as a percentage of our total revenues, our gross profit margins may decline in the future.

***Our success depends in part upon the senior members of our management and research and development teams, and our inability to attract and retain them or attract suitable replacements could have a negative effect on our ability to operate our business.***

We are dependent on the senior members of our management and research and development teams. We do not maintain key man life insurance for any of the senior members of our management and research and development teams. Competition for senior management in our industry is intense, and we may not be able to retain our senior management personnel or attract and retain new senior management personnel in the future. The loss of one or more members of our senior management and research and development teams could have a negative effect on our ability to attract and retain customers, execute our business strategy and otherwise operate our business, which could reduce our revenues, increase our expenses and reduce our profitability.

***We may encounter difficulties with our international operations and sales which could adversely affect our business, results of operations and financial condition.***

While our principal executive offices are located in Israel, 91%, 83% and 82% of our sales in the years ended December 31, 2012, 2013 and 2014, respectively, were generated in other regions and countries including, but not limited to the United States, Europe, Japan, Asia-Pacific, India and Africa. Our success in becoming a stronger competitor in the sale of application platforms, integration solutions, packaged software solutions and professional services is dependent upon our ability to increase our sales in all our markets. Our efforts to increase our penetration into these markets are subject to risks inherent to such markets, including the high cost of doing business in such locations. Our efforts may be costly and they may not result in profits, which could adversely affect our business, results of operations and financial condition.

Our international operation subjects us to many risks inherent to international business activities, including:

- Limitations and disruptions resulting from the imposition of government controls;
- Changes in regulatory requirements;
- Export license requirements;
- Economic or political instability;
- Trade restrictions;
- Changes in tariffs;
- Currency fluctuations;
- Difficulties in the collection of receivables;
- Foreign tax consequences;
- Greater difficulty in safeguarding intellectual property; and
- Difficulties in managing overseas subsidiaries and international operations.

We may encounter significant difficulties in connection with the sale of our products and services in international markets as a result of one or more of these factors and our business, results of operations and financial condition could be adversely affected.

***Currency exchange rate fluctuations in the markets in which we conduct business could adversely affect our business, results of operations and financial condition.***

Our financial statements are stated in U.S. dollars, our functional currency. However, in the years ended December 31, 2012, 2013 and 2014, approximately 49%, 51% and 52% of our revenues, respectively, were derived from sales outside the United States, particularly Europe, Japan and Asia-Pacific, Israel, the United Kingdom and Africa. We also maintain substantial non-U.S. dollar balances of assets, including cash and accounts receivable, and liabilities, including accounts payable. Similarly, a significant portion of our expenses, primarily salaries, related personnel expenses, subcontractors expenses and the leases of our offices and related administrative expenses, were incurred outside the United States. Therefore, fluctuations in the value of the currencies in which we do business relative to the U.S. dollar, primarily NIS, euros and Japanese yen, may adversely affect our business, results of operations and financial condition, by decreasing the U.S. dollar value of assets held in other currencies and increasing the U.S. dollar amount of liabilities payable in other currencies, or by decreasing the U.S. dollar value of our revenues in other currencies and increasing the U.S. dollar amount of our expenses in other currencies. Even if we use derivatives or other instruments to hedge part or all of our exposures from time to time, they may not effectively eliminate such risk, if at all.

***Breaches of network or information technology security, natural disasters or terrorist attacks could have an adverse effect on our business.***

Cyber attacks or other breaches of network or IT security, natural disasters, terrorist acts or acts of war may cause equipment failures or disrupt our systems and operations. We may be subject to attempts to breach the security of our networks and IT infrastructure through cyber attack, malware, computer viruses and other means of unauthorized access. While we maintain insurance coverage for some of these events, the potential liabilities associated with these events could exceed the insurance coverage we maintain. Our inability to operate our facilities as a result of such events, even for a limited period of time, may result in significant expenses or loss of market share to other competitors for our application platforms as well as in the process and business integration technologies and IT services market. In addition, a failure to protect the privacy of customer and employee confidential data against breaches of network or IT security could result in damage to our reputation. To date, we have not been subject to cyber attacks or other cyber incidents which, individually or in the aggregate, resulted in a material impact to our operations or financial condition.

Maintaining the security of our products, computers and networks is a critical issue for us and our customers. Security researchers, criminal hackers and other third parties regularly develop new techniques to penetrate computer and network security measures. In addition, hackers also develop and deploy viruses, worms and other malicious software programs, some of which may be specifically designed to attack our products, systems, computers or networks. Additionally, outside parties may attempt to fraudulently induce our employees or users of our products to disclose sensitive information in order to gain access to our data or our customers' data. These potential breaches of our security measures and the accidental loss, inadvertent disclosure or unauthorized dissemination of proprietary information or sensitive, personal or confidential data about us, our employees or our customers, including the potential loss or disclosure of such information or data as a result of hacking, fraud, trickery or other forms of deception, could expose us, our employees, our customers or the individuals affected to a risk of loss or misuse of this information, result in litigation and potential liability or fines for us, damage our brand and reputation or otherwise harm our business.

***Regulation of the internet and telecommunications, privacy and data security may adversely affect sales of our products and result in increased compliance costs.***

As internet commerce continues to evolve, increasing regulation by federal, state or foreign agencies and industry groups becomes more likely. For example, we believe increased regulation is likely with respect to the solicitation, collection, processing or use of personal, financial and consumer information as regulatory authorities around the world are considering a number of legislative and regulatory proposals concerning data protection, privacy and data security. In addition, the interpretation and application of consumer and data protection laws and industry standards in the United States, Europe and elsewhere are often uncertain and in flux. The application of existing laws to cloud-based solutions is particularly uncertain and cloud-based solutions may be subject to further regulation, the impact of which cannot be fully understood at this time. Moreover, it is possible that these laws may be interpreted and applied in a manner that is inconsistent with our data and privacy practices. If so, in addition to the possibility of fines, this could result in an order requiring that we change our data and privacy practices, which could have an adverse effect on our business and results of operations. Complying with these various laws could cause us to incur substantial costs or require us to change our business practices in a manner adverse to our business. Also, any new regulation, or interpretation of existing regulation, imposing greater fees or taxes on internet-based services, or restricting information exchange over the Web, could result in a decline in the use and adversely affect sales of our products and our results of operations.

***Our products have a lengthy sales cycle which could adversely affect our revenues.***

Our customers typically use our technologies to develop and deploy as well as to integrate applications that are critical to their businesses. As a result, the licensing and implementation of our technologies generally involves a significant commitment of attention and resources by prospective customers. Because of the long approval process that typically accompanies strategic initiatives or capital expenditures by companies, our sales process is often delayed, with little or no control over any delays encountered by us. Our sales cycle, which generally ranges from three to eighteen months, can be further extended for sales made through third party distributors. We spend substantial time, effort and money in

our sales efforts without any assurance that such efforts will produce any sales.

*Our products may contain defects that may be costly to correct, delay their market acceptance and expose us to difficulties in the collection of receivables and to litigation.*

Despite our regular quality assurance testing, as well as testing performed by our partners and end-users who participate in our beta-testing programs, errors may be found in our software products or in applications developed with our technology. This risk is exacerbated by the fact that a significant percentage of the applications developed with our technology were and are likely to continue to be developed by our ISVs, system integrators and enterprises over which we exercise no supervision or control. If defects are discovered, we may not be able to successfully correct them in a timely manner or at all. Defects and failures in our products could result in a loss of, or delay in, market acceptance of our products, as well as difficulties in the collection of receivables and litigation, and could damage our reputation.

Our standard license agreement with our customers contains provisions designed to limit our exposure to potential product liability claims that may not be effective or enforceable under the laws of some jurisdictions. Also, the professional liability insurance that we maintain may not be sufficient against potential claims. Accordingly, we could fail to realize revenues and suffer damage to our reputation as a result of, or in defense of, a substantial claim.

***Our proprietary technology and packaged software solutions are difficult to protect and unauthorized use of our proprietary technology by third parties may impair our ability to compete effectively.***

Our success and ability to compete depend in large part upon our ability to protect our proprietary technology. We rely on a combination of trade secret and copyright laws and confidentiality, non-disclosure and assignment-of-inventions agreements to protect our proprietary technology. We do not have any patents. Our policy is to require employees and consultants to execute confidentiality and non-compete agreements upon the commencement of their relationships with us. These measures may not be adequate to protect our technology from third-party infringement, and our competitors might independently develop technologies that are substantially equivalent or superior to ours. Additionally, our products may be sold in foreign countries that provide less protection for intellectual property rights than that provided under U.S. or Israeli laws.

***Third parties have in the past, and may in the future, claim that we infringe upon their intellectual property rights and could harm our business.***

From time to time third parties have in the past, and may in the future, assert infringement claims against us or claim that we have violated a patent or infringed upon a copyright, trademark or other proprietary right belonging to them. Intellectual property litigation is expensive and any court ruling against us or infringement claim, even one without merit, could result in the expenditure of significant financial and managerial resources to defend any such claims, which will adversely affect our financial condition and results of operations.

***Any unauthorized, and potentially improper, actions of our personnel could adversely affect our business, operating results and financial condition.***

The recognition of our revenue depends on, among other things, the terms negotiated in our contracts with our customers. Our personnel may act outside of their authority and negotiate additional terms without our knowledge. We have implemented policies to help prevent and discourage such conduct, but there can be no assurance that such policies will be followed. For instance, in the event that our sales personnel negotiate terms that do not appear in the contract and of which we are unaware, whether such additional terms are written or verbal, we could be prevented from recognizing revenue in accordance with our plans. Furthermore, depending on when we learn of unauthorized actions and the size of the transactions involved, we may have to restate revenue for a previously reported period, which would seriously harm our business, operating results and financial condition.

***Because we are controlled by Formula Systems (1985) Ltd. and Asseco Poland S.A., investors will not be able to affect the outcome of shareholder votes.***

Formula Systems (1985) Ltd., or Formula Systems (symbol: FORTY), an Israeli company whose shares trade on the NASDAQ Global Select Market and the TASE, directly owned 20,158,201 or 45.2%, of our outstanding ordinary shares as of the date of this annual report. Asseco Poland S.A., or Asseco, a Polish company listed on Warsaw Stock Exchange, owns 46.4% of the outstanding shares of Formula Systems. Although transactions between us and our controlling shareholders are subject to special approvals under Israeli law, Formula Systems and Asseco will be able to exercise control over our operations and business strategy and affairs, including any determinations with respect to potential mergers or other business combinations involving us, our acquisition or disposition of assets, our incurrence of indebtedness, our issuance of any additional ordinary shares or other equity securities, our repurchase or redemption of ordinary shares and our payment of dividends. Similarly, Formula Systems and Asseco will most probably be able to control most matters requiring shareholder approval, including the election of our directors (subject to a special majority required for the election of external directors). Such concentration of ownership may have the effect of delaying or preventing an acquisition or a change in control of us.

***If we are unable to maintain effective internal control over financial reporting in accordance with Sections 302 and 404(a) of the Sarbanes-Oxley Act of 2002, the reliability of our financial statements may be questioned and our share price may suffer.***

The Sarbanes-Oxley Act of 2002 imposes certain duties on us and on our executives and directors. To comply with this statute, we are required to document and test our internal control over financial reporting, and our independent registered public accounting firm must issue an attestation report on our internal control procedures, and our management is required to assess and issue a report concerning our internal control over financial reporting. Our efforts to comply with these requirements have resulted in increased general and administrative expenses and a diversion of management time and attention, and we expect these efforts to require the continued commitment of significant resources. We may identify material weaknesses or significant deficiencies in our assessments of our internal controls over financial reporting. Failure to maintain effective internal control over financial reporting could result in investigation or sanctions by regulatory authorities, and could adversely affect our operating results, investor confidence in our reported financial information and the market price of our ordinary shares.

## Risks Related to Our Ordinary Shares

*Our share price has been volatile in the past and may continue to be susceptible to significant market price and volume fluctuations in the future.*

Our ordinary shares have experienced significant market price and volume fluctuations in the past and may experience significant market price and volume fluctuations in the future. In 2012 our share price on the NASDAQ Global Select market declined by 7%, in 2013 our share price increased by 59% and in 2014, our share price declined by 14%. Our market price and volume may fluctuate in response to factors such as the following, some of which are beyond our control:

Quarterly variations in our operating results;

Changes in expectations as to our future financial performance, including financial estimates by securities analysts and investors;

Announcements of technological innovations or new products by us or our competitors;

Announcements by us or our competitors of significant contracts, acquisitions, strategic partnerships, joint ventures or capital commitments;

Changes in the status of our intellectual property rights;

Announcements by third parties of significant claims or proceedings against us;

Additions or departures of key personnel;

The public's response to our press releases, our other public announcements and our filings with the SEC and the Israeli Securities Authority;

Announcement of dividends;

Future sales of our ordinary shares by our directors, officers and significant shareholders;

· Political and economic conditions, such as a recession or interest rate or currency rate fluctuations or political events;

· Other events or factors in any of the markets in which we operate, including those resulting from war, incidents of terrorism, natural disasters or responses to such events; and

· General trends of the stock markets.

Domestic and international stock markets often experience extreme price and volume fluctuations. The market prices of ordinary shares of software companies have been extremely volatile. Stock prices of many software companies have often fluctuated in a manner unrelated or disproportionate to the operating performance of such companies.

In the past, securities class action litigation has often been brought against registrants following periods of volatility in the market price of their securities. We may in the future be the target of similar litigation. Securities litigation could result in substantial costs and divert management's attention and resources.

***Our ordinary shares are traded on more than one market and this may result in price variations.***

Our ordinary shares are traded primarily on the NASDAQ Global Select Market and on the TASE. Trading in our ordinary shares on these markets is made in different currencies (U.S. dollars on the NASDAQ Global Select Market and NIS on the TASE) and at different times (resulting from different time zones, different trading days and different public holidays in the United States and Israel). Consequently, the trading prices of our ordinary shares on these two markets may differ. Any decrease in the trading price of our ordinary shares on one of these markets could cause a decrease in the trading price of our ordinary shares on the other market.

***The trading volume of our shares has been low in the past and may be low in the future, resulting in lower than expected market prices for our shares.***

Our shares have traded at low volumes in the past and may trade at low volumes in the future for reasons that may be related or unrelated to our performance. This may result in a lack of liquidity, which could negatively affect the market price for our ordinary shares.

***We may in the future be classified as a passive foreign investment company, or PFIC, which will subject our U.S. investors to adverse tax rules.***

For U.S. federal income tax purposes, we will generally be classified as a PFIC for any taxable year in which either: (i) 75% or more of our gross income is passive income or (ii) at least 50% of the average quarterly value of our assets for the taxable year produce or are held for the production of passive income. Based on certain estimates of our gross income and gross assets and the nature of our business, we do not expect that we will be classified as a PFIC for the taxable year ending December 31, 2015. However, because PFIC status is based on our income, assets and activities for the entire taxable year, it is not possible to determine whether we will be characterized as a PFIC for the 2015 taxable year until after the close of the year. There can be no assurance that we will not be considered a PFIC for any taxable year. If we were determined to be a PFIC for U.S. federal income tax purposes, highly complex rules would apply to U.S. holders owning our ordinary shares and such U.S. holders could suffer adverse U.S. tax consequences. Accordingly, you are urged to consult your tax advisors regarding the application of such rules. U.S. residents should carefully read Item 10E. “Additional Information - Taxation - United States Federal Income Tax Consequences” for a more complete discussion of the U.S. federal income tax risks related to owning and disposing of our ordinary shares.

## **Risks Related to Our Location in Israel**

***Political, economic and military instability in Israel may disrupt our operations and negatively affect our business condition, harm our results of operations and adversely affect our share price.***

We are organized under the laws of the State of Israel, and our principal executive offices and manufacturing and research and development facilities are located in Israel. As a result, political, economic and military conditions affecting Israel directly influence us. Any major hostilities involving Israel, a full or partial mobilization of the reserve forces of the Israeli army, the interruption or curtailment of trade between Israel and its present trading partners, or a significant downturn in the economic or financial condition of Israel could adversely affect our business, financial condition and results of operations.

In recent years, there have been hostilities between Israel and Hezbollah in Lebanon and Hamas in the Gaza strip, both of which resulted in rockets being fired into Israel causing casualties and disruption of economic activities. Most recently, in July 2014, an armed conflict commenced between Israel and Hamas. In addition, Israel faces threats from more distant neighbors, in particular, Iran. Also, since 2011, riots and uprisings in several countries in the Middle East and neighboring regions have led to severe political instability in several neighboring states and to a decline in the regional security situation. Such instability may affect the local and global economy, could negatively affect business conditions and, therefore, could adversely affect our operations. To date, these matters have not had any material effect on our business and results of operations; however, the regional security situation and worldwide perceptions of it are outside our control and there can be no assurance that these matters will not negatively affect our business, financial condition and results of operations in the future.

Furthermore, there are a number of countries, primarily in the Middle East, as well as Malaysia and Indonesia, that restrict business with Israel or Israeli companies, and we are precluded from marketing our products to these countries. Restrictive laws or policies directed towards Israel or Israeli businesses may have an adverse impact on our operations, our financial results or the expansion of our business.

***Our results of operations may be adversely affected by the obligation of our personnel to perform military service.***

Many of our executive officers and employees in Israel are obligated to perform annual reserve duty in the Israeli Defense Forces and may be called for active duty under emergency circumstances at any time. If a military conflict or war arises, these individuals could be required to serve in the military for extended periods of time. Our operations could be disrupted by the absence for a significant period of one or more of our executive officers or key employees or a significant number of other employees due to military service. Any disruption in our operations could adversely affect our business.

***We currently have the ability to benefit from government tax benefits, which may be cancelled or reduced in the future.***

We are currently eligible to receive tax benefits under programs of the Government of Israel. In order to maintain our eligibility for these tax benefits, we must continue to meet specific requirements. If we fail to comply with these requirements in the future, such tax benefits may be cancelled.

***Service and enforcement of legal process on us and our directors and officers may be difficult to obtain.***

We are organized in Israel and some of our directors and executive officers reside outside the United States. Service of process upon them may be difficult to effect within the United States. Furthermore, most of our assets and the assets of some of our executive officers are located outside the United States. Therefore, a judgment obtained against us or any of them in the United States, including one based on the civil liability provisions of the U.S. federal securities laws may not be collectible in the United States and may not be enforced by an Israeli court. It also may be difficult for you to assert U.S. securities law claims in original actions instituted in Israel.

***Provisions of Israeli law may delay, prevent or make difficult an acquisition of us, which could prevent a change of control and therefore depress the price of our shares.***

Israeli corporate law regulates mergers, requires tender offers for acquisitions of shares above specified thresholds, requires special approvals for transactions involving directors, officers or significant shareholders and regulates other matters that may be relevant to these types of transactions. Furthermore, Israeli tax considerations may make potential transactions unappealing to us or to some of our shareholders. These provisions of Israeli corporate and tax law may have the effect of delaying, preventing or complicating a merger with, or other acquisition of, us. This could cause our ordinary shares to trade at prices below the price for which third parties might be willing to pay to gain control of us.

Third parties who are otherwise willing to pay a premium over prevailing market prices to gain control of us may be unable or unwilling to do so because of these provisions of Israeli law.

***The rights and responsibilities of our shareholders are governed by Israeli law and differ in some respects from the rights and responsibilities of shareholders under U.S. law.***

We are organized under Israeli law. The rights and responsibilities of holders of our ordinary shares are governed by our memorandum of association, articles of association and by Israeli law. These rights and responsibilities differ in some respects from the rights and responsibilities of shareholders in typical U.S. corporations. In particular, a shareholder of an Israeli company has a duty to act in good faith in exercising his or her rights and fulfilling his or her obligations toward the company and other shareholders and to refrain from abusing his power in the company, including, among other things, in voting at the general meeting of shareholders on certain matters. Israeli law provides that these duties are applicable in shareholder votes at the general meeting with respect to, among other things, amendments to a company's articles of association, increases in a company's authorized share capital, mergers and actions and transactions involving interests of officers, directors or other interested parties which require the shareholders' general meeting's approval. In addition, a controlling shareholder of an Israeli company or a shareholder who knows that he or she possesses the power to determine the outcome of a vote at a meeting of our shareholders, or who has, by virtue of the company's articles of association, the power to appoint or prevent the appointment of an office holder in the company, or any other power with respect to the company, has a duty of fairness toward the company. The Israeli Companies Law does not establish criteria for determining whether or not a shareholder has acted in good faith.

*As a foreign private issuer whose shares are listed on the NASDAQ Global Select Market, we may follow certain home country corporate governance practices instead of certain NASDAQ requirements.*

As a foreign private issuer whose shares are listed on the NASDAQ Global Select Market, we are permitted to follow certain home country corporate governance practices instead of certain requirements of the NASDAQ Stock Market Rules. Among other things, as a foreign private issuer we may also follow home country practice with regard to, the composition of the board of directors, director nomination procedure, compensation of officers and quorum at shareholders' meetings. In addition, we may follow our home country law, instead of the NASDAQ Stock Market Rules, which require that we obtain shareholder approval for certain dilutive events, such as for the establishment or amendment of certain equity based compensation plans, an issuance that will result in a change of control of the company, certain transactions other than a public offering involving issuances of a 20% or more interest in the company and certain acquisitions of the stock or assets of another company. Accordingly, our shareholders may not be afforded the same protection as provided under NASDAQ's corporate governance rules. In addition, as foreign private issuer, we are not required to file quarterly reviewed financial statements. A foreign private issuer that elects to follow a home country practice instead of such requirements must submit to NASDAQ in advance a written statement from an independent counsel in such issuer's home country certifying that the issuer's practices are not prohibited by the home country's laws. In addition, a foreign private issuer must disclose in its annual reports filed with the SEC each such requirement that it does not follow and describe the home country practice followed by the issuer instead of any such requirement.

#### ITEM 4. INFORMATION ON THE COMPANY

##### A. HISTORY AND DEVELOPMENT OF THE COMPANY

We were organized under the laws of the State of Israel in 1983 as Mashov Software Export (1983) Ltd. We changed our name to Magic Software Enterprises Ltd. and completed our initial public offering on the NASDAQ Stock Market in 1991. We completed the dual-listing of our shares for trading on the Tel Aviv Stock Exchange in 2000. We are a public limited liability company and operate under the Israeli Companies Law 1999 and associated legislation. Our registered offices and principal place of business are located at 5 Haplada Street, Or-Yehuda 6021805, Israel, and our telephone number is +972-3-538-9292. Our U.S. subsidiary, Magic Software Enterprises Inc., is located at 24422 Avenida de la Carlota, Laguna Hills, CA 92653. Our website address is [www.magicsoftware.com](http://www.magicsoftware.com). The information on our website is not incorporated by reference into this annual report.

We are a global provider of proprietary application development, business process integration and comprehensive packaged software solutions and related professional services, and a vendor of IT professional and outsourcing services. We report our results on the basis of two reportable business segments: software solutions (which include proprietary and non-proprietary software technology and complementary services) and IT professional services.

Our software is used by customers to develop, deploy and integrate on-premise, mobile and cloud-based business applications quickly and cost effectively. In addition, our technology enables enterprises to accelerate the process of delivering business solutions that meet current and future needs and allow customers to dramatically improve their business performance and return on investment. With respect to IT services, we offer a complete portfolio of professional services in the areas of infrastructure design and delivery, application development, technology consulting planning and implementation services, support services and supplemental staffing services. In addition, we offer a variety of proprietary comprehensive packaged software solutions through certain of our subsidiaries for (i) revenue management and monetization solutions in mobile, wireline, broadband and MVNO/MVNE, (ii) management systems of both hubs and traditional air cargo ground handling operations from physical handling and cargo documentation through customs, seamless EDI communications, dangerous goods, special handling, track and trace, security to billing (iii) HCM solutions, to facilitate the collection, analysis and interpretation of quality data about people, their jobs and their performance to enhance HCM decision making and (iv) a comprehensive system for managing broadcast channels through cloud-based on demand service or on premise solutions. Based on our technological capabilities, our software solutions enable customers to respond to the rapidly-evolving market needs and regulatory changes, while improving the efficiency of their core operations. We have approximately 1,200 employees and operate through a network of over 3,000 independent software vendors, who we refer to as Magic Software Providers, or MSPs, and hundreds of system integrators, distributors, resellers, and consulting and OEM partners. Thousands of enterprises in approximately 50 countries use our products and services.

Through a two-step acquisition in 2011, we acquired 100% of the shares of our South African distributor, Magix Integration. Magix Integration specializes in the software integration and application development of our platforms as well as the support of large-scale and complex systems in the public and financial sectors in South Africa.

In May 2011, we acquired 95% of Complete Business Solutions Ltd. and 100% of Complete Information Technology Ltd., both Israeli companies. The two companies are prominent software solution providers and leading Business Partners of SAP with many years of experience in distributing and implementing SAP Business One ERP Software. In December 2013, for no additional cash consideration, we increased our ownership interest in the shares of Complete Business Solutions to 96.3% following the merger of Complete Information Technology Ltd. into Complete Business Solutions.

In December 2011, we acquired the AppBuilder activity of BluePhoenix Solutions Ltd., a leading provider of value-driven legacy IT modernization solutions. AppBuilder is a comprehensive application development infrastructure used by many Fortune 1000 enterprises around the world. This enterprise application development environment is a powerful, model-driven tool that enables development teams to build, deploy, and maintain large-scale, custom-built business applications.

In May 2012, we launched a major company-wide rebranding, including a new logo and tagline and a restyled website. We renamed our products to bring them both under the Magic brand and to show that they both run on the same technology stack. uniPaaS was renamed Magic xpa Application Platform and iBOLT was renamed Magic xpi Integration Platform.

In July 2012, we acquired an 80% interest in Comm-IT Group, which includes CommIT Technology Solutions Ltd., CommIT Software Ltd. and CommIT Embedded Ltd. This group is an Israel-based software and systems development house that specializes in a broad range of advanced IT and communications services and solutions with proven experience and successful implementation of many projects in a variety of advanced technologies in the U.S., Europe and Israel. We and the other shareholders hold mutual put and call options, for the remaining 20% interest in the group.

In May 2013, our subsidiary, CommIT Technology Solutions Ltd., acquired two Israeli companies, Dario Solutions IT Ltd. and Valinor Ltd. Dario, a Microsoft Gold Level Partner, provides integration services with respect to Microsoft products and provides software integration and advanced IT solutions for large and mid-range customers in Israel. Dario's customers include Israeli governmental offices, the Israeli defense forces, banks, insurance companies, telecom and construction companies and hi-tech firms. Dario specializes in virtualization and private cloud, server based computing, storage area networks, multiple user system management and mobile solutions.

Valinor specializes in project and product consultation, installation and implementation of databases and employs a wide range of information system architects, including data base system architects, or DBAs, who have expertise in database management. Valinor assists its customers in finding creative and effective solutions, including development, conversion, upgrade and installation of complex database systems that handle large amounts of information. As a Microsoft Certified Partner and an Oracle Gold Level Partner, Valinor collaborates with both of these major software providers and is involved in different projects in Israel and internationally. Valinor's DBA employees assist Microsoft in developing SQL Server based databases and provide database consultations for strategic partners. Valinor customers include Israeli governmental offices, the Israeli defense forces, banks, insurance companies, communications companies and hi-tech firms.

On October 15, 2013, we announced the availability of new offline capabilities for Magic xpa and the launch of our Enterprise Mobility Solution that provides businesses with a holistic solution to address their critical enterprise mobility requirements. Our Enterprise Mobility Solution combines our enhanced application and integration platforms, mobile device management, or MDM, tools (based on a white label distribution agreement with SOTI, a leading provider of MDM solutions) and new mobile-oriented professional services. Our Enterprise Mobility Solution provides everything businesses need to deliver successful enterprise-grade business apps including: (i) secure and reliable access to real-time enterprise data; (ii) seamless natural user experiences enabled by native apps that can take full advantage of embedded device capabilities and third-party add-ons; (iii) fast time-to-market; (iv) full security at data, user, device and application levels; and (v), comprehensive management capabilities. We also offer professional services for every stage in the mobile app lifecycle. We believe that by offering a comprehensive solution, we can increase the attractiveness and competitiveness of our Enterprise Mobility Solution to enterprises looking to deploy mobile applications.

On October 31, 2013, we announced major enhancements to our Magic xpi Integration Platform, the adoption of an In-Memory Data Grid, or IMDG, architecture and new off-the-shelf certified adapters optimized for Sugar CRM, Sage ERP and SYSPRO applications. With core enterprise systems in place, organizations of all sizes are looking to business process integration and automation to increase operational efficiency, competitiveness and innovation. Our new IMDG-based architecture offers: (i) cost-effective elastic scalability, (ii) built-in clustering and failover capabilities (the capability to switch to a redundant or standby computer server, system, hardware component or network upon a failure) that support enterprise needs for business continuity, and (iii) faster processing and increased transaction loads spurred by new mobile, cloud and big data use cases. Our expanded library of off-the-shelf adapters, which includes native adapters for Oracle JD Edwards Enterprise One, JD Edwards World, SAP, IBM Lotus Notes, Microsoft Dynamics, Microsoft SharePoint and Salesforce, along with over 60 built-in technology adapters, facilitates use in a broad range of integration scenarios, meeting the needs of a wide range of potential customers and increasing return on investment.

In November 2013, we acquired the enterprise division of Allstates Technical Services, LLC, a U.S.-based full-service provider of consulting and staffing solutions for IT, Engineering and Telecom personnel from KBR, Inc. (NYSE: KBR). With a 60-year history, this division, now known as Allstates Consulting Services LLC brings a strong reputation and an experienced growth-focused management team serving some of the world's leading telecom and technology companies. The acquisition of the enterprise division of Allstates Technical Services, LLC broadens our existing U.S. footprint and adds leading Fortune 500 companies to our customer base. We believe that this acquisition will become an important contributor to our future growth.

In July 2014, we released Magic xpa Application Platform 2.5 with new features and enhancements to allow for fast and easy enterprise mobility application creation and improved user experience along with the brand-new Magic Mobile Accelerator Framework, which includes a set of pre-built, reusable and customizable components for a wide variety of popular mobile application features, including user interface and display, navigation, graphs and charting, location services, synchronization, and device and application auditing. Designed to work together under the same framework, accelerator components enable Magic developers to create attractive, functional mobile applications, faster and with less effort than before.

In October 2014, we acquired 100% of F.T.S. – Formula Telecom Solutions Ltd., or FTS, an Israeli based software vendor. FTS specializes in the development, sale, service and support of Business Support Systems, or BSS, including convergent charging, billing, customer management, policy control and payment software solutions for the telecommunications, content, Machine to Machine/Internet of Things or M2M/IoT, payment and other industries. FTS has a track record of proven experience and successful implementation of many projects in Western and Eastern Europe, Asia and Africa. We believe that the acquisition will broaden our professional service offerings to our existing and new customers in the fields of Business Support Systems, including convergent charging, billing, customer management and policy control.

In December 2014, we released version 4.1 of our Magic xpi Integration Platform, incorporating feedback from the field to bring our customers additional value in terms of redundancy, reliability, stability, performance, and

monitoring. For example, users can now define an alternate host for the server to work with if the main host is unavailable or if the startup procedure on the main host fails. We also added a new mechanism to rebalance the Space partitions so that the primary partition and its backup will not run on the same machine when they are deployed on a clustered environment.

Our new web-based monitoring capabilities enable 24/7 monitoring from any location, providing our customers with accurate information about the status and health of their projects through intuitive and easy to interpret graphs and dashboards. Information is available for whole projects or for different levels within the projects and filters allow you to further refine the display. The information provided by the Magic Monitor helps you to see where you can make modifications to improve project performance and alerts you to potential problems when they arise. You can also make adjustments to the servers directly from the Monitor, without having to go back to the Magic xpi Studio to reconfigure your project.

In addition, we released/updated the following connectors:

- Dynamics CRM 2013
- Dynamics CRM 2015
- Dynamics AX connector
- SugarCRM upgrade to API V10
- Google calendar – API upgrade

Our capital expenditures for the years ended December 31, 2012, 2013 and 2014 were approximately \$0.5, \$0.5 and \$1.0 million, respectively. These expenditures were principally for network equipment and computer hardware, as well as for furniture, office equipment and leasehold improvements.

## B. BUSINESS OVERVIEW

### Industry Overview

The global enterprise information technology market is expected to exceed \$3.8 trillion in 2015 (Gartner, Forecast: IT Spending, Worldwide, 4Q14 Update, December 2014). The market consists of five primary components, including telecommunication services, IT services, devices, software and data center systems. The IT services segment represented \$981 billion of the overall IT spending, or 26% of the total market opportunity (Gartner Market Databook, 4Q14 Update). The software segment represented \$335 billion of the market globally, or 9% of the total market opportunity (Gartner Market Databook, 4Q14 Update).

In recent years, the number of available enterprise applications has grown significantly which has led information system complexity within many organizations to a level that has obstructed business progress and evolution, reduced business agility and led to significantly higher costs. We believe this complexity will continue to increase in the future. Although it is not unusual for organizations to operate multiple applications, systems and platforms that were created utilizing disparate programming languages, the complexity of these environments typically reduces an organization's operating flexibility, hinders decision-making processes and leads to costly inefficiencies and redundancies. When organizations seek to swiftly change, update and upgrade IT assets to support new business processes or to cope with changes in business and regulatory environments, they often find that the introduction and integration of new or upgraded business applications is more complex than expected, requires significant implementation resources, takes a long time to implement and is costly. The proliferation of smartphones and mobile platforms necessitates device-independent and future-proof business solutions for fast, simple, and cost-effective mobile deployment. In addition, new cloud computing technologies present enterprises with an opportunity to realize greater agility and meaningful cost savings to businesses, creating a growing need for further changes to enterprises' IT applications and systems.

The enterprise application development software market consists of several application development sub-segments and includes large dominant players such as IBM, Microsoft, HP, CA Technologies and Compuware as well as a large number of highly specialized vendors, with focused capabilities for specific vertical markets. While application development for traditional platforms is a well-established and mature market which is expected to grow globally from \$9.4 billion to \$10.8 billion in 2017 (Gartner, Enterprise Software Markets, Worldwide, 2010 – 2017, 4Q14 Update, December 2014), emerging mobile applications, systems and devices are transforming the application development space rapidly. The mobile enterprise application market is expected to grow from \$1.2 billion in 2013 to reach \$3.7 billion by 2018 (IDC: Worldwide Mobile Enterprise Application Development Platform 2014–2018 Forecast and 2013 Vendor Shares). By 2018, it is expected that more than half of all business-to-employee (B2E) mobile apps will be created by enterprise business analysts using codeless tools, such as those offered by us (Gartner: Market Guide for Rapid Mobile App Development Tools, Nov. 2014).

The IT services segment of the market is comprised of a broad array of specific segments such as infrastructure design and delivery, application development, technology consulting planning and implementation services, support services and supplemental staffing services. In addition, IT professional services include quality assurance, product engineering services and process consulting. The IT services segment is also undergoing a profound transition, with some key trends that have accelerated recently. Growing demand for mobile and cloud-based applications as well as Big Data solutions also entails more complex IT development and integration projects which management and implementation require a higher level of expertise. In addition, the typical software-based projects of IT consulting have been gradually shifting towards software and technology-driven solutions that can be embedded into clients' systems, providing ongoing engagement services. This transition has been accentuated by an underlying change in IT services sourcing processes: the need for a faster go-to-market process as well as constrained resources in IT departments is resulting in greater influence by specific business units on the purchasing decision as opposed to the traditional sourcing process. The traditional outsourcing business model of capacity on demand is also transitioning towards a model of capability on demand. Information technology service buyers are increasingly looking at outcome-driven managed services with a tighter integration between software, service and infrastructure.

We have identified the following trends that are relevant to the markets we operate in:

**Increasingly complex business integration:** In recent years, enterprises operate multiple applications and platforms, using various programming languages, resulting in complex enterprise information systems. Such systems and the ability to swiftly change, update, and upgrade them to support new business processes are crucial to the enterprise's ability to cope with changes in the business, economic and regulatory environment. However, the introduction and integration of new business applications is complex, requires significant time and human resources and entails significant and often unpredicted costs. Therefore, enterprises are in need of solutions that will facilitate the rapid and seamless deployment of business applications.

**Reusing IT assets/enterprise applications:** In an increasingly dynamic technology, business and economic environment, organizations face mounting pressure to continue to leverage their large IT investments in enterprise applications, such as ERP and CRM, while increasing their ability to change business processes and support new ones. Tools to support lightweight yet rapid, iterative and modular development methodologies, reusable architectures and application life-cycle management are primary drivers for spending on application development worldwide.

**Enterprise mobility:** With the proliferation of smartphones and mobile platforms that support enterprise mobility, enterprise users now expect instant access to real-time information, a rich user experience, seamless integration with various enterprise systems and support to multiple mobile devices. As such, enterprises need to be able to develop device-independent and robust business solutions for fast and cost-effective mobile deployment.

**Cloud, Platform-as-a-Service and Software-as-a-Service:** Cloud, Platform-as-a-Service (PaaS) and Software-as-a-Service (SaaS) are each becoming a well-established phenomenon in some areas of enterprise IT. Cloud-hosted applications continue to grow as alternatives to internally managed systems as they deliver greater agility and meaningful cost savings to businesses. In addition, fast time-to-deployment, low cost-of-entry, and adoption of pay-as-you-go models drive growing adoption of SaaS applications. In turn, SaaS applications enable the rapid construction, deployment and management of some custom-built applications accessed as a service in the cloud. With more SaaS deployments, the need for integration tools that bridge the cloud apps with on-premise application increases.

**Big Data:** The amount of digital information that is being generated by enterprises each year, across a number of diverse data sources and formats, is growing rapidly. Enterprises are required to retain, process and analyze data to attain meaningful insights and gain competitive advantages, and therefore require versatile and flexible tools in order to quickly and reliably process these increasingly large amounts of data.

**IT Consulting:** The typical software-based projects of IT consulting have been gradually shifting towards software and technology-driven solutions that can be embedded into clients' systems, providing ongoing engagement services.

**Sourcing processes:** The need for a faster go-to-market process as well as constrained resources in IT departments is resulting in greater influence by specific business units on the purchasing decision as opposed to the traditional sourcing process. The traditional outsourcing business model of capacity on demand is also transitioning towards a model of capability on demand. Information technology service buyers are increasingly looking at outcome-driven managed services with a tighter integration between software, service and infrastructure.

## Business Overview

We are a global provider of proprietary application development, business process integration and comprehensive packaged software solutions and related professional services and a vendor of IT outsourcing services. We report our results on the basis of two reportable business segments: software solutions (which include proprietary and non-proprietary software technology and complementary services) and IT professional services.

Our software solutions are used by customers to develop, deploy and integrate on-premise, mobile and cloud-based business applications quickly and cost effectively. In addition, our technology enables enterprises to accelerate the process of delivering business solutions that meet current and future needs and allow customers to dramatically improve their business performance and return on investment.

In the aggregate, we have approximately 1,200 employees and operate through a network of over 3,000 independent software vendors and hundreds of system integrators, distributors, resellers, and consulting and OEM partners. Thousands of enterprises in approximately 50 countries use our products and services.

**Our software products and software solutions consist of:**

### Products

**Magic xpa Application Platform**  
**Appbuilder Application Platform**  
**Magic xpi Integration Platform**

### Software Solutions

**Leap™** – offered by our subsidiary, FTS, this is a proprietary comprehensive core software solution for BSS, including convergent charging, billing, customer management, policy control and payment software solutions for the telecommunications, content, Machine to Machine/Internet of Things or M2M/IoT, payment and other industries.

**Hermes Solution** – offered by our subsidiary, Hermes Logistics Technologies Ltd., this is a proprietary comprehensive core software solution for both hubs and traditional air cargo ground handling operations from physical handling and cargo documentation through customs, seamless EDI communications, dangerous goods, special handling, track and trace, security to billing.

**HR Pulse** – offered by our subsidiaries, Pilat (NAI) Inc and Pilat Europe Ltd., this is a customized SaaS and on premise solution for HCM that provides a menu of templates that can be used to affordably and expeditiously create customized HCM solutions for companies and promote the building and implementation of solutions that address broader business challenges.

**MBS Solution** – offered by our subsidiary, Complete Business Solutions Ltd., this is a proprietary comprehensive core system for managing TV broadcast channels.

Our software solutions are used by customers to develop, deploy and integrate on-premise, mobile and cloud-based business applications quickly and cost effectively. In addition, our technology enables enterprises to accelerate the process of delivering business solutions that meet current and future needs and allow customers to dramatically improve their business performance and return on investment. We also provide selected verticals with a complete software solution.

**Our IT services subsidiaries are:**

**Coretech Consulting Group LLC**  
**Fusion Solutions LLC**  
**Xsell Resources Inc**  
**Allstates Consulting Services LLC**  
**CommIT Group**

Our IT services offerings include a broad portfolio of professional services in the areas of infrastructure design and delivery, application development, technology consulting planning and implementation services, support services and supplemental staffing services.

**Software Solutions**

Our software solutions include application platforms for developing and deploying specialized and high-end large-scale business applications and an integration platform that allows the integration and interoperability of diverse solutions, applications and systems in a quick and efficient manner. These solutions enable our customers to improve their business performance and return on investment by supporting the affordable and rapid delivery and integration of business applications, systems and databases. Using our products solutions, enterprises and independent software vendors, or ISVs, can accelerate time-to-market by rapidly building integrated solutions, deploying them in multiple environments while leveraging existing IT resources. In addition, our solutions are scalable and platform-agnostic, enabling our customers to build solutions by specifying their business logic requirements in a commonly used language rather than in computer code, and to benefit from seamless platform upgrades and cross-platform functionality without the need to re-write applications. Our technology also enables future proof protection and supports current market trends such as the development of mobile applications that can be deployed on a variety of smartphones and tablets, and cloud environments. In addition, we also offer a variety of vertical-targeted products that are focused on the needs and requirements of specific growing markets. Certain of these products were developed utilizing our application development platform.

We sell our solutions globally through our own direct sales representatives and offices and through a broad sales distribution network, including independent country distributors, independent service vendors that use our technology to develop and sell solutions to their customers, and system integrators. We also offer software maintenance, support, training, and consulting services in connection with our products and vertical software solutions, thus aiding the successful implementation of projects and assuring successful operation of the platforms once installed. We sell our integration solutions to customers using specific popular software applications, such as SAP, Salesforce.com, IBM i (AS/400), Oracle JD Edwards, Microsoft SharePoint or other eco-systems. As such, we enjoy a well-diversified client base across geographies and industries including oil & gas companies, telecommunications groups, financial institutions, industrial companies, public institutions and international agencies.

### *Background*

Our software solutions enable enterprises to accelerate the planning, development, deployment and integration of on-premise, mobile and cloud business applications that can be rapidly customized to meet current and future needs. Our software solutions and professional services empower customers to dramatically improve their business performance and return on investment by enabling the affordable and rapid delivery, integration and mobilization of business applications, systems and databases. Our technology and solutions are especially in demand when time-to-market considerations are critical, budgets are tight, and integration is required with multiple platforms or applications, databases or existing systems and business processes, as well as for RIAs and SaaS. Our technology also provides the option to deploy our software capabilities in the cloud, hosted in a web services cloud computing environment. We believe these capabilities provide organizations with a faster deployment path and lower total cost of ownership. Our technology also allows developers to stage multiple applications before going live in production.

Development communities are facing high complexity, cost and extended pay-back periods in order to deliver cloud, RIAs, mobile and SaaS applications. Magic xpa, Appbuilder and Magic xpi provide MSPs with the ability to rapidly build integrated applications in a more productive manner, deploy them in multiple modes and architectures as needed, lower IT maintenance costs and speed time-to-market. Our solutions are comprehensive and industry proven. These technologies can be applied to the entire software development market, from the implementation of micro-vertical solutions, through tactical application renovation and process automation solutions, to enterprise spanning SOA migrations and composite applications initiatives. Unlike most competing platforms, we offer a coherent and unified toolset based on the same proven metadata driven and rules-based declarative technology. Metadata platforms consist of pre-compiled and pre-written technical and administrative functions, which are essentially ready-made business application coding that enables developers to bypass the intensive technical code-writing stage of application development and integration and move quickly and efficiently to deployment. Through the use of metadata-driven platforms such as Magic xpa, AppBuilder and Magic xpi, software vendors and enterprise customers can experience unprecedented cost savings through fast and easy implementation and reduced project risk.

An increasing number of our customers and partners across various markets and industries around the globe are using Magic solutions to develop and deploy mobile enterprise applications. In 2014, we had 121 new Magic XPA and Mobile costumers, including:

South African-based Nictus Ltd. chose our Enterprise Mobility Solution to create integrated mobile applications for thousands of its financial services employees and customers that will combine relevant data and processes from its custom CRM and Sage Accpac ERP applications.

U.S.-based Millennium MusicMedia selected our Enterprise Mobility Solution to create a cross-channel SaaS-based business application which tracks the digital assets and royalties of subscribers, including independent artists, writers, producers and publishers, from desktop, iOS or Android devices.

Germany's Rummel Matratzen used the Magic xpa Application Platform to create and deploy an iPad application for its sales team.

BNP Real Estate, a subsidiary of French bank BNP Paribas that operates in all areas of the real estate business, upgraded and mobilized its key sales application using the Magic xpa Application Platform.

U.K.-based Cape plc developed a fully certified mobile solution designed to allow construction site managers to access integrated data from a wide range of enterprise systems and multiple databases, all on a single screen on their mobile device.

U.S.-based Dove Tree Canyon Software developed a RIA-based solution for deploying its next-generation warehouse management software over mobile devices. Having used our technology to successfully deploy an application on Windows Mobile devices, Dove Tree turned to Magic xpa Application Platform to implement its decision to support iOS and Android tablets.

The Swiss branch of SAGE, a leading vendor of integrated and innovative financial software, mobilized its Prospero suite of financial solutions for portfolio managers, brokers, traders, and other financial professionals using our Enterprise Mobility Solution.

WellMark LLC, a U.S.-based manufacturer of liquid and pneumatic controls and valves for the oil and gas industry, developed and deployed iPhone and iPad mobile business applications designed to allow users to access pricing, in-house and remote warehouse inventory status and customer status information.

BKB GrainCo, a South African leader in the trading, storage, and milling of grain commodities, deployed mobile enterprise apps on mobile devices running on the BlackBerry platform. Android and iOS versions are currently being developed.

KDDI, a leading Japan-based telecom company, used our technology as the back-end integration engine for its new service connecting Salesforce.com with Android smartphones.

A top-tier Thai bank which operates approximately 1,000 branches, 6,000 ATMs, 100 foreign exchange offices and 50 international trade centers throughout Thailand, as well as many international branches, has selected AppBuilder as part of its core banking development platform.

The underlying principles and purpose of our technology are to provide:

- Simplicity – the use of code-free development tools instead of hard coding and multiple programming languages;
- Business focus – the use of pre-compiled business logic and components eliminates repetitive, low level technical and coding tasks;
- Comprehensiveness – the use of a comprehensive development and deployment platform offers a full end-to-end development, deployment and integration capability;
- Automation of mundane tasks - to accelerate development and maintenance and reduce risk; and
- Interoperability - to support business logic across multiple hardware and software platforms, operating systems and geographies.

We offer two complementary application platforms that address the wide spectrum of composite applications, Magic xpa and AppBuilder. Our Magic xpi integration platform delivers fast and simple integration and orchestration of business processes and applications. We had 57 new Magic XPI customers in 2014.

*Partnerships and Alliances:*

We continue to build on our existing strategic partnerships that include Oracle, JD Edwards, SAP, Salesforce.com, IBM, SugarCRM and Microsoft to enhance our mobile and integration offerings.

In October 2012, we joined the Samsung Enterprise Alliance Program as a Silver Partner. The Samsung Enterprise Alliance Program is an enterprise mobility ecosystem targeted to leading independent software vendors and system integrators providing differentiated and unique solutions that enhance Samsung's offerings to its enterprise customers. By joining forces with this world-leading smartphone and tablet vendor, our direct local sales representatives have access to Samsung's global and local sales, marketing, and technical expertise, positioning us well to penetrate the large and fast-growing enterprise mobility market.

In July 2013, we also established a partnership with Soti, a leading provider of MDM solutions to distribute their products as part of our Enterprise Mobility Solution.

In September 2013, we initiated a technology partnership with GigaSpaces Technologies, a pioneer provider of In-Memory Computing technology for deployment, management and scaling of mission-critical applications. By combining our technologies, we assist our customers in becoming cloud-ready and enjoying the benefits of high performance, scalability and availability that can be achieved with in-memory computing technology, all with a seamless migration effort and virtually no learning curve. Since the announcement, we have implemented IMDG architecture in our Magic xpi Integration Platform.

In October 2013, we partnered with Sugar CRM, a growing cloud and on-premise CRM ecosystem and Sage, a popular provider of ERP and other business systems to small and medium business, enabling us to provide pre-built connectors for quick and reliable integration with these applications.

#### Magic xpa Application Platform

Magic xpa Application Platform, our metadata driven application platform, provides a simple, code-free and cost-effective development and deployment environment that lets organizations and MSPs quickly create user-friendly, enterprise-grade, multi-channel mobile and desktop business app that employ the latest advanced functionalities and technologies. The Magic xpa Application Platform, formerly named uniPaaS, was first released in 2008 and is an evolution of our original eDeveloper product, a graphical, rules-based and event-driven framework that offered a pre-compiled engine for database business tasks and a wide variety of generic runtime services and functions which was released in 2001.

We have continually enhanced our xpa application platform to respond to major market trends such as the growing demand for cloud-based offerings including RIAs, mobile applications and SaaS. Accordingly, we have added new functionalities and extensions to our application platform, with the objective of enabling the development of RIAs, SaaS, mobile and cloud enabled applications. SaaS is a relatively new business and technical model for delivering software applications, similar to a phone or cable TV model, in which the software applications are installed and hosted in dedicated data centers and users subscribe to these centers and use the applications over an internet connection. This model requires the ability to deliver RIAs. Magic xpa is a comprehensive RIA platform. It uses a single development paradigm that handles all ends of the application development and deployment process including client and server partitioning and the inter-communicating layers.

Magic xpa offers customers the power to choose how they deploy their applications, whether full client or web; on-premise or on-demand; in the cloud or behind the corporate firewall; software or mobile or SaaS; global or local. Our Magic xpa Application Platform complies with event driven and service oriented architectural principles. By offering technology transparency, this product allows customers to focus on their business requirements rather than technological means. The Magic xpa single development paradigm significantly reduces the time and costs associated with the development and deployment of cloud-based applications, including RIAs, mobile and SaaS. In addition, application owners can leverage their initial investment when moving from full client mode to cloud mode, and modify these choices as the situation requires. Enterprises can use cloud-based Magic xpa applications in a SaaS model and still maintain their databases in the privacy of their own data centers. It also supports most hardware and operating system environments such as Windows, Unix, Linux and AS/400, as well as multiple databases and is interoperable with .NET and Java technologies.

Magic xpa can be applied to the full range of software development, from the implementation of micro-vertical solutions, through tactical application renovation and process automation solutions, to enterprise spanning SOA migrations and composite applications initiatives. Unlike most competing platforms, we offer a coherent and unified toolset based on the same proven metadata driven and rules based declarative technology, resulting in increased cost savings through fast and easy implementation and reduced project risk.

In June 2012, we released additional clients for iOS and Android platforms. Our mobile offering successfully addresses even the most complex work flow scenarios, such as deployment of multiple core enterprise applications across multiple back-end systems, and targets the a wide range of smartphones, without compromising functionality or security. This versatile solution enables smartphone users not only to access a vast array of mobile applications, but also to perform many business tasks, such as securely accessing ERP, CRM, or human resource systems, in real-time and from any location, with the user-friendly experience of their mobile phone.

In October 2013, we released an upgrade to our mobile offering that includes complete off-line capabilities such as disconnected operation, offline SQL database support, offline file storage and unlimited sync scenario support. This new offering enables customers dealing with mobile solutions in rural areas, underground facilities or areas without network coverage to continue use their mobile solutions, without disruption. During October 2013, we also announced the release of our End-to-End Enterprise Mobility Solution that packages Magic xpa, Magic xpi, MDM tools (from

SOTI under a white label distribution agreement), and mobility related professional services to provide customers with a holistic solution to address all critical enterprise mobility requirements.

Our Magic xpa Application Platform was acknowledged in Gartner's *2013 Magic Quadrant for On-Premise Application Platform* as "gaining in popularity versus Java as enterprises seek to exploit new technologies to improve developer productivity."

Magic's Enterprise Mobility Solution received the 2013 Shining Star Award for Enterprise Application Development from Mobile Village and also received Developer Week's 2014 Top Innovator Award for Mobile Development.

We released Magic xpa Application Platform 2.5 on July 2014, with new features and enhancements to allow for fast and easy enterprise mobility application creation and improved user experience.

This year we were awarded Frost & Sullivan's 2014 Product Innovation Leadership Award for Magic xpi Integration Platform.

Our Magic End-to-End Enterprise Mobility Solution won both DeveloperWeek's 2014 Top Innovator Award and a 2014 Mobile Village Superstar Award for mobile development.

Gartner researched and conducted a survey in Japan regarding the usage of Automatic Program Generation Tool in the Japanese market and concluded that the most selected tool actually being used is dbMagic (aka Magic XPA).

#### AppBuilder Application Platform

AppBuilder, a platform we acquired in December 2011, is a development environment used for managing, maintaining and reusing complicated applications needed by large businesses. It provides the infrastructure for enterprises worldwide, across several industries, with applications running millions of transactions daily on legacy systems. Enterprises using AppBuilder can build, deploy and maintain large-scale custom-built business applications for years without being dependent on any particular technology. The AppBuilder deployment environments include IBM mainframe, Unix, Linux and Windows. AppBuilder is intended to increase productivity and agility in the creation and deployment of enterprise class computing.

AppBuilder follows the 4GL development paradigm to help enterprises focus on the business needs and definition and overlook technical hurdles. AppBuilder developers define the business roles and prior to deployment the code is generated from the development environment to the required run time environment. Several large MSPs have utilized AppBuilder to build state of the art applications that are deployed through many large customers.

AppBuilder implements a model driven architecture approach to application development. It provides the ability to design an application at the business modeling level and generate forward to an application. AppBuilder has a platform-independent, business-rules language that enables generation to multiple platforms. It is possible to generate the client part of an application as Java and the server part as COBOL. As businesses change, the server part can be generated as Java without changing the application logic. Only a simple configuration option needs to be changed.

AppBuilder contains everything a development environment needs to create any type of simple or complex business application with platform-independent functionality, including:

- System administration security controls for scope and permissions;
- Migration, testing, and deployment functions;
- Architecture-independent development;
- An integrated toolset for designing, developing, and deploying applications;
- Object-based components managed from host, server, or client repositories;
- Support for Java/J2EE, COBOL, C#, and C programming languages;
- An efficient, cross-platform code generation facility;
- Ready-to-use business logic and libraries;
- A remote prepare facility for mainframe development;
- Multiple language user interface support; and
- DBCS support.

## Magic xpi Integration Platform

Our Magic xpi integration platform (formerly branded iBOLT) is a graphical, wizard-based code-free solution delivering fast and simple integration and orchestration of business processes and applications. Magic xpi allows businesses to more easily view, access, and leverage their mission-critical information, delivering true enterprise application integration, or EAI, business process management, or BPM, and SOA infrastructure. Increasing the usability and life span of existing legacy and other IT systems, Magic xpi allows fast EAI, development and customization of diverse applications, systems and databases, assuring rapid return on invested capital and time-to-market, increased profitability and customer satisfaction.

Magic xpi allows the integration and interoperability of diverse solutions, including legacy applications, in a quick and efficient manner. In January 2010, we released Magic xpi 3.2 and since then we have continued to develop the Magic xpi channel. We entered into agreements with additional system integrators, consultancies and service providers, who acquired Magic xpi skills and offer Magic xpi licenses and related services to their customers. We also offer special editions of Magic xpi targeted at specific enterprise application vendor ecosystems, such as SAP, Oracle JD Edwards, Microsoft Sharepoint and Salesforce.com. These special editions contain specific features and pricing tailored for these market sectors.

In January 2013, our Magic xpi Integration Platform received the CIO Choice 2013 Honor and Recognition Title for Enterprise Application Integration Software. The highly competitive CIO Choice program recognizes worldwide vendors that use innovative technology to deliver competitive advantages and enable business growth.

In April 2013, we released Magic xpi 4.0, a significant major release that provides new capabilities in the areas of high availability, scalability and fault-tolerance for enterprise integration solutions. The architecture for Magic xpi 4.0 is based on IMDG technology, enabling very high-availability and performance, while preserving our easy-to-use and simplicity tradition and allowing existing integration projects to migrate seamlessly to the new release.

In December 2014, we released version 4.1 of our Magic xpi Integration Platform, responding to feedback from the field to provide our users additional value in terms of redundancy, reliability, stability, performance, and monitoring. For example, users can now define an alternate host for the server to work with if the main host is unavailable or if the startup procedure on the main host fails. We also added a new mechanism to rebalance the space partitions so that the primary partition and its backup will not run on the same machine when they are deployed in a clustered environment.

Our new web-based monitoring capabilities enable 24/7 monitoring from any location, providing our users with accurate information about the status and health of their projects through intuitive and easy to interpret graphs and dashboards. Information is available for whole projects or for different levels within the projects. Filters allow users to

further refine the display. The information provided by the Magic Monitor helps the user see where modifications can be made to improve project performance and alerts the user to potential problems when they arise. The user may also make adjustments to the servers directly from the Magic Monitor, without having to go back to the Magic xpi Studio to reconfigure the project.

Vertical software solutions

Leap™

Our FTS subsidiary has over 18 years of BSS experience, based on dozens of projects delivered to customers in over 40 countries. We implement revenue management and monetization solutions in mobile, wireline, broadband, MVNO/E, payments, e-commerce, M2M / Internet of Things, mobile money, cable, cloud and content markets under the brand name of Leap™. Our Leap™ solutions lower the total cost of ownership (TCO) for telecoms and content service providers.

FTS works with telecommunications, content and payment service providers globally to help them manage complex transactions and relationships with greater flexibility and independence. Analyzing transactions from a business standpoint, FTS offers end-to-end and add-on telecom billing, charging, policy control and payments solutions to customers worldwide, and services both growing and major providers.

FTS targets mid to lower level tier service providers, supporting their BSS needs with end-to-end, turnkey billing and other BSS projects. In addition, FTS offers upper-tiers of service providers with BSS and monetization solutions for specific needs, including policy control and charging solutions, M2M billing, billing for content services, MVNE/MVNO billing, mobile money software solutions, payment and mobile payment solutions and others.

Our Leap™ offering is comprised of:

Leap™ BCCF (Business Control and Charging Function) – a proprietary packaged software solution which serves as the underlying foundation of our Leap™ products and solutions. Leap BCCF enables service providers to handle the aspects of event processing, from defining the system's business logic, through importing events and formatting, to charging and executing business rules. With Leap BCCF, new services are deployed on the fly, and strategic business rules are formulated more easily, ensuring real-time responses to both service and customer-related events and providing a baseline for policy control.

Leap™ Billing 6.2 – a convergent charging, billing and customer care solution that realizes substantial reductions in OPEX and CAPEX while increasing customer satisfaction and retention. Leap Billing software's flexibility and ease of use enables the service providers' billing platform to work more at the speed of marketing by offering new marketing plans or services in a rapid time-to-market.

Leap™ Policy Control - Leap Policy Control is an integrated charging and policy control solution (a full PCC solution based on PCRF & online/offline charging). Compliant with the 3GPP's Diameter policy control standard, Leap Policy Control provides traffic and subscriber management strategies. Leap Policy Control gives operators the power to monitor usage in real time and, using fully configurable business rules, define how they manage network resources, applications, and subscribers – in real time – while generating revenue from personalized mobile applications, content and services. Leap Policy Control can be implemented as a stand-alone solution or as part of a larger BSS project implementation.

FTS express™ - FTS express™ is an all-in-one software appliance for online charging, billing, AAA, balance management, customer care, policy control and interconnect, designed for entry-level operations of MVNOs, LTE, WiMAX, VoIP, ISP, broadband, IPTV and more.

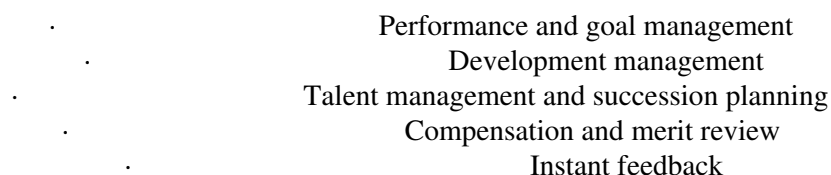
The following is a sample of the monetization solutions offered by FTS:

- End-to-end, turnkey billing and customer care solutions;
- Convergent, online charging and billing;
- Policy control and charging;
- MVNO/E billing;
- Billing for content;
- Interconnect billing;
- M2M / IoT billing;
- Broadband and multi-play billing;
- Mobile money solutions;
- E-commerce and M-commerce solutions;
- Payments and mobile payments solutions;
- Smart revenue sharing and partner management solutions and
- Billing service bureau

FTS's solutions are delivered via cloud, on-premises or in a fully managed-services mode and are backed by our Israel and Bulgaria-based experienced professional services support team.

## HR Pulse

Now in its 10<sup>th</sup> release, HR Pulse is a proprietary platform that creates and customizes software applications for HCM, with the goal to combine technology with effective processes, to facilitate the collection, analysis and interpretation of quality data about people, their jobs and their performance, to enhance HCM decision making, resulting in increased organizational efficiency and effectiveness. HR Pulse addresses five distinct functional areas with the ability to also work as one consolidated system:



Our offering includes customizable HCM SaaS Solutions that provides a menu of templates that can be used to affordably and expeditiously create customized HCM solutions for companies. The HR Pulse platform promotes the building and implementation of solutions that address broader business challenges as well. Such offerings include 360 degree feedback, employee surveys, leadership and management development, coaching and job evaluation.

## Hermes

The Hermes system is a proprietary, state-of-the-art, packaged software solution for managing air cargo ground handling stations, or GHA, encompassing all aspects of cargo handling, from physical handling and cargo documentation through customs, seamless EDI communications, dangerous goods, special handling, track and trace, security to billing. Over the last 10 years the Hermes system has been implemented into over 70 terminals globally on five continents, providing efficiency and accuracy in connection with the handling of more than 5 million tons of freight annually. Customers benefit through faster processing and more accurate billing, reporting and ultimately enhanced revenue. Customers include independent ground handlers, airlines with a cargo arm or hubs belonging to one airline or those catering to a number of airlines transiting cargo to additional destinations. The Hermes solution is delivered on a licensed or fully hosted basis.

## *Our Value Proposition*

Our technology and solutions are especially in demand when budgets are tight and time-to-market considerations are critical. Our technology enables enterprises to accelerate the process of building and deploying business software applications that can be rapidly customized to meet current and future needs. Our development and integration products empower customers to dramatically improve their business performance and return on investment by

enabling the affordable and rapid integration of diverse applications, systems and databases to streamline business processes from within one comprehensive framework.

We address the critical business needs of companies so that they are able to quickly respond to changing market forces and demands. Robust business solutions are created, deployed and maintained with unrivaled productivity and time-to-market results.

### *Strategy*

Our goal is to continue our profitable and cash generative growth within our software solutions and professional services markets. We plan to achieve this goal by focusing on the following principles:

**Expand sales to existing customers.** We intend to capitalize on the opportunity to more effectively cross-sell solutions and services across our existing customer base. In addition to selling complementary software solutions to customers that already use our development application solutions or packaged software solutions, we believe our strong customer, MSP and partner relationships and execution track record position us to successfully grow our revenues by delivering complementary development and integration tools from our product offering to our existing IT services customers and by delivering IT services to our existing application development customer base.

**Capitalize on opportunities created by new technological trends.** We believe that emerging industry trends such as mobile applications, cloud applications, SaaS and big data will require our enterprise customers and partners to continue and upgrade existing systems and to integrate their current infrastructure with new mobile and cloud applications or with new big data management solutions. We intend to market the capabilities of our software solutions and professional services offerings to customers that are currently impacted or will potentially be impacted by the increased complexity resulting from these trends. For instance, we intend to promote Magic xpa through Rich Internet Applications (RIAs).

**Grow our customer base through new offerings.** We plan to grow our business by attracting new ISV enterprise customers with new technology offerings and new professional services through our already established expertise in the areas of mobile technologies and projects, cloud applications, SaaS and Big Data solutions, and integration solutions. Due to our track record in these industry segments, we believe we are well positioned to develop and offer new application development and integration solutions that will enable us to attract new customers. In addition, we believe our familiarity with these verticals will allow us to differentiate our IT services offering and grow our market share in this vertical as well.

**Provide new solutions to new ecosystems.** We expect the same industry trends of mobile, cloud, SaaS and big data to lead to the creation of additional enterprise applications ecosystems. We intend to continue to develop new solutions that will allow us to form new partnerships, which in turn will grow our revenues. We also intend to focus on recruiting OEM partners that will incorporate our Magic xpi integration technology into their product offerings.

Acquire complementary businesses. As part of our growth strategy, we will continue to seek and evaluate opportunities to grow through acquisitions of companies with complementary software solutions, technologies and related intellectual property, packaged software solutions, augmenting integration and services capabilities, additional distribution channels or market share. We have a strict acquisition policy pursuant to which we only pursue acquisitions in cases we identify as having a clear business opportunity and a clear path to revenue growth. In addition, we only pursue acquisitions which we believe entail low integration and operational risk as a result of our internal familiarity with the target or the industry in which it operates, through our network of MSPs, system integrators, distributors, resellers, and consulting and OEM partners. We intend to balance any investments in such acquisitions with investments in our existing business and our policy of returning value to shareholders in the form of dividends.

### *Product Development*

We place considerable emphasis on research and development in order to improve and expand the functionality of our technology and to develop new applications. We believe that our future success depends upon our ability to maintain our technological leadership, to enhance our existing products and to introduce new commercially viable products addressing the needs of our customers on a timely basis. We also intend to support emerging technologies as they are

introduced in the same way we have supported new technologies in the past. We will continue to devote a significant portion of our resources to research and development. We believe that internal development of our technology is the most effective means of achieving our strategic objective of providing an extensive, integrated and feature-rich development technology.

During 2014, we continued to release new capabilities and features for Magic xpa 2.x and maintenance releases for Magic xpi. In addition, in response to significant market demand, in October 2013 we released our new off-line capabilities for the development and deployment of mobile enterprise applications that enables our customers to build solutions that can work while not connected to the internet, and continue and provide the same level of interactivity and functionality as when connected. Such off-line capabilities were identified as critical for successful deployment of mobile solutions in many business scenarios, including areas with limited network coverage and underground facilities.

In July 2014, we announced the next version of our multi-channel application development platform, Magic xpa 2.5, along with a new Mobile Accelerator Framework, both designed to improve the user and developer experience for mobile business apps based on Magic technology.

In December 2014, we released version 4.1 of our Magic xpi Integration Platform in response to feedback from our customer base, in order to bring our users additional value in terms of redundancy, reliability, stability, performance, and monitoring.

In April 2013, a new major release of Magic xpi, Magic xpi 4.0 was launched. This new release is based on IMDG technologies and enables our customers to deploy highly-available, scalable and fault-tolerant integration solutions at a fraction of the cost and complexity of comparable solutions.

#### *Product Related Services*

**Professional Services.** We offer fee-based consulting services in connection with installation assurance, application audits and performance enhancement, application migration and application prototyping and design. Consulting services are aimed at generating both additional revenues and ensuring successful implementation of Magic xpa, Magic xpi and Enterprise Mobility projects through knowledge transfer. As part of management efforts to focus on license sales, our goal is to provide such activities as a complementary service to our customers and partners. We believe that the availability of effective consulting services is an important factor in achieving widespread market acceptance.

Services are offered as separately purchased add-on packages or as part of an overall software development and deployment technology framework. Over the last several years, we have built upon our established global presence to form business alliances with our MSPs that use our technology to develop solutions for their customers, and distributors to deliver successful solutions in focused market sectors.

**Maintenance.** We offer our customers annual maintenance contracts providing for unspecified upgrades and new versions and enhancements for our products on a when-and-if-available basis for an annual fee.

**Customer Support.** We believe that a high level of customer support is important to the successful marketing and sale of our products. Our in-house technical support group provides training and post-sale support. We believe that effective technical support during product evaluation as well as after the sale has substantially contributed to product acceptance and customer satisfaction and will continue to do so in the future.

We offer online support systems for our MSPs and end users, providing them with the ability to instantaneously enter, confirm and track support requests through the Internet. These systems support MSPs and end-users worldwide. As part of this online support, we offer Support Knowledge Base tools providing the full range of technical notes and other documentation including technical papers, product information, and answers to most common customer queries and known issues that have already been reported.

**Training.** We conduct formal and organized training on our development tools and packaged software solutions. We develop courses, pertaining to our principal products and provide trainer and student guidebooks. Course materials are available both in traditional, classroom courses and as web-based training modules, which can be downloaded and studied at the student's own pace and location. The courses and course materials are designed to accelerate the learning process, using an intensive technical curriculum in an atmosphere conducive to productive training.

## **IT Services**

### *Background*

Our IT services offerings consist of a variety of professional services that can be grouped into integration and other IT services. Our integration services include:

**Infrastructure design and delivery** - management of complex, tailor-made projects and telecom infrastructure projects in wireless and wire-line as well as IT consulting services, mainly for the defense and public sectors.

**Technology consulting and implementation services** - planning and execution of end-to-end, large-scale, complex solutions in networking, cyber security, command & control and high performance transaction systems.

**Application development** - We specialize in end-to-end projects that feature an array of technologies, from development and implementation of concepts for startups to overall responsibility for the development of systems for large enterprises. Our development services include development of on-premise, mobile and cloud applications as well as embedded and real time software development.

With more than 200 experts and more than 300 projects gone live in a variety of advanced technologies in the US, Europe and Israel, we have developed significant expertise and accumulated vast experience in integration projects. Such projects are typically more complex and require a high level of industry knowledge and highly skilled professionals. Our integration expertise, as well as our global reach allows us to deliver comprehensive, value added services to our customers. Our IT services customers include major global telecoms, OEMs and engineering, furnish and installation service companies.

### *Strategic Consulting and Staffing Services*

We provide a broad range of IT consulting services in the areas of infrastructure design and delivery, application development, technology planning and implementation services, as well as supplemental staffing services. Our wholly-owned subsidiaries, Coretech Consulting Group LLC, Fusion Solutions LLC, Xsell Resources Inc., Allstates Consulting Services LLC and the Comm-IT Group, provide advanced IT consulting and staffing services to a wide variety of companies including Fortune 1000 companies. Our technical personnel generally supplement the in-house capabilities of our customers. Our approach is to make available a broad range of technical personnel to meet the requirements of our customers rather than focusing on specific specialized areas. We have extensive knowledge of and have worked with virtually all types of wireless and wireline telecom infrastructure technologies as well as in the areas of infrastructure design and delivery, application development, project management, technology planning and implementation services. Our consulting partners come from a wide range of industries, including finance, insurance, government, health care, logistics, manufacturing, media, retail and telecommunications. With an experienced team of recruiters in the telecom and IT areas and with a substantial and a growing database of telecom talent, we can rapidly respond to a wide range of requirements with well qualified candidates. Our customer list includes major global telecoms, OEMs and engineering, furnish and installation service companies. We have built long-term relationships with our customers by providing expert telecom talent. We provide individual consultants for contract and contract-to-hire assignments as well as candidates for full time placement. In addition, we configure teams of technical consultants for assigned projects at our customers' sites.

### *General - Customers, End-Users and Markets*

We market and sell our products and services in more than 50 countries worldwide. The following tables present our revenues by revenue type and geographical market for the periods indicated:

|                                   | Year ended December 31, |          |          |
|-----------------------------------|-------------------------|----------|----------|
|                                   | 2012                    | 2013     | 2014     |
|                                   | <b>(in thousands)</b>   |          |          |
| Software sales                    | \$23,684                | \$23,254 | \$25,351 |
| Maintenance and technical support | 22,384                  | 22,685   | 22,780   |
| Consulting services               | 80,312                  | 99,019   | 116,173  |

Total revenues \$126,380 \$144,958 \$164,304

|                | Year ended December 31, |           |           |
|----------------|-------------------------|-----------|-----------|
|                | 2012                    | 2013      | 2014      |
|                | (in thousands)          |           |           |
| Israel         | \$11,561                | \$24,006  | \$29,198  |
| Europe         | 29,139                  | 31,386    | 37,409    |
| United States. | 64,591                  | 70,872    | 82,470    |
| Japan          | 12,661                  | 11,965    | 11,299    |
| Other          | 8,428                   | 6,729     | 3,927     |
| Total revenues | \$126,380               | \$144,958 | \$164,304 |

Our Magic xpa, Magic xpi and AppBuilder technologies are used by a wide variety of developers, integrators and solution providers, that can generally be divided into two sectors (i) those performing in-house development (corporate IT departments), and (ii) MSPs, including large system integrators and smaller independent developers, and VARs that use our technology to develop or provide solutions to their customers. MSPs who are packaged software publishers use our technology to write standard packaged software products that are sold to multiple customers, typically within a vertical industry sector or a horizontal business function.

Among the thousands of customers running their business systems with our technology are the following

|                             |                                        |                                      |
|-----------------------------|----------------------------------------|--------------------------------------|
| Able B.V                    | Franken Brunnen                        | Lloyds Bank                          |
| adidas Canada               | Fujitsu Marketing                      | Nespresso                            |
| Adecco Nederland            | Fujitsu-ten                            | Newrest                              |
| Agricultural Bank of China  | Gakken                                 | NextiraOne                           |
| Allstate Life Insurance     | GE Capital                             | Nintendo                             |
| ATLAS Grupo Financiero      | GGD Amsterdam                          | Phoenix Pharma                       |
| Seguros y Fianzas           | Grange Life Company                    | RDC Datacenterum                     |
| AutoScout24                 | Groupe Flo                             | Rosenbauer                           |
| Aviapartner                 | Grupo Inversionistas en                | Staff Development Management Systems |
| Auchan                      | Autotransportes Mexicanos              | (SDMS Ltd)                           |
| Banco Caminos               | Hebrew University of Jerusalem         | SECOM Trust Systems                  |
| Bank Leumi                  | HONDA                                  | Sodiaal                              |
| BNP Paribas                 | Hitachi Systems                        | Stallergenes                         |
| BSkyB                       | Immobilier                             | Synbra                               |
| CBIA                        | ING Commercial Finance Industry        | Tecan                                |
| CCV                         | Industrial Bank of Korea               | Telenet NV                           |
| Çelebi Ground Handling Inc. | Invitel                                | The Himalaya Drug Company            |
| Club Med                    | ISS                                    | TOA                                  |
| Electra                     | Lekkerland Nederland BV                | Total                                |
| Ekro                        | Menzies (John Menzies plc)             | Temenos                              |
| Euroclear                   | Nagarjuna Fertilizers & Chemicals Ltd. | Vinci                                |
| Factory Master              | Japan Chamber of Commerce              | Vodafone Iceland                     |
| Finanz Informatik           |                                        | Volvo Brazil                         |

#### Sales, Marketing and Distribution

We market, sell and support our products through our own global offices and marketing department, as well as through a broad global channel-network of MSPs, system integrators, value-added distributors and resellers, and OEM and consulting partners. Our sales force is based in our regional offices in the United States, Japan, Germany, United Kingdom, Netherlands, France, Hungary, South Africa, India and Israel, and through regional distributors elsewhere. Our sales network is present in about 50 countries worldwide.

**Direct Sales.** For Magic xpa and AppBuilder, our direct sales force pursues software solution providers and enterprise accounts. Our sales personnel carry out strategic sales with a direct approach to decision makers, managing a constantly monitored consultative type of sales cycle. Magic xpi is mostly sold through indirect channels and through our ecosystem business relationships, but we have some direct customers with integration needs.

As of December 31, 2014, we had approximately 129 sales personnel including a team of sales engineers who provide pre-sale technical support, presentations and demonstrations in order to support our sales force.

**Indirect Sales.** We maintain an indirect sales channel, through our ecosystem business relationships, as well as through system integrators, value added distributors and resellers, OEM partners, as well as consultancies and service providers. We maintain an indirect sales channel for Magic xpa and AppBuilder through MSPs and system integrators, who use our application and integration platforms to develop and deploy different applications for sale to their end-user customers.

**Distributors.** In general, we distribute our products through regional non-exclusive distributors in those countries where we do not have a sales office. A regional distributor is typically a software marketing organization with the capability to add value with consulting, training and support. Distributors that are also MSPs are generally responsible for the implementation of both our application platform and business and process integration suite and localization into their native languages. The distributors also translate our marketing literature and technical documentation. Distributors must undergo our program of sales and technical training. Marketing, sales, training, consulting, product and customer support are provided by the local distributor. We are available for backup support for the distributor and for end-users. In coordination with the local subsidiaries and distributors, we also provide sales support for large and multinational accounts. We have 44 distributors in Europe, Latin America and Asia, many of whom are also MSPs.

**VARs.** In general, we resell our products through VARs that extend their capabilities with our offerings. These include SAP VARs.

**Global Marketing Activities.** We carry out a wide range of marketing activities aimed at generating awareness of our solutions offerings. Among our activities, we focus on online marketing, including a content-rich website available in eight foreign languages, social networks communication, search engine optimization, on-line advertising, lead generation campaigns, public relations, case studies, blogs, industry analyst relations, attendance at conferences and trade shows and lead generation campaigns around key professional white papers and webinars. We conduct distributor and user conferences to update our worldwide affiliates and user base on our new product offerings, marketing and promotional activities, pricing, best practices, technical information and other information.

In light of the increased impact of cloud and enterprise mobility technologies on the IT landscape, in 2011 we commenced a strategic marketing repositioning initiative that led to a complete rebranding of certain of our products' look, feel and naming (to emphasize that our products belong to the same technology stack), messaging, as well as a refined definition of our market positioning, value proposition and corporate values. In June 2012, we launched the new branding after we completed the strategic repositioning and designed a fresh and dynamic new logo, a new corporate tagline as well as fully re-written web site in English and seven other languages. To expand our community of developers and reach out to new audiences around the world, we run an ongoing introductory campaign, which offers Magic xpa Single User Edition as a freely downloadable product. Magic xpa Single User Edition is an ideal gateway for new developers who want to join Magic Software's global community and take advantage of new opportunities as their businesses grow. Thousands of developers around the world have downloaded, learned and used Magic xpa Single User Edition, and we are confident that this campaign will increase their understanding, awareness and adoption of our application platform.

In 2013, we implemented the Salesforce.com CRM platform globally and are now able to connect all our lead generation campaigns with our sales pipeline management. With this new CRM system in place, we have aligned all our local offices to work according to the same global sales and marketing processes. In October 2014, we completed an integration project of our Salesforce and SAP systems using our own integration platform Magic xpi.

## Competition

The markets for our Enterprise Mobility Solution, and Magic xpa and Magic xpi platforms are characterized by rapidly changing technology, evolving industry standards, frequent new product introductions, mergers and acquisitions, and rapidly changing customer requirements. These markets are therefore highly competitive, and we expect competition to continue to intensify. The growth of the SaaS and mobile markets increases the competition in these areas. We constantly follow and analyze the market trends and our competitors in order to effectively compete in these markets and avoid losing market share to our direct competitors and other players.

With Magic xpa, we compete in the application platform, SOA architecture and enterprise mobility markets. Among our current competitors are Kony, IBM, Microsoft, Adobe, Oracle, SAP Sybase and Antenna Software/Pegasystems. With Magic xpi, we compete in the integration platform market. Among our current competitors are IBM, Informatica, TIBCO, and Software AG.

There are several similar products in the market utilizing the model driven architecture, or MDA, approach utilized by AppBuilder. The market for this type of platform is highly competitive. Companies such as CA and IBM have tools that compete directly with AppBuilder. Furthermore, new development paradigms have become very popular in IT software development and developers today have many alternatives.

The telecom BSS domain in which we operate through our FTS subsidiary is a highly competitive market in which we compete based on product quality, service quality, timeliness in delivery and pricing. Within the global billing, charging and policy control market, FTS principally competes against global IT providers and the in-house IT departments of telecommunications operators. Among the competitors focused on this market are Amdocs, Ericsson, Comverse, NetCracker Technology, CSG Systems, Redknee Solutions and Oracle Communications.

There are also a number of smaller or regional telecom BSS competitors who compete on a regional or domestic market level. These tend to be smaller players, and may include companies such as Comarch, Mind CTI, Tecnotree, Cerillion, Openet and Elitcore, among others.

Additional competitors may enter each of our markets at any time. Moreover, our customers may choose to develop internally the functionality and capabilities our current product line offers them and therefore they may also compete with us.

Our goal is to maintain our technological advantages, time to market and worldwide sales and distribution network. We believe that the principal competitive factors affecting the market for our products include developer productivity, rapid results, product functionality, performance, reliability, scalability, portability, interoperability, ease-of-use, demonstrable economic benefits for developers and users relative to cost, quality of customer support and documentation, ease of installation, vendor reputation and experience, financial stability as well as intuitive and out-of-the-box solutions to extend the capabilities of ERP, CRM and other application vendors for enterprise integration.

## Intellectual Property

We do not hold any patents and rely upon a combination of copyright, trademark, trade secret laws and contractual restrictions to protect our rights in our software products. Our policy has been to pursue copyright protection for our software and related documentation and trademark registration of our product names. Also, our key employees and independent contractors and distributors are required to sign non-disclosure and secrecy agreements.

We provide our products to customers under a non-exclusive, non-transferable license. Usually, we have not required end-users of our products to sign license agreements. Generally, a “shrink wrap” license agreement is included in the product packaging, which explains that by opening the package seal, the user is agreeing to the terms contained therein. It is uncertain whether license agreements of this type are legally enforceable in all of the countries in which the software is marketed.

Our trademark rights include rights associated with our use of our trademarks and rights obtained by registration of our trademarks. We have obtained trademark registrations in South Africa, Canada, China, Israel, the Netherlands (Benelux), Switzerland, Thailand, Japan, the United Kingdom and the United States. The initial terms of the registration of our trademarks range from 10 to 20 years and are renewable thereafter. Our use and registration of our trademarks do not ensure that we have superior rights to others that may have registered or used identical or related marks on related goods or services. We have registered a copyright for our software in the United States and Japan. Also, we have registered copyrights for some of our manuals in the United States and have acquired an International Standard Book Number (ISBN) for some of our manuals. Our copyrights expire 70 years from date of first publication.

We do not believe that patent laws are a significant source of protection for our products since the software industry is characterized by rapid technological changes, the policing of the unauthorized use of software is a difficult task and software piracy is expected to continue to be a persistent problem for the packaged software industry. As there can be no assurance that the above-mentioned means of legal protection will be effective against piracy of our products, and since policing unauthorized use of software is difficult, software piracy can be expected to be a persistent potential problem.

We believe that because of the rapid pace of technological change in the software industry, the legal protections for our products are less significant factors in our success than the knowledge, ability and experience of our employees, the frequency of product enhancements and the timeliness and quality of our support services.

### C. ORGANIZATIONAL STRUCTURE

Asseco, a Polish company listed on the Warsaw Stock Exchange, has a 46.36% interest in our controlling shareholder, Formula Systems (1985) Ltd., an Israeli publicly-traded company (NASDAQ: FORTY). As of March 31, 2015, Formula Systems beneficially owned 45.2% of our outstanding ordinary shares. Formula Systems is an international holding company principally engaged, through its subsidiaries and affiliates, in providing IT software consulting services, developing proprietary software products and producing computer-based solutions.

The following table sets forth the legal name, location and country of incorporation and percentage ownership of each of our subsidiaries as of December 31, 2014:

| <b>Subsidiary Name</b>                                                    | <b>Country of Incorporation</b> | <b>Ownership Percentage</b> |
|---------------------------------------------------------------------------|---------------------------------|-----------------------------|
| Magic Software Japan K.K                                                  | Japan                           | 100%                        |
| Magic Software Enterprises Inc.                                           | Delaware                        | 100%                        |
| Magic Software Enterprises (UK) Ltd .                                     | United Kingdom                  | 100%                        |
| Hermes Logistics Technologies Limited                                     | United Kingdom                  | 100%                        |
| Magic Software Enterprises Spain Ltd                                      | Spain                           | 100%                        |
| Coretech Consulting Group, Inc.                                           | Pennsylvania                    | 100%                        |
| Coretech Consulting Group LLC                                             | Delaware                        | 100%                        |
| Magic Software Enterprises (Israel) Ltd                                   | Israel                          | 100%                        |
| Magic Software Enterprises Netherlands B.V                                | Netherlands                     | 100%                        |
| Magic Software Enterprises France .                                       | France                          | 100%                        |
| Magic Beheer B.V                                                          | Netherlands                     | 100%                        |
| Magic Benelux B.V                                                         | Netherlands                     | 100%                        |
| Magic Software Enterprises GMBH                                           | Germany                         | 100%                        |
| Magic Software Enterprises India Pvt. Ltd                                 | India                           | 100%                        |
| Onyx Magyarorszag Szsoftverhaz                                            | Hungary                         | 100%                        |
| Fusion Solutions LLC.                                                     | Delaware                        | 100%                        |
| Xsell Resources Inc.                                                      | Pennsylvania                    | 100%                        |
| Magix Integration (Proprietary) Ltd                                       | South Africa                    | 100%                        |
| Complete Business Solutions Ltd                                           | Israel                          | 96.3%                       |
| Datamind Ltd                                                              | Israel                          | 80%                         |
| AppBuilder Solutions UK                                                   | United Kingdom                  | 100%                        |
| CommIT Technology Solutions Ltd                                           | Israel                          | 80%                         |
| CommIT Software Ltd (shares held by Comm-IT Technology Solutions Ltd.)    | Israel                          | 100%                        |
| CommIT Embedded Ltd (shares held by Comm-IT Technology Solutions Ltd.)    | Israel                          | 50.1%                       |
| Valinor Ltd. (shares held by Comm-IT Technology Solutions Ltd.)           | Israel                          | 100%                        |
| Dario Solutions IT Ltd (shares held by Comm-IT Technology Solutions Ltd.) | Israel                          | 100%                        |
| Pilat Europe Ltd.                                                         | United Kingdom                  | 100%                        |

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|                                         |                |      |
|-----------------------------------------|----------------|------|
| Pilat (North America), Inc.             | New Jersey     | 100% |
| F.T.S. - Formula Telecom Solutions Ltd. | Israel         | 100% |
| FTS Bulgaria Ltd.                       | Bulgaria       | 100% |
| BridgeQuest Labs, Inc..                 | North Carolina | 100% |
| BridgeQuest, Inc.                       | North Carolina | 100% |
| Allstates Consulting Services LLC       | Delaware       | 100% |

D. PROPERTY, PLANTS AND EQUIPMENT

Our headquarters and principal administrative, finance, sales, marketing and research and development office is located in a 7,271 square foot office facility that we lease in Or Yehuda, Israel, a suburb of Tel Aviv. We pay an aggregate annual rent of \$0.4 million for the facilities under a lease agreement expiring in December 2015. We have an option to terminate the lease upon six months prior written notice.

Our subsidiaries lease office space in Laguna Hills, California; King of Prussia, Pennsylvania; Dallas, Texas; Paris, France; Munich, Germany; Pune, India; Bangalore, India; Tokyo, Japan; Budapest, Hungary; Houten, the Netherlands; Johannesburg, South Africa; Bracknell, the United Kingdom; and Israel. The aggregate annual cost for such facilities was \$1.7 million in the year ended December 31, 2014.

ITEM 4 A. UNRESOLVED STAFF COMMENTS

Not applicable.

ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

A. OPERATING RESULTS

The following discussion of our results of operations should be read together with our consolidated financial statements and the related notes, which appear elsewhere in this annual report. The following discussion contains forward-looking statements that reflect our current plans, estimates and beliefs and involve risks and uncertainties. Our actual results may differ materially from those discussed in the forward-looking statements. Factors that could cause or contribute to such differences include those discussed below and elsewhere in this annual report.

Background

We were organized under the laws of Israel in February 1983 and began operations in 1986. Our ordinary shares have been listed on the NASDAQ Stock Market (symbol: MGIC) since our initial public offering in the United States on August 16, 1991. On January 3, 2011, our shares were transferred to the NASDAQ Global Select Market. Since November 16, 2000, our ordinary shares have also traded on the Tel Aviv Stock Exchange, or the TASE, and since December 15, 2011, our shares have been included in the TASE's TA-100 Index.

Overview

We develop market, sell and support application platforms, business and process integration and selected vertical complete software solutions. We have 29 active wholly-owned subsidiaries in the United States, Europe, Asia, South Africa and Israel. Of such subsidiaries, 19 are engaged in developing, marketing and supporting vertical applications, as well as in selling and supporting our products, and ten subsidiaries specialize in providing broad range of IT

consulting services in the areas of infrastructure design and delivery, application development, technology planning and implementation services, as well as supplemental staffing services.

As an IT technology innovator, we have many years of experience in assisting software companies and enterprise software companies worldwide to produce and integrate their business applications. Our application platforms, Magic xpa and AppBuilder, are used by thousands of enterprises and MSPs to develop solutions for their users and customers in approximately 50 countries. We also refer to these MSPs as Magic service providers, or MSPs. We also provide maintenance and technical support as well as professional services to our enterprise customers and to MSPs. In addition, we sell our Magic xpi technology for business integration to customers using specific popular software applications, such as SAP, Salesforce.com, IBM i (AS/400) or Oracle JD Edwards and other business applications. We refer to these vendor-centered market sectors as ecosystems.

### ***Strategy and Focus Areas***

Our vision of how the industry will evolve is being driven by the change in enterprise mobility, RIAs and cloud computing. We believe that our technology will allow us to expand our offerings into the cloud and mobile enterprise markets with speed, scale and flexibility. We intend to remain focused on both the technology and business architectures that will enable our customers to take advantage of the cost efficiencies and competitive advantages conveyed by these technologies. We intend to continue to prudently take advantage of opportunities to capture market transitions and to put our assets to use in existing and new markets as the recovery continues. We believe that our strategy and our ability to innovate and execute may enable us to improve our competitive position in difficult business conditions and may continue to provide us with long-term growth opportunities.

## **Key Factors Affecting our Business**

Our operations and the operating metrics discussed below have been, and will likely continue to be affected by certain key factors as well as certain historical events and actions. The key factors affecting our business and results of operations include among others, dependence on a limited number of core product families, selected vertical software solutions and services, competition, ability to realize benefits from business acquisitions, dependence on a key customer for a significant percentage of our revenues and changes in the mix of revenues generated by different revenue elements affect our gross margins and profitability. For further discussion of the factors affecting our results of operations, see “Risk Factors.”

### **Dependence on a limited number of core product families and services**

We derive a significant portion of our revenues from sales of application and integration platforms primarily under our Magic xpa, Magic xpi and AppBuilder brands and from related professional services, software maintenance and technical support as well as from other IT professional services, which include IT consulting and staffing services. Our future growth depends heavily on our ability to effectively develop and sell new products developed by us or acquired from third parties as well as add new features to existing products. A decrease in revenues from our principal products and services would adversely affect our business, results of operations and financial condition.

### **Competition**

We compete with other companies in the areas of application platforms, business integration and business process management, and in the applications and services markets in which we operate. The growth of the SaaS and Enterprise Mobility market has increased the competition in these areas. We expect that such competition will continue to increase in the future, both with respect to our technology, applications and services which we currently offer and applications and services which we and other vendors are developing. Increased competition, direct and indirect, could adversely affect our business, financial condition and results of operations.

We also compete with other companies in the technical IT consulting and staffing services industry. This industry is highly competitive and fragmented and has low entry barriers. We, through four of our subsidiaries in the United States and five of our subsidiaries in Israel, compete for potential customers with providers of outsourcing services, systems integrators, computer systems consultants, other providers of technical IT consulting services and, to a lesser extent, temporary personnel agencies. We expect competition to increase, and we may not be able to remain competitive.

Some of our existing and potential competitors are larger companies, have substantially greater resources than us, including financial, technological, marketing, skilled human resources and distribution capabilities, and enjoy greater market recognition than us. We may not be able to differentiate our products and services from those of our competitors, offer our products as part of integrated systems or solutions to the same extent as our competitors, or successfully develop or introduce new products that are more cost-effective, or offer better performance than our competitors. Failure to do so could adversely affect our business, financial condition and results of operations.

#### Dependence on a key customer for our principal IT professional services subsidiary

The revenues in one of our principal IT professional services subsidiaries are dependent upon Ericsson, which is currently our largest customer, accounting for 19%, 13% and 10% of our total revenues for the years ended December 31, 2012, 2013 and 2014, respectively. We do not know if, or for how much longer, Ericsson will continue to utilize the IT professional services of such subsidiary. A significant decrease in revenues from Ericsson may adversely affect our business, results of operations and financial condition.

#### Revenue Mix

We derive our revenues from the sale of software licenses, related professional services, maintenance and technical support as well as from IT professional services. Our gross margin is affected by the proportion of our revenues generated from the sale of each of those elements of our revenues. Our revenues from the sale of our software licenses, related professional services, maintenance and technical support have higher gross margins than our revenues from other IT professional services. Our software licenses revenues include the sale of third party software licenses, which have a lower gross margin than sales of our proprietary software products. Any increase in the portion of third party software license sales out of total license sales will decrease our gross profit margin. If the relative proportion of our revenues from the sale of IT professional services increases as a percentage of our total revenues, our gross profit margins may decline in the future.

We may encounter difficulties in realizing the potential financial or strategic benefits of recent and future business acquisitions.

It is a part of our business strategy to pursue acquisitions and other initiatives in order to expand our product offerings or services or otherwise enhance our market position and strategic strengths. In the past we made a number of acquisitions, including: (i) our distributor in South Africa, Magix Integration (Proprietary) Ltd., or Magix Integration, which specializes in the software integration and application development of our platforms as well as the support of large-scale and complex systems in the public and financial sectors in South Africa; (ii) the AppBuilder activity of BluePhoenix Solutions Ltd, a development platform for managing, maintaining, and reusing business applications required by large-scale enterprises; (iii) Complete Business Solutions Ltd., a software solution integrator and a Business Partner of SAP; (iv) Comm-IT Group, a software and systems development house that specializes in providing advanced IT and communications services and solutions, project and product consultation, installation and implementation of databases and software integration; (v) Dario Solutions IT Ltd., a provider of software integration and software solutions for large and mid-range customers in Israel and Microsoft Gold Level Partner; (vi) Valinor Ltd., a Microsoft Certified Partner and a Oracle Gold Level Partner that specializes in project and product consultation, and the installation and implementation of databases; (vii) the enterprise division of Allstates Technical Services, LLC, a U.S.-based full-service provider of consulting and staffing solutions for IT, engineering and telecom personnel; (viii) Datamind, a software solutions integrator of user-driven BI solutions (mainly QlikView and Qlik Sense) that enable customers to make better, faster and more informed business decisions, wherever they are. QlikView and Qlik Sense are self-service data visualization and analysis applications/tools built using market-proven data indexing engine, delivering the ease-of-use business users require to create personalized visualizations, reports and dashboards through simple drag-and-drop techniques, while ensuring centralized data security and governance. These BI tools are designed to expand the focus of filling the gap between visualization or dashboard solutions and complex BI platforms tied to report-centric ways of doing business. As Data Discovery is being adopted as an alternative BI platform, these BI tools are designed to give users the immediate insights they need and IT professionals the enterprise manageability and governance they require. It supports the way human curiosity naturally searches, filters, questions and finds associations in data to find meaning in information more easily, revealing insights and enabling decisions in the process; (ix) FTS, an Israeli based global proprietary software vendor, specializes in the development, sale, service and support of BSS, including convergent charging, billing, customer management, policy control and payment software solutions for the telecommunications, content, M2M/IoT, payment and other industries; and (x) our most recent announcement of February 25, 2015 regarding our entry into a definitive agreement to acquire a 70% stake, with an option to increase our holdings to 100%, in an Israeli-based company specializing in software professional services for mainframes and complex large-scale environments. The acquisition is subject to the fulfillment of certain conditions defined in the acquisition agreement.

Mergers and acquisitions of companies are inherently risky and subject to many factors outside of our control and no assurance can be given that our future acquisitions will be successful and will not adversely affect our business, operating results, or financial condition. In the future, We may seek to acquire or make strategic investments in complementary businesses, technologies, services or products, or enter into strategic partnerships or alliances with third parties in the future in order to expand our business. Failure to manage and successfully integrate acquisitions could materially harm our business and operating results. Prior acquisitions have resulted in a wide range of outcomes, from successful introduction of new products and technologies to a failure to do so. Even when an acquired company has previously developed and marketed products, there can be no assurance that new product enhancements will be made in a timely manner or that pre-acquisition due diligence will have identified all possible issues that might arise

with respect to such products.

If we acquire another business, we may face difficulties, including: Difficulties in integrating the operations, systems, technologies, products, and personnel of the acquired businesses or enterprises;

Diversion of management's attention from normal daily operations of the business and the challenges of managing larger and more widespread operations resulting from acquisitions;

- Potential difficulties in completing projects associated with in-process research and development;

Difficulties in entering markets in which we have no or limited direct prior experience and where competitors in such markets have stronger market positions;

- Insufficient revenue to offset increased expenses associated with acquisitions; and

The potential loss of key employees, customers, distributors, vendors and other business partners of the companies we acquire following and continuing after announcement of acquisition plans.

#### *Impact of Currency Fluctuations and of Inflation*

Our financial statements are stated in U.S. dollars, our functional currency. However, a substantial portion of our revenues and costs are incurred in other currencies, particularly NIS, Euros, Japanese yen, and the British pound. We also maintain substantial non-U.S. dollar balances of assets, including cash, accounts receivable, and liabilities, including accounts payable. Therefore, fluctuations in the value of the currencies in which we do business relative to the U.S. dollar may adversely affect our business, results of operations and financial condition. The depreciation of such other currencies in relation to the U.S. dollar has the effect of reducing the U.S. dollar value of any of our liabilities which are payable in those other currencies (unless such costs or payables are linked to the U.S. dollar). Such depreciation also has the effect of decreasing the U.S. dollar value of any asset that is denominated in such other currencies or receivables payable in such other currencies (unless such receivables are linked to the U.S. dollar). In addition, the U.S. dollar value of revenues and expenses denominated in such other currencies would increase. Conversely, the appreciation of any currency in relation to the U.S. dollar has the effect of increasing the U.S. dollar value of any unlinked assets and the U.S. dollar amounts of any unlinked liabilities and increasing the U.S. dollar value of revenues and expenses denominated in other currencies.

In addition, while we incur a portion of our costs in NIS, the U.S. dollar cost of our operations in Israel is influenced by the extent to which any increase in the rate of inflation in Israel is (or is not) offset, or is offset on a lagging basis, by a devaluation of the NIS in relation to the U.S. dollar.

Because exchange rates between the NIS, euro, Japanese Yen and the British pound and the U.S. dollar fluctuate continuously, exchange rate fluctuations and especially larger periodic devaluations will have an impact on our profitability and period-to-period comparisons of our results. We cannot assure you that in the future our results of operations may not be adversely affected by currency fluctuations.

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The following table sets forth for the periods indicated, depreciation or appreciation of the U.S. dollar against the most important currencies for our business and the Israeli consumer price index:

|                              | Year Ended December 31, |         |          |          |          |  |
|------------------------------|-------------------------|---------|----------|----------|----------|--|
|                              | 2010                    | 2011    | 2012     | 2013     | 2014     |  |
| New Israeli Shekel           | 6.4 %                   | (7.1 )% | 2.3 %    | 7.0 %    | (12 )%   |  |
| Euro                         | (7.4 )%                 | (3.2 )% | 2.0 %    | 4.3 %    | (11.5 )% |  |
| Japanese Yen                 | 13.4 %                  | 5.0 %   | (11.2 )% | (22.1 )% | (14.9 )% |  |
| British Pound                | (4.4 )%                 | (0.4 )% | 4.6 %    | 1.9 %    | (5.5 )%  |  |
| Israeli Consumer Price Index | 2.6 %                   | 2.2 %   | 1.6 %    | 1.8 %    | (-0.2 )% |  |

## Segments

We report our results on the basis of two reportable business segments: software services (which include proprietary and non-proprietary software technology and complementary services) and IT professional services. Set forth below is segment information for the years ended December 31, 2012, 2013 and 2014.

|  | Software<br>services | IT<br>professional<br>services | Unallocated<br>expense | Total |
|--|----------------------|--------------------------------|------------------------|-------|
|--|----------------------|--------------------------------|------------------------|-------|

(U.S. dollars in thousands)

## 2012

|                         |          |           |            |            |
|-------------------------|----------|-----------|------------|------------|
| Total revenues          | \$65,410 | \$ 60,970 | \$ -       | \$126,380  |
| Expenses                | 50,497   | 55,456    | 4,019      | 109,972    |
| Operating income (loss) | \$14,913 | \$ 5,514  | \$ (4,019) | ) \$16,408 |
| EBITDA                  | \$15,881 | \$ 6,696  | \$ (3,675) | ) \$18,902 |

## 2013

|                         |          |           |            |            |
|-------------------------|----------|-----------|------------|------------|
| Total revenues          | \$67,453 | \$ 77,505 | \$ -       | \$144,958  |
| Expenses                | 53,164   | 68,846    | 3,821      | 125,831    |
| Operating income (loss) | \$14,289 | \$ 8,659  | \$ (3,821) | ) \$19,127 |
| EBITDA                  | \$15,493 | \$ 10,869 | \$ (3,559) | ) \$22,803 |

## 2014

|                         |          |           |            |            |
|-------------------------|----------|-----------|------------|------------|
| Total revenues          | \$69,861 | \$ 94,443 | \$ -       | \$164,304  |
| Expenses                | 54,464   | 84,873    | 4,241      | 143,578    |
| Operating income (loss) | 15,397   | \$ 9,570  | \$ (4,241) | ) \$20,726 |
| EBITDA                  | \$17,195 | \$ 11,833 | \$ (3,975) | ) \$25,053 |

## Explanation of Key Income Statement Items

**Revenues.** Revenues are derived from sales of software licenses (proprietary and non-proprietary), related professional services, maintenance and technical support and other IT professional services, which include IT consulting and staffing services. Revenues may continue to be affected by factors including market uncertainty, which can result in cautious spending in our global markets; changes in the geopolitical environment; sales cycles; fluctuation of exchange rates; changes in the mix of direct sales and indirect sales and variations in sales channels.

**Cost of Revenues.** Cost of revenues for software sales consist primarily of software production costs, royalties and licenses payable to third parties, as well as amortization of capitalized and acquired software costs. Cost of revenues for maintenance and technical support and professional services consists primarily of personnel expenses, subcontracting and other related costs. Cost of revenues for software sales is affected by changes in the mix of products sold; price competition; sales discounts; fluctuation of exchange rates; and increases in labor costs. Service gross margin may be impacted by various factors such as the change in mix between technical support services and advanced IT professional services, the timing of technical support service contract initiations and renewals and the timing of our strategic investments in headcount and resources to support this business.

***Research and Development Expenses, Net.*** Research and development costs consist primarily of personnel expenses of employees engaged in on-going research and development activities, subcontracting, development tools and other related expenses. The capitalization of software development costs is applied as reductions to gross research and development costs to calculate net research and development expenses.

The following table sets forth the gross research and development costs, capitalized software development costs, and the net research and development expenses for the periods indicated:

|                                             | Year ended December 31,     |         |         |
|---------------------------------------------|-----------------------------|---------|---------|
|                                             | 2012                        | 2013    | 2014    |
|                                             | (U.S. dollars in thousands) |         |         |
| Gross research and development costs        | \$7,916                     | \$8,419 | \$9,017 |
| Less capitalized software development costs | (4,969)                     | (4,713) | (4,267) |
| Research and development expenses, net      | \$2,947                     | \$3,706 | \$4,750 |

***Selling and Marketing Expenses.*** Selling and marketing expenses consist primarily of salaries and related expenses for sales and marketing personnel, sales commissions, marketing programs and campaigns, website related expenses, public relations, on-line advertising, industry analyst relations, promotional materials, travel expenses and conferences and trade shows exhibit expenses, as well as amortization of acquired customer relationships recorded as a result of business combinations.

***General and Administrative Expenses.*** General and administrative expenses consist primarily of salaries and related expenses for executive, accounting, human resources and administrative personnel, professional fees, legal expenses, provisions for doubtful accounts, and other general and administrative corporate expenses.

***Financial income (expenses), net.*** Net financial income (expenses) consists primarily of interest earned on cash equivalents deposits and marketable securities, bank fees and interest paid on loans received, interest expenses related to liabilities in connection with acquisitions and foreign currency translation adjustments.

## Results of Operations

The following table presents selected consolidated statement of operations data for the periods indicated as a percentage of total revenues:

|                                   | Year ended December 31, |        |        |
|-----------------------------------|-------------------------|--------|--------|
|                                   | 2012                    | 2013   | 2014   |
| Revenues:                         |                         |        |        |
| Software                          | 18.8 %                  | 16.0 % | 15.5 % |
| Maintenance and technical support | 17.7                    | 15.7   | 13.9   |
| Consulting services               | 63.5                    | 68.3   | 70.6   |
| Total revenues                    | 100.0%                  | 100.0% | 100.0% |
| Cost of revenues:                 |                         |        |        |
| Software                          | 5.9                     | 4.6    | 4.7    |
| Maintenance and technical support | 2.6                     | 2.1    | 1.8    |
| Consulting services               | 49.6                    | 52.6   | 54.3   |

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|                                                      |        |        |        |
|------------------------------------------------------|--------|--------|--------|
| Total cost of revenues                               | 58.1   | 59.3   | 60.7   |
| Gross profit                                         | 41.9   | 40.7   | 39.3   |
| Operating costs and expenses:                        |        |        |        |
| Research and development, net                        | 2.3    | 2.6    | 2.9    |
| Selling and marketing,                               | 18.2   | 15.9   | 15.0   |
| General and administrative                           | 8.4    | 9.0    | 8.8    |
| Total operating expenses, net                        | 28.9   | 27.5   | 26.7   |
| Operating income                                     | 13.0   | 13.2   | 12.6   |
| Financial expenses, net                              | -      | 0.5    | 1.1    |
| Other income, net                                    | 0.1    | 0.0    | 0.0    |
| Income before taxes on income                        | 13.1   | 12.7   | 11.5   |
| Tax benefit (taxes on income)                        | (0.1 ) | (1.0 ) | (1.4 ) |
| Net income attributable to non-controlling interests | (0.2 ) | (0.7 ) | (0.7 ) |
| Net income attributable to Magic's shareholders      | 12.8   | 11.0   | 9.4    |

Year Ended December 31, 2014 Compared With Year Ended December 31, 2013

**Revenues.** Revenues in 2014 increased by 13% from \$145.0 million in 2013 to \$164.3 million in 2014. Revenues from the software services business segment increased by 4%, from \$67.5 million in 2013 to \$69.9 million in 2014 primarily attributable to a \$2.9 million increase in both our license sales of our software products and proprietary packaged and third party software solutions activity, which was partially offset by the negative impact of the devaluation of currencies, primarily the Japanese Yen against the U.S. dollar of \$0.7 million. Revenues from the IT professional services business segment increased by 22% from \$77.5 million in 2013 to \$94.4 million in 2014 primarily attributable to increased demand for our professional services and the acquisition of Allstates Technical Services, LLC in November 2013.

Revenues from sales of software licenses increased by 2% from \$18.0 million in 2013 to \$18.4 million in 2014. The increase in sales of licenses was primarily attributable to an increase in demand for our software products in Europe and Japan by \$1.3 million and \$0.7 million, respectively, offset by the devaluation of the Japanese Yen versus the U.S. dollar, having a negative impact of approximately \$0.8 million.

Revenues from sales of proprietary packaged and third party software solutions increased by 32% from \$5.3 million in 2013 to \$7.0 million in 2014. The increase in sales of proprietary packaged and third party software solutions was primarily attributable to increased demand along with our expanded portfolio of BI and BSS solutions due to the acquisitions of Datamind and FTS in 2014.

Revenues from maintenance and technical support remained relatively constant, totaling \$22.7 million in 2013 and \$22.8 million in 2014.

Revenues from IT consulting services increased by 17% from \$99.0 million in 2013 to \$116.2 million in 2014. The increase was primarily attributable to the acquisition of Allstates Technical Services, LLC in November 2013 and increased demand for our professional services in Israel.

The following table presents our revenues by geographical market for the years ended December 31, 2013 and 2014:

|                |      |
|----------------|------|
| Year ended     |      |
| December 31,   |      |
| 2013           | 2014 |
| (in thousands) |      |

|                |           |           |
|----------------|-----------|-----------|
| Israel         | \$24,006  | \$29,198  |
| Europe         | 31,386    | 37,409    |
| United States  | 70,872    | 82,470    |
| Japan          | 11,965    | 11,299    |
| Other          | 6,729     | 3,927     |
| Total revenues | \$144,958 | \$164,304 |

**Cost of Revenues.** Cost of revenues increased by 16% from \$85.9 million in 2013 to \$99.7 million in 2014. Cost of revenues for licenses increased from \$4.4 million in 2013 to \$4.6 in million 2014. Cost of revenues for packaged software solutions increased by 39% from \$2.2 million in 2013 to \$3.1 million in 2014. The increase in cost of revenues for packaged software solutions was primarily attributable to the acquisition of FTS and Datamind in 2014 and are consistent with the increase in revenues from proprietary packaged and third party software solutions.

Cost of revenues for maintenance and technical support remained constant totaling \$2.9 million in 2013 and 2014.

Cost of revenues for IT consulting services increased by 17% from \$76.3 million in 2013 to \$89.2 million in 2014. The increase in cost of revenues for IT consulting services was primarily attributable to the inclusion of the costs of revenues of Allstates Technical Services, LLC for a full year and is consistent with the increase from IT consulting services. Cost of revenues for the years ended December 31, 2013 and 2014 include \$11,000 and \$30,000, respectively, of stock-based compensation recorded under ASC 718.

**Gross Margin.** Gross margin in 2013 was 41% compared to gross profit of 39% in 2014. The decrease in gross profit resulted primarily from the increase in sales of IT professional services and third party software solutions which have a lower gross margin compared to the increase in sales of our proprietary software products which have a higher gross margin, together with devaluation of the Japanese Yen against the U.S. dollar which had a negative impact of \$0.7 million, reducing our license sales of our software products denominated in Japanese Yen.

**Research and Development Expenses, Net.** Gross research and development costs increased by 7% from \$8.4 million in 2013 to \$9.0 million in 2014. Net research and development expenses increased by 28% from \$3.7 million in 2013 to \$4.8 million in 2014. In 2014, we capitalized \$4.3 million of software development costs compared to \$4.7 million in 2013. Net research and development costs as a percentage of revenues was 2.9% in 2014 compared to 2.6% in 2013. The increase in research and development costs in 2014 is primarily attributable to the additional investment in our packaged software solutions, primarily in Hermes, and as a result of the consolidation of FTS which was acquired during October 2014, offset by cost savings initiatives made in our research and development departments. Research and development expenses for the years ended December 31, 2013 and 2014 include \$67,000 and \$29,000, respectively, of stock-based compensation recorded under ASC 718.

**Selling and Marketing Expenses.** Selling and marketing expenses increased by 7% from \$23.1 million in 2013 to \$24.6 million in 2014. Selling and marketing expenses as a percentage of revenues decreased from 15.9% in 2013 to 15% in 2014. The increase in selling and marketing costs is primarily attributable to the inclusion for the full year of the selling and marketing costs of Allstates Technical Services, LLC that was acquired in November 2013. The decrease in selling and marketing expenses as a percentage of revenues is primarily due to the decrease in headcount of sales and marketing employees from 136 in 2013 to 129 in 2014 and the devaluation of the Japanese Yen and South African Rand against the U.S. dollar which had a positive impact of \$0.4 million. Selling and marketing expenses for the years ended December 31, 2013 and 2014 include \$85,000 and \$220,000, respectively, of stock-based compensation recorded under ASC 718.

**General and Administrative Expenses.** General and administrative expenses increased by 10% from \$13.2 million in 2013 to \$14.5 million in 2014. General and administrative expenses as a percentage of revenues decreased from 9.1% in 2013 to 8.8% in 2014. The increase in general and administrative expenses is primarily attributable to: (i) the net impact of \$1.6 million of arbitration expenses recorded in excess of accruals recorded in previous years; (ii) acquisitions of subsidiaries consolidated for the entire year for the first time in 2014 amounting to \$0.4 million; and (iii) stock-based compensation expenses amounting to \$1.2 million recorded in one of our subsidiaries following stock-based compensation granted to its chief executive officer. Offsetting these additional costs were: (i) a decrease in headcount of general and administrative employees from 94 in 2013 to 72 in 2014; (ii) a \$1.0 million decrease in contingent liabilities relating to acquisitions which are subject to meeting certain operational targets; (iii) a decrease in the allowance for doubtful accounts from \$1.3 million in 2013 to \$0.7 million in 2014; and (iv) savings initiatives and continued operational discipline. General and administrative expenses for the years ended December 31, 2013 and 2014 include \$162,000 and \$1,280,000, respectively, of stock-based compensation recorded under ASC 718.

**Financial Income (Expenses), Net.** We recorded financial expenses, net of \$0.7 million in 2013 and \$1.8 million in 2014. The devaluation of the Euro, Japanese Yen and New Israeli Shekel against the U.S. dollar, which decreased by 13%, 14% and 12% against the dollar, respectively between December 31, 2014 and December 31, 2013, negatively impacted our cash and other working capital balances denominated in these currencies in the amount of \$1.6 million. Our financial expense, net in 2013 was primarily attributable to interest expenses related to liabilities recorded in connection with acquisitions of \$0.4 million and realized losses, mainly on our account receivables, due to unfavorable foreign currency exchange rates of \$0.2 million.

**Taxes on Income.** We recorded taxes on income of \$1.6 million in 2013 compared to \$2.3 million in 2014. Our taxes on income in 2013 and 2014 were primarily attributable to current taxes recorded by our subsidiaries in Japan, Europe and Israel and to the decrease of our deferred tax assets recorded with respect to utilization of carry-forward tax losses.

**Net Income Attributable to Our Shareholders.** Our net income decreased from \$15.9 million in 2013 to \$15.4 million in 2014, primarily due to the increase in (i) investments in research and development, net of \$1.0 million, (ii) selling and marketing expenses of \$1.5 million (iii) general and administrative expenses of \$1.4 million, and (iv) financial expenses, net of \$1.1 million, which was offset by the \$5.5 million increase in gross profit resulting from our increased revenues.

Year Ended December 31, 2013 Compared With Year Ended December 31, 2012

**Revenues.** Revenues in 2013 increased by 14.7% from \$126.4 million in 2012 to \$145.0 million in 2013. Revenues from the software services business segment increased by 3.1% from \$65.4 million in 2012 to \$67.5 million in 2013 primarily attributable to an increase in our project activity which was partially offset by the negative impact of the devaluation of the Japanese Yen against the U.S. dollar. Revenues from the IT professional services business segment increased by 27% from \$61.0 million in 2012 to \$77.5 million in 2013 primarily attributable to increased demand for our professional services and to the inclusion of the professional services revenues of the Comm-IT Group for a full year.

Revenues from sales of software licenses decreased by 3.6% from \$18.7 million in 2012 to \$18.0 million in 2013. The decrease in sales of licenses was primarily attributable to the devaluation of the Japanese Yen versus the U.S. dollar, having a negative impact of approximately \$1.6 million, which was partially offset by the appreciation of the euro versus the U.S. dollar, having a positive impact of approximately \$ 0.2 million.

Revenues from sales of proprietary packaged and third party software solutions increased by 5% from \$5.0 million in 2012 to \$5.2 million in 2013. The increase in sales of proprietary packaged and third party software solutions was primarily attributable to consolidating the results of operations of Pilat (North America) and Pilat Europe for the first time in 2013, which was partially offset by a decrease in sales of third party software and by the negative impact attributable to the devaluation of the Japanese Yen versus the U.S. dollar.

Revenues from maintenance and technical support increased by 1.3% from \$22.4 million in 2012 to \$22.7 million in 2013.

Revenues from IT consulting services increased by 23.3% from \$80.3 million in 2012 to \$99.0 million in 2013. The increase was primarily attributable to the acquisition of the Comm-IT Group in July 2012 (whose operations were included for a full year in 2013) and to the increasing demand for our professional services in Europe, Israel and Japan. Revenues from IT consulting services were positively impacted by the \$0.8 million gain attributable to the appreciation of the New Israeli Shekel versus the U.S. dollar that was partially offset by the devaluation of the Japanese Yen versus the U.S. dollar.

The following table presents our revenues by geographical market for the years ended December 31, 2012 and 2013:

|                | Year ended<br>December 31, |           |
|----------------|----------------------------|-----------|
|                | 2012                       | 2013      |
|                | (in thousands)             |           |
| Israel         | \$11,561                   | \$24,006  |
| Europe         | 29,139                     | 31,386    |
| United States  | 64,591                     | 70,872    |
| Japan          | 12,661                     | 11,965    |
| Other          | 8,428                      | 6,729     |
| Total revenues | \$126,380                  | \$144,958 |

**Cost of Revenues.** Cost of revenues increased by 17% from \$73.4 million in 2012 to \$85.9 million in 2013. Cost of revenues for licenses amounted to approximately \$4.4 million in 2012 and 2013. Cost of revenues for applications decreased by 26.9% from \$3.0 million in 2012 to \$2.2 million in 2013. The decrease in cost of revenues for applications was primarily attributable to the decrease in sales of third party software and by the positive impact attributable to the devaluation of the Japanese Yen against the U.S. dollar.

Cost of revenues for maintenance and technical support decreased by 8.9% from \$3.2 million in 2012 to \$2.9 million in 2013 primarily attributable to increased operating discipline.

Cost of revenues for IT consulting services increased by 21.7% from \$62.7 million in 2012 to \$76.3 million in 2013. The increase in cost of revenues for IT consulting services was primarily attributable to the inclusion of the costs of revenues of the Comm-IT Group for a full year and the cost of revenues of Pilat (North America) and Pilat Europe in 2013. Cost of revenues for the years ended December 31, 2012 and 2013 include \$16,000 and \$11,000, respectively, of stock-based compensation recorded under ASC 718.

**Gross Margin.** Gross margin in 2012 was 42% compared to gross profit of 41% in 2013.

**Research and Development Expenses, Net.** Gross research and development costs increased by 6.4% from \$7.9 million in 2012 to \$8.4 million in 2013. Net research and development expenses increased by 25.8% from \$2.9 million in 2012 to \$3.7 million in 2013. In 2013, we capitalized \$4.7 million of software development costs compared to \$5.0 million in 2012. Net research and development costs as a percentage of revenues was 2.6% in 2013 compared to 2.3% in 2012. The increase in research and development costs is primarily attributable to our additional investment in 2013 in our application development and integration platforms and in acquired application products. Research and development expenses for the years ended December 31, 2012 and 2013 include \$114,000 and \$67,000, respectively, of stock-based compensation recorded under ASC 718.

**Selling and Marketing Expenses.** Selling and marketing expenses amounted to approximately \$23.0 million in both 2012 and 2013. Selling and marketing expenses as a percentage of revenues decreased from 18.0% in 2012 to 15.9% in 2013. The decrease in selling and marketing expenses as a percentage of revenues is primarily attributable to our focus on operational discipline, seeking efficiency and cost savings. Selling and marketing expenses for the years ended December 31, 2012 and 2013 include \$82,000 and \$85,000, respectively, of stock-based compensation recorded under ASC 718.

**General and Administrative Expenses.** General and administrative expenses increased by 24% from \$10.6 million in 2012 to \$13.2 million in 2013. General and administrative expenses as a percentage of revenues increased to 9.1% in 2013 compared to 8.4% in 2012. The increase in general and administrative expenses is primarily attributable to the acquisitions of subsidiaries consolidated for the entire year for the first time in 2013 and an additional expense of \$0.2 million related to the change in valuation of contingent consideration of one of our subsidiaries, partly offset by the decrease in stock-based compensation. General and administrative expenses for the years ended December 31, 2012 and 2013 include \$303,000 and \$162,000, respectively, of stock-based compensation recorded under ASC 718.

**Other Income, Net.** We recorded other income, net of \$0.1 million in 2012 and nil in 2013. Other income, net in 2012 is attributable to proceeds from the sale of the assets of CarPro Systems Ltd. which we sold in December 2006.

**Financial Income (expenses), Net.** We recorded financial expenses of nil in 2012 and \$0.7 million in 2013. Our financial expense, net in 2013 was primarily attributable to the realized losses mainly on our account receivables recorded due to unfavorable foreign currency exchange rates and acquisition related costs.

**Taxes on Income.** We recorded taxes on income of \$0.1 million in 2012 compared to \$1.6 million in 2013. Our taxes on income in 2013 were primarily attributable to current taxes recorded in our subsidiaries due to local tax authorities in Japan, Europe and Israel and to the decrease of our deferred tax assets recorded with respect to utilization of

carry-forward tax losses.

**Net Income Attributable to our Shareholders.** Our net income decreased from \$16.2 million in 2012 to \$15.9 million in 2013. The decrease in net income was primarily attributable to an approximately \$1.0 million increase in amortization of capitalized software and other intangible assets and financial expenses attributable to realized losses mainly on our account receivables recorded due to unfavorable foreign currency exchange rates offset by the increase in our gross profit and operating income.

B.

Liquidity and Capital Resources

Historically, we have financed our operations through income generated by operations, proceeds from our public offerings in 1991 (approximately \$8.5 million), 1996 (approximately \$5.0 million), 2000 (approximately \$79.6 million) and 2014 (approximately \$54.7 million), private equity investments in 1998 (approximately \$12.2 million) and 2010 (approximately \$20.3 million) and research and development and marketing grants primarily from the Government of Israel. In addition, we have also financed our operations through short-term loans and borrowings under available credit facilities.

In December 2010, we raised approximately \$20.3 million, net of issuance expenses, in a private placement to institutional investors in the United States and abroad. We issued an aggregate of 3,287,616 ordinary shares at a price of \$6.50 per share in the offering. Certain of the purchasers also received warrants to purchase up to an aggregate of 1,134,231 ordinary shares at an exercise price of \$8.26 (later adjusted to \$7.75) per share. We received additional proceeds of approximately \$9.4 million from exercises of the warrants before they expired in June 2014.

In March 2014, we raised approximately \$54.7 million, net of issuance expenses, in a public offering of 6,900,000 ordinary shares, including 900,000 shares sold pursuant to the underwriters' exercise of their over-allotment option, at a price to the public of \$8.50 per share.

As of December 31, 2014, we had approximately \$84.4 million in cash and cash equivalents and available-for-sale marketable securities, with working capital of approximately \$102.9 million, compared to approximately \$36.0 million in cash and cash equivalents and available-for-sale marketable securities, with working capital of approximately \$45.2 million, as of December 31, 2013. The increase in cash and cash equivalent and available-for-sale marketable securities is primarily attributable to the proceeds of our public offering in March 2014.

As of December 31, 2014 and 2013, our long-term and short term debt amounted to \$3.3 million. We believe that our cash and cash equivalents (including available-for-sale marketable securities), in conjunction with cash generated from operations, will be sufficient to meet our cash requirements for working capital and capital expenditures for at least the next 12 months. We expect that cash provided by operating activities may fluctuate in future periods as a result of a number of factors, including fluctuations in our operating results, accounts receivable collections, and the timing and amount of tax and other payments.

We believe the overall credit quality of our portfolio is strong, with our cash equivalents and fixed income portfolio invested in securities with a weighted-average credit rating exceeding A. Our fixed income and publicly traded equity securities are classified as either Level 1 or Level 2 investments, as measured under ASC 820, "Fair Value Measurements and Disclosures," as these vendors either provide a quoted market price in an active market or use observable inputs.

## Cash Flows

The following table summarizes our cash flows for the periods presented:

Year ended December 31,

|                                                                                   | 2012                               | 2013     | 2014     |
|-----------------------------------------------------------------------------------|------------------------------------|----------|----------|
|                                                                                   | <b>(U.S. dollars in thousands)</b> |          |          |
| Net income from operations                                                        | \$16,460                           | \$16,856 | \$16,566 |
| Adjustments to reconcile net income to net cash provided by operating activities: | 6,488                              | 5,424    | 1,628    |
| Net cash provided by operating activities                                         | 22,948                             | 22,280   | 18,194   |
| Net cash used in investing activities                                             | (10,426)                           | (21,707) | (26,061) |
| Net cash provided by (used in) financing activities                               | (3,425 )                           | (3,328 ) | 46,318   |
| Effect of exchange rate changes on cash and cash equivalents                      | (64 )                              | 145      | (1,070 ) |
| Increase (decrease) in cash and cash equivalents from operations                  | 9,033                              | (2,610 ) | 37,381   |

Net cash provided by operating activities was \$18.2 million for the year ended December 31, 2014, compared to \$22.3 million and \$22.9 million for the years ended December 31, 2013 and 2012, respectively. Net cash provided by operations in 2014 consists primarily of \$1.6 million of net income adjusted for non-cash activities, including \$8.7 million of depreciation and amortization expenses, a \$1.2 million decrease in deferred income taxes, net, a \$0.2 million increase in deferred revenues, and \$1.6 million of stock compensation expenses, offset by a \$0.3 million decrease in accrued expenses and other accounts payable, and a \$0.3 million decrease in trade payables. Net cash provided by operations in 2013 consists primarily of \$16.9 million of net income adjusted by \$5.4 million for non-cash activities, including \$8.4 million of depreciation and amortization expenses, a \$0.5 million decrease in trade receivables, a \$0.7 million decrease in deferred income taxes, net and \$0.3 million of stock compensation expenses, offset by a \$1.6 million decrease in accrued expenses and other accounts payable, a \$1.8 million decrease in deferred revenues, a \$0.7 million decrease in trade payables and a \$0.4 million increase in other long-term and short term accounts receivable and prepaid expenses. Net cash provided by operations in 2012 consists primarily of \$16.5 million of net income adjusted by \$6.5 million for non-cash activities, including \$7.4 million of depreciation and amortization expenses, a \$0.8 million increase in trade payables, a \$1.1 million decrease in deferred income taxes, net and \$0.5 million of stock compensation expenses, offset by a \$2.3 million decrease in accrued expenses and other accounts payable and a \$1.1 million decrease in deferred revenues.

Net cash used in investing activities was approximately \$26.0 million for the year ended December 31, 2014, compared to net cash used in investing activities of approximately \$21.7 million for the year ended December 31, 2013 and net cash used in investing activities of approximately \$10.4 million for the year ended December 31, 2012. Net cash used in investing activities in 2014 is primarily attributable to \$11.4 million investment in marketable securities, net, \$9.4 million used in business combinations, \$1.0 million used to purchase property and equipment and \$4.3 million of capitalized software development costs. Net cash used in investing activities in 2013 is primarily attributable to \$16.6 million used in business combinations, \$0.5 million used to purchase property and equipment and \$4.7 million of capitalized software development costs. Net cash used in investing activities in 2012 is primarily attributable to \$7.6 million used in connection with business combinations, \$5.0 million of capitalized software development costs, \$1.4 million of investments in short-term bank deposits and \$0.5 million used to purchase property and equipment, partially offset by proceeds of \$3.6 million from short-term bank deposits, \$0.3 million in proceeds upon the maturity of marketable securities and \$0.1 million from the sale of a subsidiary's operation.

Net cash provided by financing activities was approximately \$46.3 million for the year ended December 31, 2014, primarily attributable to our issuance of shares in a follow-on public offering in the amount of \$54.7 million offset by dividend distributions of \$8.7 million. Net cash used in financing activities was approximately \$3.3 million for the year ended December 31, 2013, primarily attributable to dividend distributions of \$7.8 million, partially offset by \$3.3 million in long-term loans and \$1.5 million received from the exercise of employee options. Net cash used in financing activities was approximately \$3.4 million for the year ended December 31, 2012, primarily attributable to a dividend distribution of \$3.7 million, offset in part by proceeds of \$0.3 million received from the exercise of employee options.

## **Dividends**

We have paid dividends since October 2012 consistent with our Board of Directors' dividend policy to distribute a dividend of up to 50% of our annual distributable profits each year, subject to applicable law. Our Board of Directors may at its discretion and at any time, change, whether as a result of a one-time decision or a change in policy, the rate of dividend distributions or decide not to distribute a dividend. For information about our dividend policy and distributions, see Item 8A. "Financial Information - Consolidated Statements and Other Financial Information."

## **General**

Our consolidated financial statements appearing in this annual report have been prepared in U.S. dollars and in accordance with U.S. GAAP.

Transactions and balances originally denominated in dollars are presented at their original amounts. Transactions and balances in currencies other than the U.S. dollar are converted into dollars in accordance with the Financial Accounting Standards Board, or FASB, Accounting Standards Codification, or ASC, 830 “Foreign Currency Matters.” The majority of our sales are made outside of Israel and a substantial part of them is in dollars. In addition, a substantial portion of our costs is incurred in dollars. Since the dollar is the primary currency of the economic environment in which we and certain of our subsidiaries operate, the dollar is our functional and reporting currency and accordingly, monetary accounts maintained in currencies other than the dollar are remeasured into dollars using the foreign exchange rate in effect at each balance sheet date. Operational accounts and non-monetary balance sheet accounts are measured and recorded at the exchange rate in effect at the date of the transaction. For certain foreign subsidiaries whose functional currency is other than the U.S. dollar, all balance sheet accounts have been translated using the exchange rates in effect at each balance sheet date. Operational accounts have been translated using the average exchange rate prevailing during each year. The resulting translation adjustments are reported as a component of accumulated other comprehensive income (loss) in equity.

## Critical Accounting Policies and Estimations

We have identified the policies below as critical to the understanding of our financial statements. The preparation of our consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions in certain circumstances that affect the amounts reported in the accompanying financial statements and the related footnotes. Actual results may differ from these estimates. To facilitate the understanding of our business activities, certain of our accounting policies that we believe are the most important to the portrayal of our financial condition and results of operations and that require management's subjective judgments are described below. We base our judgments on our experience and various assumptions that we believe are reasonable.

### Revenue Recognition

We derive our revenues from licensing the rights to use our software (proprietary and non-proprietary), provision of related professional services, maintenance and technical support as well as from other IT professional services. We sell our products primarily through direct sales force and indirectly through distributors and value added resellers.

We account for our software sales in accordance with ASC 985-605. Software license revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred, the vendor's fee is fixed or determinable, no further obligation exists and collectability is probable.

As required by ASC 985-605, "Software Revenue Recognition," or ASC 985-605, we determine the value of the software component of our multiple-element arrangements using the residual method when vendor specific objective evidence, or VSOE, of fair value exists for the undelivered elements of the support and maintenance agreements. VSOE is based on the price charged when an element is sold separately or renewed. Under the residual method, the fair value of the undelivered elements is deferred and the remaining portion of the arrangement fee is allocated to the delivered elements and is recognized as revenue. Maintenance and support revenue included in multiple element arrangements is deferred and recognized on a straight-line basis over the term of the maintenance and support agreement.

Our revenues from maintenance and support are derived from annual maintenance contracts providing for unspecified upgrades for new versions and enhancements on a when-and-if-available basis for an annual fee. The right for an unspecified upgrade for new versions and enhancements on a when-and-if-available basis do not specify the features, functionality and release date of future product enhancements for the customer to know what will be made available and the general timeframe in which it will be delivered.

We generally do not grant a right of return to our customers. When a right of return exists, we defer revenue until the right of return expires, at which time revenue is recognized provided that all other revenue recognition criteria are met.

Revenue from professional services both related to software and IT professional services businesses consists of billable hours for services provided and is recognized as the services are rendered.

Arrangements that include professional services bundled with licensed software and other software related elements, are evaluated to determine whether those services are essential to the functionality of other elements of the arrangement. When services are considered essential to the software, revenues under the arrangement are recognized using contract accounting based on ASC 605-35, "Construction-Type and Production-Type Contracts," or ASC 605-35, on a percentage of completion method based on inputs measures. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are first determined, in the amount of the estimated loss for the entire contract. During the years ended December 31, 2012, 2013 and 2014, no such estimated losses were identified.

When professional services are not considered essential to the functionality of other elements of the arrangement, revenue allocable to the consulting services is recognized as the services are performed, using the VSOE fair value. In most cases, we have determined that the services are not considered essential to the functionality of other elements of the arrangement.

Deferred revenue includes unearned amounts received under maintenance and support contracts, and amounts received from customers but not yet recognized as revenues.

Revenue from third-party sales is recorded at a gross or net amount according to certain indicators. The application of these indicators for gross and net reporting of revenue depends on the relative facts and circumstances of each sale and requires significant judgment.

#### Research and development costs

Research and development costs incurred in the process of software development before establishment of technological feasibility are charged to expenses as incurred. Costs incurred subsequent to the establishment of technological feasibility are capitalized according to the principles set forth in ASC 985-20, "Costs of Software to be Sold, Leased or Marketed." We establish technological feasibility upon completion of a detailed program design or working model.

Research and development costs incurred in the process of developing product enhancements are generally charged to expenses as incurred.

Capitalized software costs are amortized on a product by product basis, by the straight-line method over the estimated useful life of the software product (between 3 to 5 years). We assess the recoverability of these intangible assets on a regular basis by determining whether the amortization of the assets over their remaining economic useful lives can be recovered through undiscounted future operating cash flows from the specific software product sold. As of December 31, 2012, 2013 and 2014, no impairment losses have been identified.

#### Business Combinations

We account for business combinations under ASC 805 "Business Combinations," which requires that we allocate the purchase price of acquired businesses to assets acquired, liabilities assumed, non-controlling interest and redeemable non-controlling interest in the acquiree at the acquisition date, measured at their fair values as of that date. We expense acquisition-related expenses and restructuring costs as they are incurred. In addition, changes in valuation allowance related to acquired deferred tax assets and in acquired income tax position are to be recognized in earnings. We engage third-party appraisal firms to assist management in determining the fair values of certain assets acquired and liabilities assumed. Such valuations require management to make significant estimates and assumptions, especially with respect to intangible assets.

Management makes estimates of fair value based upon assumptions it believes to be reasonable. These estimates are based on historical experience and information obtained from the management of the acquired businesses and relevant market and industry data and are, inherently, uncertain. Critical estimates made in valuing certain of the intangible assets include, among other things, the following: (i) future expected cash flows from license sales, maintenance agreements, customer contracts and acquired developed technologies and patents; (ii) expected costs to develop the in-process research and development into commercially viable products and estimated cash flows from the projects when completed; (iii) the acquired company's brand and market position as well as assumptions about the period of time the acquired brand will continue to be used in the combined company's product portfolio; and (iv) discount rates. Unanticipated events and circumstances may occur which may affect the accuracy or validity of such assumptions, estimates or actual results. Changes to these estimates, relating to circumstances that existed at the acquisition date, are recorded as an adjustment to goodwill during the purchase price allocation period (generally within one year of the acquisition date) and as operating expenses, if otherwise.

In connection with purchase price allocations, we estimate the fair value of the support obligations assumed in connection with acquisitions. The estimated fair value of the support obligations is determined utilizing a cost build-up approach. The cost build-up approach determines fair value by estimating the costs related to fulfilling the obligations plus a normal profit margin. The sum of the costs and operating profit approximates, in theory, the amount that we would be required to pay a third party to assume the support obligation. See Note 3 to our consolidated financial statements for additional information on accounting for our recent acquisitions.

## Variable Interest Entities

ASC 810, "Consolidation," provides a framework for identifying variable interest entities, or VIEs, and determining when a registrant should include the assets, liabilities, non-controlling interests and results of activities of a VIE in its consolidated financial statements.

The assessment of whether an entity is a VIE and the determination of the primary beneficiary requires judgment and involves the use of significant estimates and assumptions. Those include, among other things, forecasted cash flows, their respective probabilities and the economic value of certain preference rights. In addition, such assessment also involves estimates of whether a group entity can finance its current activities, until it reaches profitability, without additional subordinated financial support.

Effective January 1, 2010, we adopted an updated guidance for the consolidation of VIEs. The guidance implements a qualitative approach, based on which an enterprise should consolidate a VIE if it has both (i) the power to direct the economically significant activities of the entity; and (ii) the obligation to absorb losses of, or the right to receive benefits from, the entity that could potentially be significant to the variable interest entity. Determination about whether an enterprise should consolidate a VIE is required to be evaluated continuously as changes to existing relationships or future transactions.

A U.S.-based consulting and staffing services business that we acquired through one of our wholly-owned subsidiaries on January 17, 2010 is considered to be a VIE. The subsidiary is the primary beneficiary of the VIE, as a result of the fact that it holds the power to direct the activities of the acquired business, which significantly impacts its economic performance, and has the right to receive the benefits accruing from the acquired business.

## Goodwill

As a result of our acquisitions, our goodwill represents the excess of the purchase price in a business combination over the fair value of net tangible and intangible assets acquired.

Goodwill was allocated to the reporting segments at acquisition. We follow ASC 350, "Intangibles – Goodwill and Other," or ASC 350, and perform our goodwill annual impairment test for each of our reporting units at December 31 of each year, or more often if indicators of impairment are present.

As required by ASC 350, we compare the fair value of each reporting unit to its carrying value ('step 1'). If the fair value exceeds the carrying value of the reporting unit net assets, goodwill is considered not impaired, and no further testing is required. If the carrying value exceeds the fair value of the reporting unit, then the implied fair value of goodwill is determined by subtracting the fair value of all the identifiable net assets from the fair value of the reporting unit. An impairment loss is recorded for the excess, if any, of the carrying value of goodwill over its implied fair value ('step 2').

As required by ASC 820, "Fair Value Measurements and disclosures," or ASC 820, we apply assumptions that market place participants would consider in determining the fair value of each reporting unit.

In September 2011, the FASB issued ASU 2011-08 which amends the rules for testing goodwill for impairment. Under the new rules, an entity has the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary.

We have adopted the provisions of ASU 2011-08 for our annual impairment test as of January 1, 2012. This analysis determines that no indicators of impairment existed primarily because (i) our market capitalization has consistently exceeded its book value by a sufficient margin, (ii) our overall financial performance has been stable since its respective acquisitions, and (iii) forecasts of operating income and cash flows generated by each of our reporting units appear sufficient to support the book values of the net assets of each reporting unit.

We performed annual impairment tests during the fourth quarter in each of the years ended December 31, 2012, 2013 and 2014 and did not identify any impairment losses, as the fair values of all of our reporting units significantly exceeded their carrying values. Therefore, we currently do not believe that our reporting units are at risk of impairment.

#### Impairment of long-lived assets and intangible assets subject to amortization

We review our long-lived assets for impairment in accordance with ASC 360, "Property, Plant and Equipment," or ASC 360, whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the future undiscounted cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying value of the assets exceeds the fair value of the assets. During the years ended December 31, 2012, 2013 and 2014, no impairment indicators have been identified.

Intangible assets with finite lives are comprised of distribution rights, acquired technology, customer relationships, backlog and non-compete agreements and are amortized over their economic useful life using a method of amortization that reflects the pattern in which the economic benefits of the intangible assets are consumed or otherwise used up. Distribution rights, acquired technology and non-compete agreements were amortized on a straight line basis and customer relationships and backlog were amortized on an accelerated method basis over a period between 3.5 and 15 years based on the customer relationships identified.

#### Marketable Securities

We account for investments in marketable securities in accordance with ASC 320 "Investments – Debt and Equity Securities," or ASC 320. Our management determines the appropriate classification of its investments in marketable debt and equity securities at the time of purchase and reevaluates such determinations at each balance sheet date. Our marketable securities consist mainly of debt securities which are designated as available-for-sale and are stated at fair value, with unrealized gains and losses reported in accumulated other comprehensive income (loss), a separate component of shareholders' equity. Realized gains and losses on sales of investments, as determined on a specific identification basis, are included in financial income, net, together with accretion (amortization) of discount (premium), and interest or dividends.

We recognize an impairment charge when a decline in the fair value of an investment that falls below its cost basis is determined to be other-than-temporary.

Declines in fair value of available-for-sale equity securities that are considered other-than-temporary, based on criteria described in SAB Topic 5M, "Other Than Temporary Impairment of Certain Investments in Equity Securities," are charged to earnings (based on the entire difference between fair value and amortized cost). Factors considered in making such a determination include the duration and severity of the impairment, the financial condition and near-term prospects of the issuer, and the intent and ability of the company to retain its investment for a period of time sufficient to allow for any anticipated recovery in market value.

For declines in value of debt securities we apply an amendment to ASC 320. Under the amended impairment model, an other-than-temporary impairment loss is deemed to exist and recognized in earnings if management intends to sell or if it is more likely than not that it will be required to sell, a debt security, before recovery of its amortized cost basis. If the criteria mentioned above, does not exist, we evaluate the collectability of the security in order to determine if the security is other than temporary impaired.

For debt securities that are deemed other-than-temporary impaired, the amount of impairment recognized in the statement of operations is limited to the amount related to "credit losses" (the difference between the amortized cost of the security and the present value of the cash flows expected to be collected), while impairment related to other factors is recognized in other comprehensive income.

We did not record any impairment of marketable securities during the years ended December 31, 2012, 2013 and 2014.

## Stock-based compensation

We account for stock-based compensation in accordance with ASC 718 “Compensation – Stock Compensation,” or ASC 718. ASC 718 requires registrants to estimate the fair value of equity-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as an expense over the requisite service periods in our consolidated statement of income. We recognize compensation expenses for the value of our awards, which have graded vesting based on the accelerated method over the requisite service period of each of the awards, net of estimated forfeitures. To measure and recognize compensation expense for share-based awards we use the Binomial option-pricing model. The Binomial model for option pricing requires a number of assumptions, of which the most significant are the suboptimal exercise factor and expected stock price volatility. The suboptimal exercise factor is estimated based on employees' historical option exercise behavior.

The suboptimal exercise factor is the ratio by which the stock price must increase over the exercise price before employees are expected to exercise their stock options. Expected volatility is based upon actual historical stock price movements and was calculated as of the grant dates for different periods, since the Binomial model can be used for different expected volatilities for different periods. The risk-free interest rate is based on the yield from U.S. Treasury zero-coupon bonds with an equivalent term to the contractual term of the options. Prior to September 2012, we did not have any foreseeable plans to pay dividends and therefore used an expected dividend yield of zero in our past years option pricing models. In September 2012, our management adopted a dividend distribution policy according to which we will distribute in each year a dividend of up to 50% of our annual distributable profits. Therefore, we will use an expected dividend yield for our future grants. The expected term of options granted is derived from the output of the option valuation model and represents the period of time that options granted are expected to be outstanding. Estimated forfeitures are based on actual historical pre-vesting forfeitures. For awards with performance conditions, compensation cost is recognized over the requisite service period if it is 'probable' that the performance conditions will be satisfied, as defined in ASC 450-20-20, “Loss Contingencies.”

## Contingencies

From time to time, we are subject to legal, administrative and regulatory proceedings, claims, demands and investigations in the ordinary course of business, including claims with respect to intellectual property, contracts, employment and other matters. We accrue a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. Significant judgment is required in both the determination of probability and the determination as to whether a loss is reasonably estimable. These accruals are reviewed and adjusted to reflect the impact of negotiations, settlements, rulings, advice of legal counsel and other information and events pertaining to a particular matter.

## Fair Value Measurements

We account for certain assets and liabilities at fair value under ASC 820. Fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or a liability. As a basis for considering such assumptions, ASC 820 establishes a three-tier value hierarchy, which prioritizes the inputs used in the valuation methodologies in measuring fair value:

Level 1 - Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets;

Level 2 - Significant other observable inputs based on market data obtained from sources independent of the reporting entity;

Level 3 - Unobservable inputs which are supported by little or no market activity (for example cash flow modeling inputs based on assumptions).

Assets and liabilities measured at fair value on a recurring basis are comprised of marketable securities, foreign currency forward contracts and contingent consideration of acquisitions (See Note 5 to the consolidated financial statements).

The carrying amounts reported in the balance sheet for cash and cash equivalents, short term bank deposits, trade receivables, other accounts receivable, short-term bank credit, trade payables and other accounts payable approximate their fair values due to the short-term maturities of such instruments.

#### Accounting for income tax

We account for income taxes in accordance with ASC 740, "Income Taxes," or ASC740. ASC 740 prescribes the use of the "asset and liability" method whereby deferred tax asset and liability account balances are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. We provide a valuation allowance, if necessary, to reduce deferred tax assets to their estimated realizable value. Deferred tax assets and liabilities are classified as current or non-current according to the expected reversal dates.

Taxes that would apply in the event of disposal of investments in subsidiaries have not been taken into account in computing deferred taxes, as it is our intention to hold these investments, rather than realize them. We do not expect our non-Israeli subsidiaries to distribute taxable dividends in the foreseeable future, as their earnings are needed to fund their growth while we expect to have sufficient resources in the Israeli companies to fund our cash needs in Israel.

We utilize a two-step approach in recognizing and measuring uncertain tax positions accounted for in accordance with ASC 740. Under the first step we evaluate a tax position taken or expected to be taken in a tax return by determining if the weight of available evidence indicates that it is more likely than not that, based on technical merits, the tax position will be sustained on audit, including resolution of any related appeals or litigation processes. The second step is to measure the tax benefit as the largest amount that is more than 50% likely to be realized upon ultimate settlement with the tax authorities. We have accrued interest and penalties related to unrecognized tax benefits in our provisions for income taxes. The total amount of gross unrecognized tax benefits (tax on income) for the years ended December 31, 2012, 2013 and 2014 were \$(240,000), \$(2,811,000) and \$(156,000), respectively.

#### Recently Issued Accounting Standards

In August 2014, the Financial Accounting Standards Board (“FASB”) issued amended guidance related to disclosure of uncertainties about an entity’s ability to continue as a going concern. The new guidance requires management to evaluate whether there is substantial doubt about the entity’s ability to continue as a going concern and, as necessary, to provide related footnote disclosures. The guidance has an effective date of December 31, 2016. We believe that the adoption of this new standard will not have a material impact on our consolidated financial statements.

In May 2014, the FASB issued guidance on revenue from contracts with customers that will supersede most current revenue recognition guidance, including industry-specific guidance. The underlying principle is that an entity will recognize revenue upon the transfer of goods or services to customers in an amount that the entity expects to be entitled to in exchange for those goods or services. The guidance provides a five-step analysis of transactions to determine when and how revenue is recognized. Other major provisions include capitalization of certain contract costs, consideration of the time value of money in the transaction price, and allowing estimates of variable consideration to be recognized before contingencies are resolved in certain circumstances. The guidance also requires enhanced disclosures regarding the nature, amount, timing and uncertainty of revenue and cash flows arising from an entity’s contracts with customers. The guidance is effective for the interim and annual periods beginning on or after December 15, 2016 (early adoption is not permitted). The guidance permits the use of either a retrospective or cumulative effect transition method. The Company has not yet selected a transition method and it is currently evaluating the effect that the updated standard will have on its consolidated financial statements and related disclosures.

## C. RESEARCH AND DEVELOPMENT

Our research and development and support personnel work closely with our customers and prospective customers to determine their requirements and to design enhancements and new releases to meet their needs. We periodically release enhancements and upgrades to our core products. In the years ended December 31, 2014, 2013 and 2012, we invested \$9.0 million, \$8.4 million and \$7.9 million in research and development, respectively. Research and development activities take place in our facilities in Israel, India, Russia and Japan.

As of December 31, 2014, we employed 173 employees in research and development activities, of which 73 persons were located in Israel, 61 persons in India, 33 persons in Russia and 6 persons in Japan. Our product development team includes technical writers who prepare user documentation for our products. In addition, we have also entered into arrangements with subcontractors for the preparation of product user documentation and certain product development work.

For additional information regarding product development see Item 4. “Information on the Company - Business Overview - Product Development.”

## D. TREND INFORMATION

For information see discussion in Item 4. “Information on the Company-Business Overview-Industry Background and Trends” and Item 5. “Operating and Financial Review and Prospects - Results of Operations.”

## E. OFF-BALANCE SHEET ARRANGEMENTS

We are not a party to any off-balance sheet arrangements. In addition, we have no unconsolidated special purpose financing or partnership entities that are likely to create material contingent obligations.

## F. TABULAR DISCLOSURE OF CONTRACTUAL OBLIGATIONS

The following table summarizes our minimum contractual obligations as of December 31, 2014 and the effect we expect them to have on our liquidity and cash flow in future periods.

| Contractual Obligations                    | Payments due by period |                     |             |           |
|--------------------------------------------|------------------------|---------------------|-------------|-----------|
|                                            | Total                  | less than<br>1 year | 1-3 years   | 3-5 years |
| Operating lease obligations                | \$3,797,000            | \$1,798,000         | \$1,999,000 | \$-       |
| Liabilities due to acquisition activities  | 382,000                | 173,000             | 209,000     | -         |
| Severance payments, net*                   | 2,562,000              | -                   | -           | -         |
| Uncertainties in income taxes (ASC 740) ** | 341,000                | -                   | -           | -         |
| Long term loan                             | 490,000                | -                   | -           | 490,000   |
| Total contractual obligations.....         | \$7,492,000            | \$1,730,000         | \$2,139,000 | \$490,000 |

\*Severance payments relate to accrued severance obligations and notice obligations mainly to our Israeli employees as required under Israeli labor law or personal employment agreements. We are legally required to pay severance upon certain circumstances, primarily upon termination of employment by our company, retirement or death of the respective employee. Our liability for all of our Israeli employees is fully provided for by monthly deposits with insurance policies and by an accrual.

\*\* Payment of uncertain tax benefits would result from settlements with taxing authorities. Due to the difficulty in determining the timing of settlements, this information is not included in the above table. We do not expect to make any significant payments for these uncertain tax positions within the next 12 months.

**ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES****A. DIRECTORS AND SENIOR MANAGEMENT**

Set forth below are the name, age, principal position and a biographical description of each of our directors and executive officers:

| <b>Name</b>                   | <b>Age</b> | <b>Position</b>                                                                   |
|-------------------------------|------------|-----------------------------------------------------------------------------------|
| Guy Bernstein                 | 47         | Chief Executive Officer and Director                                              |
| Itiel Efrat <sup>(1)</sup>    | 51         | External director                                                                 |
| Ron Ettlinger <sup>(1)</sup>  | 48         | External director                                                                 |
| Naamit Salomon                | 50         | Director                                                                          |
| Yehezkel Zeira <sup>(1)</sup> | 71         | Director                                                                          |
| Asaf Berenstin                | 37         | Chief Financial Officer                                                           |
| Udi Ertel                     | 55         | President, Software Solutions division                                            |
| Eyal Pfeifel                  | 46         | Chief Technology Officer                                                          |
| Amit Birk                     | 44         | Vice President, Mergers and Acquisitions, General Counsel and Corporate Secretary |
| Arik Kilman                   | 62         | President, AppBuilder Software Solutions division                                 |
| Yakov Tsaroya                 | 45         | Chief Executive Officer of Coretech Consulting Services and Fusion Solutions      |
| Moshe Gez                     | 54         | Chief Executive Officer of Complete Business Solutions                            |
| Arik Faingold                 | 38         | President, Integration Solutions division                                         |
| Yuval Baruch                  | 48         | Chief Executive Officer of Hermes Logistics                                       |

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(1) Member of our Audit and Compensation Committees

Messrs. Guy Bernstein and Yehezkel Zeira and Ms. Naamit Salomon were re-elected at our 2014 annual general meeting of shareholders to serve as directors until our 2015 annual general meeting of shareholders. Mr. Itiel Efrat was re-elected at our 2012 annual general meeting to serve as an external director for a third three-year term until November 25, 2015. Mr. Ron Ettlinger is serving as an external director pursuant to the provisions of the Israeli Companies Law for an initial three-year term ending December 21, 2017, succeeding Mr. Elan Penn whose term as external director ended at our 2014 annual general meeting of shareholders.

Mr. Guy Bernstein and Mr. Asaf Berenstin are first cousins. Mr. Arik Faingold is the brother of Mr. Idan Faingold who is an executive officer of the Comm-IT Group and the two brothers are the owners of the 20% minority interest in that company. Other than such relationships, there are no family relationships among our directors and senior executives.

**Guy Bernstein** has served as our chief executive officer since April 2010 and has served as a director of our company since January 2007. Mr. Bernstein served as the chairman of our board of directors from April 2008 to April 2010. Mr. Bernstein has also served as the chief executive officer of Formula Systems, our parent company, since January 2008. From December 2006 to November 2010, Mr. Bernstein served as a director and the chief executive officer of Emblaze Ltd., or Emblaze, our former controlling shareholder. Mr. Bernstein also serves as the chairman of the board of directors of Sapiens International Corporation N.V., or Sapiens, and is the chairman of the board of directors of Matrix IT Ltd., both of which are subsidiaries of Formula Systems. From April 2004 to December 2006, Mr. Bernstein served as the chief financial officer of Emblaze and he has served as a director of Emblaze since April 2004. Prior to that and from 1999, Mr. Bernstein served as our chief financial and operations officer. Prior to joining our company, Mr. Bernstein was employed by Kost Forer Gabbay & Kasierer, a member of Ernst & Young Global, where he acted as senior manager from 1994 to 1997. Mr. Bernstein holds a B.A. degree in Accounting and Economics from Tel Aviv University and is a certified public accountant (CPA) in Israel.

**Itiel Efrat** has served as an external director of our company since December 2006 and is a member of our audit committee. Mr. Efrat is the founder and has served as co-managing director of ERB Ltd., a leading financial consulting firm, since 1995. Mr. Efrat was also the founder and is a member of the board of directors of ESOP-Excellence Trust Company since 2004. Mr. Efrat is a certified public accountant (CPA) in Israel and holds a B.A. degree in Accounting and Economics from Tel Aviv College of Management.

**Ron Ettlinger** has served as a director of our company since December 2014 and is a member of our audit committee. Mr. Ettlinger is the founder and has been the chief executive officer of “Nippon Europe Israel Ltd.,” a leading provider of car multimedia advanced systems, since October 2000. Prior to that, Mr. Ettlinger was the owner and general manager of Universal Ltd., a car service. Mr. Ettlinger is the founder and since July 2014 has served as chief executive officer of Nippon Lights Ltd., a leading provider of LED lights and panels. Mr. Ettlinger holds a B.A. degree in business, with a major in finance and marketing from Tel-Aviv College of Management.

**Naamit Salomon** has served as director of our company since March 2003. Since January 2010, Ms. Salomon has served as a partner in an investment company. Ms. Salomon also serves as a director of Sapiens, which is part of the Formula group. Ms. Salomon served as the chief financial officer of Formula Systems from August 1997 until December 2009. From 1990 through August 1997, Ms. Salomon served as the controller of two large privately held companies in the Formula group. Ms. Salomon holds a B.A. degree in economics and business administration from Ben Gurion University and an LL.M. degree from Bar-Ilan University.

**Yehezkel Zeira** has served as a director of our company since December 2005 and is a member of our audit committee. Mr. Zeira has served as an independent IT consultant since 2001. From 2000 to 2001, Mr. Zeira served as executive vice president international of Ness Technologies Inc., and from 1970 to 2000, Mr. Zeira served in various positions at Advanced Technology Ltd., including as chief executive officer which position he assumed in 1982. Mr. Zeira was also a lecturer at Ben Gurion University Faculty of Engineering. Mr. Zeira holds a B.Sc. degree in Industrial Engineering and an M.Sc. degree in Operations Research, both from the Technion - Israel Institute of Technology and has participated in the Harvard Business School program for management development.

**Asaf Berenstin** has served as our chief financial officer since April 2010. In November 2011, Asaf was appointed as Chief Financial Officer of our parent company Formula Systems (1985) Ltd. in addition to his position as chief financial officer of our company. Prior to that and from August 2008, Mr. Berenstin served as our corporate controller. Prior to joining our company and from July 2007, Mr. Berenstin served as a controller at Gilat Satellite Networks Ltd. (NASDAQ: GILT). From October 2003 to July 2008, Mr. Berenstin was a certified public accountant at Kesselman & Kesselman, a member of PriceWaterhouseCooper. Mr. Berenstin holds a B.A. degree in Accounting and Economics and an M.B.A. degree, both from Tel Aviv University, and is a certified public accountant (CPA) in Israel.

**Udi Ertel** has served as president of Software Solutions division since 2013. Prior to that and from January 2011, Mr. Ertel served as vice president, sales and distribution, responsible for our sales and business activities in South Africa, Hungary and was responsible for distribution in the Asia Pacific region, East Europe and the Mediterranean basin. Mr. Ertel joined our company in 2004, initially serving as the chief executive officer of our Israeli subsidiary, Magic Software Enterprises (Israel) Ltd., and from January 2009 as our vice president, global services and operations. Before joining our company, Mr. Ertel served for nine years as the chief executive officer of Complot (83) Ltd. Mr. Ertel holds a B.Sc. degree in Computer Science and Mathematics and completed his studies towards an M.B.A. degree (without thesis), both from Tel Aviv University in Israel.

**Eyal Pfeifel** has served as our chief technology officer since October 2009. From February 2007 to July 2009, Mr. Pfeifel served as the chief technology officer of Ai Research and Technology. Mr. Pfeifel previously served as marketing general manager of our Japanese branch from 1998 to 2000 and as product manager at our headquarters from 1993 to 1998. Mr. Pfeifel has also served in a range of other senior positions, including vice president for product management at Artificial Intelligence, director of product marketing for Babylon Ltd. and director of business development for M-Systems.

**Amit Birk** has served as our vice president, mergers and acquisitions, general counsel and corporate secretary since May 1999. From 1997 to 1998, Mr. Birk was an associate at Avital Dromi & Co., a leading law firm in Tel Aviv, Israel. Since November 2007, Mr. Birk serves as an external director of BGI Investment (1961) Ltd., an Israeli public company. Mr. Birk holds an LL.B. degree from the University of Sheffield, an M.B.A. degree from Bar Ilan University and a Practical Engineer degree from ORT College. Mr. Birk is also a certified mediator.

**Arik Kilman** has served as president of AppBuilder Software Solutions division since January 2012, following our acquisition of AppBuilder Solutions Ltd. at which time he was named Chief Executive Officer of AppBuilder. Prior to joining our company, Mr. Kilman served as Chief Executive Officer of BluePhoenix Solutions Ltd., the former parent of AppBuilder from May 2003 to January 2009 and from April 2010 to December 2011. Mr. Kilman holds a B.A. degree in Economics and Computer Science from New York City College of Technology.

**Yakov Tsaroya** has served as chief executive officer of our subsidiary, CoreTech Consulting Group LLC, since 2006. Mr. Tsaroya has also served as Chief Executive Officer of Fusion Solution LLC and Xsell Resources Inc. since our acquisition of these companies in 2010. Mr. Tsaroya holds a B.A. degree in Accounting and Finance from the College of Administration in Israel and is a certified public accountant (CPA) in Israel.

**Moshe Gez** has served as founder and CEO of Complete Business Solutions since July 2001. Mr. Gez is responsible for our ERP division. Mr. Gez founded Complete in July, 2001 and since October 2013 he has as Chairman of the Board of Complete. Before founding Complete, Mr. Gez served as V.P. professional services for our company. Mr. Gez was also the founder and manager of I.T.M., an Israeli software development and marketing company, during the period of March 1998 through March 2000. Between June 1987 and March 1998, Mr. Gez served in several positions at Afek Engineering consultancy, including as its CEO. Mr. Gez holds a B.A. degree in Industrial Engineering from Beer-Sheva University in Israel.

**Arik Faingold** has served as president of Integration Solutions division since July 2012. Mr. Faingold has served as chairman of Comm-IT Group since 2009. Mr. Faingold was General Manager of Open TV Israel, part of OpenTV Global, from 2003 to 2009. Mr. Faingold served as Co-founder and CTO of Betting Corp from 1999 to 2003. Mr. Faingold holds a B.A. degree in Computer Science from the Interdisciplinary Center in Herzliya and an M.B.A. from Tel Aviv University.

**Yuval Baruch** has served as an officer of our company since his appointment in September 2012 as the chief executive officer of our subsidiary, Hermes Logistics Technologies (HLT). Mr. Baruch has also served as the chief executive officer of Pilat HR solutions since April 2013. Mr. Baruch was chief executive officer of J.R. Holdings & Development from November 2007 to January 2012. Mr. Baruch has served as an external director of Marix IT, a publicly traded company in Israel, since 2011. Between 2004 and 2008 Mr. Baruch launched, managed and divested a chain of fitness centers in Israel. Mr. Baruch holds a B.A. degree in Marketing and Finance from The College of Management in Israel and an M.B.A. degree from the Stanford Graduate School of Business.

## B.

## COMPENSATION

The following table sets forth all compensation we paid with respect to all of our directors and executive officers as a group for the year ended December 31, 2014.

|                                                              | Salaries, fees,<br>commissions<br>and bonuses | Pension,<br>retirement<br>and<br>similar<br>benefits |
|--------------------------------------------------------------|-----------------------------------------------|------------------------------------------------------|
| All directors and executive officers as a group (15 persons) | \$ 3,421,336                                  | \$ 85,000                                            |

For so long as we qualify as a foreign private issuer, we are not required to comply with the proxy rules applicable to U.S. domestic companies, including the requirement to disclose information concerning the amount and type of compensation paid to our chief executive officer, chief financial officer and the three other most highly compensated executive officers, rather than on an aggregate basis. Nevertheless, a recent amendment to the regulations promulgated under the Israeli Companies Law requires us to disclose the annual compensation of our five most highly compensated officers on an individual basis, rather than on an aggregate basis, as was previously permitted for Israeli public companies listed overseas. Under the Companies Law regulations, this disclosure is required to be included in the annual proxy statement for our annual meeting of shareholders each year, which we furnish to the SEC under cover of a Report of Foreign Private Issuer on Form 6-K. Because of that disclosure requirement under Israeli law, we are also including such information in this annual report, pursuant to the disclosure requirements of Form 20-F.

The table below reflects the compensation granted to our five most highly compensated officers during or with respect to the year ended December 31, 2014. All amounts reported in the table reflect the cost to our company, as recognized in our financial statements for the year ended December 31, 2014.

## 2014 Summary Compensation Table

| Name and Position                                                                            | Salary     | Bonus <sup>(1)</sup> | Equity Based Compensation <sup>(2)</sup> | All Other Compensation <sup>(3)</sup> | Total      |
|----------------------------------------------------------------------------------------------|------------|----------------------|------------------------------------------|---------------------------------------|------------|
| Arik Kilman, President, AppBuilder Solutions Division                                        | \$ 180,000 | \$ 741,960           | \$ 0                                     | \$ 0                                  | \$ 921,960 |
| Yakov Tsaroya, President, Coretech Consulting Group LLC                                      | \$ 145,000 | \$ 322,000           | \$ 0                                     | \$ 9,000                              | \$ 476,000 |
| Udi Ertel, President, Software Division                                                      | \$ 223,671 | \$ 111,307           | \$ 74,072                                | \$ 41,330                             | \$ 450,380 |
| Arik Faingold, President, Integration Solutions division                                     | \$ 240,423 | \$ 82,881            | \$ 0                                     | \$ 0                                  | \$ 323,304 |
| Amit Birk, Vice President, Mergers and Acquisitions, General Counsel and Corporate Secretary | \$ 190,018 | \$ 96,250            | \$ ,8488                                 | \$ 1,000                              | \$ 295,756 |

(1) Amounts reported in this column represent annual incentive bonuses granted to the covered executives based on performance-metric based formulas set forth in their respective employment agreements.

(2) Amounts reported in this column represent the grant date fair value computed in accordance with accounting guidance for share-based compensation.

(3) Amounts reported in this column include personal benefits and perquisites, including those mandated by applicable law. Such benefits and perquisites may include, to the extent applicable to the respective covered executive, payments, contributions and/or allocations for savings funds (e.g., Managers Life Insurance Policy), education funds (referred to in Hebrew as “keren hishtalmut”), pension, severance, vacation, car or car allowance, medical insurances and benefits, risk insurance (e.g., life insurance or work disability insurance), telephone expense reimbursement, convalescence or recreation pay, relocation reimbursement, payments for social security, and other personal benefits and perquisites consistent with our company’s guidelines. All amounts reported in the table represent incremental cost to our company.

During the year ended December 31, 2014, we paid to each of our outside and independent directors an annual fee of approximately \$19,000 and a per-meeting attendance fee of approximately \$637. Such fees are paid based on the fees detailed in a schedule published semi-annually by the Committee for Public Directors under the Israeli Securities Law.

The above compensation excludes stock- based compensation costs in accordance with ASC 718.

As of December 31, 2014, our directors and executive officers as a group, then consisting of 15 persons, held options to purchase an aggregate of 293,000 ordinary shares, at exercise prices ranging from \$1.12 to \$6.00 per share and an aggregate of 160,000 of our ordinary shares. Of such options, options to purchase 20,000 ordinary shares expire in 2018, options to purchase 118,000 ordinary shares expire in 2020, options to purchase 105,000 ordinary shares expire in 2021 and options to purchase 50,000 ordinary shares expire in 2023. All such options were granted under our 2000 Stock Option Plan and 2007 Incentive Compensation Plan. See Item 6E. “Directors, Senior Management and Employees - Share Ownership - Stock-Based Compensation Plans.”

C.

BOARD PRACTICES

**Introduction**

According to the Israeli Companies Law and our Articles of Association, the management of our business is vested in our board of directors. The board of directors may exercise all powers and may take all actions that are not specifically granted to our shareholders. Our executive officers are responsible for our day-to-day management. The executive officers have individual responsibilities established by our board of directors. Executive officers are appointed by and serve at the discretion of the board of directors, subject to any applicable agreements.

**Election of Directors**

Our articles of association provide for a board of directors consisting of no less than three and no more than eleven members or such other number as may be determined from time to time at a general meeting of shareholders. Our board of directors is currently composed of five directors.

Pursuant to our articles of association, all of our directors are elected at our annual general meeting of shareholders, which are required to be held at least once during every calendar year and not more than 15 months after the last preceding meeting. Except for our external directors (as described below), our directors are elected by a vote of the holders of a majority of the voting power represented and voting at such meeting and hold office until the next annual meeting of shareholders following the annual meeting at which they were appointed. Directors (other than external directors) may be removed earlier from office by resolution passed at a general meeting of our shareholders. Our board of directors may temporarily fill vacancies in the board until the next annual meeting of shareholders, provided that the total number of directors will not exceed the maximum number permitted under our articles of association.

Under the Israeli Companies Law, our board of directors is required to determine the minimum number of directors who must have “accounting and financial expertise” (as such term is defined in regulations promulgated under the Israeli Companies Law). In determining such number, the board of directors must consider, among other things, the type and size of the company and the scope of and complexity of its operations. Our board of directors has determined that at least one director must have “accounting and financial expertise,” within the meaning of the regulations promulgated under the Israeli Companies Law.

**External and Independent Directors**

**External Directors.** The Israeli Companies Law requires companies organized under the laws of the State of Israel with shares that have been offered to the public in or outside of Israel to appoint at least two external directors. No person may be appointed as an external director if the person is a relative of the controlling shareholder of the company or if the person or the person's relative, partner, employer or any entity under the person's control has or had, on or within the two years preceding the date of the person's appointment to serve as an external director, any affiliation with the company or the controlling shareholder of the company or the controlling shareholder's relative or any entity controlled by the company or by the controlling shareholder of the company. If the company does not have a controlling shareholder or a person or entity which holds 25% of the total voting rights of the company, an external director may also not have an affiliation with chairman of the board, the chief executive officer, beneficial owner of 5% or more of the issued shares or the voting power of the company and the most senior executive officer of the company in the finance field. The term "affiliation" includes an employment relationship, a business or professional relationship maintained on a regular basis (other than negligible relationships), control and service as an "office holder" as defined in the Israeli Companies Law, however, "affiliation" does not include service as a director of a private company prior to its first public offering if the director was appointed to such office for the purpose of serving as an external director following the company's first public offering. In addition, no person may serve as an external director if the person's position or other activities create or may create a conflict of interest with the person's responsibilities as an external director or may otherwise interfere with the person's ability to serve as an external director. In addition, a director in a company may not be appointed as an external director in another company if at that time, a director of the other company serves as an external director in the first company. Moreover, a person may not be appointed as an external director, if he or she is employed by the Israeli Securities Authority or by Tel-Aviv Stock Exchange. If, at the time external directors are to be appointed, all current members of the board of directors which are not the controlling shareholders of the company or their relatives are of the same gender, then at least one external director must be of the other gender.

At least one of the external directors must have “accounting and financial expertise” and the other external directors must have “professional expertise,” as such terms are defined by regulations promulgated under the Israeli Companies Law.

The election of the nominee for external director requires the affirmative vote of (i) the majority of the votes actually cast with respect to such proposal including at least a majority of the voting power of the non-controlling shareholders (as such term is defined in the Israel Securities Law, 1968) or those shareholders who do not have a personal interest in approval of the nomination except for a personal interest that is not as a result of the shareholder’s connections with the controlling shareholder, who are present in person or by proxy and vote on such proposal, or (ii) the majority of the votes cast on such proposal at the meeting, provided that the total votes cast in opposition to such proposal by the non-controlling shareholders or those shareholders who do not have a personal interest in approval of the nomination except for a personal interest that is not as a result of the shareholder’s connections with the controlling shareholder (as such term is defined in the Israel Securities Law, 1968) does not exceed 2% of all the voting power in the Company.

External directors serve for a three-year term. However, in accordance with the Israeli Companies Law regulations, external directors of a public company whose shares are traded on the NASDAQ may be appointed for additional periods of three-year each provided that the audit committee and the board of directors have approved that, given the external director's expertise and contribution to the board and committee meetings, such appointment is for the company's benefit and provided further that the nomination to additional periods of three-year terms is approved through one of the following mechanisms: (i) the board of directors proposed the nominee and his appointment was approved by the shareholders in the manner required to appoint external directors for their initial term (described above); or (ii) one or more shareholders holding 1% or more of the voting rights proposed the nominee, and the nominee is approved by the majority of the votes actually cast with respect to such proposal and all of the following conditions are met: (a) the majority of votes does not include the votes of the controlling shareholder or votes of shareholders who have a personal interest in approval of the nomination except for a personal interest that is not as a result of the shareholder’s connections with the controlling shareholder and (b) the total votes cast in favor of such proposal by the non-controlling shareholders or those shareholders who do not have a personal interest in the approval of the nomination except for a personal interest that is not as a result of the shareholder’s connections with the controlling shareholder exceed 2% of all the voting power in the company

External directors may be removed from office only by the same percentage of shareholders as is required for their election, or by a court, and then only if the external directors cease to meet the statutory qualifications for their appointment, violate their duty of loyalty to the company or are found by a court to be unable to perform his or hers duties on a full time basis. External directors may also be removed by the court if they are found guilty of bribery, fraud, administrative offenses or use of inside information.

Each committee of the board of directors that may exercise a responsibility of the board of directors must include at least one external director. The audit committee must be comprised of at least three directors and include all the external directors. An external director is entitled to compensation as provided in regulations adopted under the Israeli Companies Law and is otherwise prohibited from receiving any other compensation, directly or indirectly, in

connection with such service.

Until the lapse of two year from termination of office, we may not engage an external director, or his or her spouse or child to service as an office holder and cannot employ or receive services from that person, either directly or indirectly, including through a corporation controlled by that person.

***Independent Directors.*** NASDAQ Stock Market Rules require us to establish an audit committee comprised of at least three members and only of independent directors each of whom satisfies the respective “independence” requirements of the SEC and NASDAQ.

Pursuant to the Israeli Companies Law, a director may be qualified as an independent director if such director is either (i) an external director; or (ii) a director that serves as a board member less than nine years and the audit committee has approved that he or she meets the independence requirements of an external director. A majority of the members serving on the audit committee must be independent under the Israeli Companies Law. In addition, an Israeli company whose shares are publicly traded may elect to adopt a provision in its articles of association pursuant to which a majority of its board of directors will constitute individuals complying with certain independence criteria prescribed by the Israeli Companies Law. We have not included such a provision in our articles of association. Pursuant to Israeli regulations adopted in January 2011, directors who comply with the independence requirements of NASDAQ and the SEC are deemed to comply with the independence requirements of the Israeli Companies Law.

Our board of directors has determined that Mr. Itiel Efrat and Mr. Ron Ettlinger both qualify as independent directors under the SEC and NASDAQ requirements and as external directors under the Israeli Companies Law requirements. Our board of directors has further determined that Mr. Yehezkel Zeira qualifies as an independent director under the SEC, NASDAQ and Israeli Companies Law requirements.

### **Committees of the Board of Directors**

***Audit Committee.*** Our audit committee, established in accordance with Sections 114-117 of the Israeli Companies Law and Section 3(a)(58)(A) of the Securities Exchange Act of 1934, assists our board of directors in overseeing the accounting and financial reporting processes of our company and audits of our financial statements, including the integrity of our financial statements, compliance with legal and regulatory requirements, our independent public accountants' qualifications and independence, the performance of our internal audit function and independent public accountants, finding any irregularities in the business management of our company for which purpose the audit committee may consult with our independent auditors and internal auditor, proposing to the board of directors ways to correct such irregularities and such other duties as may be directed by our board of directors. The responsibilities of the audit committee also include approving related-party transactions as required by law. The audit committee is also required to determine whether any action is material and whether any transaction is an extraordinary transaction or non-negligible transaction, for the purpose of approving such action or transaction as required by the Israeli Companies Law. Under Israeli law, an audit committee may not approve an action or a transaction with a controlling shareholder, or with an office holder, unless at the time of approval two external directors are serving as members of the audit committee and at least one of the external directors was present at the meeting in which an approval was granted.

Our audit committee is currently composed of Messrs. Efrat, Ettlinger and Zeira, each of whom satisfies the respective "independence" requirements of the SEC and NASDAQ. We also comply with Israeli law requirements for audit committee members. Mr. Efrat has been elected as the chairperson of the audit committee, and our board of directors has determined that he qualifies as a financial expert. The audit committee meets at least once each quarter.

**Compensation Committee.** In accordance with the Israeli Companies Law, we have a compensation committee, whose role is to: (i) recommend a compensation policy for office holders and to recommend to the board, once every three years, on the approval of the continued validity of the compensation policy that was determined for a period exceeding three years; (ii) recommend an update the compensation policy from time to time and to examine its implementation; (iii) determine whether to approve the terms of service and employment of office holders that require the committee's approval; and (iv) exempt a transaction from the requirement of shareholders' approval in accordance with the provisions of the Israeli companies Law. The compensation committee also has oversight authority over the actual terms of employment of directors and officers and may make recommendations to the board of directors and the shareholders (where applicable) with respect to deviation from the compensation policy that was adopted by the company.

In December 2014, the compensation policy for our directors and officers was approved by our shareholders.

Under the Israeli Companies Law, a compensation committee must consist of no less than three members, including all of the external directors (who must constitute a majority of the members of the committee), and the remainder of the members of the compensation committee must be directors whose terms of service and employment were determined pursuant to the applicable regulations. The same restrictions on the actions and membership in the audit committee as discussed above under "Audit Committee," including the requirement that an external director serve as the chairman of the committee and the list of persons who may not serve on the committee, also apply to the compensation committee. We have established a compensation committee that is currently composed of our external directors, Messrs. Efrat, Ettlinger and Zeira.

## **Internal Auditor**

The Israeli Companies Law also requires the board of directors of a public company to appoint an internal auditor proposed by the audit committee. A person who does not satisfy the Israeli Companies Law's independence requirements may not be appointed as an internal auditor.

The role of the internal auditor is to examine, among other things, the compliance of the company's conduct with applicable law and orderly business practice. Our internal auditor complies with the requirements of the Israeli Companies Law. Mr. Eyal Weizman currently serves as our internal auditor.

## **Directors' Service Contracts**

There are no arrangements or understandings between us and any of our subsidiaries, on the one hand, and any of our directors, on the other hand, providing for benefits upon termination of their employment or service as directors of our company or any of our subsidiaries.

## **Approval of Related Party Transactions Under Israeli Law**

### ***Fiduciary Duties of Office Holders***

The Israeli Companies Law codifies the fiduciary duties that "office holders," including directors and executive officers, owe to a company. An "office holder" is defined in the Israeli Companies Law as a chief executive officer, chief business manager, deputy general manager, vice general manager, any other person assuming the responsibilities of any of the foregoing positions without regard to such person's title or a director or any other manager directly subordinate to the general manager. An office holder's fiduciary duties consist of a duty of care and a duty of loyalty. The duty of care requires an office holder to act at a level of care that a reasonable office holder in the same position would employ under the same circumstances. This includes the duty to utilize reasonable means to obtain (i) information regarding the appropriateness of a given action brought for his approval or performed by him by virtue of his position and (ii) all other information of importance pertaining to the foregoing actions. The duty of loyalty includes (i) avoiding any conflict of interest between the office holder's position in the company and any other position he holds or his personal affairs, (ii) avoiding any competition with the company's business, (iii) avoiding exploiting any business opportunity of the company in order to receive personal gain for the office holder or others, and (iv) disclosing to the company any information or documents relating to the company's affairs that the office holder has received due to his position as an office holder.

***Disclosure of Personal Interests of an Office Holder***

The Israeli Companies Law requires that an office holder promptly, and no later than the first board meeting at which such transaction is considered, disclose any personal interest that he or she may have and all related material information known to him or her and any documents in their position, in connection with any existing or proposed transaction by us. In addition, if the transaction is an extraordinary transaction, that is, a transaction other than in the ordinary course of business, other than on market terms, or likely to have a material impact on the company's profitability, assets or liabilities, the office holder must also disclose any personal interest held by the office holder's spouse, siblings, parents, grandparents, descendants, spouse's descendants and the spouses of any of the foregoing, or by any corporation in which the office holder or a relative is a 5% or greater shareholder, director or general manager or in which he or she has the right to appoint at least one director or the general manager.

***Approval of Transactions with Office Holders and Controlling Shareholders***

Some transactions, actions and arrangements involving an office holder (or a third party in which an office holder has a personal interest) must be approved by the board of directors and, in some cases, by the audit committee or the compensation committee and by the board of directors, and under certain circumstances shareholder approval may also be required, provided, however, that such transactions are for the benefit of the company. Subject to certain exceptions, a person who has a personal interest in the approval of a transaction by the audit committee or the Board, may not be present and take part in the voting. An officer or a director who has a personal interest, may be present at the meeting for the purpose of presenting the transaction if the chairman of the audit committee or the Board, as relevant, has determined that the presence of the officer or director is required. A director may be present and vote at the meetings of the audit committee and Board if the majority of the directors have a personal interest in the approval of the transaction. In such case, the transaction also requires approval by the general meeting. The disclosure requirements which apply to an office holder also apply to such transaction with respect to his or her personal interest in the transaction.

The Companies Law provides for certain procedural constraints on a public company entering into a transaction in which a controlling shareholder and other interested parties have a personal interest. More specifically, Section 275 of the Companies Law provides that an extraordinary transaction (which is defined as a transaction that is either not in a company's ordinary course of business; or a transaction that is not undertaken in market conditions; or a transaction that is likely to substantially influence the profitability of a company, its property or liabilities) between a public company and its controlling shareholder, or an extraordinary transaction of a public company with a third party in which the controlling shareholder has a personal interest, including a transaction of a public company with a controlling shareholder, directly or indirectly, for the receipt of services therefrom (and including a transaction concerning the compensation arrangement of a controlling shareholder in its capacity as an employee or office holder of the company) (a "Controlling Party Transaction"), requires the approval of the audit committee (and with respect to a transaction concerning the compensation arrangement – the compensation committee), the board of directors and the general meeting of shareholders, provided however that the majority approving the transaction shall include at least one half of the votes of shareholders who do not have a personal interest in the transaction and are participating in the vote, or that the aggregate number of votes against the approval of the transaction, voted by shareholders who do not have such personal interest do not exceed 2% of the entire voting rights in the company. Section 275 of the Companies Law further provides that if the term of the Controlling Party Transaction extends beyond three years, the above approvals are required once every three years. However, if such transaction does not relate to a compensation arrangement, then the audit committee may approve the transaction for a longer duration, provided that the audit committee determines that such duration is reasonable under the circumstances. In accordance with the Israeli Companies law the audit committee is responsible to determine that Controlling Party Transactions shall be subject to a competitive procedure or other similar procedure before such transactions are approved.

On September 1, 2011, our company signed a non-exclusive distribution agreement with Asseco, our controlling shareholder, according to which Asseco will have the non-exclusive right to sell our company's products in Poland. The terms of the agreement were consistent with the standard distribution agreements that we have entered into from time to time with third party distributors. Our Audit Committee and Board of Directors determined that the agreement with Asseco was carried out on an arm's - length basis and at our 2011 annual general meeting, our shareholders approved the agreement with Asseco. The distribution agreement with Asseco was terminated on December 31, 2012.

#### ***Approval Process of Terms of Service and Employment of Office Holders***

Under the Israeli Companies Law, the method of approval of Terms of Service and Employment of office holders must be approved as follows:

With respect to an office holder who is not the general manager, a director, a controlling shareholder or a relative of the controlling shareholder:

In the event the transaction is in accordance with the compensation policy of the company – approval (in the following order) of: (i) compensation committee and (ii) board of directors.

In the event the transaction is not in accordance with the compensation policy of the company – approval, in special cases (in the following order), by the (i) compensation committee, (ii) board of directors and (iii) company's shareholders, by a simple majority, provided that such majority shall include (i) at least one half of the votes of shareholders who are participating in the vote and are not controlling shareholders or do not have a personal interest regarding the approval of the compensation policy, or (ii) the aggregate number of the opposing votes, voted by shareholders who do not have such personal interest or are not controlling shareholders, do not exceed two percent (2%) of the entire voting rights in the company (the "**Special Majority**"). Under these circumstances, the compensation committee and board of directors are required to approve the transaction based on certain considerations and include certain instructions in connection with the compensation policy. In the event the company's shareholders do not approve the compensation of the office holder, the compensation committee and board of directors may still approve the transaction, in special cases and with detailed reasons and after discussion and examining the rejection of the company's shareholders.

· With respect to a company's general manager (generally the equivalent of a CEO):

In the event the transaction is in accordance with the compensation policy - approval (in the following order) by the: (i) compensation committee, (ii) board of directors and (iii) company's shareholders with the "Special Majority" described above.

In the event the transaction is not in accordance with the compensation policy – the approval process and requirements are the same as the approval process for such a transaction with an office holder who is not the general manager, a controlling shareholder or a relative of the controlling shareholder.

The Israeli Companies Law includes an exception from the shareholder approval requirement in connection with the approval of a transaction with a general manager candidate, subject to certain conditions. In addition, in the event the § company's shareholders do not approve the compensation of the general manager, the compensation committee and board of directors may still approve the transaction, in special cases and with detailed reasons and after discussion and examining the rejection of the company's shareholders.

· With respect to a director who is not a controlling shareholder or a relative of the controlling shareholder:

In the event the transaction is in accordance with the compensation policy – approval (in the following order) by the: (i) compensation committee, (ii) board of directors and (iii) company's shareholders with a regular majority.

In the event the transaction is not in accordance with the compensation policy – the approval process and requirements are the same as the approval process for such a transaction with an office holder who is not the general manager, a controlling shareholder or a relative of the controlling shareholder (other than the possibility to approve a transaction that was not approved by the shareholders).

· With respect to a controlling shareholder or a relative of a controlling shareholder:

In the event the transaction is in accordance with the compensation policy - approval (in the following order) by the: (i) compensation committee, (ii) board of directors and (iii) company's shareholders with the "Special Majority" described above.

In the event the transaction is not in accordance with the compensation policy: the approval process and requirements are the same as the approval process for such a transaction with an office holder who is not the general manager, a controlling shareholder or a relative of the controlling shareholder (other than the possibility to approve a transaction that was not approved by the shareholders).

In accordance with the Israeli Companies Law, the audit committee is responsible to determine that Controlling Party Transactions shall be subject to a competitive procedure or other similar procedure before such transactions are approved.

## **Provisions Restricting Change in Control of Our Company**

***Tender Offer.*** In certain circumstances, an acquisition of shares in a public company must be made by means of a tender offer if, as a result of the acquisition, the purchaser would hold 25% or more of the voting rights in the company (unless there is already a 25% or greater shareholder of the company) or more than 45% of the voting rights in the company (unless there is already a shareholder that holds more than 45% of the voting rights in the company). If, as a result of an acquisition, the acquirer would hold more than 90% of a company's shares or voting rights, the acquisition must be made by means of a tender offer for all of the shares. A purchase by a tender offer is subject to additional requirements as specified in the Israeli Law and regulations promulgated thereunder.

***Merger.*** The Israeli Companies Law generally requires that a merger be approved by the board of directors and by the general meeting of the shareholders. Upon the request of any creditor of a merging company, a court may delay or prevent the merger if it concludes that there is a reasonable concern that, as a result of the merger, the surviving company will be unable to satisfy its obligations. In addition, a merger may generally not be completed unless at least (i) 50 days have passed since the filing of the merger proposal with the Israeli Registrar of Companies, and (ii) 30 days have passed since the merger was approved by the shareholders of each of the merging companies. The approval of merger by the company is also subject to additional approval requirements as specified in the Israeli Companies Law and regulations promulgated thereunder.

## **Exculpation, Indemnification and Insurance of Directors and Officers**

### ***Exculpation and Indemnification of Office Holders***

The Israeli Companies Law and our Articles of Association authorize us, subject to the receipt of requisite corporate approvals, to indemnify and exempt our directors and officers, subject to certain conditions and limitations. Most recently, in November 2011 our shareholders approved a form of indemnification and exculpation letter to ensure that our directors and officers (including any director and officer who may be deemed to be a controlling shareholder, within the meaning of the Israeli Companies Law) are afforded protection to the fullest extent permitted by law as currently in effect. Under the approved form of indemnification and exculpation letter, the total amount of indemnification allowed may not exceed an amount equal to 25% of our shareholders' equity in the aggregate, calculated with respect to each of our directors and officers.

The Israeli Companies Law provides that an Israeli company may not exculpate an office holder from liability for a breach of the duty of loyalty of the office holder. The company may, however, approve an office holder's act performed in breach of the duty of loyalty, provided that the office holder acted in good faith, the act or its approval does not harm the company and the office holder discloses the nature of his or her personal interest in the act and all

material facts and documents a reasonable time before discussion of the approval. An Israeli company may exculpate an office holder in advance from liability to the company, in whole or in part, for a breach of duty of care, but only if a provision authorizing such exculpation is inserted in its articles of association. An Israeli company may also not exculpate a director for liability arising out of a prohibited dividend or distribution to shareholders.

The Israeli Companies Law provides that a company may, if permitted by its articles of association, indemnify an office holder for acts or omissions performed by the office holder in such capacity for:

A financial liability imposed on the office holder in favor of another person by any judgment, including a settlement or an arbitrator's award approved by a court;

Reasonable litigation expenses, including attorney's fees, actually incurred by the office holder as a result of an investigation or proceeding instituted against him or her by a competent authority, provided that such investigation or proceeding concluded without the filing of an indictment against the office holder or the imposition of any financial liability instead of criminal proceedings, or concluded without the filing of an indictment against the office holder and a financial liability was imposed on the officer holder instead of criminal proceedings with respect to a criminal offense that does not require proof of criminal intent; and

Reasonable litigation expenses, including attorneys' fees, incurred by such office holder or which were imposed on him by a court, in proceedings the company instituted against the office holder or that were instituted on the company's behalf or by another person, or in a criminal charge from which the office holder was acquitted, or in a criminal proceeding in which the office holder was convicted of a crime which does not require proof of criminal intent.

Expenses, including reasonable litigation expenses and legal fees, incurred by such office holder as a result of a proceeding instituted against him in relation to (A) infringements that may result in imposition of financial sanction pursuant to the provisions of Chapter H'3 under the Israeli Securities Law or (B) administrative infringements pursuant to the provisions of Chapter H'4 under the Israeli Securities Law or (C) infringements pursuant to the provisions of Chapter I'1 under the Israeli Securities Law; and (e) payments to an injured party of infringement under Section 52ND(a)(1)(a) of the Israeli Securities Law.

In accordance with the Israeli Companies Law, a company's articles of association may permit the company to:

Undertake in advance to indemnify an office holder, except that with respect to a financial liability imposed on the office holder by any judgment, settlement or court-approved arbitration award, the undertaking must be limited to types of occurrences, which, in the opinion of the company's board of directors, are, at the time of the undertaking, foreseeable due to the company's activities and to an amount or standard that the board of directors has determined is reasonable under the circumstances; and

Retroactively indemnify an office holder of the company.

### ***Insurance for Office Holders***

The Israeli Companies Law provides that a company may, if permitted by its articles of association, insure an office holder for acts or omissions performed by the office holder in such capacity for:

A breach of his or her duty of care to the company or to another person;

A breach of his or her duty of loyalty to the company, provided that the office holder acted in good faith and had reasonable cause to assume that his act would not prejudice the company's interests; and

A financial liability imposed upon the office holder in favor of another person.

Subject to the provisions of the Israeli Companies Law and the Israeli Securities Law, a company may also enter into a contract to insure an office holder for (A) expenses, including reasonable litigation expenses and legal fees, incurred by the office holder as a result of a proceeding instituted against such office holder in relation to (1) infringements that may impose financial sanction pursuant to the provisions of Chapter H'3 under the Israeli Securities Law or (2) administrative infringements pursuant to the provisions of Chapter H'4 under the Israeli Securities Law or (3) infringements pursuant to the provisions of Chapter I'1 under the Israeli Securities Law and (B) payments made to the injured parties of such infringement under Section 52ND(a)(1)(a) of the Israeli Securities Law.

Our articles of association allow us to insure our office holders to the fullest extent permitted by law. At our 2011 annual general meeting, our shareholders approved a framework agreement of terms and conditions for the renewal, extension or replacement, from time to time, for a period of up to three years from December 14, 2011, of our directors' and officers' liability insurance policy for all directors and officers of the company and its subsidiaries, who may serve from time to time (including a director who may be deemed a controlling shareholder, within the meaning

of the Israeli Companies Law), according to which (i) the annual aggregate premium of the new policy may not exceed 25% of the previous year's aggregate premium; (ii) the coverage limit per claim and in the aggregate under the new policy may not exceed an amount representing an increase of 25% in any year, as compared to the previous year's aggregate coverage limit; and (iii) the terms of any new policy must be identical with respect to all of our officers and directors (including officers and directors who may be deemed controlling shareholders, within the meaning of the Israeli Companies Law). No further approval by our shareholders will be required in connection with any renewal, extension or purchase of any new policy entered into in compliance with the foregoing terms and conditions of the framework agreement.

***Limitations on Exculpation, Insurance and Indemnification***

The Israeli Companies Law provides that neither a provision of the articles of association permitting the company to enter into a contract to insure the liability of an office holder, nor a provision in the articles of association or a resolution of the board of directors permitting the indemnification of an office holder, nor a provision in the articles of association exempting an office holder from duty to the company shall be valid, where such insurance, indemnification or exemption relates to any of the following:

- a breach by the office holder of his duty of loyalty, except with respect to insurance coverage or indemnification if the office holder acted in good faith and had reasonable grounds to assume that the act would not prejudice the company;

- a breach by the office holder of his duty of care if such breach was committed intentionally or recklessly, unless the breach was committed only negligently;

- any act or omission committed with intent to derive an unlawful personal gain; and

- any fine, civil fine, financial sanction or forfeiture imposed on the office holder.

In addition, pursuant to the Israeli Companies Law, exemption of, procurement of insurance coverage for, an undertaking to indemnify or indemnification of an office holder must be approved by the compensation committee and the board of directors and, if such office holder is a director or a controlling shareholder or a relative of the controlling shareholder, also by the shareholders general meeting.

Our articles of association allow us to insure, indemnify and exempt our office holders to the fullest extent permitted by law, subject to the provisions of the Israeli Companies Law. We currently maintain a directors' and officers' liability insurance policy with a per-claim and aggregate coverage limit of \$20 million, including legal costs incurred world-wide.

**D.**

**EMPLOYEES**

The following table presents the number of our employees categorized by geographic location as of December 31, 2012, 2013 and 2014:

|               | Year ended December 31, |       |       |
|---------------|-------------------------|-------|-------|
|               | 2012                    | 2013  | 2014  |
| Israel        | 287                     | 373   | 395   |
| Asia          | 105                     | 111   | 111   |
| North America | 460                     | 682   | 524   |
| South Africa  | 34                      | 29    | 30    |
| Europe        | 120                     | 107   | 121   |
| Total         | 1,006                   | 1,302 | 1,181 |

The following table presents the number of our employees categorized by activity as of December 31, 2012, 2013 and 2014:

|                                  | Year ended December 31, |       |       |
|----------------------------------|-------------------------|-------|-------|
|                                  | 2012                    | 2013  | 2014  |
| Technical support and consulting | 681                     | 920   | 808   |
| Research and development         | 136                     | 152   | 173   |
| Marketing and sales              | 109                     | 136   | 129   |
| Operations and administrations   | 80                      | 94    | 71    |
| Total                            | 1,006                   | 1,302 | 1,181 |

Our relationships with our employees in Israel are governed by Israeli labor legislation and regulations, extension orders of the Israeli Ministry of Labor and personal employment agreements. Israeli labor laws and regulations are applicable to all of our employees in Israel. The laws concern various matters, including severance pay rights at termination, notice period for termination, retirement or death, length of workday and workweek, minimum wage, overtime payments and insurance for work-related accidents. We currently fund our ongoing legal severance pay obligations by paying monthly premiums for our employees' insurance policies and or pension funds. At the time of commencement of employment, our employees generally sign written employment agreements specifying basic terms and conditions of employment as well as non-disclosure, confidentiality and non-compete provisions.

## E. SHARE OWNERSHIP

### Beneficial Ownership of Executive Officers and Directors

The following table sets forth certain information as of March 31, 2015 regarding the beneficial ownership by each of our directors and executive officers:

| <u>Name</u>                    | Number of<br>Ordinary<br>Shares<br>Beneficially<br>Owned <sup>(1)</sup> | Percentage<br>of<br>Ownership<br><sup>(2)</sup> |
|--------------------------------|-------------------------------------------------------------------------|-------------------------------------------------|
| Guy Bernstein <sup>(3)</sup>   | 150,000                                                                 | *                                               |
| Asaf Berenstin <sup>(4)</sup>  | 72,500                                                                  | *                                               |
| Itiel Efrat                    | --                                                                      | --                                              |
| Naamit Salomon                 | 18,000                                                                  | --                                              |
| Yehezkel Zeira .....           | --                                                                      | --                                              |
| Ron Ettlinger.....             | --                                                                      | --                                              |
| Udi Ertel <sup>(6)</sup> ..... | 22,500                                                                  | --                                              |
| Eyal Pfeifel.....              | 7,500                                                                   | --                                              |
| Amit Birk <sup>(5)</sup> ..... | 62,500                                                                  | --                                              |
| Yoram Aharon.....              |                                                                         |                                                 |
| Moshe Gez.....                 | --                                                                      | --                                              |
| Arik Faingold.....             | --                                                                      | --                                              |
| Yuval Baruch.....              | --                                                                      | --                                              |
| Arik Kilman.....               | --                                                                      | --                                              |
| Yakov Tsaroya.....             | 40,000                                                                  | --                                              |

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\* Less than 1%

Beneficial ownership is determined in accordance with the rules of the SEC and generally includes voting or investment power with respect to securities. Ordinary shares relating to options currently exercisable or exercisable within 60 days of the date of this table are deemed outstanding for computing the percentage of the person holding such securities but are not deemed outstanding for computing the percentage of any other person. Except as indicated by footnote, and subject to community property laws where applicable, the persons named in the table above have sole voting and investment power with respect to all shares shown as beneficially owned by them.

(2) The percentages shown are based on 44,223,967 ordinary shares issued and outstanding as of March 31, 2015.

(3) Subject to outstanding ordinary shares.

(4) Subject to 70,000 currently exercisable options granted under our 2007 Stock Option Plan, having an exercise price ranging from \$1.12 to \$4.00 per share that expire in 2021 at the latest and 10,000 outstanding ordinary shares.

(5) Subject to 22,500 currently exercisable options granted under our 2007 Stock Option Plan, having an exercise price ranging from \$2.26 to \$4.00 per share that expire in 2021 and 40,000 outstanding ordinary shares.

(6) Subject to 22,500 currently exercisable options granted under our 2007 Stock Option Plan, having an exercise price of \$4.00 per share that expire in 2021.

## Stock-Based Compensation Plans

### 2000 Stock Option Plan

In 2000, we adopted our 2000 Employee Stock Option Plan, or the 2000 Plan, which terminated in November 2010. No award of options can be made under this plan after such date. An option may not be exercisable after the expiration of ten years from the date of its award, except that in case of an incentive stock option made to a 10% owner (as such term is defined in the 2000 Plan), such option may not be exercisable after the expiration of five years from its date of award. No option may be exercised after the expiration of its term. Options are not assignable or transferable by the optionee, other than by will or the laws of descent and distribution, and may be exercised during the lifetime of the optionee only by the optionee or his guardian or legal representative; provided, however, that during the optionee's lifetime, the optionee may, with the consent of the Option Committee transfer without consideration all or any portion of his options to members of the optionee's immediate family, a trust established for the exclusive benefit of members of the optionee's immediate family, or a limited liability company in which all members are members of the optionee's immediate family.

During 2014, options to purchase an aggregate of 14,030 ordinary shares were exercised under the 2000 Plan at an average exercise price of \$2.51 per share and options to purchase 44,750 ordinary shares remained outstanding.

### **2007 Incentive Compensation Plan.**

In 2007, we adopted our 2007 Incentive Compensation Plan, or the 2007 Plan, under which we may grant options, restricted shares, restricted share units and performance awards to employees, officers, directors and consultants of our company and its subsidiaries. The shares subject to the 2007 Plan may be either authorized and unissued shares or previously issued shares acquired by our company or any of its subsidiaries. The total number of shares that may be delivered pursuant to awards under the 2007 Plan shall not exceed 1,500,000 shares in the aggregate. If any award shall expire, terminate, be cancelled or forfeited without having been fully exercised or satisfied by the issuance of shares, then the shares subject to such award shall be available again for delivery in connection with future awards under the 2007 Plan.

The 2007 Plan will terminate upon the earliest of (i) the expiration of its ten year period, or (ii) the termination of all outstanding awards in connection with a corporate transaction, or (iii) in connection with, and as a result of, any other relevant event, including the 2007 Plan's termination by the Board of Directors.

Under the 2007 Plan, the option committee shall have full discretionary authority to grant or, when so restricted by applicable law, recommend the Board of Directors to grant, pursuant to the terms of the 2007 Plan, options and restricted shares and restricted share units to those individuals who are eligible to receive awards under the 2007 Plan.

The 2007 Plan provides that each option will expire on the date stated in the award agreement, which will not be more than ten years from its date of grant. The exercise price of an option shall be determined by the option committee of the Board of Directors and set forth in the award agreement. Unless determined otherwise by the Board of Directors, the exercise price shall be equal to, or higher than, the fair market value of our company's shares on the date of grant.

Under the 2007 Plan, restricted shares and restricted share units shall not be purchased for less than the ordinary share's par value, unless determined otherwise by the Board of Directors.

In September 2013, our shareholders approved to increase the number of ordinary shares available for issuance under the 2007 Stock Option Plan by an additional 1,000,000 shares.

Our Board of Directors may, from time to time, alter, amend, suspend or terminate the 2007 Plan, with respect to awards that have not been granted, subject to shareholder approval, if and to the extent required by applicable law. In addition, no such amendment, alteration, suspension or termination of the 2007 Plan or any award theretofore granted, shall be made which would materially impair the previously accrued rights of a participant under any outstanding award without the written consent of such participant, provided, however, that the Board of Directors may amend or alter the 2007 Plan and the option committee may amend or alter any award, including any agreement, either retroactively or prospectively, without the consent of the applicable participant, (i) so as to preserve or come within any exemptions from liability under any law or the rules and releases promulgated by the SEC, or (ii) if the Board of Directors or the option committee determines in its discretion that such amendment or alteration either is (a) required or advisable for us, the 2007 Plan or the award to satisfy, comply with or meet the requirements of any law, regulation, rule or accounting standard or (b) not reasonably likely to significantly diminish the benefits provided under such award, or that such diminishment has been or will be adequately compensated.

During 2014, options to purchase an aggregate of 101,691 ordinary shares were exercised under the 2007 Plan at an average exercise price of \$2.88 per share and options to purchase 542,639 ordinary shares remained outstanding. As of December 31, 2014, our executive officers and directors as a group, consisting of 15 persons, held options to purchase 293,000 ordinary shares under the 2000 Plan, having an average exercise price of \$3.17 per share.

ITEM 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS

A. MAJOR SHAREHOLDERS

Formula Systems, an Israeli company traded on the NASDAQ Global Select Market and the TASE, holds 20,158,201 or 45.6% of our outstanding ordinary shares. Formula Systems is controlled by Asseco, a Polish company listed on the Warsaw Stock Exchange, which holds 46.3% of the ordinary shares of Formula Systems. Accordingly, Asseco ultimately controls our company.

The following table sets forth as of March 31, 2015 certain information regarding the beneficial ownership by all shareholders known to us to own beneficially 5.0% or more of our ordinary shares:

| Name                                          | Number of<br>Ordinary<br>Shares<br>Beneficially<br>Owned <sup>(1)</sup> | Percentage<br>of<br>Ownership <sup>(2)</sup> |
|-----------------------------------------------|-------------------------------------------------------------------------|----------------------------------------------|
| Formula Systems (1985) Ltd. <sup>(3)</sup>    | 20,158,201                                                              | 45.6%                                        |
| Asseco Poland S.A. <sup>(3)</sup>             | 20,158,201                                                              | 45.6%                                        |
| Denver Investment Advisors LLC <sup>(4)</sup> | 5,944,821                                                               | 13.4%                                        |

Beneficial ownership is determined in accordance with the rules of the SEC and generally includes voting or investment power with respect to securities. Ordinary shares relating to options currently exercisable or exercisable within 60 days of the date of this table are deemed outstanding for computing the percentage of the person holding such securities but are not deemed outstanding for computing the percentage of any other person. Except as indicated by footnote, and subject to community property laws where applicable, the persons named in the table above have sole voting and investment power with respect to all shares shown as beneficially owned by them.

(2) The percentages shown are based on 44,223,967 ordinary shares issued and outstanding as of March 31, 2015.

(3) Asseco owned 46.36% of the outstanding shares of Formula Systems based on the Schedule 13D filed by Asseco with the SEC on December 6, 2010. As such, Asseco may be deemed to be the beneficial owner of the aggregate 20,158,201 ordinary shares held directly by Formula Systems. The address of Formula Systems is 5 Haplada Street, Or-Yehuda, Israel. The address of Asseco is 35-322 Rzeszow, ul. Olchowa 14, Poland.

(4) Based on the Schedule 13G/A filed by Denver Investment Advisors with the SEC on February 17, 2015.

#### Significant Changes in the Ownership of Major Shareholders

On March 11, 2014, Formula Systems filed a Schedule 13D/A with the SEC reflecting ownership of 19,860,044 of our ordinary shares. According to the Schedule 13D/A, from September 2012 through April 2013, it purchased an aggregate of 110,000 of our ordinary shares in open market transactions increasing its ownership interest in our shares to 52.2%. On March 5, 2014, we completed a follow-on public offering of 6,900,000 of our ordinary shares at a price to the public of \$8.50 per share. Formula Systems purchased 700,000 of the 6,900,000 ordinary shares issued in the offering. As a result of the issuance of our ordinary shares, Formula Systems' percentage interest in our company decreased from 51.6% to 45.0%.

On February 17, 2015, Denver Investment Advisors LLC filed a Schedule 13G/A with the SEC, reflecting ownership of 5,944,821, or 13.46% of our ordinary shares. On August 11, 2014, Denver Investment Advisors LLC filed a Schedule 13G with the SEC reflecting ownership of 4,436,012 of our ordinary shares, or 10.05% of our ordinary shares.

#### Major Shareholders Voting Rights

Our major shareholders do not have different voting rights.

#### Record Holders

Based on a review of the information provided to us by our U.S. transfer agent, as of April 14, 2015, there were approximately 71 record holders, of which 57 record holders holding approximately 99.9% of our ordinary shares had registered addresses in the United States. These numbers are not representative of the number of beneficial holders of our shares nor are they representative of where such beneficial holders reside, since many of these ordinary shares were held of record by brokers or other nominees (including one U.S. nominee company, CEDE & Co., which held approximately 99.8% of our outstanding ordinary shares as of such date).

### B. RELATED PARTY TRANSACTIONS

For information about related party transactions see "Item 6C. Directors, Senior Management and Employees – Board Practices - Approval of Related Party Transactions Under Israeli Law.

### C. INTERESTS OF EXPERTS AND COUNSEL

Not applicable.

## ITEM 8. FINANCIAL INFORMATION

### A. CONSOLIDATED STATEMENTS AND OTHER FINANCIAL INFORMATION

See the consolidated financial statements, including the notes thereto, included in Item 18.

## Legal Proceedings

In addition to the below mentioned legal proceedings, we and our subsidiaries are, from time to time, subject to legal, administrative and regulatory proceedings, claims, demands and investigations in the ordinary course of business, including claims with respect to intellectual property, contracts, employment and other matters. Based upon the advice of counsel, we do not believe that the ultimate resolution of these matters will materially affect our consolidated financial position, results of operations or cash flows.

In August 2009, a software company and one of its owners filed an arbitration proceeding against us and one of our subsidiaries, claiming an alleged breach of a non-disclosure agreement between the parties. The plaintiffs sought damages in the amount of approximately NIS 52 million (approximately \$13.4 million). The arbitrator rendered his ruling in January 2015 and determined the damages that we and one of our subsidiaries should pay the plaintiffs. Therefore, our financial results of operations of 2014 includes a net impact of \$1.6 million resulting from the arbitration expenses recorded in excess to accruals recorded in previous years.

## Dividend Distribution Policy

In December 2009, we declared a cash dividend of \$0.5 per share (\$16.0 million in the aggregate) to our shareholders of record on January 11, 2010, that was payable on January 25, 2010.

In September 2012, we declared a cash dividend of \$0.10 per share (\$3.7 million in the aggregate) to our shareholders of record on October 2, 2012, that was payable on October 17, 2012.

In February 2013 we declared a cash dividend of \$0.12 per share (\$4.4 million in the aggregate) to our shareholders of record on February 25, 2013 that was payable on March 14, 2013.

In August 2013, we declared an additional cash dividend of \$0.09 per share (\$3.4 million in the aggregate) to our shareholders of record on August 21, 2013 that was payable on September 3, 2013.

In February 2014, we declared paid a cash dividend of \$0.12 per share (\$4.5 million in the aggregate) to our shareholders of record on February 27, 2014, that was payable on March 14, 2014.

In September 2014, we declared a cash dividend in the amount of US \$0.095 per share (\$4.2 million in the aggregate) to shareholders of record on August 19, 2014, that was payable on September 4, 2014.

During 2014, we distributed cash dividends totaling \$8.7 million (or \$0.215 per share), providing a dividend yield of approximately 3.6%.

In February 2015, we declared a cash dividend in the amount of US \$0.081 per share (\$3.6 million in the aggregate) to our shareholders of record on February 23, 2015, that was paid on March 11, 2015.

In September 2012, our Board of Directors adopted a policy for distributing dividends, under which we will distribute a dividend of up to 50% of our annual distributable profits each year, subject to any applicable law. It is possible that our Board of Directors will decide, subject to the conditions stated above, to declare additional dividend distributions. Our Board of Directors may at its discretion and at any time, change, whether as a result of a one-time decision or a change in policy, the rate of dividend distributions or not to distribute a dividend.

According to the Israeli Companies Law, a company may distribute dividends out of its profits provided that there is no reasonable concern that such dividend distribution will prevent the company from paying all its current and foreseeable obligations, as they become due. Notwithstanding the foregoing, dividends may be paid with the approval of a court, provided that there is no reasonable concern that such dividend distribution will prevent the company from satisfying its current and foreseeable obligations, as they become due. Profits, for purposes of the Israeli Companies

Law, means the greater of retained earnings or earnings accumulated during the preceding two years, after deducting previous distributions that were not deducted from the surpluses.

## B. SIGNIFICANT CHANGES

Except as otherwise disclosed in this annual report, no significant change has occurred since December 31, 2014.

## ITEM 9. THE OFFER AND LISTING

### A. OFFER AND LISTING DETAILS

#### Annual Stock Information

The following table sets forth, for each of the years indicated, the range of high ask and low bid prices of our ordinary shares on the NASDAQ Global Select Market (for periods from January 3, 2011) or the NASDAQ Global Market (for periods prior to January 3, 2011) and the TASE:

|      | NASDAQ |        | TASE*  |        |
|------|--------|--------|--------|--------|
|      | High   | Low    | High   | Low    |
| Year |        |        |        |        |
| 2010 | \$8.43 | \$1.55 | \$8.11 | \$1.56 |
| 2011 | \$9.74 | \$3.91 | \$9.55 | \$3.95 |
| 2012 | \$7.32 | \$3.76 | \$7.42 | \$3.94 |
| 2013 | \$7.18 | \$4.53 | \$7.06 | \$4.73 |
| 2014 | \$9.60 | \$5.94 | \$9.30 | \$6.40 |

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\* The U.S. dollar price of shares on the TASE is determined by dividing the price of an ordinary share in NIS by the representative exchange rate of the NIS against the U.S. dollar on the same date.

## Quarterly Stock Information

The following table sets forth, for each of the financial quarters in the two most recent financial years, the range of high ask and low bid prices of our ordinary shares on the NASDAQ Global Select Market and the TASE:

|                                        | NASDAQ |        | TASE*  |        |
|----------------------------------------|--------|--------|--------|--------|
|                                        | High   | Low    | High   | Low    |
| 2013                                   |        |        |        |        |
| First Quarter                          | \$5.47 | \$4.53 | \$5.36 | \$4.60 |
| Second Quarter                         | \$5.59 | \$4.91 | \$5.65 | \$4.83 |
| Third Quarter                          | \$6.95 | \$5.40 | \$6.85 | \$5.50 |
| Fourth Quarter                         | \$7.18 | \$6.12 | \$7.23 | \$6.18 |
| 2014                                   |        |        |        |        |
| First Quarter                          | \$9.60 | \$7.12 | \$9.52 | \$7.02 |
| Second Quarter                         | \$8.63 | \$7.17 | \$8.83 | \$7.01 |
| Third Quarter                          | \$7.74 | \$6.66 | \$7.97 | \$6.51 |
| Fourth Quarter                         | \$7.20 | \$5.94 | \$7.24 | \$6.09 |
| 2015                                   |        |        |        |        |
| First Quarter (through March 31, 2015) | \$7.04 | \$5.42 | \$7.15 | \$5.47 |

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\* The U.S. dollar price of shares on the TASE is determined by dividing the price of an ordinary share in NIS by the representative exchange rate of the NIS against the U.S. dollar on the same date.

## Monthly Stock Information

The following table sets forth, for the most recent six months, the range of high ask and low bid prices of our ordinary shares on the NASDAQ Global Select Market and the TASE:

|                | NASDAQ |        | TASE*  |        |
|----------------|--------|--------|--------|--------|
|                | High   | Low    | High   | Low    |
| September 2014 | \$7.74 | \$6.66 | \$7.72 | \$6.82 |
| October 2014   | \$6.99 | \$6.45 | \$6.98 | \$6.48 |
| November 2014  | \$7.20 | \$6.89 | \$7.22 | \$6.74 |
| December 2014  | \$6.91 | \$5.94 | \$7.05 | \$5.93 |
| January 2015   | \$6.10 | \$5.42 | \$6.07 | \$5.59 |

|                                     |        |        |        |        |
|-------------------------------------|--------|--------|--------|--------|
| February 2015                       | \$6.91 | \$6.09 | \$7.06 | \$5.55 |
| March 2015 (through March 31, 2015) | \$7.04 | \$6.36 | \$7.03 | \$6.33 |

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\* The U.S. dollar price of shares on the TASE is determined by dividing the price of an ordinary share in NIS by the representative exchange rate of the NIS against the U.S. dollar on the same date.

B. PLAN OF DISTRIBUTION

Not applicable.

## C. MARKETS

Our ordinary shares were listed on the NASDAQ Global Market (symbol: MGIC) from our initial public offering in the United States on August 16, 1991 until January 3, 2011, at which date the listing of our ordinary shares was transferred to the NASDAQ Global Select Market. Since November 16, 2000, our ordinary shares have also traded on the TASE, and on December 15, 2011 they have been included in the TASE's TA-100 Index.

## D. SELLING SHAREHOLDERS

Not applicable.

## E. DILUTION

Not applicable.

## F. EXPENSES OF THE ISSUE

Not applicable.

## ITEM 10. ADDITIONAL INFORMATION

### A. SHARE CAPITAL

Not applicable.

### B. MEMORANDUM AND ARTICLES OF ASSOCIATION

*Set out below is a description of certain provisions of our Articles of Association and of the Israeli Companies Law related to such provisions. This description is only a summary and does not purport to be complete and is qualified by reference to the full text of the Articles of Association, which are incorporated by reference as an exhibit to this Annual Report.*

## Purposes and Objects of the Company

We are a public company registered with the Israeli Companies Registry as Magic Software Enterprises Ltd., registration number 52-003674-0. Section 2 of our memorandum of association provides that we were established for the purpose of engaging in all fields of the computer business and in any other lawful activity permissible under Israeli law.

## The Powers of the Directors

According to our articles of association, and under the limitations described therein, our board of directors may cause the company to borrow or secure the payment of any sum or sums of money for the purposes of the company, and set aside any amount out of our profits as a reserve for any purpose.

Under our articles of association, retirement of directors from office is not subject to any age limitation and our directors are not required to own shares in our company in order to qualify to serve as directors.

## Rights Attached to Shares

Our authorized share capital consists of 50,000,000 ordinary shares of a nominal value of NIS 0.1 each. All outstanding ordinary shares are validly issued, fully paid and non-assessable. The rights attached to the ordinary shares are as follows:

***Dividend rights.*** Holders of our ordinary shares are entitled to the full amount of any cash or share dividend subsequently declared. The board of directors may declare interim dividends and propose the final dividend with respect to any fiscal year only out of the retained earnings, in accordance with the provisions of the Israeli Companies Law. See “Item 8A. Financial Information – Consolidated and Other Financial Information – Dividend Distributions Policy.” All unclaimed dividends or other monies payable in respect of a share may be invested or otherwise made use of by the Board of Directors for our benefit until claimed. Any dividend unclaimed after a period of three years from the date of declaration of such dividend will be forfeited and will revert to us; provided, however, that the Board of Directors may, at its discretion, cause us to pay any such dividend to a person who would have been entitled thereto had the same not reverted to us. We are not obligated to pay interest or linkage differentials on an unclaimed dividend.

***Voting rights.*** Holders of ordinary shares have one vote for each ordinary share held on all matters submitted to a vote of shareholders. Such voting rights may be affected by the grant of any special voting rights to the holders of a class of shares with preferential rights that may be authorized in the future subject to the provisions of Israeli law.

The quorum required at any meeting of shareholders consists of at least two shareholders present in person or represented by proxy who hold or represent, in the aggregate, at least one-third (33%) of the voting rights in the company. A meeting adjourned for lack of a quorum is generally adjourned to the same day in the following week at the same time and place or any time and place as the directors designate in a notice to the shareholders. At the reconvened meeting, the required quorum consists of any two members present in person or by proxy. Under our articles of association, all resolutions require approval of no less than a majority of the voting rights represented at the meeting in person or by proxy and voting thereon.

Pursuant to our articles of association, our directors (except external directors) are elected at our annual general meeting of shareholders by a vote of the holders of a majority of the voting power represented and voting at such meeting and hold office until the next annual general meeting of shareholders and until their successors have been elected. All the members of our Board of Directors (except the external directors) may be reelected upon completion of their term of office. Asseco, our controlling shareholder, and Formula Systems, our parent company, will be able to exercise control over the election of our directors (subject to a special majority required for the election of external directors). See “Item 7A. Major Shareholders and Related Party Transactions – Major Shareholders.” For information regarding the election of external directors, see “Item 6C. Directors, Senior Management and Employees – Board Practices -- Election of Directors.”

***Rights to share in the company’s profits.*** Our shareholders have the right to share in our profits distributed as a dividend and any other permitted distribution. See this Item 10B. “Additional Information – Memorandum and Articles of Association – Rights Attached to Shares – Dividend Rights.”

***Rights to share in surplus in the event of liquidation.*** In the event of our liquidation, after satisfaction of liabilities to creditors, our assets will be distributed to the holders of ordinary shares in proportion to the nominal value of their

holdings. This right may be affected by the grant of preferential dividend or distribution rights to the holders of a class of shares with preferential rights that may be authorized in the future *subject to Israeli law*.

***Liability to capital calls by the company.*** Under our memorandum of association and the Israeli Companies Law, the liability of our shareholders to provide us with additional funds is limited to the par value of the shares held by them.

***Limitations on any existing or prospective major shareholder.*** See Item 6C. “Directors and Senior Management –Board Practices – Approval of Related Party Transactions Under Israeli Law.”

### Changing Rights Attached to Shares

According to our articles of association, the rights attached to any class of shares may be modified or abrogated by us, subject to the consent in writing of, or sanction of a resolution passed by, the holders of a majority of the issued shares of such class at a separate general meeting of the holders of the shares of such class.

### Annual and Extraordinary Meetings

Under the Israeli Companies Law a company must convene an annual meeting of shareholders at least once every calendar year and within fifteen months of the last annual meeting. Depending on the matter to be voted upon, notice of at least 21 days or 35 days prior to the date of the meeting is required. Our board of directors may, in its discretion, convene additional meetings as “extraordinary general meetings.” In addition, the board must convene an extraordinary general meeting upon the demand of two of the directors or 25% of the nominated directors, one or more shareholders holding at least 5% of the outstanding share capital and at least 1% of the voting power in the company, or one or more shareholders holding at least 5% of the voting power in the company.

### Limitations on the Rights to Own Securities in Our Company

Neither our memorandum of association or our articles of association nor the laws of the State of Israel restrict in any way the ownership or voting of shares by non-residents, except with respect to subjects of countries which are in a state of war with Israel.

### Provisions Restricting Change in Control of Our Company

See Item 6C. "Provisions Restricting Change in Control of Our Company" and Item 6C "Directors, Senior Management and Employees – Board Practices – Approval of Related Party Transactions Under Israeli Law."

## C. MATERIAL CONTRACTS

While we have numerous contracts with customers, resellers, distributors and landlords, we do not deem any such individual contract to be material contracts which are not in the ordinary course of our business.

D. EXCHANGE CONTROLS

Israeli law and regulations do not impose any material foreign exchange restrictions on non-Israeli holders of our ordinary shares.

Non-residents of Israel who purchase our ordinary shares will be able to convert dividends, if any, thereon, and any amounts payable upon our dissolution, liquidation or winding up, as well as the proceeds of any sale in Israel of our ordinary shares to an Israeli resident, into freely repatriable dollars, at the exchange rate prevailing at the time of conversion, provided that the Israeli income tax has been withheld (or paid) with respect to such amounts or an exemption has been obtained.

E. TAXATION

The following is a discussion of Israeli and United States tax consequences material to our shareholders. To the extent that the discussion is based on new tax legislation which has not been subject to judicial or administrative interpretation, we cannot assure you that the views expressed in the discussion will be accepted by the appropriate tax authorities or the courts. The discussion is not intended, and should not be construed, as legal or professional tax advice and is not exhaustive of all possible tax considerations.

Holders of our ordinary shares should consult their own tax advisors as to the United States, Israeli or other tax consequences of the purchase, ownership and disposition of ordinary shares, including, in particular, the effect of any foreign, state or local taxes.

## Israeli Tax Considerations

Tax regulations have a material impact on our business, particularly in Israel where we have our headquarters. The following is a summary of some of the current tax law applicable to companies in Israel, with special reference to its effect on us. The following also contains a discussion of specified Israeli tax consequences to our shareholders and government programs benefiting us. To the extent that the discussion is based on tax legislation that has not been subject to judicial or administrative interpretation, there can be no assurance that the views expressed in the discussion will be accepted by the tax authorities in question. The discussion is not intended, and should not be construed, as legal or professional tax advice and is not exhaustive of all possible tax considerations.

## General Corporate Tax Structure

The Israeli corporate tax rate was 25% in 2012 and 2013. The corporate tax rate increased to 26.5% in 2014 and on.

## Tax Benefits Under the Law for the Encouragement of Capital Investments, 1959

Certain of our production and development facilities have been granted “approved enterprise” status under the Law for the Encouragement of Capital Investments, 1959, as amended, or the Investment Law and we are, therefore, eligible for certain tax benefits. Subject to compliance with applicable requirements, the portion of our income derived from the approved enterprise programs will be tax-exempt for a period of two to four years commencing in the first year in which an approved enterprise generates taxable income and will be subject, for a period of five to eight years, to a reduced corporate tax (such reduced tax rates are dependent on the level of foreign investments in the company). However, these benefits will not be available to us with respect to any income derived by our non-Israeli subsidiaries. As of December 31, 2014 the benefit periods under the Law have not yet commenced.

## ***Tax Benefits for Income from Approved Enterprises Approved Before April 1, 2005***

Prior to April 1, 2005, the Investment Law provided that a proposed capital investment in production facilities or other eligible facilities may be designated as an “approved enterprise.” Each approval for an approved enterprise relates to a specific investment program that is defined both by the financial scope of the investment, including sources of funds, and by the physical characteristics of the facility or other assets. The tax benefits relate only to taxable profits attributable to the specific program and are contingent upon meeting the criteria set out in the certificate of approval

Prior to April 1, 2005, an approved enterprise was entitled to either receive a grant from the Government of Israel or an alternative package of tax benefits, referred to as the Alternative Benefits. We elected to forego the entitlement to grants and elected the Alternative Benefits package, under which undistributed income that we generate from our approved enterprises will be completely tax exempt. The period of such tax exemption for a company electing the Alternative Benefits ranges between two and ten years, depending upon the location within Israel and the type of the approved enterprise. Because we are located in Or Yehuda, the period of such tax exemption is two to four years.

On expiration of the exemption period, the approved enterprise would be eligible for beneficial tax rates otherwise available for approved enterprises under the Investment Law (for our company, a rate of 25%) for the remainder of the otherwise applicable benefits period.

Alternative Benefits are available until the earliest of (i) seven consecutive years, commencing in the year in which the specific approved enterprise first generates taxable income, (ii) 12 years from commencement of production and (iii) 14 years from the date of approval of the approved enterprise status.

Dividends paid out of income generated by an approved enterprise (or out of dividends received from a company whose income is derived from an approved enterprise) are generally subject to withholding tax at the rate of 15%. This withholding tax is deductible at source by the approved enterprise. The 15% tax rate is limited to dividends and distributions out of income derived during the benefits period and actually paid at any time up to 12 years thereafter. Since we elected the Alternative Benefits track, we will be subject to payment of corporate tax at the rate of 25% in respect of the gross amount of the dividend that we may distribute out of profits which were exempt from corporate tax in accordance with the provisions of the Alternative Benefits track. If we are also deemed to be a "Foreign Investors' Company," or FIC, and if the FIC (the definition of which appears below) is at least 49% owned by non-Israeli residents, the corporate tax rate paid by us in respect of the dividend we may distribute from income derived by our approved enterprises during the tax exemption period may be taxed at a lower rate.

Since we have elected the Alternative Benefits package, we are not obliged to attribute any part of dividends that we may distribute to exempt profits, and we may decide from which year's profits to declare dividends. We currently intend to reinvest any income that we may in the future derive from our approved enterprise programs and not to distribute the income as a dividend.

If we qualify as a FIC, our approved enterprises will be entitled to additional tax benefits. Subject to certain conditions, a FIC is a company with a level of foreign investment of more than 25%. The level of foreign investment is measured as the percentage of rights in the company (in terms of shares, rights to profits, voting and appointment of directors), and of combined share and loan capital, that are owned, directly or indirectly, by persons who are not residents of Israel. Such a company will be eligible for an extension of the period during which it is entitled to tax benefits under its approved enterprise status (so that the benefit periods may be up to ten years) and for further tax benefits if the level of foreign investment exceeds 49%.

The Investment Center of the Ministry of Industry and Trade has granted approved enterprise status under Israeli law to eight investment programs at our manufacturing facility. We have elected the Alternative Benefits package with respect to each of these approved enterprise programs. The benefits available to an approved enterprise are subject to the fulfillment of conditions stipulated in the Investment Law and its regulations and the criteria in the specific certificate of approval, as described above. If a company does not meet these conditions, it may be required to refund the amount of tax benefits, together with consumer price index linkage adjustment and interest.

***Tax Benefits under an Amendment that Became Effective on April 1, 2005***

On April 1, 2005, an amendment to the Investment Law became effective. The Investment Law provides that terms and benefits included in any certificate of approval that was granted before the 2005 amendment came into effect will remain subject to the provisions of the Investment Law as they were on the date of such approval.

Under the 2005 amendment it is no longer necessary for a company to acquire approved enterprise status in order to receive the tax benefits previously available under the Alternative Benefits provisions. Rather, a company may claim the tax benefits offered by the Investment Law directly in its tax returns, provided that its facilities meet the criteria for tax benefits set out by the amendment. Companies are entitled to approach the Israeli Tax Authority for a pre-ruling regarding their eligibility for benefits under the amendment.

Tax benefits are available under the 2005 amendment to production facilities (or other eligible facilities), which are generally required to derive more than 25% of their business income from export. In order to receive the tax benefits, the amendment states that the company must make an investment which meets all the conditions set out in the amendment for tax benefits and exceeds a minimum amount specified in the Investment Law. Such investment allows

the company to receive a “benefited enterprise” status, and may be made over a period of no more than three years ending at the end of the year in which the company requested to have the tax benefits apply to the benefited enterprise, referred to as the Year of Election. Where the company requests to have the tax benefits apply to an expansion of existing facilities, only the expansion will be considered to be a benefited enterprise and the company’s effective tax rate will be the weighted average of the applicable rates. In this case, the minimum investment required in order to qualify as a benefited enterprise is required to exceed a certain amount or certain percentage of the value of the company’s production assets before the expansion.

The extent of the tax benefits available under the 2005 amendment to qualifying income of a benefited enterprise are determined by the geographic location of the benefited enterprise. The location will also determine the period for which tax benefits are available.

Dividends paid out of income derived by a benefited enterprise will be treated similarly to payment of dividends by an approved enterprise under the Alternative Benefits track. Therefore, dividends paid out of income derived by a benefited enterprise (or out of dividends received from a company whose income is derived from a benefited enterprise) are generally subject to withholding tax at the rate of 15% (deductible at source) subject to the rates under any applicable double tax treaty. The reduced rate of 15% is limited to dividends and distributions out of income derived from a benefited enterprise during the benefits period and actually paid at any time up to 12 years thereafter. A company qualifying for tax benefits under the amendment which pays a dividend out of income derived by its benefited enterprise during the tax exemption period will be subject to tax in respect of the gross amount of the dividend at the otherwise applicable rate of 25%, (or lower in the case of a qualified “FIC” which is at least 49% owned by non-Israeli residents). The dividend recipient would be subject to tax at the rate of 15% on the amount received which tax would be deducted at source.

As a result of the 2005 amendment, tax-exempt income generated under the provisions of the amended law will subject us to taxes upon distribution of the tax-exempt income to shareholders or liquidation of the company, and we may be required to record a deferred tax liability with respect to such tax-exempt income. The 2005 amendment sets a minimal amount of foreign investment required for a company to be regarded a FIC.

***Tax benefits under the 2011 Amendment that became effective on January 1, 2011.***

In December 2010, the Knesset passed the Law for Economic Policy for 2011 and 2012 (Amended Legislation), 2011, which, among other things, includes an amendment to the Investment Law, effective as of January 1, 2011. According to the 2010 amendment, the benefit tracks under the Investment Law were modified and a uniform tax rate will apply to companies eligible for the "Preferred Enterprise" status. In order to be eligible for preferred enterprise status, a company must meet minimum requirements to establish that it contributes to the country's economic growth and is a competitive factor for the gross domestic product. Companies may elect to irrevocably implement the amendment (while waiving benefits provided under the Investment Law as currently in effect) and subsequently would be subject to the amended tax rates as follows: in peripheral regions (Development Area A) the reduced tax rate is 10% in 2011 and 2012, 7% in 2013 and 9% in 2014. In other regions the tax rate is 15% in 2011 and 2012, 12.5% in 2013 and 16% in 2014. Preferred Enterprises in peripheral regions will be eligible for Investment Center grants, as well as the applicable reduced tax rates.

Dividends paid out of income attributed to a Preferred Enterprise during 2014 and thereafter are generally subject to withholding tax at the rate of 20% or such lower rate as may be provided in an applicable tax treaty. However, if such dividends are paid to an Israeli company, no tax is required to be withheld (however, if afterward distributed to individuals or non-Israeli company a withholding of 20% or such lower rate as may be provided in an applicable tax treaty, will apply).

As of December 31, 2014, we had not generated income under the provisions of the 2005 amendment or the 2011 amendment.

**Tax Benefits and Grants for Research and Development**

Israeli tax law allows, under certain conditions, a tax deduction in the year incurred for expenditures (including capital expenditures) in scientific research and development projects if the expenditures are approved by the relevant Israeli government ministry (determined by the field of research) and the research and development is for the promotion of the enterprise and is carried out by or on behalf of the company seeking such deduction. Expenditures not so approved are deductible over a three-year period. However, expenditures made out of proceeds made available to us through government grants are not deductible according to Israeli law.

Law for the Encouragement of Industry (Taxes), 1969

The Law for the Encouragement of Industry (Taxes), 5729-1969 (the “**Industry Encouragement Law**”) provides several tax benefits for an “Industrial Company.” Pursuant to the Industry Encouragement Law, a company qualifies as an Industrial Company if it is an Israeli resident company which was incorporated in Israel and at least 90% of its income in any tax year (other than income from certain government loans) is generated from an “Industrial Enterprise” that it owns and is located in Israel. An “Industrial Enterprise” is defined as an enterprise whose major activity, in a given tax year, is industrial production.

An Industrial Company is entitled to certain tax benefits, including:

Deduction of the cost of the purchases of patents, or the right to use a patent or know-how used for the development § or promotion of the Industrial Enterprise, over an eight year period commencing on the year in which such rights were first exercised;

§ The right to elect, under certain conditions, to file a consolidated tax return together with Israeli Industrial Companies controlled by it; and

§ Accelerated depreciation rates on equipment and buildings.

Eligibility for benefits under the Industry Encouragement Law is not subject to receipt of prior approval from any governmental authority.

We believe that certain of our Israeli subsidiaries currently qualify as Industrial Companies within the definition under the Industry Encouragement Law. We cannot assure you that they will continue to qualify as Industrial Companies or that the benefits described above will be available in the future.

#### Transfer Pricing

As part of the Israeli 2003 tax reform, the Israeli Income Tax Ordinance (New Version), 1961 (the “Ordinance”) was amended to include section 85A, dealing with international transactions transfer pricing. Section 85A of the Ordinance provides that regardless of the actual conditions of an international transaction between related parties, the transaction shall be reported and taxed, based on the arm’s length standard, i.e., based on market conditions in similar transactions between unrelated parties. On October 30, 2006, the Income Tax Regulations (Determination of Market Conditions) (the “Regulations”), which provide instructions for the implementation of Section 85A, came into effect.

In accordance with the Regulations, a transaction shall be considered an international transaction if (i) one of the parties is a “foreign resident” as defined thereunder or if the income generated from such transaction, in all or in part, is taxed both in and outside of Israel; and (ii) there are special relations between the parties of the transaction. The Regulations establish acceptable methods for comparison between transactions, and methods for calculating the price range against which the transaction is measured.

Taxpayers are required to include in their yearly income tax returns a report declaring that their international transactions are at arm's length. The Regulations have not had a material effect on us.

As of December 31, 2014, our consolidated net operating loss carry-forwards for Israeli tax purposes was approximately \$3.7 million. Under current Israeli tax laws, operating loss carry-forwards do not expire and may be offset against future taxable income. As of December 31, 2014, our subsidiaries in Europe had estimated total available tax loss carry-forwards of \$4.8 million, which may be offset against future taxable income.

As of December 31, 2014, our subsidiaries in the U.S. had estimated total available tax loss carryforwards of \$ 0.4 million, which can be carried forward and offset against taxable income in the future for up to 20 years from the year the loss was incurred. We have received final tax assessments through the year 2010 from the Israeli tax authorities.

### Israeli Capital Gains Tax

*The following is a short summary of the material provisions of the tax environment to which shareholders may be subject. This summary is based on the current provisions of tax law. To the extent that the discussion is based on new tax legislation that has not been subject to judicial or administrative interpretation, we cannot assure you that the views expressed in the discussion will be accepted by the appropriate tax authorities or the courts.*

*The summary does not address all of the tax consequences that may be relevant to all purchasers of our ordinary shares in light of each purchaser's particular circumstances and specific tax treatment. For example, the summary below does not address the tax treatment of residents of Israel and traders in securities who are subject to specific tax regimes. As individual circumstances may differ, holders of our ordinary shares should consult their own tax adviser as to the United States, Israeli or other tax consequences of the purchase, ownership and disposition of ordinary shares. The following is not intended, and should not be construed, as legal or professional tax advice and is not exhaustive of all possible tax considerations. Each individual should consult his or her own tax or legal adviser.*

*Tax Consequences Regarding Disposition of Our Ordinary Shares*

*Overview*

Israeli law generally imposes a capital gain tax on the sale of capital assets by residents of Israel, as defined for Israeli tax purposes, and on the sale of assets located in Israel, including shares of Israeli companies, by both residents and non-residents of Israel, unless a specific exemption is available or unless a tax treaty between Israel and the seller's country of residence provides otherwise. The Ordinance distinguishes between "Real Capital Gain" and "Inflationary Surplus". The Inflationary Surplus is a portion of the total capital gain which is equivalent to the increase of the relevant asset's purchase price which is attributable to the increase in the Israeli consumer price index or, in certain circumstances, a foreign currency exchange rate, between the date of purchase and the date of sale. The Real Capital Gain is the excess of the total capital gain over the Inflationary Surplus.

***Israeli Resident Shareholders***

As of January 1, 2006, the tax rate applicable to Real Capital Gain derived by Israeli individuals from the sale of shares which had been purchased on or after January 1, 2003, whether or not listed on a stock exchange, is 20%, unless such shareholder claims a deduction for interest and linkage differences expenses in connection with the purchase and holding of such shares, in which case the gain will generally be taxed at a rate of 25%. Additionally, if such shareholder is considered a Substantial Shareholder (i.e., a person who holds, directly or indirectly, alone or together with another, 10% or more of any of the company's "means of control" (including, among other things, the right to receive profits of the company, voting rights, the right to receive the company's liquidation proceeds and the right to appoint a director)) at the time of sale or at any time during the preceding 12-month period, such gain will be taxed at the rate of 25%. Individual shareholders dealing in securities in Israel are taxed at their marginal tax rates applicable to business income (up to 48% in 2014).

Notwithstanding the foregoing, pursuant to the Law for Change in the Tax Burden (Legislative Amendments) (Taxes), 2011, the capital gain tax rate applicable to individuals was raised from 20% to 25% from 2012 and onwards (or from 25% to 30% if the selling individual shareholder is a Substantial Shareholder at any time during the 12-month period preceding the sale and/or claims a deduction for interest and linkage differences expenses in connection with the purchase and holding of such shares). With respect to assets (not shares that are listed on a stock exchange) purchased on or after January 1, 2003, the portion of the gain generated from the date of acquisition until December 31, 2011 will be subject to the previous capital gain tax rates (20% or 25%) and the portion of the gain generated from January 1, 2012 until the date of sale will be subject to the new tax rates (25% or 30%).

Under current Israeli tax legislation, the tax rate applicable to Real Capital Gain derived by Israeli resident corporations from the sale of shares of an Israeli company is the general corporate tax rate. As described above, the corporate tax rate from 2014 and onwards is 26.5%.

### ***Non-Israeli Resident Shareholders***

Israeli capital gains tax is imposed on the disposal of capital assets by a non-Israeli resident if such assets are either (i) located in Israel; (ii) shares or rights to shares in an Israeli resident company; or (iii) represent, directly or indirectly, rights to assets located in Israel, unless a tax treaty between Israel and the seller's country of residence provides otherwise. As mentioned above, Real Capital Gain derived by a company is generally subject to tax at the corporate tax rate (25% in 2012 and 2013, 26.5% in 2013) or, if derived by an individual, at the rate of 25%, or 30% in case of "substantial shareholder." Individual and corporate shareholders dealing in securities in Israel are taxed at the tax rates applicable to business income (a corporate tax rate for a corporation and a marginal tax rate of up to 50% for an individual in 2014).

Notwithstanding the foregoing, shareholders who are non-Israeli residents (individuals and corporations) are generally exempt from Israeli capital gain tax on any gains derived from the sale, exchange or disposition of shares publicly traded on the Tel Aviv Stock Exchange or on a recognized stock exchange outside of Israel, provided, among other things, that (i) such gains are not generated through a permanent establishment that the non-Israeli resident maintains in Israel, (ii) the shares were purchased after being listed on a recognized stock exchange, and (iii) with respect to shares listed on a recognized stock exchange outside of Israel, such shareholders are not subject to the Israeli Income Tax Law (Inflationary Adjustments) 5745-1985. However, non-Israeli corporations will not be entitled to the foregoing exemptions if Israeli residents (a) have a controlling interest of 25% or more in such non-Israeli corporation, or (b) are the beneficiaries of or are entitled to 25% or more of the revenues or profits of such non-Israeli corporation, whether directly or indirectly. Such exemption is not applicable to a person whose gains from selling or otherwise disposing of the shares are deemed to be business income.

In addition, a sale of shares may be exempt from Israeli capital gain tax under the provisions of an applicable tax treaty. For example, under the U.S.-Israel Tax Treaty (the "U.S.-Israel Treaty"), the sale, exchange or disposition of shares of an Israeli company by a shareholder who is a U.S. resident (for purposes of the U.S.-Israel Treaty) holding the shares as a capital asset is exempt from Israeli capital gain tax unless either (i) the shareholder holds, directly or indirectly, shares representing 10% or more of the voting rights during any part of the 12-month period preceding such sale, exchange or disposition; (ii) the shareholder, if an individual, has been present in Israel for a period or periods of 183 days or more in the aggregate during the applicable taxable year; or (iii) the capital gain arising from such sale are attributable to a permanent establishment of the shareholder which is maintained in Israel. In each case, the sale, exchange or disposition of such shares would be subject to Israeli tax, to the extent applicable; however, under the U.S.-Israel Treaty, a U.S. resident would be permitted to claim a credit for the Israeli tax against the U.S. federal income tax imposed with respect to the sale, exchange or disposition, subject to the limitations in U.S. laws applicable to foreign tax credits. The U.S.-Israel Treaty does not provide such credit against any U.S. state or local taxes.

In some instances where our shareholders may be liable for Israeli tax on the sale of their ordinary shares, the payment of the consideration may be subject to the withholding of Israeli tax at source. Shareholders may be required to demonstrate that they are exempt from tax on their capital gains in order to avoid withholding at source at the time of sale. Specifically, in transactions involving a sale of all of the shares of an Israeli resident company, in the form of a merger or otherwise, the Israel Tax Authority may require from shareholders who are not liable for Israeli tax to sign declarations in forms specified by this authority or obtain a specific exemption from the Israel Tax Authority to confirm their status as non-Israeli resident, and, in the absence of such declarations or exemptions, may require the purchaser of the shares to withhold taxes at source.

## Israeli Tax on Dividend Income

### *Israeli Resident Shareholders*

Israeli residents who are individuals are generally subject to Israeli income tax for dividends paid on our ordinary shares (other than bonus shares or share dividends) at 20%, or 25% if the recipient of such dividend is a substantial shareholder at the time of distribution or at any time during the preceding 12-month period. Pursuant to the Tax Burden Law, as of 2013 such tax rate is 25%, or 30% if the dividend recipient is a substantial shareholder at the time of distribution or at any time during the preceding 12-month period. However, dividends distributed from taxable income accrued during the period of benefit of an Approved Enterprise, Benefited Enterprise or Preferred Enterprise are subject to withholding tax at the rate of 15% (and 20% with respect to Preferred Enterprise), if the dividend is distributed during the tax benefit period under the Investment Law or within 12 years after that period. An average rate will be set in case the dividend is distributed from mixed types of income (regular and Approved/ Benefited/ Preferred income).

Israeli resident corporations are generally exempt from Israeli corporate tax for dividends paid on shares of Israeli resident corporations (like our ordinary shares). However, dividends distributed from taxable income accrued during the benefits period of an Approved Enterprise or Benefited Enterprise are subject to withholding tax at the rate of 15%, if the dividend is distributed during the tax benefits period under the Investment Law or within 12 years after such period.

#### ***Non-Israeli Resident Shareholders***

Non-Israeli residents (whether individuals or corporations) are generally subject to Israeli withholding tax on the receipt of dividends paid for publicly traded shares, like our ordinary shares, at the rate of 25% or 30% (if the dividend recipient is a Substantial Shareholder at the time of distribution or at any time during the preceding 12-month period) or 15% if the dividend is distributed from income attributed to our Approved Enterprises (and 20% with respect to Preferred Enterprise). Such dividends are generally subject to Israeli withholding tax at a rate of 25% so long as the shares are registered with a Nominee Company (whether the recipient is a Substantial Shareholder or not), unless a reduced rate is provided under an applicable tax treaty. For example, under the U.S.-Israel Treaty, the maximum rate of tax withheld in Israel on dividends paid to a holder of our ordinary shares who is a U.S. resident (for purposes of the U.S.-Israel Treaty) is 25%. However, generally, the maximum rate of withholding tax on dividends that are paid to a U.S. corporation holding at least 10% or more of our outstanding voting capital from the start of the tax year preceding the distribution of the dividend through (and including) the distribution of the dividend, is 12.5%, provided that no more than 25% of our gross income for such preceding year consists of certain types of dividends and interest. Notwithstanding the foregoing, dividends distributed from income attributed to an Approved Enterprise, a Benefited Enterprise or a Preferred Enterprise are subject to a withholding tax rate of 15% for such a U.S. corporation shareholder, provided that the condition related to our gross income for the previous year (as set forth in the previous sentence) is met. If the dividend is attributable partly to income derived from an Approved Enterprise, a Benefited Enterprise or a Preferred Enterprise, and partly to other sources of income, the withholding rate will be a blended rate reflecting the relative portions of the two types of income. U.S. residents who are subject to Israeli withholding tax on a dividend may be entitled to a credit or deduction for U.S. federal income tax purposes in the amount of the taxes withheld, subject to detailed rules contained in United States tax legislation.

A non-Israeli resident who receives dividends from which tax was withheld is generally exempt from the obligation to file tax returns in Israel with respect to such income, provided that (i) such income was not generated from business conducted in Israel by the taxpayer, and (ii) the taxpayer has no other taxable sources of income in Israel with respect to which a tax return is required to be filed.

### ***Excess Tax***

Individuals who are subject to tax in Israel are also subject to an additional tax at a rate of 2% on annual income exceeding NIS 811,560 for 2014, which amount is linked to the annual change in the Israeli consumer price index, including, but not limited to, dividends, interest and capital gain, subject to the provisions of an applicable tax treaty.

### **United States Federal Income Tax Consequences**

The following is a summary of certain material U.S. federal income tax consequences that apply to U.S. Holders (as defined below) who hold ordinary shares as capital assets. This summary is based on the U.S. Internal Revenue Code of 1986, as amended, (the “Code”) Treasury regulations promulgated thereunder, judicial and administrative interpretations thereof, and the U.S.-Israel Tax Treaty, all as in effect on the date hereof and all of which are subject to change either prospectively or retroactively. This summary does not address all tax considerations that may be relevant with respect to an investment in ordinary shares. This summary does not account for the specific circumstances of any particular investor, such as:

- broker-dealers,
- financial institutions,
- certain insurance companies,
- investors liable for alternative minimum tax,
- tax-exempt organizations,
- non-resident aliens of the United States or taxpayers whose functional currency is not the U.S. dollar,

- persons who hold the ordinary shares through partnerships or other pass-through entities,

persons who acquire their ordinary shares through the exercise or cancellation of employee stock options or otherwise as compensation for services,

- investors that actually or constructively own 10% or more of our shares by vote or value, and

investors holding ordinary shares as part of a straddle, appreciated financial position or a hedging or conversion transaction.

If a partnership (including any entity treated as a partnership for U.S. federal income tax purposes) owns ordinary shares, the U.S. federal income tax treatment of a partner in such a partnership will generally depend upon the status of the partner and the activities of the partnership. A partnership that owns ordinary shares and the partners in such partnership should consult their tax advisors about the U.S. federal income tax consequences of holding and disposing of ordinary shares.

This summary does not address the effect of any U.S. federal taxation other than U.S. federal income taxation. In addition, this summary does not include any discussion of state, local or foreign taxation.

**You are advised to consult your tax advisors regarding the foreign and U.S. federal, state and local tax consequences of an investment in ordinary shares.**

For purposes of this summary, a U.S. Holder is:

- an individual who is a citizen or, for U.S. federal income tax purposes, a resident of the United States;
- a corporation or other entity taxable as a corporation created or organized in or under the laws of the United States or any political subdivision thereof;
- an estate whose income is subject to U.S. federal income tax regardless of its source; or
- a trust that (a) is subject to the primary supervision of a court within the United States and the control of one or more U.S. persons or (b) has a valid election in effect under applicable U.S. Treasury regulations to be treated as a U.S. person.

## **Taxation of Dividends**

Subject to the discussion, below, under the heading “Passive Foreign Investment Companies,” the gross amount of any distributions received with respect to ordinary shares, including the amount of any Israeli taxes withheld therefrom, will constitute dividends for U.S. federal income tax purposes to the extent of our current and accumulated earnings and profits, as determined for U.S. federal income tax purposes. You will be required to include this amount of dividends in gross income as ordinary income. Distributions in excess of our current and accumulated earnings and profits will be treated as a non-taxable return of capital to the extent of your tax basis in the ordinary shares and any amount in excess of your tax basis will be treated as gain from the sale of ordinary shares. See “-Disposition of

Ordinary Shares” below for a discussion of the taxation of capital gains. Our dividends will not qualify for the dividends-received deduction generally available to corporations under section 243 of the Code.

Dividends that we pay in NIS, including the amount of any Israeli taxes withheld therefrom, will be included in your income in a U.S. dollar amount calculated by reference to the exchange rate in effect on the day such dividends are received. A U.S. Holder who receives payment in NIS and converts NIS into U.S. dollars at an exchange rate other than the rate in effect on such day may have a foreign currency exchange gain or loss that would be treated as ordinary income or loss. U.S. Holders should consult their own tax advisors concerning the U.S. tax consequences of acquiring, holding and disposing of NIS.

Subject to complex limitations, any Israeli withholding tax imposed on such dividends will be a foreign income tax eligible for credit against a U.S. Holder's U.S. federal income tax liability (or, alternatively, for deduction against income in determining such tax liability). The limitations set out in the Code include computational rules under which foreign tax credits allowable with respect to specific classes of income cannot exceed the U.S. federal income taxes otherwise payable with respect to each such class of income. Dividends generally will be treated as foreign-source passive category income for U.S. foreign tax credit purposes. Further, there are special rules for computing the foreign tax credit limitation of a taxpayer who receives dividends subject to a reduced tax rate, see discussion below. A U.S. Holder will be denied a foreign tax credit with respect to Israeli income tax withheld from dividends received on the ordinary shares to the extent such U.S. Holder has not held the ordinary shares for at least 16 days of the 31-day period beginning on the date which is 15 days before the ex-dividend date or to the extent such U.S. Holder is under an obligation to make related payments with respect to substantially similar or related property. Any days during which a U.S. Holder has substantially diminished its risk of loss on the ordinary shares are not counted toward meeting the 16-day holding period required by the statute. The rules relating to the determination of the foreign tax credit are complex. You should consult with your personal tax advisors to determine whether and to what extent you would be entitled to this credit.

Subject to certain limitations, including the 3.8% net investment tax, discussed below, “qualified dividend income” received by a non-corporate U.S. Holder will be subject to tax at a reduced maximum tax rate of 20%. Distributions taxable as dividends paid on the ordinary shares should qualify for the 20% rate, provided that either: (i) we are entitled to benefits under the income tax treaty between the United States and Israel (the “Treaty”) or (ii) the ordinary shares are readily tradable on an established securities market in the United States and certain other requirements are met. We believe that we are entitled to benefits under the Treaty and that the ordinary shares currently are readily tradable on an established securities market in the United States. However, no assurance can be given that the ordinary shares will remain readily tradable. The rate reduction does not apply unless certain holding period requirements are satisfied. With respect to the ordinary shares, the U.S. Holder must have held such shares for at least 61 days during the 121-day period beginning 60 days before the ex-dividend date. The rate reduction also does not apply to dividends received from a passive foreign investment company, see discussion below, or in respect of certain hedged positions or in certain other situations. The legislation enacting the reduced tax rate on qualified dividends contains special rules for computing the foreign tax credit limitation of a taxpayer who receives dividends subject to the reduced tax rate. U.S. Holders of ordinary shares should consult their own tax advisors regarding the effect of these rules in their particular circumstances.

#### **Additional Tax on Investment Income**

In addition to the income taxes described above, U.S. Holders that are individuals, estates or trusts and whose income exceeds certain thresholds will be subject to a 3.8% Medicare contribution tax on net investment income, which includes dividends and capital gains.

#### **Disposition of Ordinary Shares**

Subject to the discussion below under “Passive Foreign Investment Companies,” upon the sale, exchange or other disposition of our ordinary shares, a U.S. holder will recognize capital gain or loss in an amount equal to the difference between the amount realized on the disposition and the U.S. holder’s tax basis in our ordinary shares. The gain or loss recognized on the disposition of the ordinary shares will be long-term capital gain or loss if the U.S. holder held the ordinary shares for more than one year at the time of the disposition and would be eligible for a reduced rate of taxation for certain non-corporate U.S. holders. The effective maximum long-term capital gains rate is 20% for individuals with annual taxable income over \$400,000. In addition, under the Patient Protection and Affordable Care Act, higher income taxpayers must pay an additional 3.8 percent tax on net investment income to the extent certain threshold amounts of income are exceeded. Capital gain from the sale, exchange or other disposition of ordinary shares held for one year or less is short-term capital gain and taxed as ordinary income. Gain or loss recognized by a U.S. holder on a sale, exchange or other disposition of our ordinary shares generally will be treated as U.S. source income or loss. The deductibility of capital losses is subject to certain limitations.

In the case of a cash basis U.S. Holder who receives NIS in connection with the sale or disposition of ordinary shares, the amount realized will be based on the U.S. dollar value of the NIS received with respect to the ordinary shares as determined on the settlement date of such exchange. A U.S. Holder who receives payment in NIS and converts NIS into United States dollars at a conversion rate other than the rate in effect on the settlement date may have a foreign currency exchange gain or loss that would be treated as ordinary income or loss.

An accrual basis U.S. Holder may elect the same treatment required of cash basis taxpayers with respect to a sale or disposition of ordinary shares, provided that the election is applied consistently from year to year. Such election may not be changed without the consent of the Internal Revenue Service (the "IRS"). In the event that an accrual basis U.S. Holder does not elect to be treated as a cash basis taxpayer (pursuant to the Treasury regulations applicable to foreign currency transactions), such U.S. Holder may have a foreign currency gain or loss for U.S. federal income tax purposes because of differences between the U.S. dollar value of the currency received prevailing on the trade date and the settlement date. Any such currency gain or loss would be treated as ordinary income or loss and would be in addition to the gain or loss, if any, recognized by such U.S. Holder on the sale or disposition of such ordinary shares.

### Passive Foreign Investment Companies

If we were to be classified as a “passive foreign investment company” in any taxable year, a U.S. Holder would be subject to special rules generally intended to reduce or eliminate any benefits from the deferral of U.S. federal income tax that a U.S. Holder could otherwise derive from investing in a non-U.S. company that does not distribute all of its earnings on a current basis. We will be considered a PFIC, for any taxable year in which either (i) 75% or more of our gross income is passive income or (ii) at least 50% of the average value of all of our assets for the taxable year produce or are held for the production of passive income. For this purpose, passive income generally includes dividends, interest, royalties, rents, annuities and the excess of gains over losses from the disposition of assets that produce passive income. Included in the calculation of our income and assets is our proportionate share of the income and assets of each corporation in which we own, directly or indirectly, at least a 25% interest, by value. If we were determined to be a PFIC for U.S. federal income tax purposes, unfavorable and highly complex rules would apply to U.S. Holders owning ordinary shares directly or indirectly. Accordingly, you are urged to consult your tax advisors regarding the application of such rules.

Based on our current and projected income, assets and activities, we believe that we are not currently a PFIC, nor do we expect to become a PFIC in the foreseeable future. However, because the determination of whether we are a PFIC is based upon the composition of our income and assets, and our market capitalization, from time to time, there can be no assurance that we will not become a PFIC for any future taxable year.

If we are treated as a PFIC for any taxable year, dividends would not qualify for the reduced tax rate on qualified dividend income, discussed above, and, unless you elect either to treat your investment in ordinary shares as an investment in a “qualified electing fund,” by making a “QEF election” or to “mark-to-market” your ordinary shares, as described below,

you would be required to allocate income recognized upon receiving certain dividends or gain recognized upon the disposition of ordinary shares ratably over your holding period for such ordinary shares,

the amount allocated to the current taxable year, and to any taxable years in your holding period prior to the first day in which we were treated as a PFIC will be treated as ordinary income, and

the amount allocated to each prior taxable year during which we are considered a PFIC would be subject to tax at the highest individual or corporate tax rate, as the case may be, and an interest charge would be imposed with respect to the resulting tax liability allocated to each such year.

If we were a PFIC for any taxable year during which a U.S. Holder holds our ordinary shares and any of our non-U.S. subsidiaries is also a PFIC, such U.S. Holder would generally be treated as owning a proportionate amount (by value) of the underlying shares of each such non-U.S. subsidiary classified as a PFIC for purposes of the application of these rules. U.S. Holders are urged to consult their tax advisers regarding the application of the PFIC rules to any of our subsidiaries.

If you make either a timely QEF election or a timely mark-to-market election in respect of your ordinary shares, you would not be subject to the rules described above. You would not be eligible to make a QEF election unless we comply with certain information reporting requirements. We do not intend to provide the information necessary for U.S. Holders to make QEF elections.

If we are a PFIC for any taxable year during which a U.S. Holder holds our ordinary shares, then instead of being subject to the tax and interest charge rules discussed above, a U.S. Holder may make an election to include gain on the stock of a PFIC as ordinary income under a mark-to-market method, provided that such ordinary shares are “regularly traded” on a “qualified exchange.” In general, our ordinary shares will be treated such as “regularly traded” for a given calendar year if more than a de minimis quantity of our ordinary shares are traded on a qualified exchange on at least 15 days during each calendar quarter of such calendar year. Our ordinary shares are listed on the Tel Aviv Stock Exchange and the NASDAQ Global Select Market. However, no assurance can be given that our ordinary shares will be regularly traded on a qualified exchange for purposes of the mark-to-market election. In addition, because a mark-to-market election cannot be made for any lower-tier PFICs that we may own, a U.S. Holder may continue to be subject to the PFIC rules with respect to such holder’s indirect interest in any investments held by us that are treated as an equity interest in a PFIC for U.S. federal income tax purposes.

If you elect to “mark to market” your ordinary shares, you will generally include in income, in each year in which we are considered a PFIC, any excess of the fair market value of the ordinary shares at the close of each tax year over your adjusted basis in the ordinary shares. If the fair market value of the ordinary shares had depreciated below your adjusted basis at the close of the tax year, you may generally deduct the excess of the adjusted basis of the ordinary shares over its fair market value at that time. However, such deductions would generally be limited to the net mark-to-market gains, if any, that you included in income with respect to such ordinary shares in prior years. A U.S. Holder’s adjusted tax basis in the ordinary shares will be increased by the amount of any income inclusion and decreased by the amount of any deductions under the mark-to-market rules. Income recognized and deductions allowed under the mark-to-market provisions, as well as any gain or loss on the disposition of ordinary shares with respect to which the mark-to-market election is made in a year in which we are classified as a PFIC, is treated as ordinary income or loss (except that loss on a disposition of ordinary shares is treated as capital loss to the extent the loss exceeds the net mark-to-market gains, if any, that you included in income with respect to such ordinary shares in prior years). Gain or loss from the disposition of ordinary shares (as to which a mark-to-market election was made) in a year in which we are no longer classified as a PFIC, will be capital gain or loss.

If a U.S. Holder owns our ordinary shares during any year in which we are a PFIC, the U.S. Holder generally must file an IRS Form 8621 with respect to the company, generally with the U.S. Holder’s federal income tax return for that year. U.S. Holders should consult their tax advisers regarding whether we are a PFIC and the potential application of the PFIC rules.

### **Backup Withholding and Information Reporting**

Payments in respect of ordinary shares may be subject to information reporting to the IRS and to U.S. backup withholding tax at the rate (currently) of 28%. Backup withholding will not apply, however, if you (i) are a corporation or fall within certain exempt categories and demonstrate the fact when so required, or (ii) furnish a correct taxpayer identification number and make any other required certification.

Backup withholding is not an additional tax. Amounts withheld under the backup withholding rules may be credited against a U.S. Holder’s U.S. tax liability. A U.S. Holder may obtain a refund of any excess amounts withheld under the backup withholding rules by filing the appropriate claim for refund with the IRS.

### **Information Reporting by Certain U.S. Holders**

U.S. citizens and individuals taxable as resident aliens of the United States that own “specified foreign financial assets” with an aggregate value in a taxable year in excess of certain thresholds (as determined under rules in Treasury regulations) and that are required to file a U.S. federal income tax return generally will be required to file an

information report with respect to those assets with their tax returns. IRS Form 8938 has been issued for that purpose. “Specified foreign financial assets” include any financial accounts maintained by foreign financial institutions, foreign stocks held directly, and interests in foreign estates, foreign pension plans or foreign deferred compensation plans. Under those rules, our ordinary shares, whether owned directly or through a financial institution, estate or pension or deferred compensation plan, would be “specified foreign financial assets”. Under Treasury regulations, the reporting obligation applies to certain U.S. entities that hold, directly or indirectly, specified foreign financial assets. Penalties can apply if there is a failure to satisfy this reporting obligation. A U.S. Holder is urged to consult his tax adviser regarding his reporting obligation.

Any U.S. holder who holds 10% or more in vote or value of our ordinary shares will be subject to certain additional U.S. information reporting requirements.

F. DIVIDENDS AND PAYING AGENTS

Not applicable.

G. STATEMENT BY EXPERTS

Not applicable.

H. DOCUMENTS ON DISPLAY

We are subject to certain of the reporting requirements of the Exchange Act, as applicable to “foreign private issuers” as defined in Rule 3b-4 under the Exchange Act. As a foreign private issuer, we are exempt from certain provisions of the Exchange Act. Accordingly, our proxy solicitations are not subject to the disclosure and procedural requirements of Regulation 14A under the Exchange Act, and transactions in our equity securities by our officers and directors are exempt from reporting and the “short-swing” profit recovery provisions contained in Section 16 of the Exchange Act. In addition, we are not required under the Exchange Act to file periodic reports and financial statements as frequently or as promptly as U.S. companies whose securities are registered under the Exchange Act. However, we file with the SEC an annual report on Form 20-F containing financial statements audited by an independent accounting firm. We also submit to the SEC reports on Form 6-K containing (among other things) press releases and unaudited financial information. We post our annual report on Form 20-F on our website ([www.magicsoftware.com](http://www.magicsoftware.com)) promptly following the filing of our annual report with the SEC. The information on our website is not incorporated by reference into this annual report.

This annual report and the exhibits thereto and any other document we file pursuant to the Exchange Act may be inspected without charge and copied at prescribed rates at the SEC public reference room at 100 F Street, N.E., Room 1580, Washington, D.C. 20549. You may obtain information on the operation of the SEC’s public reference room in Washington, D.C. by calling the SEC at 1-800-SEC-0330. The Exchange Act file number for our SEC filings is 000-19415.

The SEC maintains a website at [www.sec.gov](http://www.sec.gov) that contains reports, proxy and information statements, and other information regarding registrants that make electronic filings with the SEC using its EDGAR (Electronic Data Gathering, Analysis, and Retrieval) system.

The documents concerning our company that are referred to in this annual report may also be inspected at our offices located at 5 Haplada Street, Or Yehuda 6021805, Israel.

I. SUBSIDIARY INFORMATION

Not applicable.

ITEM 11. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS

We are exposed to a variety of market risks, primarily changes in interest rates affecting our investments in marketable securities and foreign currency fluctuations.

Cash Investments, Marketable Securities and Interest Rate Risk

Our cash investment policy seeks to preserve principal and maintain adequate liquidity while maximizing the income we receive from our investments without significantly increasing the risk of loss. To minimize investment risk, we maintain a diversified portfolio across various maturities, types of investments and issuers, which may include, from time to time, money market funds, U.S. government bonds, state debt, bank deposits and certificates of deposit, and investment grade corporate debt. Our cash management policy does not allow us to purchase or hold commodity instruments, structures or “sub-prime” related holdings (such as auction rate securities and collateralized debt obligation) or other financial instruments for trading purposes.

As of December 31, 2014, we had approximately \$72.5 million in cash and cash equivalents and short term bank deposits and \$11.9 million in marketable securities. Our marketable securities include investments in commercial and government bonds and foreign banks and equity funds. As of such date our marketable securities portfolio was composed primarily of governmental and commercial bonds bearing average annual interest rates of approximately 4.2%, with average maturities of 3.0 years and maximum maturities of 4.4 years. The performance of the capital markets affects the values of the funds we hold in marketable securities. These assets are subject to market fluctuations, such as the declines experienced in 2008 and the first six months of 2009. In such case, the fair value of our investments may decline. As of December 31, 2014, net unrealized losses in our marketable securities portfolio totaled \$119. We periodically monitor our investments for adverse material holdings related to the underlying financial solvency of the issuers of the marketable securities in our portfolio.

Our exposure to market risk for changes in interest rates relates primarily to our investment in marketable securities. Investments in both fixed rate and floating rate interest bearing securities carry a degree of interest rate risk. The fair market value of fixed rate securities may be adversely impacted due to a rise in interest rates, while floating rate securities may produce less income than predicted if interest rates fall. Due in part to these factors, our future financial results may be negatively affected in the event that interest rates fluctuate.

#### Foreign Currency Exchange Risk

Our financial results may be negatively impacted by foreign currency fluctuations. Our foreign operations are transacted through a global network of subsidiaries. These sales and related expenses are generally denominated in currencies other than the U.S. dollar, except in Israel, where our sales are denominated in U.S. dollars and our expenses are denominated in NIS. Because our financial results are reported in U.S. dollars, our results of operations may be adversely impacted by fluctuations in the rates of exchange between the U.S. dollar and such other currencies as the financial results of our foreign subsidiaries are converted into U.S. dollars in consolidation. Our earnings are predominantly affected by fluctuations in the value of the U.S. dollar as compared to the NIS, as well as the value of the U.S. dollar as compared to the euro, Japanese Yen and British Pound.

We measure and record non-monetary accounts in our balance sheet (principally fixed assets and prepaid expenses) in U.S. dollars. For this measurement, we use the U.S. dollar value in effect at the date that the asset or liability was initially recorded in our balance sheet (the date of the transaction).

In 2014, we entered into forward and option contracts to hedge the fair value of assets and liabilities denominated in NIS, euro and Japanese Yen. As of December 31, 2014, we had outstanding forward contracts that did not meet the requirement for hedge accounting in the amount of \$1.7 million. These contracts were for a period of up to 12 months. The net gains recognized in “financial income, net” during 2014 were \$24,000.

Our operating expenses may be affected by fluctuations in the value of the U.S. dollar as it relates to foreign currencies, with NIS, euro and Japanese Yen having the greatest potential impact. In managing our foreign exchange risk we periodically enter into foreign exchange hedging contracts. Our goal is to mitigate the potential exposure with these contracts. By way of example, an increase of 10% in the value of the NIS relative to the U.S. dollar in 2014 would have resulted in a decrease in the U.S. dollar reporting value of our operating income of \$1.3 million for that year, while a decrease of 10% in the value of the NIS relative to the U.S. dollar in 2014 would have resulted in an increase in the U.S. dollar reporting value of our operating income of \$1.1 million for the year. An increase of 10% in the value of the euro, the Japanese yen and the British Pound relative to the U.S. dollar in 2014 would have resulted in an increase in the U.S. dollar reporting value of our operating income of \$1.0 million, \$0.4 million and \$0.2 million, respectively, for that year, while a decrease of 10% in the value of the euro, Japanese Yen and British Pound relative to the U.S. dollar in 2014 would have resulted in a decrease in the U.S. dollar reporting value of our operating income of \$1.0 million, \$0.3 million and \$0.2 million, respectively, for that year.

#### Equity Price Risk

As of December 31, 2014, we had \$11.9 million of trading securities that are classified as available for sale. Those securities have exposure to equity price risk. The estimated potential loss in fair value resulting from a hypothetical 10% decrease in prices quoted on stock exchanges is approximately \$1.2 million.

#### ITEM 12. DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES

Not applicable.

PART II

ITEM 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES

None.

ITEM 14. MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS

Not applicable.

ITEM 15. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in its Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our chief executive officer and chief financial officer to allow timely decisions regarding required disclosure. Our management, including our chief executive officer and chief financial officer, conducted an evaluation of our disclosure controls and procedures, as defined under Exchange Act Rule 13a-15(e), as of the end of the period covered by this Annual Report on Form 20-F. Based upon that evaluation, our chief executive officer and chief financial officer concluded that, as of such date, our disclosure controls and procedures were effective.

Management's Annual Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over our financial reporting. Internal control over financial reporting is defined in Rule 13a-15(f) or 15d-15(f) promulgated under the Securities Exchange Act of 1934 as a process designed by, or under the supervision of, the company's principal executive and principal financial officers 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 and includes those policies and procedures that:

pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transaction and dispositions of the assets of the company;

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

provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have an effect on the financial statements.

Our management assessed the effectiveness of our internal control over financial reporting as of December 31, 2014. In making this assessment, our management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework. Based on that assessment, our management concluded that as of December 31, 2014, our internal control over financial reporting was effective.

The effectiveness of our management's internal control over financial reporting as of December 31, 2014 has been audited by our company's independent registered public accountants, Kost Forer Gabbay & Kasierer, a member of Ernst & Young Global, and their report as of April 21, 2015, herein expresses an unqualified opinion on our company's internal control over financial reporting.

### **Attestation Report of the Registered Public Accounting Firm**

Our independent registered public accounting firm has issued an audit report on the effectiveness of our internal control over financial reporting. This report is included under Item 18.

### **Changes in Internal Control over Financial Reporting**

There was no change in our internal controls over financial reporting that occurred during the period covered by this annual report that has materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting.

### **ITEM 16. RESERVED**

### **ITEM 16A. AUDIT COMMITTEE FINANCIAL EXPERT**

Our board of directors has determined that Mr. Itiel Efrat, an external director within the meaning of the Israeli Companies Law, meets the definition of an audit committee financial expert, as defined by rules of the SEC. For a brief listing of Mr. Efrat's relevant experience, see Item 6A. "Directors, Senior Management and Employees -- Directors and Senior Management."

### **ITEM 16B. CODE OF ETHICS**

We have adopted a code of ethics that applies to any chief executive officer and all senior financial officers of our company, including the chief financial officer, chief accounting officer or controller, or persons performing similar functions. The code of ethics is publicly available on our website at [www.magicsoftware.com](http://www.magicsoftware.com). Written copies are available upon request. If we make any substantive amendment to the code of ethics or grant any waivers, including any implicit waiver, from a provision of the codes of ethics, we will disclose the nature of such amendment or waiver on our website.

### **ITEM 16C. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

Independent Registered Public Accounting Firm Fees

The following table sets forth, for each of the years indicated, the fees billed by our principal independent registered public accounting firm. All of such fees were pre-approved by our Audit Committee.

| Services Rendered | Year Ended<br>December 31, |           |
|-------------------|----------------------------|-----------|
|                   | 2013                       | 2014      |
| Audit (1)         | \$238,000                  | \$301,000 |
| Audit-related(2)  | \$24,000                   | -         |
| Tax (3)           | \$47,700                   | \$40,000  |
| Total             | \$309,000                  | \$341,000 |

Audit fees relate to audit services provided for each of the years shown in the table, including fees associated with (1) the annual audit, the filing of a shelf registration statement, various accounting issues and audit services provided in connection with other statutory or regulatory filings.

(2) Audit-related fees in 2013 relate to due diligence services performed in connection with our acquisitions.

(3) Tax fees relate to services performed by the tax division for tax compliance, planning and advice.

#### Pre-Approval Policies and Procedures

Our Audit Committee has adopted a policy and procedures for the pre-approval of audit and non-audit services rendered by our independent registered public accountants, Kost Forer Gabbay & Kasierer, a member of Ernst & Young Global. Pre-approval of an audit or non-audit service may be given as a general pre-approval, as part of the audit committee's approval of the scope of the engagement of our independent auditor, or on an individual basis. Any proposed services that exceed general pre-approved levels also require specific pre-approval by our audit committee. The policy prohibits retention of the independent public accountants to perform the prohibited non-audit functions defined in Section 201 of the Sarbanes-Oxley Act of 2002 or the rules of the SEC, and also requires the Audit Committee to consider whether proposed services are compatible with the independence of the public accountants.

**ITEM 16D. EXEMPTIONS FROM THE LISTING STANDARDS FOR AUDIT COMMITTEES**

Not applicable.

**ITEM 16E. PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASERS**

We did not purchase any ordinary shares of our company nor did any affiliated purchaser purchase any shares on our behalf during 2014. Although we do not believe that Formula Systems may be deemed to be an affiliated purchaser as defined in the Exchange Act, according to the Schedules 13D/A Formula Systems filed with the SEC on September 11, 2012 and March 11, 2014, from December 2008 through September 7, 2012, it purchased an aggregate of 515,292 of our ordinary shares in open market transactions for an aggregate purchase price of approximately \$2,500,000 and from September 2012 through April 2013, it purchased an aggregate of 110,000 of our ordinary shares in open market transactions for an aggregate purchase price of approximately \$509,472. This brought Formula System's ownership interest in our shares to 52.2%. On March 5, 2014, we completed a follow-on public offering of our ordinary shares. We issued 6,900,000 ordinary shares, including 900,000 shares sold pursuant to the underwriters' full exercise of their over-allotment option at a price to the public of \$8.50 per share. Formula Systems purchased 700,000 of the 6,900,000 ordinary shares issued and sold in the offering. As a result of the March 2014 public offering, Formula Systems' percentage interest in us decreased from 51.6% to 45.0%. Its percentage ownership currently stands at 45.2%.

**ITEM 16F. CHANGES IN REGISTRANT'S CERTIFYING ACCOUNTANT**

None.

**ITEM 16G. CORPORATE GOVERNANCE**

NASDAQ Stock Market Rules and Home Country Practice

Under NASDAQ Stock Market Rule 5615(a)(3), foreign private issuers, such as our company, are permitted to follow certain home country corporate governance practices instead of certain provisions of the NASDAQ Stock Market Rules. As a foreign private issuer listed on the NASDAQ Global Select Market, we may follow home country practice with regard to, among other things, the composition of the board of directors, compensation of officers, director nomination process and quorum at shareholders' meetings. We may also follow home country practice with regard to, the NASDAQ Stock Market Rules requirement to obtain shareholder approval for certain dilutive events (such as for the establishment or amendment of certain equity based compensation plans, an issuance that will result in a change of control of the company, certain transactions other than a public offering involving issuances of a 20% or more interest in the company and certain acquisitions of the stock or assets of another company). A foreign private issuer that elects

to follow a home country practice instead of any of such NASDAQ requirements must submit to NASDAQ, in advance, a written statement from an independent counsel in such issuer's home country certifying that the issuer's practices are not prohibited by the home country's laws.

We provided NASDAQ with a notice of non-compliance with respect to the NASDAQ requirement that independent directors have regularly scheduled meetings at which only independent directors are present. Instead, we follow Israel law and practice, under which independent directors are not required to hold executive sessions.

**ITEM 16H. MINE SAFETY DISCLOSURE**

Not applicable.

PART III

**ITEM 17. FINANCIAL STATEMENTS**

Not applicable.

**ITEM 18. FINANCIAL STATEMENTS**

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**ITEM 19. EXHIBITS**

Index to Exhibits

**Exhibit Description**

- 1.1 Memorandum of Association of the Registrant<sup>1</sup>
- 1.2 Articles of Association of the Registrant<sup>2</sup>

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- 2.1 Specimen of Ordinary Share Certificate<sup>3</sup>
- 4.1 2000 Employee Stock Option Plan<sup>4</sup>
- 4.2 2007 Incentive Compensation Plan<sup>5</sup>
- 4.3 Underwriting Agreement, dated February 28, 2014, by and among our company and Barclays Capital Inc. and William Blair & Company, LLC, as representatives for the several underwriters<sup>6</sup>
- 8.1 List of Subsidiaries of the Registrant
- 12.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as amended
- 12.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as amended
- 13.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 13.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 15.1 Consent of Kost Forer Gabbay & Kasierer, a Member of Ernst & Young Global
- 15.2 Consent of Levy Cohen & Co., Chartered Accountants (relating to Magic Software Enterprises (UK) Limited)
- 15.3 Consent of Levy Cohen & Co., Chartered Accountants (relating to Hermes Logistics Technologies Limited)

15.4 Consent of KDA Audit Corporation (relating to Magic Software Japan K.K.)

101.INS\* XBRL Instance Document  
101.SCH\* XBRL Taxonomy Extension Schema Document  
101.PRE\* XBRL Taxonomy Presentation Linkbase Document  
101.CAL\* XBRL Taxonomy Calculation Linkbase Document  
101.LAB\* XBRL Taxonomy Label Linkbase Document  
101.DEF\* XBRL Taxonomy Extension Definition Linkbase Document

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Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for the purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

- (1) Filed as Exhibit 3.2 to the registrant's registration statement on Form F-1, registration number 33-41486, and incorporated herein by reference.
- (2) Filed as an Item to the registrant's Form 6-K for the month of December 2011, filed on December 7, 2011, and incorporated herein by reference.
- (3) Filed as Exhibit 4.1 to the registrant's registration statement on Form F-1, registration number 33-41486, and incorporated herein by reference.
- (4) Filed as Exhibit 10.2 to the registrant's annual report on Form 20-F for the year ended December 31, 2000, and incorporated herein by reference.
- (5) Filed as Exhibit 4.3 to the registrant's annual report on Form 20-F for the year ended December 31, 2007, and incorporated herein by reference.
- (6) Filed as Exhibit 1.1 to the registrant's Form 6-K for the month of February 2014, filed on February 28, 2014, and incorporated herein by reference.

**MAGIC SOFTWARE ENTERPRISES LTD. AND ITS SUBSIDIARIES**

**CONSOLIDATED FINANCIAL STATEMENTS**

**AS OF DECEMBER 31, 2014**

**U.S. DOLLARS IN THOUSANDS**

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

**To the Shareholders and the Board of Directors of**

**MAGIC SOFTWARE ENTERPRISES LTD.**

We have audited the accompanying consolidated balance sheets of Magic Software Enterprises Ltd. ("the Company") and its subsidiaries as of December 31, 2013 and 2014, and the related consolidated statements of income, comprehensive income, shareholders' equity and cash flows for each of the three years in the period ended December 31, 2014. These financial statements are the responsibility of Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of certain subsidiaries, which statements reflect total assets of 7% and 4% as of December 31, 2013 and 2014, respectively, and total revenues of 16%, 14% and 11% for the years ended December 31, 2012, 2013 and 2014, respectively of the related consolidated totals. Those statements were audited by other auditors whose reports have been furnished to us, and our opinion, insofar as it relates to the amounts included for those subsidiaries, is based solely on the reports of the other auditors.

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.

In our opinion, based on our audits and the reports of the other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries as of December 31, 2013 and 2014, and the related consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2014, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2014, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway

Commission (2013 framework) and our report dated April 21, 2015 expressed an unqualified opinion thereon.

/s/ Kost Forer Gabbay & Kasierer  
Tel-Aviv, Israel KOST FORER GABBAY & KASIERER  
April 21, 2015 A Member of Ernst & Young Global

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## **REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

**To the Shareholders and the Board of Directors of**

**MAGIC SOFTWARE ENTERPRISES LTD.**

We have audited Magic Software Enterprises Ltd. ("the Company") internal control over financial reporting as of December 31, 2014, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) ("the COSO criteria"). 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 Annual 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 the assessed 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 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 its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2014, based on the COSO criteria.

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We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of the Company and its subsidiaries as of December 31, 2013 and 2014, and the related consolidated statements of income, comprehensive income, shareholders' equity and cash flows for each of the three years in the period ended December 31, 2014 and our report dated April 21, 2015 expressed an unqualified opinion thereon.

/s/ Kost Forer Gabbay & Kasierer  
Tel-Aviv, Israel KOST FORER GABBAY & KASIERER  
April 21, 2015 A Member of Ernst & Young Global

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**MAGIC SOFTWARE ENTERPRISES LTD.****AND ITS SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS****U.S. dollars in thousands**

|                                                                                                                                 | December 31, |           |
|---------------------------------------------------------------------------------------------------------------------------------|--------------|-----------|
|                                                                                                                                 | 2013         | 2014      |
| <b>ASSETS</b>                                                                                                                   |              |           |
| <b>CURRENT ASSETS:</b>                                                                                                          |              |           |
| Cash and cash equivalents                                                                                                       | \$35,134     | \$72,515  |
| Available-for-sale marketable securities (Note 4)                                                                               | 854          | 11,915    |
| Trade receivables (net of allowance for doubtful accounts of \$ 3,313 and \$ 2,380 at December 31, 2013 and 2014, respectively) | 31,976       | 40,358    |
| Other accounts receivable and prepaid expenses (Note 6)                                                                         | 5,209        | 3,973     |
| <u>Total</u> current assets                                                                                                     | 73,173       | 128,761   |
| <b>LONG-TERM RECEIVABLES:</b>                                                                                                   |              |           |
| Severance pay fund                                                                                                              | 403          | 1,426     |
| Long term deferred tax asset (Note 12)                                                                                          | 1,674        | 1,583     |
| Other long-term receivables                                                                                                     | 2,118        | 2,376     |
| <u>Total</u> long-term receivables                                                                                              | 4,195        | 5,385     |
| PROPERTY AND EQUIPMENT, NET (Note 7)                                                                                            | 1,773        | 2,005     |
| INTANGIBLE ASSETS, NET (Note 8)                                                                                                 | 32,549       | 32,543    |
| GOODWILL (Note 9)                                                                                                               | 55,313       | 55,490    |
| <u>Total</u> assets                                                                                                             | \$167,003    | \$224,184 |

The accompanying notes are an integral part of the consolidated financial statements.

**MAGIC SOFTWARE ENTERPRISES LTD.****AND ITS SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS****U.S. dollars in thousands (except share and per share data)**

|                                                                                                                                                                                                          | December 31, |          |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------|----------|
|                                                                                                                                                                                                          | 2013         | 2014     |
| <b>LIABILITIES AND EQUITY</b>                                                                                                                                                                            |              |          |
| <b>CURRENT LIABILITIES:</b>                                                                                                                                                                              |              |          |
| Short term debt (Note 11)                                                                                                                                                                                | \$1,055      | \$2,853  |
| Trade payables                                                                                                                                                                                           | 4,149        | 3,861    |
| Accrued expenses and other accounts payable (Note 10)                                                                                                                                                    | 16,937       | 15,013   |
| Deferred tax liability (Note 12)                                                                                                                                                                         | 2,567        | 760      |
| Deferred revenues                                                                                                                                                                                        | 3,294        | 3,431    |
| <u>Total</u> current liabilities                                                                                                                                                                         | 28,002       | 25,918   |
| <b>ACCRUED SEVERANCE PAY</b>                                                                                                                                                                             | 1,275        | 2,562    |
| <b>LONG TERM LIABILITIES:</b>                                                                                                                                                                            |              |          |
| Long term debt (Note 11)                                                                                                                                                                                 | 2,274        | 490      |
| Liabilities due to acquisition activities and other (Note 3)                                                                                                                                             | 1,396        | 474      |
| Long term deferred tax liability (Note 12)                                                                                                                                                               | 2,204        | 4,086    |
|                                                                                                                                                                                                          | 5,874        | 5,050    |
| <b>COMMITMENTS AND CONTINGENCIES (Note 15)</b>                                                                                                                                                           |              |          |
| <b>REDEEMABLE NON-CONTROLLING INTEREST</b>                                                                                                                                                               | 2,721        | 2,930    |
| <b>EQUITY (Note 13):</b>                                                                                                                                                                                 |              |          |
| Magic Software Enterprises' equity:                                                                                                                                                                      |              |          |
| Share capital:                                                                                                                                                                                           |              |          |
| Ordinary shares of NIS 0.1 par value - Authorized: 50,000,000 shares at December 31, 2013 and 2014; Issued and Outstanding: 37,155,355 and 44,174,217 shares at December 31, 2013 and 2014, respectively | 826          | 1,029    |
| Additional paid-in capital                                                                                                                                                                               | 127,060      | 182,114  |
| Accumulated other comprehensive loss                                                                                                                                                                     | (172 )       | (5,347 ) |
| Accumulated (deficit) earnings                                                                                                                                                                           | 430          | 7,269    |
| Total Magic Software Enterprises' equity                                                                                                                                                                 | 128,144      | 185,065  |
| Non-controlling interests                                                                                                                                                                                | 987          | 2,659    |
| <u>Total</u> equity                                                                                                                                                                                      | 129,131      | 187,724  |

|                                                                          |            |            |
|--------------------------------------------------------------------------|------------|------------|
| <u>Total</u> liabilities, redeemable non-controlling interest and equity | \$ 167,003 | \$ 224,184 |
|--------------------------------------------------------------------------|------------|------------|

The accompanying notes are an integral part of the consolidated financial statements.

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**MAGIC SOFTWARE ENTERPRISES LTD.****AND ITS SUBSIDIARIES****CONSOLIDATED STATEMENTS OF INCOME****U.S. dollars in thousands (except per share data)**

|                                                                    | Year ended December 31, |          |          |
|--------------------------------------------------------------------|-------------------------|----------|----------|
|                                                                    | 2012                    | 2013     | 2014     |
| Revenues (Note 17):                                                |                         |          |          |
| Software                                                           | \$23,684                | \$23,254 | \$25,351 |
| Maintenance and technical support                                  | 22,384                  | 22,685   | 22,780   |
| Consulting services                                                | 80,312                  | 99,019   | 116,173  |
| <u>Total</u> revenues                                              | 126,380                 | 144,958  | 164,304  |
| Cost of revenues:                                                  |                         |          |          |
| Software                                                           | 7,439                   | 6,648    | 7,646    |
| Maintenance and technical support                                  | 3,238                   | 2,949    | 2,921    |
| Consulting services                                                | 62,716                  | 76,296   | 89,160   |
| <u>Total</u> cost of revenues                                      | 73,393                  | 85,893   | 99,727   |
| Gross profit                                                       | 52,987                  | 59,065   | 64,577   |
| Operating costs and expenses:                                      |                         |          |          |
| Research and development, net (Note 14a)                           | 2,947                   | 3,706    | 4,750    |
| Selling and marketing                                              | 22,990                  | 23,066   | 24,580   |
| General and administrative                                         | 10,642                  | 13,166   | 14,521   |
| <u>Total</u> operating costs and expenses                          | 36,579                  | 39,938   | 43,851   |
| Operating income                                                   | 16,408                  | 19,127   | 20,726   |
| Financial income (expense), net (Note 14b)                         | 10                      | (684 )   | (1,786 ) |
| Other income (expense), net                                        | 136                     | (12 )    | (67 )    |
| Income before taxes on income                                      | 16,554                  | 18,431   | 18,873   |
| Taxes on income (Note 12)                                          | 94                      | 1,575    | 2,307    |
| Net income                                                         | 16,460                  | 16,856   | 16,566   |
| Net income attributable to redeemable non-controlling interests    | 184                     | 546      | 425      |
| Net income attributable to non-controlling interests               | 93                      | 430      | 621      |
| Net income attributable to Magic Software Enterprises Shareholders | \$16,183                | \$15,880 | \$15,520 |

Net earnings per share attributable to Magic Software Enterprises' shareholders

(Note 16):

|                                      |        |        |        |
|--------------------------------------|--------|--------|--------|
| Basic and diluted earnings per share | \$0.44 | \$0.43 | \$0.36 |
|--------------------------------------|--------|--------|--------|

The accompanying notes are an integral part of the consolidated financial statements.

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**MAGIC SOFTWARE ENTERPRISES LTD.****AND ITS SUBSIDIARIES****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME****U.S. dollars in thousands (except per share data)**

|                                                                               | Year ended December 31, |          |          |
|-------------------------------------------------------------------------------|-------------------------|----------|----------|
|                                                                               | 2012                    | 2013     | 2014     |
| Net income                                                                    | \$16,460                | \$16,856 | \$16,566 |
| Other comprehensive income (loss), net of tax                                 |                         |          |          |
| Foreign currency translation adjustments, net                                 | (621 )                  | 495      | (5,469 ) |
| Unrealized gain from derivative instruments, net                              | 29                      | -        | -        |
| Unrealized loss (gain) from available-for-sale securities                     | 28                      | (35 )    | (259 )   |
| Total other comprehensive income (loss), net of tax                           | (564 )                  | 460      | (5,728 ) |
| Total comprehensive income                                                    | 15,896                  | 17,316   | 10,838   |
| Comprehensive income attributable to redeemable non-controlling interests     | 157                     | 807      | 51       |
| Comprehensive income attributable to non-controlling interests                | 96                      | 476      | 442      |
| Comprehensive income attributable to Magic Software Enterprises' shareholders | \$15,643                | \$16,033 | \$10,345 |

The accompanying notes are an integral part of the consolidated financial statements.

**MAGIC SOFTWARE ENTERPRISES LTD.****AND ITS SUBSIDIARIES****STATEMENTS OF CHANGES IN EQUITY****U.S. dollars in thousands (except per share data)**

|                                                                | Attributable to the Company's shareholders |                            |                                  |                                                        |                        |                                 |                 |
|----------------------------------------------------------------|--------------------------------------------|----------------------------|----------------------------------|--------------------------------------------------------|------------------------|---------------------------------|-----------------|
|                                                                | Number of<br>Shares                        | Share<br>capital<br>amount | Additional<br>paid-in<br>capital | Accumulated<br>other<br>comprehensive<br>income (loss) | Accumulated<br>deficit | Non<br>controlling<br>interests | Total<br>equity |
| Balance as of January 1, 2012                                  | 36,490,020                                 | \$ 808                     | \$ 124,616                       | \$ (19 )                                               | \$ (20,249 )           | \$ 469                          | \$ 105,625      |
| Exercise of stock options                                      | 136,708                                    | 3                          | 306                              | -                                                      | -                      | -                               | 309             |
| Stock-based compensation expenses                              | -                                          | -                          | 515                              | -                                                      | -                      | -                               | 515             |
| Dividend                                                       | -                                          | -                          | -                                | -                                                      | (3,661 )               | -                               | (3,661 )        |
| Acquisition of non-controlling interests in Xsell (see Note 3) | -                                          | -                          | (149 )                           | -                                                      | -                      | (165 )                          | (314 )          |
| Other comprehensive income                                     | -                                          | -                          | -                                | (567 )                                                 | -                      | 3                               | (564 )          |
| Net income                                                     | -                                          | -                          | -                                | -                                                      | 16,183                 | 268                             | 16,451          |
| Balance as of December 31, 2012                                | 36,626,728                                 | 811                        | 125,288                          | (586 )                                                 | (7,727 )               | 575                             | 118,361         |
| Exercise of stock options                                      | 528,627                                    | 15                         | 1,447                            | -                                                      | -                      | -                               | 1,462           |
| Stock-based compensation expenses                              | -                                          | -                          | 325                              | -                                                      | -                      | -                               | 325             |
| Dividend                                                       | -                                          | -                          | -                                | -                                                      | (7,723 )               | (64 )                           | (7,787 )        |
| Other comprehensive income                                     | -                                          | -                          | -                                | 414                                                    | -                      | 46                              | 460             |
| Net income                                                     | -                                          | -                          | -                                | -                                                      | 15,880                 | 430                             | 16,310          |
| Balance as of December 31, 2013                                | 37,155,355                                 | 826                        | 127,060                          | (172 )                                                 | 430                    | 987                             | 129,131         |
| Issuance of shares                                             | 6,903,141                                  | 201                        | 54,525                           | -                                                      | -                      | -                               | 54,726          |
| Exercise of stock options                                      | 115,721                                    | 2                          | 202                              | -                                                      | -                      | -                               | 204             |
| Stock-based compensation expenses                              | -                                          | -                          | 327                              | -                                                      | -                      | 1,230                           | 1,557           |
| Dividend                                                       | -                                          | -                          | -                                | -                                                      | (8,681 )               | -                               | (8,681 )        |
| Other comprehensive income                                     | -                                          | -                          | -                                | (5,175 )                                               | -                      | (179 )                          | (5,354 )        |
| Net income                                                     | -                                          | -                          | -                                | -                                                      | 15,520                 | 621                             | 16,141          |
| Balance as of December 31, 2014                                | 44,174,217                                 | 1,029                      | 182,114                          | (5,347 )                                               | 7,269                  | 2,659                           | 187,724         |

The accompanying notes are an integral part of the consolidated financial statements.

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**MAGIC SOFTWARE ENTERPRISES LTD.****AND ITS SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS****U.S. dollars in thousands**

|                                                                                                | Year ended December 31, |          |          |
|------------------------------------------------------------------------------------------------|-------------------------|----------|----------|
|                                                                                                | 2012                    | 2013     | 2014     |
| Cash flows from operating activities:                                                          |                         |          |          |
| Net income                                                                                     | \$16,460                | \$16,856 | \$16,566 |
| Adjustments to reconcile net income to net cash provided by operating activities:              |                         |          |          |
| Depreciation and amortization                                                                  | 7,444                   | 8,380    | 8,660    |
| Interest expenses related to liabilities in connection with acquisitions                       | 48                      | -        | -        |
| Accrued severance pay, net                                                                     | 8                       | -        | -        |
| Loss on sale of property and equipment                                                         | -                       | 10       | -        |
| Stock-based compensation expenses                                                              | 515                     | 325      | 1,557    |
| Amortization of marketable securities premium, accretion of discount                           | -                       | -        | 62       |
| Gain on sale of subsidiary's operation                                                         | (136 )                  | -        | -        |
| Decrease (increase) in trade receivables, net                                                  | 11                      | 473      | (9,378 ) |
| Decrease (increase) in other long term and short term accounts receivable and prepaid expenses | 145                     | (397 )   | (23 )    |
| Increase in trade payables                                                                     | 780                     | (700 )   | (342 )   |
| Increase (decrease) in accrued expenses and other accounts payable                             | (2,279 )                | (1,589 ) | (303 )   |
| Increase (decrease) in deferred revenues                                                       | (1,131 )                | (1,765 ) | 191      |
| Change in deferred income taxes, net                                                           | 1,083                   | 687      | 1,204    |
| Net cash provided by operating activities                                                      | 22,948                  | 22,280   | 18,194   |

The accompanying notes are an integral part of the consolidated financial statements.

**MAGIC SOFTWARE ENTERPRISES LTD.****AND ITS SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS****U.S. dollars in thousands**

|                                                                  | Year ended December 31, |          |          |
|------------------------------------------------------------------|-------------------------|----------|----------|
|                                                                  | 2012                    | 2013     | 2014     |
| Cash flows from investing activities:                            |                         |          |          |
| Capitalized software development costs                           | (4,969 )                | (4,713 ) | (4,267 ) |
| Purchase of property and equipment                               | (510 )                  | (497 )   | (993 )   |
| Cash paid in conjunction with acquisitions, net of acquired cash | (7,627 )                | (16,557) | (9,363 ) |
| Proceeds from sale of subsidiary's operation                     | 136                     | -        | -        |
| Proceeds from sale of property and equipment                     | -                       | 60       | -        |
| Proceeds from maturity of marketable securities                  | 343                     | -        | 596      |
| Proceeds from short-term bank deposits                           | 3,601                   | -        | -        |
| Change in loans to employees and other deposits ,net             | (34 )                   | -        | (58 )    |
| Investment in marketable securities                              | -                       | -        | (11,976) |
| Investment in short-term bank deposit                            | (1,366 )                | -        | -        |
| Net cash used in investing activities                            | (10,426)                | (21,707) | (26,061) |
| Cash flows from financing activities:                            |                         |          |          |
| Proceeds from exercise of options by employees                   | 309                     | 1,462    | 204      |
| Issuance of Ordinary shares, net                                 | -                       | -        | 54,726   |
| Dividend paid                                                    | (3,661 )                | (7,787 ) | (8,681 ) |
| Short-term credit, net                                           | 14                      | (47 )    | 2,974    |
| Purchase of non-controlling interest                             | (87 )                   | (168 )   | -        |
| Long term loan received                                          | -                       | 3,307    | -        |
| Repayment of long-term loans                                     | -                       | (95 )    | (2,905 ) |
| Net cash used in financing activities                            | (3,425 )                | (3,328 ) | 46,318   |
| Effect of exchange rate changes on cash and cash equivalents     | (64 )                   | 145      | (1,070 ) |
| Increase (decrease) in cash and cash equivalents                 | 9,033                   | (2,610 ) | 37,381   |
| Cash and cash equivalents at the beginning of the year           | 28,711                  | 37,744   | 35,134   |
| Cash and cash equivalents at end of the year                     | \$37,744                | \$35,134 | \$72,515 |

The accompanying notes are an integral part of the consolidated financial statements.

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**MAGIC SOFTWARE ENTERPRISES LTD.**

**AND ITS SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**U.S. dollars in thousands**

|                                                                                           | Year ended December 31, |         |         |
|-------------------------------------------------------------------------------------------|-------------------------|---------|---------|
|                                                                                           | 2012                    | 2013    | 2014    |
| Supplementary information on investing and financing activities not involving cash flows: |                         |         |         |
| Non-cash activities:                                                                      |                         |         |         |
| Deferred acquisition payment                                                              | \$3,103                 | \$1,581 | \$250   |
| Contingent acquisition payment                                                            | \$1,192                 | \$3,981 | \$-     |
| Supplemental disclosure of cash flow activities:                                          |                         |         |         |
| Cash paid during the year for:                                                            |                         |         |         |
| Income taxes                                                                              | \$1,250                 | \$1,519 | \$1,601 |
| Interest                                                                                  | \$17                    | \$34    | \$74    |

The accompanying notes are an integral part of the consolidated financial statements.

MAGIC SOFTWARE ENTERPRISES LTD.

AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except share and per share data)

NOTE 1:- GENERAL

Magic Software Enterprises Ltd., an Israeli company, and its subsidiaries ("the Group") is a global provider of software platforms and professional services that accelerate the planning, development, deployment and integration of on-premise, mobile and cloud business applications ("the Magic technology"). Magic technology enables enterprises to accelerate the process of delivering business solutions that meet current and future needs and allow customers to dramatically improve their business performance and return on investment. To complement its software products and to increase its traction with customers, the Group also offers a complete portfolio of IT professional services in the areas of infrastructure design and delivery, application development, technology planning and implementation services, communications services and solutions, and supplemental staffing services. The Company reports its results on the basis of two reportable business segments: software services (which include proprietary and non-proprietary software and related services) and IT professional services (see Note 17 for further details). The principal markets of the Group are Europe, United States, Japan and Israel (see Note 17).

For information about the Company's holdings in subsidiaries and affiliates, see Appendix A to the consolidated financial statements.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States ("U.S. GAAP"), applied on a consistent basis, as follows:

**Use of estimates**

The preparation of the consolidated financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. The Company's management believes that the estimates, judgments and assumptions used are reasonable based upon information available at the time they are made. Actual results could differ from those estimates. The most significant assumptions are employed in estimates used in determining values of goodwill and identifiable intangible assets and their subsequent impairment analysis, revenue recognition, tax assets

and tax positions, legal contingencies, research and development capitalization, contingent consideration related to acquisitions and stock-based compensation costs. Actual results could differ from those estimates.

**Financial statements in United States dollars**

A substantial portion of the revenues and expenses of the Company and certain of its subsidiaries is generated in U.S. dollars ("dollar"). The Company's management believes that the dollar is the currency of the primary economic environment in which the Company and certain of its subsidiaries operate. Thus, the functional and reporting currency of the Company and certain of its subsidiaries is the dollar.

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U.S. dollars in thousands (except share and per share data)

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Accordingly, monetary accounts maintained in currencies other than the dollar are remeasured into dollars in accordance with the Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 830, "Foreign Currency Matters". All transaction gains and losses of the remeasurement of monetary balance sheet items are reflected in the statements of income as financial income or expenses, as appropriate.

For those foreign subsidiaries whose functional currency is not the dollar, all balance sheet amounts have been translated using the exchange rates in effect at each balance sheet date. Statement of income amounts have been translated using the average exchange rate prevailing during each year. Such translation adjustments are reported as a component of other comprehensive income (loss) in equity.

**Principles of consolidation**

The consolidated financial statements include the accounts of the Company and its subsidiaries. Intercompany balances and transactions, including profit from intercompany sales not yet realized outside the Group, have been eliminated upon consolidation.

Changes in the parent's ownership interest in a subsidiary with no change of control are treated as equity transactions, with any difference between the amount of consideration paid and the change in the carrying amount of the non-controlling interest, recognized in equity.

Non-controlling interests of subsidiaries represent the non-controlling share of the total comprehensive income (loss) of the subsidiaries and fair value of the net assets upon the acquisition of the subsidiaries. The non-controlling interests are presented in equity separately from the equity attributable to the equity holders of the Company. Redeemable non-controlling interests are classified as mezzanine equity, separate from permanent equity, on the consolidated balance sheets and measured at each reporting period at the higher of their redemption amount or the Non controlling interest book value, in accordance with the requirements of ASC 810 "Consolidation" and ASC 480-10-S99-3A, "Distinguishing Liabilities from Equity".

The following table provides a reconciliation of the redeemable non-controlling interests:

|                                                                 |        |
|-----------------------------------------------------------------|--------|
| January 1, 2014                                                 | 2,721  |
| Net income attributable to redeemable non-controlling interests | 425    |
| Non-controlling interest as part of acquisitions                | 158    |
| Foreign currency translation adjustments                        | (374 ) |
| December 31, 2014                                               | 2,930  |

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U.S. dollars in thousands (except share and per share data)

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

### **Cash and cash equivalents**

Cash and cash equivalents are short-term highly liquid investments that are readily convertible to cash with original maturities of three months or less, at the date acquired.

Cash and cash equivalent includes amounts held primarily in NIS, U.S. dollars, Euro, Japanese Yen and British Pound.

### **Short-term deposits and restricted deposits**

Short-term deposits include deposits with original maturities of more than three months and less than one year. Such deposits are presented at cost (including accrued interest) which approximates their fair value. Restricted deposits are used to secure certain Group's ongoing projects and are classified under other receivables.

### **Marketable securities**

The Company accounts for investments in marketable securities in accordance with ASC No. 320, "Investments – Debt and Equity Securities". Management determines the appropriate classification of its investments at the time of purchase and reevaluates such determinations at each balance sheet date. The Company classifies all of its marketable securities as available for sale. Available for sale securities are carried at fair value, with the unrealized gains and losses, net of tax, reported in "accumulated other comprehensive income (loss)" in equity. Realized gains and losses on sale of investments are included in "financial income, net" and are derived using the specific identification method for determining the cost of securities.

The amortized cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization together with interest on securities is included in “financial income, net”.

The Company recognizes an impairment charge when a decline in the fair value of its investments in debt securities below the cost basis of such securities is judged to be other-than-temporary. Factors considered in making such a determination include the duration and severity of the impairment, the reason for the decline in value, the potential recovery period and the Company’s intent to sell, including whether it is more likely than not that the Company will be required to sell the investment before recovery of cost basis. For securities that are deemed other-than-temporarily impaired, the amount of impairment is recognized in “net gain (impairment net of gains) on sale of marketable securities previously impaired” in the statements of income and is limited to the amount related to credit losses, while impairment related to other factors is recognized in other comprehensive income.

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NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

### **Property and equipment, net**

Property and equipment are stated at cost, net of accumulated depreciation. Depreciation is calculated by the straight-line method over the estimated useful lives of the assets, at the following annual rates:

|                                    | <b>Years</b>                                               |
|------------------------------------|------------------------------------------------------------|
| Computers and peripheral equipment | 3                                                          |
| Office furniture and equipment     | 7 - 15 (mainly 7)                                          |
| Motor vehicles                     | 7                                                          |
| Software                           | 3 – 5 (mainly 5)                                           |
| Leasehold improvements             | Over the shorter of the lease term or useful economic life |

### **Business combinations**

The Company accounts for business combinations under ASC 805, "Business Combinations". ASC 805 requires recognition of assets acquired, liabilities assumed, non-controlling interest and redeemable non-controlling interest in the acquiree at the acquisition date, measured at their fair values as of that date. As required by ASC 820, "Fair Value Measurements and disclosures" the Company applies assumptions that marketplace participants would consider in determining the fair value of assets acquired, liabilities assumed, non-controlling interest and redeemable non-controlling interest in the acquiree at the acquisition date. Any excess of the fair value of net assets acquired over purchase price and any subsequent changes in estimated contingencies are to be recorded in earnings.

### **Variable interest entities**

ASC 810, "Consolidation" provides a framework for identifying variable interest entities (or "VIEs") and determining when a company should include the assets, liabilities, non-controlling interests and results of activities of a VIE in its consolidated financial statements.

The Company's assessment of whether an entity is a VIE and the determination of the primary beneficiary requires judgment and involves the use of significant estimates and assumptions. Those include, among others, forecasted cash flows, their respective probabilities and the economic value of certain preference rights. In addition, such assessment also involves estimates of whether a group entity can finance its current activities, until it reaches profitability, without additional subordinated financial support.

Effective as of January 1, 2010, the Company applies updated guidance for the consolidation of VIEs. The guidance qualitative approach, based on which enterprise has both (1) the power to direct the economically significant activities of the entity and (2) the obligation to absorb losses of, or the right to receive benefits from, the entity that could potentially be significant to the variable interest entity. Determination about whether an enterprise should consolidate a VIE is required to be evaluated continuously as changes to existing relationships or future transactions.

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**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

One of the Company's U.S. based consulting and staffing services business acquired through one of its wholly owned subsidiaries on January 17, 2010 is considered to be a VIE. The subsidiary is the primary beneficiary of the VIE, as a result of the fact that it holds the power to direct the activities of the acquired business, which significantly impacts its economic performance, and has the right to receive benefits accruing from the acquired business.

**Research and development costs**

Research and development costs incurred in the process of software development before establishment of technological feasibility are charged to expenses as incurred. Costs incurred subsequent to the establishment of technological feasibility are capitalized according to the principles set forth in ASC 985-20, "Costs of Software to be Sold, Leased or Marketed".

The Company and its subsidiaries establish technological feasibility upon completion of a detailed program design or working model.

Research and development costs incurred in the process of developing product enhancements are generally charged to expenses as incurred.

Capitalized software costs are amortized on a product by product basis by the straight-line method over the estimated useful life of the software product (between 4-5 years). The Company assesses the recoverability of these intangible assets on a regular basis by determining whether the amortization of the asset over its remaining economical useful life can be recovered through undiscounted future operating cash flows from the specific software product sold. During the years ended December 31, 2012, 2013 and 2014, no such unrecoverable amounts were identified.

**Long-Lived Assets**

The Company long-lived, non-current assets are comprised mainly of goodwill, identifiable intangible assets and property, plants and equipment.

**Impairment of long-lived assets and intangible assets subject to amortization**

The Company's long-lived assets are reviewed for impairment in accordance with ASC 360, "Property, Plant and Equipment" whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the future undiscounted cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets.

As required by ASC 820, "Fair Value Measurements and disclosures" the Company applies assumptions that marketplace participants would consider in determining the fair value of long-lived assets (or asset groups).

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NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Intangible assets with finite lives are amortized over their economic useful life using a method of amortization that reflects the pattern in which the economic benefits of the intangible assets are consumed or otherwise used up. Distribution rights, acquired technology and non-compete were amortized on a straight line basis and customer relationships and backlog were amortized on an accelerated method basis over a period between 3.5 - 15 years based on the intangible assets identified.

During the years ended December 31, 2012, 2013 and 2014, no impairment was identified.

**Goodwill**

Goodwill represents the excess of the purchase price in a business combination over the fair value of the net tangible and intangible assets acquired. Under ASC 350, "Intangibles - Goodwill and Other", goodwill is subject to an annual impairment test or more frequently if impairment indicators are present. Goodwill impairment is deemed to exist if the net book value of a reporting unit exceeds its estimated fair value. As of December 31, 2014, the Company operates in four reporting units within its operating segments.

Goodwill reflects the excess of the consideration paid or transferred plus the fair value of contingent consideration and any non-controlling interest in the acquiree at the acquisition date over the fair values of the identifiable net assets acquired. The goodwill impairment test is performed according to the following principles:

An initial qualitative assessment of the likelihood of impairment may be performed. If this step does not result in a more likely than not indication of impairment, no further impairment testing is required. If it does result in a more likely than not indication of impairment, the impairment test is performed.

In step one of the impairment test, the company compares the fair value of the reporting units to the carrying value of net assets allocated to the reporting units. If the fair value of the reporting unit exceeds the carrying value of the net assets allocated to that unit, goodwill is not impaired, and no further testing is required. Otherwise, the company must perform the second step of the impairment test to measure the amount of the impairment.

In the second step, the reporting unit's fair value is allocated to all the assets and liabilities of the reporting unit, including any unrecognized intangible assets, in a hypothetical analysis that simulates the business combination principles to derive an implied goodwill value. If the implied fair value of the reporting unit's goodwill is less than its carrying value, the difference is recorded as impairment

The Company performed an annual impairment tests as of December 31, of each of 2012, 2013 and 2014 and did not identify any impairment losses (see Note 9).

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NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

### **Revenue recognition**

The Company derives its revenues from licensing the rights to use software (proprietary and non-proprietary), provision of related professional services, maintenance and technical support as well as from other IT professional services. The Company sells its products and services primarily through its direct sales force and indirectly through distributors and value added resellers.

The Company accounts for its software sales in accordance with ASC 985-605, "Software Revenue Recognition". Software license revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred, the vendor's fee is fixed or determinable, no further obligation exists and collectability is probable.

Maintenance and support includes annual maintenance contracts providing for unspecified upgrades for new versions and enhancements on a when-and-if-available basis for an annual fee. The right for an unspecified upgrade for new versions and enhancements on a when-and-if-available basis do not specify the features, functionality and release date of future product enhancements for the customer to know what will be made available and the general timeframe in which it will be delivered.

Maintenance and support revenue included in multiple element arrangements is deferred and recognized on a straight-line basis over the term of the maintenance and support agreement.

As required by ASC 985-605, the Company allocates revenues to the software component of its multiple-element arrangements using the residual method when vendor specific objective evidence ("VSOE") of fair value exists for the undelivered elements of the support and maintenance agreements. VSOE is based on the price charged when an element is sold separately or renewed. Under the residual method, the fair value of the undelivered elements is deferred and the remaining portion of the arrangement fee is allocated to the delivered elements and is recognized as revenue.

The Company generally does not grant a right of return to its customers. When a right of return exists, the Company defers revenue until the right of return expires, at which time revenue is recognized provided that all other revenue recognition criteria are met.

Revenue from professional services related to both software and the IT professional services businesses consists of billable hours for services provided and is recognized as the services are rendered.

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U.S. dollars in thousands (except share and per share data)

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Arrangements that include professional services bundled with licensed software and other software related elements, are evaluated to determine whether those services are essential to the functionality of other elements of the arrangement. When services are considered essential to the software, revenues under the arrangement are recognized using contract accounting based on ASC 605-35, "Construction-Type and Production-Type Contracts", on a percentage of completion method based on inputs measures. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are first determined, in the amount of the estimated loss for the entire contract. During the years ended December 31, 2012, 2013 and 2014, no such estimated losses were identified.

When professional services are not considered essential to the functionality of other elements of the arrangement, revenue allocable to the services is recognized as the services are performed, using VSOE of fair value. In most cases, the Company has determined that the services are not considered essential to the functionality of other elements of the arrangement.

Deferred revenue includes unearned amounts received under maintenance, support and services contracts, and amounts received from customers but not yet recognized as revenues.

Revenue from third-party sales is recorded at a gross or net amount according to certain indicators. The application of these indicators for gross and net reporting of revenue depends on the relative facts and circumstances of each sale and requires significant judgment.

**Severance pay**

The Company's and its Israeli subsidiary's obligation for severance pay with respect to their Israeli employees (for the period for which the employees were not included under Section 14 of the Severance Pay Law, 1963) is calculated pursuant to the Israeli Severance Pay Law based on the most recent salary of the employees multiplied by the number of years of employment as of the balance sheet date, and are presented on an undiscounted basis (referred to as the "Shut Down Method"). Employees are entitled to one month's salary for each year of employment or a portion thereof.

The Company's obligation for all of its Israeli employees is fully provided for by monthly deposits with insurance policies and by an accrual.

The Group has a number of savings plans in the United States that qualify under Section 401(k) of the Internal Revenue Code. U.S employees may contribute up to 100% of their pretax salary, but not more than statutory limits. Matching contributions are discretionary and are up to 3% of the participants contributions. When contributions are granted, they are invested in proportion to each participant's voluntary contributions in the investment options provided under the plan.

The carrying value of deposited funds includes profits (losses) accumulated up to the balance sheet date. The deposited funds may be withdrawn only upon the fulfillment of the obligations pursuant to the Israeli Severance Pay Law or labor agreements and are recorded as an asset in the Company's consolidated balance sheet.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

The Company and its Israeli subsidiaries' agreements with most of their Israeli employees are in accordance with Section 14 of the Severance Pay Law -1963, mandating that upon termination of such employees' employment; all the amounts accrued in their insurance policies shall be released to them instead of severance compensation. Upon release of deposited amounts to the employee, no additional liability exists between the parties regarding the matter of severance pay and no additional payments shall be made by the Company or its subsidiaries to the employee. Further, the related obligation and amounts deposited on behalf of such obligation are not stated on the balance sheet, as the Company and its subsidiaries are is legally released from their obligations to employees once the deposit amounts have been paid.

Severance expenses for the years ended December 31, 2012, 2013 and 2014 amounted to approximately \$ 829, \$ 1,371 and \$ 1,673, respectively.

**Advertising expenses**

Advertising expenses are charged to selling and marketing expenses, as incurred. Advertising expenses for the years ended December 31, 2012, 2013 and 2014 amounted to \$ 556, \$ 306 and \$ 466, respectively.

**Income taxes**

The Company and its subsidiaries account for income taxes in accordance with ASC 740, "Income Taxes". The ASC prescribes the use of the liability method whereby deferred tax asset and liability account balances are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. The Company and its subsidiaries provide a valuation allowance, if necessary, to reduce deferred tax assets to their estimated realizable value. Deferred tax assets and liabilities are classified as current or non-current according to the expected reversal

dates.

The Company utilizes a two-step approach for recognizing and measuring uncertain tax positions accounted for in accordance with an amendment of ASC 740 "Income Taxes." Under the first step the Company evaluates a tax position taken or expected to be taken in a tax return by determining if the weight of available evidence indicates that it is more likely than not that, based on its technical merits, the tax position will be sustained on audit, including resolution of any related appeals or litigation processes. The second step is to measure the tax benefit as the largest amount that is more than 50% likely to be realized upon ultimate settlement with the tax authorities. The Company accrued interest and penalties related to unrecognized tax benefits in its provisions for income taxes.

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U.S. dollars in thousands (except share and per share data)

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

### **Basic and diluted net earnings per share**

Basic net earnings per share are computed based on the weighted average number of ordinary shares outstanding during each year. Diluted net earnings per share are computed based on the weighted average number of ordinary shares outstanding during each year, plus dilutive potential ordinary shares considered outstanding during the year, in accordance with ASC 260, "Earnings Per Share."

A portion of the outstanding stock options have been excluded from the calculation of the diluted earnings per share because such securities are anti-dilutive. The total weighted average number of Ordinary shares related to the outstanding options excluded from the calculations of diluted earnings per share was 669,887, 536,877 and 35,010 for the years ended December 31, 2012, 2013 and 2014, respectively.

### **Stock-based compensation**

The Company accounts for stock-based compensation in accordance with ASC 718, "Compensation - Stock Compensation" which requires companies to estimate the fair value of equity-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as an expense over the requisite service periods in the Company's consolidated statement of income.

The Company recognizes compensation expenses for the value of its awards, which have graded vesting based on the accelerated method over the requisite service period of each of the awards, net of estimated forfeitures.

The Company measures and recognizes compensation expense for share-based awards based on estimated fair values on the date of grant using the Binomial option-pricing model ("the Binomial model"). The Binomial model for option pricing requires a number of assumptions, of which the most significant are the suboptimal exercise factor and expected stock price volatility. The suboptimal exercise factor is estimated based on employees' historical option exercise behavior.

The suboptimal exercise factor is the ratio by which the stock price must increase over the exercise price before employees are expected to exercise their stock options. Expected volatility is based upon actual historical stock price movements and was calculated as of the grant dates for different periods, since the Binomial model can be used for different expected volatilities for different periods. The risk-free interest rate is based on the yield from U.S. Treasury zero-coupon bonds with an equivalent term to the contractual term of the options. Historically the Company did not hold any foreseeable plans to pay dividends and therefore used an expected dividend yield of zero in its past years option pricing models. In September 2012, the Company adopted a dividend distribution policy according to which it will distribute in each year a dividend of up to 50% of its annual distributable profits.

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NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

The expected term of options granted is derived from the output of the option valuation model and represents the period of time that options granted are expected to be outstanding. Estimated forfeitures are based on actual historical pre-vesting forfeitures.

For awards with performance conditions, compensation cost is recognized over the requisite service period if it is 'probable' that the performance conditions will be satisfied, as defined in ASC 450-20-20, "Loss Contingencies."

The fair value for the Company's stock options granted to employees and directors was estimated using the following assumptions:

|                                           | 2013        | 2014        |
|-------------------------------------------|-------------|-------------|
| Dividend yield                            | 0%          | 0%          |
| Expected volatility                       | 32% - 59%   | 32% - 59%   |
| Risk-free interest rate                   | 0.1% - 2.6% | 0.1% - 2.6% |
| Expected forfeiture (employees)           | -           | -           |
| Expected forfeiture (executives)          | -           | -           |
| Contractual term of up to                 | 10 years    | 10 years    |
| Suboptimal exercise multiple (employees)  | 2           | -           |
| Suboptimal exercise multiple (executives) | 2           | 2           |

During the years ended December 31, 2012, 2013 and 2014, the Company recognized stock-based compensation expense related to employee stock options in the amount of \$ 515, \$ 325 and \$ 1,557, respectively, as follows:

|                 | Year ended December 31, |       |       |
|-----------------|-------------------------|-------|-------|
|                 | 2012                    | 2013  | 2014  |
| Cost of revenue | \$ 16                   | \$ 11 | \$ 30 |

|                                        |        |        |          |
|----------------------------------------|--------|--------|----------|
| Research and development               | 114    | 67     | 29       |
| Selling and marketing                  | 82     | 85     | 220      |
| General and administrative             | 303    | 162    | 1,278    |
| Total stock-based compensation expense | \$ 515 | \$ 325 | \$ 1,557 |

### **Concentrations of credit risk**

Financial instruments that potentially subject the Company and its subsidiaries to concentration of credit risk consist principally of cash and cash equivalents, short-term deposits, marketable securities, trade receivables and foreign currency derivative contracts.

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U.S. dollars in thousands (except share and per share data)

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

The Company's cash and cash equivalents and short-term deposits are invested primarily in deposits with major banks worldwide, mainly in the United States and Israel, however, such cash and cash equivalents and short-term deposits in the United States may be in excess of insured limits and are not insured in other jurisdictions. The Company believes that such institutions are of high rating and therefore bear low risk.

The Company's marketable securities include investments in commercial and government bonds and foreign banks. The Company's marketable securities are considered to be highly liquid and have a high credit standing. In addition, management considered its portfolios in foreign banks to be well-diversified (also refer to Note 4).

Trade receivables of the Company and its subsidiaries are derived from sales to customers located primarily in the United States, Europe, Japan, South Africa and Israel. The Company performs ongoing credit evaluations of its customers and excluding 2013 to date has not experienced any material losses. An allowance for doubtful accounts is determined with respect to those amounts that the Company has determined to be doubtful of collection. The expense related to doubtful accounts for the years ended December 31, 2012, 2013 and 2014 was \$ 420, \$ 1,285 and \$ 735, respectively.

The Company has entered into foreign exchange forward contracts intended to protect against the changes in value of forecasted non-dollar currency cash flows related to salary and related expenses. These derivative instruments are designed to offset the Company's non-dollar currency exposure (see "Derivative instruments" below).

**Fair value measurements**

The Company accounts for certain assets and liabilities at fair value under ASC 820, "Fair Value Measurements and Disclosures". Fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or a liability. As a basis for considering such assumptions, ASC 820 establishes a three-tier value hierarchy, which

prioritizes the inputs used in the valuation methodologies in measuring fair value:

Level 1 - Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets;

Level 2 - Significant other observable inputs based on market data obtained from sources independent of the reporting entity;

Level 3 - Unobservable inputs which are supported by little or no market activity;

The fair value hierarchy also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The Company categorized each of its fair value measurements in one of these three levels of hierarchy.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Assets and liabilities measured at fair value on a recurring basis are comprised of marketable securities, foreign currency forward contracts and contingent consideration of acquisitions (see Note 5).

The carrying amounts reported in the balance sheet for cash and cash equivalents, short term bank deposits, trade receivables, other accounts receivable, short-term bank credit, trade payables and other accounts payable approximate their fair values due to the short-term maturities of such instruments.

**Comprehensive income (loss)**

The Company accounts for comprehensive income (loss) in accordance with ASC 220, "Comprehensive Income." This Statement establishes standards for the reporting and display of comprehensive income and its components in a full set of general purpose financial statements. Comprehensive income (loss) generally represents all changes in equity during the period except those resulting from investments by, or distributions to, shareholders. The Company determined that its items of other comprehensive income (loss) relate to gain and loss on foreign currency translation adjustments, unrealized gain and loss on derivative instruments designated as hedges and unrealized gain and loss on available-for-sale marketable securities.

**Derivative instruments**

A material portion of the Company's revenues, expenses and earnings is exposed to changes in foreign exchange rates. Depending on market conditions, foreign exchange risk is also managed through the use of derivative financial instruments. These financial instruments serve to protect net income against the impact of the translation into U.S. dollars of certain foreign exchange-denominated transactions. The derivative instruments hedge or offset exposures to Euro, Japanese Yen and NIS exchange rate fluctuations.

ASC 815, "Derivatives and Hedging," requires companies to recognize all of their derivative instruments as either assets or liabilities in their balance sheet at fair value. Derivative instruments that are designated and qualify as hedges of forecasted transactions (i.e., cash flow hedges) are carried at fair value with the effective portion of a derivative's gain or loss recorded in other comprehensive income and subsequently recognized in earnings in the same period or periods in which the hedged forecasted transaction affects earnings. For derivative instruments that are not designated and qualified as hedging instruments, the gains or losses on the derivative instruments are recognized in current earnings during the period of the change in fair values.

The derivative instruments used by the Company are designed to reduce the market risk associated with the exposure of its underlying transactions to fluctuations in currency exchange rates.

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NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

The Company has instituted a foreign currency cash flow hedging program in order to hedge against the risk of overall changes in future cash flows. The Company hedges portions of its forecasted expenses denominated in NIS with currency forwards contracts and put and call options. These forward and option contracts are designated as cash flow hedges.

For derivative instruments that are designated and qualify as a cash flow hedge (i.e., hedging the exposure to variability in expected future cash flows that is attributable to a particular risk), the effective portion of the gain or loss on the derivative instrument is reported as a component of other comprehensive income and reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. The remaining gain or loss on the derivative instrument in excess of the cumulative change in the present value of future cash flows of the hedged item, if any, is recognized in current earnings during the period of change.

For derivative instruments not designated as hedging instruments, the gain or loss is recognized in current earnings during the period of change.

The notional principal of foreign exchange contracts to purchase NIS with U.S. dollars was \$ 0 and \$ 1,736 as of December 31, 2013 and 2014, respectively.

At December 31, 2014, the Company did not have any cash flow hedges.

The following tables present fair value amounts and gains and losses of derivative instruments and related hedged items:

Fair values of derivative instruments  
Assets

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|                                       |                                                  | December 31, |      |
|---------------------------------------|--------------------------------------------------|--------------|------|
| Balance sheet item                    |                                                  | 2013         | 2014 |
| Assets                                |                                                  |              |      |
| Derivatives not designated as hedging | "Other accounts receivable and prepaid expenses" | \$ -         | \$ 9 |
| Total derivatives                     |                                                  | \$ -         | \$ 9 |

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MAGIC SOFTWARE ENTERPRISES LTD.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except share and per share data)

## NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

|                                        | Statements<br>of<br>income item | Gain (loss)<br>recognized in the<br>statements of income<br>Year ended December 31,<br>2012      2013      2014 |        |       |
|----------------------------------------|---------------------------------|-----------------------------------------------------------------------------------------------------------------|--------|-------|
| Derivatives not designated as hedging: |                                 |                                                                                                                 |        |       |
| Foreign exchange forward contracts     | "Financial expenses, net"       | 245                                                                                                             | 139    | 24    |
| Total derivatives                      |                                 | \$ 245                                                                                                          | \$ 139 | \$ 24 |

**Reclassification**

Certain amounts in prior years' financial statements have been reclassified to conform with the current year's presentation. The reclassification had no effect on previously reported net income, equity or cash flow.

**Recently Issued Accounting Pronouncement:**

In August 2014, the Financial Accounting Standards Board ("FASB") issued amended guidance related to disclosure of uncertainties about an entity's ability to continue as a going concern. The new guidance requires management to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern and, as necessary, to provide related footnote disclosures. The guidance has an effective date of December 31, 2016.

In May 2014, Financial Accounting Standards Board ("FASB") issued ASU 2014-09, "Revenue from Contracts with Customers (Topic 606)", a comprehensive new revenue recognition standard that will supersede existing revenue guidance under US GAAP and IFRS ("ASU 2014-09"). ASU 2014-09's core principle is that a company will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the

consideration to which the company expects to be entitled in exchange for those goods or services. ASU 2014-09 is effective for annual periods beginning after December 15, 2016, including interim periods within that period. Early adoption is not permitted under US GAAP. The Company is currently evaluating the method of adoption, as well as the effect that adoption of this ASU will have on its consolidated financial statements.

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MAGIC SOFTWARE ENTERPRISES LTD.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except share and per share data)

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

In April 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. 2014-08 (ASU 2014-08) "Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity. The new guidance limits the presentation of discontinued operations to business circumstances when the disposal of the business operation represents a strategic shift that has had or will have a major effect on operations and financial results. This guidance is effective for fiscal years beginning January 1, 2015. The company believes that the adoption of this new standard will not materially impact its consolidated financial statements.

**NOTE 3:- BUSINESS COMBINATION, SIGNIFICANT TRANSACTION AND SALE OF BUSINESS**

On December 27, 2011, the Company completed the acquisition of the AppBuilder activity of BluePhoenix Solutions ("AppBuilder"), a leading provider of value-driven legacy IT modernization solutions, for \$ 12,565. During 2012, the Company paid an additional amount of \$ 140 with respect to the acquisition. AppBuilder is a comprehensive application development infrastructure used by many enterprises around the world. This premier enterprise application development environment is a powerful, model-driven tool that enables development teams to build, deploy, and maintain large-scale, custom-built business applications. The Company believes the acquisition will broaden its product portfolio and strengthens the presence in numerous global markets. Acquisition related costs were immaterial.

The acquisition was accounted for by the purchase method. The results of operations were included in the consolidated financial statements of the Company commencing January 1, 2012.

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed:

|                     |            |
|---------------------|------------|
| Net liabilities     | \$(3,248 ) |
| Intangible assets   | 7,251      |
| Goodwill            | 8,702      |
| Net assets acquired | \$12,705   |

Identifiable intangible assets, including customer relationship were valued using a variation of the income approach. This method utilized a forecast of expected cash inflows, cash outflows and contributory charges for economic returns on tangible and intangible assets employed.

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**MAGIC SOFTWARE ENTERPRISES LTD.  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
U.S. dollars in thousands (except share and per share data)**

**NOTE 3:- BUSINESS COMBINATION, SIGNIFICANT TRANSACTION AND SALE OF BUSINESS (Cont.)**

Amounts of \$ 4,430, \$ 2,138 and \$ 683 of the purchase price were allocated to customer relationships, developed technology and backlog, respectively. The Company amortizes the customer relationships, backlog and acquired technology over periods of 15 years, 15 years and 3.5 years, respectively.

In July 2012, the Company acquired an 80% interest in Comm-IT Group, (including "Comm-IT Technology Solutions" and "Comm-IT Software"), a software and systems development house that specializes in providing advanced IT and communications services and solutions, for a total consideration of \$ 8,933, of which \$ 4,990 was paid upon closing and the remaining \$ 3,943 is to be paid during the next two years, of which, \$ 1,192 is contingent upon the acquired business meeting certain operational targets in 2012 and 2013, and \$ 2,751 in deferred payments. The Purchaser and the seller hold mutual Call and Put options respectively for the remaining 20% interest in the group. As a result of the Put option, the Company recorded redeemable non-controlling interest in the amount of \$ 1,750. In March 2014, the paid the sellers the remaining deferred payments.

The company believes that the acquisition of this business will enable it to expand its professional services offering and leverage its relationships with top tier customers. Acquisition related costs were immaterial.

In accordance with ASC 805-30-35-1, the Company re-measures the contingent consideration based on the fair value at each reporting date until the contingency is resolved or the payment is made, while the changes in fair value are recognized in earnings in the financial expenses using the interest method over the period. The contingent payment was recorded at present value and was amortized using the interest method during the relevant period into financial expenses.

The acquisition was accounted for by the purchase method. The results of operations were included in the consolidated financial statements of the Company commencing July 1, 2012.

**MAGIC SOFTWARE ENTERPRISES LTD.  
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U.S. dollars in thousands (except share and per share data)**

**NOTE 3:- BUSINESS COMBINATION, SIGNIFICANT TRANSACTION AND SALE OF BUSINESS (Cont.)**

On May 2013 the company finalized the process of identifying the tangible and intangible assets for its acquisition. The following table summarize the fair value of the assets and liabilities acquired:

|                             | As reported<br>on December<br>31, 2012 | Adjustment | Modified |
|-----------------------------|----------------------------------------|------------|----------|
| Net assets                  | \$ 1,219                               | \$ 14      | \$ 1,233 |
| Non-controlling interest    | (1,880 )                               | 130        | (1,750 ) |
| Intangible assets           | 3,873                                  | 397        | 4,270    |
| Goodwill                    | 5,809                                  | 439        | 6,248    |
| Deferred tax liability, net | -                                      | (1,068 )   | (1,068 ) |
| Net assets acquired         | \$ 9,021                               | \$ (88 )   | \$ 8,933 |

On February 26, 2013, the Company purchased Pilat Europe Limited Ltd. and Pilat (North America) Inc. which provides custom human capital management solutions, for a total consideration of \$ 1,233. The Company believes the acquisition will broaden its application product portfolio, customer base and strengthen its presence in numerous global markets. Acquisition related costs were immaterial.

The acquisition was accounted for by the purchase method. The results of operations of these entities were included in the consolidated financial statements of the Company commencing March 1, 2013.

The following table summarizes the estimated fair values of the assets acquired and liabilities at the date of acquisition:

|                       |         |
|-----------------------|---------|
| Net assets            | \$490   |
| Intangible assets     | 715     |
| Total assets acquired | \$1,205 |

d. On May 16, 2013, the Company purchased Valinor Ltd, a consulting company specializing in project and product consultation, installation and implementation of databases for a total consideration of \$ 1,618, of which \$ 339 was paid upon closing, \$ 339 was paid in November 2013, \$340 paid on May 25, 2014, and \$ 600 is contingently

payable upon the business meeting certain operational targets in 2013 and 2014. The amount related to operational targets of 2013 was paid in September 2014. On December 2013 the company increased the total consideration according to 2013 results by \$230 recorded in the Company's statement of operations. The Company believes the acquisition will broaden its professional service offering to its existing and new customers in the fields of projects and product consultation and installation and implementation of databases. Acquisition related costs were immaterial.

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**NOTE 3:- BUSINESS COMBINATION, SIGNIFICANT TRANSACTION AND SALE OF BUSINESS (Cont.)**

The acquisition was accounted for by the purchase method.

The results of operations of these entities were included in the consolidated financial statements of the Company commencing May 15, 2013.

The following table summarizes the estimated fair values of the assets acquired and liabilities at the date of acquisition:

|                   |        |
|-------------------|--------|
| Net assets        | \$ 119 |
| Intangible assets | 464    |
| Goodwill          | 1,035  |

Total assets acquired \$1,618

On May 30, 2013, the Company purchased Dario Solutions IT Ltd, a consulting company specializing in integration services of Microsoft products in enterprise IT environments for a total consideration of \$ 3,723, of which \$ 1,100 was paid upon closing, \$ 906 is to be paid by February 28, 2014 and the remaining \$ 1,717 is contingently payable upon the business meeting certain operational targets in 2013, 2014 and 2015. The amount related to operational e. targets of 2013 was paid in September 2014. On September 2014 the company decreased the total consideration according to 2014 results by \$997 recorded in the Company's statement of operations. The company believes the acquisition will complement the company's professional services offering to its existing and new customers in the field of software integration and advanced on target IT solutions for large and mid- range customers. Acquisition related costs were immaterial.

The acquisition was accounted for by the purchase method.

The results of operations of these entities were included in the consolidated financial statements of the Company commencing June 1, 2013.

The following table summarizes the estimated fair values of the assets acquired and liabilities at the date of acquisition:

|                   |       |
|-------------------|-------|
| Net Assets        | \$371 |
| Intangible assets | 707   |
| Goodwill          | 2,645 |

Total assets acquired \$3,723

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**MAGIC SOFTWARE ENTERPRISES LTD.  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
U.S. dollars in thousands (except share and per share data)**

**NOTE 3:- BUSINESS COMBINATION, SIGNIFICANT TRANSACTION AND SALE OF BUSINESS (Cont.)**

On November 11, 2013 the Company acquired the operations of Allstates Technical Services, LLC, a US-based full-service provider of consulting and staffing solutions for IT, Engineering and Telecom personnel, for a total consideration of \$10,963. The company believes the acquisition will broaden its existing US footprint and adds leading Fortune 500 companies to its customer base, making an important contribution to its growth strategy in the IT professional services operating segment. The results of operations were included in the consolidated financial statements of the Company commencing November 11, 2013.

The following table summarizes the estimated fair values of the assets acquired and liabilities at the date of acquisition:

|                   |         |
|-------------------|---------|
| Net Assets        | \$3,063 |
| Intangible assets | 2,874   |
| Goodwill          | 5,026   |

Total assets acquired \$10,963

In addition, the Company acquired additional activities during the years ended December 31, 2013 and 2014, whose influence on the financial statements of the Company was immaterial, for a total consideration of \$ 0.9 million and \$ 0.7 million, respectively.

On October 1, 2014 the Company acquired the operations Formula Telecom Solutions Ltd. (FTS), an Israel-based software vendor, for a total consideration of \$5,800. FTS specializes in the development, sale, service and support of Business Support Systems (BSS), including convergent charging, billing, customer management, policy control and payment software solutions for the telecommunications. The Company believes the acquisition will broaden its professional service offering to its existing and new customers in the fields of Business Support Systems, including convergent charging, billing, customer management and policy control. Acquisition related costs were immaterial. The acquisition was accounted for by the purchase method.

The results of operations were included in the consolidated financial statements of the Company commencing October 1, 2014.

The following table summarizes the estimated fair values of the assets acquired and liabilities at the date of acquisition:

|                   |         |
|-------------------|---------|
| Net Assets        | \$(57 ) |
| Intangible assets | 2,951   |
| Goodwill          | 2,906   |

Total assets acquired \$5,800

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**MAGIC SOFTWARE ENTERPRISES LTD.  
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U.S. dollars in thousands (except share and per share data)**

**NOTE 4:- MARKETABLE SECURITIES**

The Group invests in marketable debt and equity securities, which are classified as available-for-sale. The following is a summary of marketable securities:

|                                                       | December 31,<br>2013 |                      |                     |                 | 2014              |                      |                     |                 |
|-------------------------------------------------------|----------------------|----------------------|---------------------|-----------------|-------------------|----------------------|---------------------|-----------------|
|                                                       | Amortized<br>cost    | Unrealized<br>losses | Unrealized<br>gains | Market<br>value | Amortized<br>cost | Unrealized<br>losses | Unrealized<br>gains | Market<br>value |
| Available-for-sale:                                   |                      |                      |                     |                 |                   |                      |                     |                 |
| Governmental bonds                                    | \$407                | \$ -                 | \$ 3                | \$ 410          | \$11,916          | \$ (232 )            | \$ -                | \$11,684        |
| Commercial bonds                                      | 190                  | -                    | 25                  | 215             | -                 | -                    | -                   | -               |
| Equity funds                                          | 119                  | -                    | 110                 | 229             | 116               | -                    | 115                 | 231             |
| <u>Total</u> available-for-sale marketable securities | \$716                | \$ -                 | \$ 138              | \$ 854          | \$12,032          | \$ (232 )            | \$ 115              | \$11,915        |

Marketable securities with contractual maturities from one to three years are as follows:

|                                | Unrealized gains (losses) |       |           |              |
|--------------------------------|---------------------------|-------|-----------|--------------|
|                                | Amortized<br>cost         | Gains | Losses    | Market value |
| Due between one to three years | \$ 6,219                  | \$ -  | \$ (124 ) | \$ 6,095     |
|                                | \$ 6,219                  | \$ -  | \$ (124 ) | \$ 6,095     |

Marketable securities with contractual maturities from three to five years are as follows:

|                                 | Unrealized gains (losses) |       |           |              |
|---------------------------------|---------------------------|-------|-----------|--------------|
|                                 | Amortized<br>cost         | Gains | Losses    | Market value |
| Due between three to five years | \$ 5,697                  | \$ -  | \$ (108 ) | \$ 5,589     |

\$ 5,697      \$ -      \$ (108      ) \$ 5,589

The following is the change in the other comprehensive income of available-for-sale securities during 2013:

|                                                                                       | Other<br>comprehensive<br>income |
|---------------------------------------------------------------------------------------|----------------------------------|
| Other comprehensive income from available-for-sale securities as of January 1, 2013   | \$ 173                           |
| Unrealized loss from available-for-sale securities                                    | (35      )                       |
| Other comprehensive income from available-for-sale securities as of December 31, 2013 | \$ 138                           |

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**MAGIC SOFTWARE ENTERPRISES LTD.  
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U.S. dollars in thousands (except share and per share data)**

**NOTE 4:- MARKETABLE SECURITIES (Cont.)**

The following is the change in the other comprehensive income of available-for-sale securities during 2014:

|                                                                                       | Other<br>comprehensive<br>income |
|---------------------------------------------------------------------------------------|----------------------------------|
| Other comprehensive income from available-for-sale securities as of January 1, 2014   | \$ 138                           |
| Unrealized losses from available-for-sale securities                                  | (259 )                           |
| Other comprehensive income from available-for-sale securities as of December 31, 2014 | \$ (121 )                        |

**NOTE 5:- FAIR VALUE MEASUREMENTS**

In accordance with ASC 820, the Company measures its investment in marketable securities and foreign currency derivative contracts at fair value. Generally marketable securities are classified within Level 1, this is because these assets are valued using quoted prices in active markets. Foreign currency derivative contracts and certain corporate bonds are classified within Level 2 as the valuation inputs are based on quoted prices and market observable data of similar instruments.

Contingent consideration is classified within Level 3. The Company values the Level 3 contingent consideration using discounted cash flow of the expected future payments, whose inputs include interest rate.

The Company's financial assets measured at fair value on a recurring basis, excluding accrued interest components, consisted of the following types of instruments as of the following dates:

December 31, 2013  
Fair value measurements  
using input type

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|                              | Level<br>1 | Level<br>2 | Level<br>3 | Total   |
|------------------------------|------------|------------|------------|---------|
| Assets:                      |            |            |            |         |
| Government bonds             | \$410      | \$-        | \$-        | \$410   |
| Corporate bonds              | -          | 215        | -          | 215     |
| Equity fund                  | 229        | -          | -          | 229     |
| Total financial assets       | \$639      | \$215      | \$-        | \$854   |
| Liabilities:                 |            |            |            |         |
| Contingent consideration     | \$-        | \$-        | \$3,981    | \$3,981 |
| Total financials liabilities | \$-        | \$-        | \$3,981    | \$3,981 |

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**MAGIC SOFTWARE ENTERPRISES LTD.  
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U.S. dollars in thousands (except share and per share data)**

**NOTE 5:- FAIR VALUE MEASUREMENTS (Cont.)**

| December 31, 2014                        |         |          |         |          |
|------------------------------------------|---------|----------|---------|----------|
| Fair value measurements using input type |         |          |         |          |
|                                          | Level 1 | Level 2  | Level 3 | Total    |
| Assets:                                  |         |          |         |          |
| Corporate bonds                          | \$-     | \$11,684 | \$-     | \$11,684 |
| Equity fund                              | 231     | -        | -       | 231      |
| Total financial assets                   | \$231   | \$11,684 | \$-     | \$11,915 |
| Liabilities:                             |         |          |         |          |
| Contingent consideration                 | \$-     | \$-      | \$382   | \$382    |
| Total financial liabilities              | \$-     | \$-      | \$382   | \$382    |

Fair value measurements using significant unobservable inputs (Level 3):

|                                                  | December 31, |          |
|--------------------------------------------------|--------------|----------|
|                                                  | 2013         | 2014     |
| Opening balance                                  | \$1,942      | \$3,981  |
| Increase in contingent consideration             | 2,459        | 250      |
| Payment in contingent consideration              | (750 )       | (3,053 ) |
| Change in fair value of contingent consideration | -            | (948 )   |
| Amortization of interest                         | 330          | 152      |
| Closing balance                                  | \$3,981      | \$382    |

**NOTE 6:- OTHER ACCOUNTS RECEIVABLE AND PREPAID EXPENSES**

December 31,

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|                          | 2013    | 2014    |
|--------------------------|---------|---------|
| Prepaid expenses         | \$1,156 | \$1,159 |
| Government authorities   | 862     | 1,081   |
| Deferred tax assets, net | 1,949   | 554     |
| Restricted deposits      | 289     | 149     |
| Related parties          | 92      | 447     |
| Other                    | 861     | 583     |
|                          | \$5,209 | \$3,973 |

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**MAGIC SOFTWARE ENTERPRISES LTD.  
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U.S. dollars in thousands (except share and per share data)**

**NOTE 7:- PROPERTY AND EQUIPMENT**

|                                    | December 31, |          |
|------------------------------------|--------------|----------|
|                                    | 2013         | 2014     |
| Cost:                              |              |          |
| Leasehold improvements             | \$ 546       | \$ 523   |
| Computers and peripheral equipment | 10,106       | 12,942   |
| Office furniture and equipment     | 2,639        | 2,620    |
| Motor vehicles                     | 98           | 177      |
| Software                           | 1,962        | 3,478    |
|                                    | 15,351       | 19,740   |
| Accumulated depreciation:          |              |          |
| Leasehold improvements             | 288          | 175      |
| Computers and peripheral equipment | 9,657        | 12,426   |
| Office furniture and equipment     | 1,947        | 1,985    |
| Motor vehicles                     | 68           | 133      |
| Software                           | 1,618        | 3,016    |
|                                    | 13,578       | 17,735   |
| Depreciated cost                   | \$ 1,773     | \$ 2,005 |

Depreciation expenses amounted to \$ 757, \$ 656 and \$ 675 for the years ended December 31, 2012, 2013 and 2014, respectively.

**NOTE 8:- INTANGIBLE ASSETS**

a. Intangible assets:

|                   | December 31, |      |
|-------------------|--------------|------|
|                   | 2013         | 2014 |
| Original amounts: |              |      |

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|                                   |          |          |
|-----------------------------------|----------|----------|
| Capitalized software costs        | \$59,069 | \$63,260 |
| Customer relationships            | 23,843   | 26,618   |
| Backlog and non-compete agreement | 1,554    | 1,623    |
| Acquired technology               | 3,112    | 4,862    |

87,578 96,363

Accumulated amortization:

|                                   |        |        |
|-----------------------------------|--------|--------|
| Capitalized software costs        | 45,075 | 49,072 |
| Customer relationships            | 8,895  | 12,817 |
| Backlog and non-compete agreement | 630    | 1,142  |
| Acquired technology               | 429    | 789    |

55,029 63,820

|                        |          |          |
|------------------------|----------|----------|
| Intangible assets, net | \$32,549 | \$32,543 |
|------------------------|----------|----------|

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**MAGIC SOFTWARE ENTERPRISES LTD.  
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U.S. dollars in thousands (except share and per share data)**

**NOTE 8:- INTANGIBLE ASSETS (Cont.)**

b. Amortization expenses amounted to \$ 6,687, \$ 7,724 and \$ 7,919 for the years ended December 31, 2012, 2013 and 2014, respectively.

c. The estimated future amortization expense of intangible assets as of December 31, 2014 is as follows:

|                     |          |
|---------------------|----------|
| 2015                | 8,230    |
| 2016                | 7,140    |
| 2017                | 5,764    |
| 2018                | 4,383    |
| 2019                | 3,043    |
| 2020 and thereafter | 3,983    |
|                     | \$32,543 |

**NOTE 9:- GOODWILL**

Changes in the carrying amount of goodwill for the years ended December 31, 2013 and 2014 according to the Company's reporting units are as follows (see also 16):

|                                          | IT<br>professional<br>services | Software<br>services | Total    |
|------------------------------------------|--------------------------------|----------------------|----------|
| As of January 1, 2013                    | \$ 18,036                      | \$26,627             | \$44,663 |
| Business combination                     | 9,007                          | 1,036                | 10,043   |
| Classifications                          | 430                            | -                    | 430      |
| Foreign currency translation adjustments | 1,022                          | (845 )               | 177      |
| As of December 31, 2013                  | 28,495                         | 26,818               | 55,313   |
| Business combination                     | -                              | 3,664                | 3,664    |
| Classifications                          | -                              | (496 )               | (735 )   |

|                                          |          |          |          |
|------------------------------------------|----------|----------|----------|
| Foreign currency translation adjustments | (1,906 ) | (1,085 ) | (2,752 ) |
|------------------------------------------|----------|----------|----------|

|                         |        |        |        |
|-------------------------|--------|--------|--------|
| As of December 31, 2014 | 26,589 | 28,901 | 55,490 |
|-------------------------|--------|--------|--------|

The Company performed an annual impairment tests as of December 31, of each of 2012, 2013 and 2014 and did not identify any impairment losses (see Note 2).

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**MAGIC SOFTWARE ENTERPRISES LTD.  
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**NOTE 10:- ACCRUED EXPENSES AND OTHER ACCOUNTS PAYABLE**

|                                                          | December 31, |          |
|----------------------------------------------------------|--------------|----------|
|                                                          | 2013         | 2014     |
| Employees and payroll accruals                           | \$6,675      | \$7,243  |
| Accrued expenses                                         | 2,925        | 5,191    |
| Deferred and contingent payments related to acquisitions | 4,167        | 170      |
| Government authorities                                   | 2,495        | 1,395    |
| Other                                                    | 675          | 1,014    |
|                                                          | \$16,937     | \$15,013 |

**NOTE 11:- LONG TERM DEBT**

|                                                              | Interest rate as<br>of December 31,<br>2014 | December 31, |       |
|--------------------------------------------------------------|---------------------------------------------|--------------|-------|
|                                                              |                                             | 2013         | 2014  |
|                                                              | %                                           |              |       |
| Loans from banks in USD <sup>(1)</sup>                       | 3.7%                                        | \$2,904      | \$-   |
| Loan from banks and other in NIS                             | 4.1%-5.9%                                   | 405          | 481   |
| Other long term debt                                         |                                             | 20           | 8     |
| Less – Current maturities (included under “short-term debt”) |                                             | (1,055)      | -     |
|                                                              |                                             | \$2,274      | \$490 |

(1) Loan from a US bank, received on November 2013 in the amount of \$3,000, paid monthly in equal payment, for a period of 36 months bearing interest of Libor+3.5%. The loan agreement contains various covenants which require us to maintain certain financial ratios. The Company has met the financial ratios as of December 31, 2013. During 2014 the company repaid the loan.

(2) On November 2013, the Company entered into a credit line agreement with a U.S. bank, under which the bank provides the Company with a credit line of \$3 million for a period of three years. As of December 31, 2014, the Company had drawn down an amount of approximately \$2.8 million from the credit line, which is subject to

interest equal to the Prime Rate in effect from time to time, plus 3% per annum; provided that the interest rate in effect on any day shall not be less than 6.0% per annum. In relation to this credit line, the Company is obliged by the bank to comply with certain financial covenants, as defined in the agreement. As of December 31, 2014, the Company was in full compliance with the financial covenants. During January 2015 the company fully repaid the credit line.

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**MAGIC SOFTWARE ENTERPRISES LTD.  
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**NOTE 12:- TAXES ON INCOME**

a. Israeli taxation:

1. Corporate tax rate in Israel:

Taxable income of Israeli companies is subject to tax at the rate of 25% in 2012, 25% in 2013 and 26.5% in 2014.

2. Tax benefits under the Israeli Law for the Encouragement of Capital Investments, 1959 ("the Law"):

Certain production and development facilities of the Company have been granted "Approved Enterprise" status pursuant to the Law, which provides certain tax benefits to its investment programs including tax exemptions and reduced tax rates. Income not eligible for Approved Enterprise benefits is taxed at regular rates.

In the event of distribution of dividends from the said tax-exempt income, the amount distributed will be subject to corporate tax at the rate ordinarily applicable to the Approved Enterprise's income.

The entitlement to the above benefits is conditional upon the fulfilling of the conditions stipulated by the Laws and regulations. Should they fail to meet such requirements in the future, income attributable to its Approved Enterprise programs could be subject to the statutory Israeli corporate tax rate and they could be required to refund a portion of the tax benefits already received, with respect to such programs. As of December 31, 2014, management believes that the Company's Israeli subsidiaries are in compliance with all the conditions required by the Law.

Effective January 1, 2011, the Knesset enacted the Law for Economic Policy for 2011 and 2012 (Amended Legislation), and among other things, amended the Law, ("the Amendment"). According to the Amendment, the benefit tracks in the Investment Law were modified and a flat tax rate applies to the Company's entire preferred income. The Company will be able to opt to apply (the waiver is non-recourse) the Amendment and from then on it will be subject to the amended tax rates as follows: 2014 - 16%. As of December 31, 2014, the Company has not applied for this amendment. The profits of these "Industrial Companies" will be freely distributable as dividends, subject to a withholding tax of 20% (on distribution commencing January 1, 2014) or lower, under an applicable tax treaty.

The Company and certain of its Israeli subsidiaries intend to apply the new incentives regime under the Amendment to their industrial activity in Israel starting in 2014 and believes it will qualify as an “Beneficiary Company” under the Amendment.

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**NOTE 12:- TAXES ON INCOME (Cont.)**

3. The Company's Israeli entities have received final tax assessments for their Israeli tax return filings through the year 2010.

4. Tax benefits under the Law for the Encouragement of Industry (Taxes), 1969:

The Company qualifies as an Industrial Company within the meaning of the Law for the Encouragement of Industry (Taxes), 1969 (the "Industrial Encouragement Law"). The Industrial Encouragement Law defines an "Industrial Company" as a company that is resident in Israel and that derives at least 90% of its income in any tax year, other than income from defense loans, capital gains, interest and dividends, from an enterprise whose major activity in a given tax year is industrial production. Under the Industrial Encouragement Law, the Company is entitled to amortization of the cost of purchased know-how and patents over an eight-year period for tax purposes as well as accelerated depreciation rates on equipment and buildings.

Eligibility for the benefits under the Industrial Encouragement Law is not subject to receipt of prior approval from any governmental authority.

b. Non-Israeli subsidiaries:

Non-Israeli subsidiaries are taxed according to the tax laws in their respective domiciles of residence. If earnings are distributed to Israel in the form of dividends or otherwise, the Company may be subject to additional Israeli income taxes (subject to an adjustment for foreign tax credits) and foreign withholding taxes.

The amount of the Company cash and cash equivalents that are currently held outside of Israel that would be subject to income taxes if distributed as dividends is \$21.2 million. However, a determination of the amount of the unrecognized deferred tax liability for temporary difference related to those undistributed earnings of foreign subsidiaries is not practicable due to the complexity of the structure of our group of subsidiaries for tax purposes and the difficulty of projecting the amount of future tax liability

c. Net operating loss carryforwards:

As of December 31, 2014, the Company and its Israeli subsidiaries had operating loss carryforwards of \$ 15,929, which can be carried forward and offset against taxable income in the future for an indefinite period.

The Company's subsidiaries in Europe had estimated total available tax loss carryforwards of \$ 4,999 as of December 31, 2014, to offset against future taxable income.

The Company's subsidiaries in the U.S. had estimated total available tax loss carryforwards of \$ 427 as of December 31, 2014, which can be carried forward and offset against taxable income for a period of up to 20 years, from the year the loss was incurred.

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**NOTE 12:- TAXES ON INCOME (Cont.)**

Utilization of U.S. net operating losses may be subject to substantial annual limitations due to the "change in ownership" provisions ("annual limitations") of the Internal Revenue Code of 1986 and similar state provisions. The annual limitation may result in the expiration of net operating losses before utilization.

d. Income before taxes on income:

|          | Year ended December 31, |          |          |
|----------|-------------------------|----------|----------|
|          | 2012                    | 2013     | 2014     |
| Domestic | \$10,462                | \$16,165 | \$14,690 |
| Foreign  | 6,092                   | 2,266    | 4,183    |
|          | \$16,554                | \$18,431 | \$18,873 |

e. Taxes on income:

Taxes on income (tax benefit) consist of the following:

|                 | Year ended December 31, |           |         |
|-----------------|-------------------------|-----------|---------|
|                 | 2012                    | 2013      | 2014    |
| Current:        |                         |           |         |
| Domestic        | \$(1,291)               | \$(1,277) | \$241   |
| Foreign         | 302                     | 781       | 689     |
|                 | (989 )                  | (496 )    | 930     |
| Deferred taxes: |                         |           |         |
| Domestic        | 414                     | 2,673     | 2,575   |
| Foreign         | 669                     | (602 )    | (1,198) |
|                 | 1,083                   | 2,071     | 1,377   |

|                               |      |         |         |
|-------------------------------|------|---------|---------|
| Taxes on income (tax benefit) | \$94 | \$1,575 | \$2,307 |
|-------------------------------|------|---------|---------|

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**NOTE 12:- TAXES ON INCOME (Cont.)**

f. Deferred tax assets and liabilities:

Deferred taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company and its subsidiaries deferred tax assets are as follows:

|                                                | December 31, |         |
|------------------------------------------------|--------------|---------|
|                                                | 2013         | 2014    |
| Net operating loss carryforwards               | \$5,293      | \$4,627 |
| Allowances, reserves and intangible assets     | 1,207        | 1,080   |
| Deferred tax assets before valuation allowance | 6,500        | 5,707   |
| Less - valuation allowance                     | (1,154)      | (3,570) |
| Deferred tax assets                            | 5,346        | 2,137   |
| Capitalized software costs                     | (1,723)      | -       |
| Deferred tax assets, net                       | \$3,623      | \$2,137 |

|                        | December 31, |         |
|------------------------|--------------|---------|
|                        | 2013         | 2014    |
| Current tax assets     | \$1,949      | \$554   |
| Non-current tax assets | 1,674        | 1,583   |
| Deferred tax assets    | \$3,623      | \$2,137 |

Current taxes are included under other accounts receivable and prepaid expenses.

Significant components of the Company and its subsidiaries deferred tax liability are as follows:

|                              | December 31, |         |
|------------------------------|--------------|---------|
|                              | 2013         | 2014    |
| Current tax liabilities      | \$2,567      | \$760   |
| Non-current tax liabilities  | 2,204        | 4,086   |
| Net deferred tax liabilities | \$4,771      | \$4,846 |

Both current deferred tax liabilities and long term deferred tax liabilities are in respect of acquired intangible assets.

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**NOTE 12:- TAXES ON INCOME (Cont.)**

g. Reconciliation of the theoretical tax expense to the actual tax expense:

Reconciling items between the 2012, 2013 and 2014 statutory tax rate (25%, 25% and 26.5%, respectively) of the Company and the effective tax rate is presented in the following table:

|                                                                                      | Year ended December 31, |   |           |   |           |   |
|--------------------------------------------------------------------------------------|-------------------------|---|-----------|---|-----------|---|
|                                                                                      | 2012                    |   | 2013      |   | 2014      |   |
| Income before taxes, as reported in the consolidated statements of income            | \$ 16,554               |   | \$ 18,431 |   | \$ 18,873 |   |
| Statutory tax rate                                                                   | 25                      | % | 25        | % | 26.5      | % |
| Theoretical tax expenses on the above amount at the Israeli statutory tax rate       | \$ 4,139                |   | \$ 4,609  |   | \$ 5,001  |   |
| Tax adjustment in respect of different tax rates                                     | 444                     |   | 484       |   | 80        |   |
| Deferred taxes on losses for which full valuation allowance was provided in the past | 651                     |   | (304 )    |   | 236       |   |
| Changes in valuation allowance                                                       | (2,003 )                |   | -         |   | -         |   |
| Tax benefits in respect of prior years, net                                          | (1,126 )*               |   | 203       |   | (516 )    |   |
| Nondeductible expenses                                                               | 20                      |   | 95        |   | 82        |   |
| Uncertain tax position and other differences                                         | (2,031 )**)             |   | (3,512 )  |   | (2,576 )  |   |
| Income tax (tax benefit)                                                             | \$ 94                   |   | \$ 1,575  |   | \$ 2,307  |   |

\*) In 2012, the Company reversed its write-off of tax prepayment advances from prior years since the Company believes the utilization of the prepayments is more-likely-than not in the near future.

\*\*\*) This amount is mainly comprised of tax provisions reversal due to statute of limitation of prior years' tax assessments amounting to \$1,270.

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**NOTE 12:- TAXES ON INCOME (Cont.)**

The Company applies ASC 740, "Income Taxes" with regards to tax uncertainties. During the years ended h. December 31, 2012, 2013 and 2014, the Company recorded \$ 219, \$ 2,811 and \$ 156 of tax income, respectively, as a result of this application.

A reconciliation of the beginning and ending balances of the total amounts of gross unrecognized tax benefits is as follows:

|                                                      |         |
|------------------------------------------------------|---------|
| Gross unrecognized tax benefits at January 1, 2012   | \$3,528 |
| Increase in tax positions taken in prior years       | 270     |
| Decrease in tax positions taken in prior years       | (489 )  |
| Gross unrecognized tax benefits at December 31, 2012 | 3,309   |
| Increase in tax positions taken in prior years       | -       |
| Decrease in tax positions taken in prior years       | (2,811) |
| Gross unrecognized tax benefits at December 31, 2013 | 498     |
| Increase in tax positions taken in prior years       | -       |
| Decrease in tax positions taken in prior years       | (156 )  |
| Gross unrecognized tax benefits at December 31, 2014 | \$342   |

As of December 31, 2014, the entire amount of unrecognized tax benefit could affect the Company's income tax provision and the effective tax rate.

**NOTE 13:- EQUITY**

a. The ordinary shares of the Company are listed on the NASDAQ Global Select Market in the United States and are traded on the Tel-Aviv Stock Exchange in Israel.

b. Issuance of ordinary shares:

On December 23, 2010, the Company issued 3,287,616 ordinary shares at a price of \$ 6.5 per share and in a total amount of \$ 20,290 net of issuance expenses. The shares were issued to institutional investors in a private placement. In addition, certain of the purchasers received warrants to purchase up to an aggregate of 1,134,231 ordinary shares at an exercise price of \$ 8.26 per share. The warrants are exercisable as of six months from the date of issuance, have a term of three years, and the exercise price is subject to future adjustment for various events, such as stock splits or dividend distributions. Following the Company's dividend distribution and in respect to warrants issuance agreement. The warrants expired on June 2014.

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**NOTE 13:- EQUITY (Cont.)**

**c. Stock Option Plans:**

Under the Company's 2007 Stock Option Plan, as amended ("the Plan"), options may be granted to employees, officers, directors and consultants of the Company and its subsidiaries. Pursuant to the 2007 Stock Option Plan, the Company reserved for issuance 1,500,000 ordinary shares. In 2012, the Company increased the amount of ordinary shares reserved for issuance by additional 1,000,000 ordinary shares in connection with the 2007 Stock Option Plan (mentioned above). As of December 31, 2014, an aggregate of 1,001,563 ordinary shares of the Company are available for future grants under the Plan. Each option granted under the Plan is exercisable for a period of ten years from the date of the grant of the option. The 2007 Plan will expire on August 1, 2017.

The exercise price for each option is determined by the Board of Directors and set forth in the Company's award agreement. Unless determined otherwise by the Board of Directors, the option exercise price shall be equal to or higher than the share market price at the grant date. The options generally vest over 3-4 years. Any option that is forfeited or canceled before expiration becomes available for future grants under the Plans.

A summary of employee option activity under the Plans as of December 31, 2014 and changes during the year ended December 31, 2014 are as follows:

|                                  | Number<br>of options | Weighted<br>average<br>exercise<br>price | Weighted<br>average<br>remaining<br>contractual<br>term<br>(in years) | Aggregate<br>intrinsic<br>value |
|----------------------------------|----------------------|------------------------------------------|-----------------------------------------------------------------------|---------------------------------|
| Outstanding at January 1, 2014   | 703,110              | \$ 3.16                                  | 6.68                                                                  | \$ 2,298                        |
| Granted                          | 155,000              | \$ 7.47                                  |                                                                       |                                 |
| Exercised                        | (115,721 )           | \$ 1.86                                  |                                                                       |                                 |
| Forfeited                        | (3,500 )             | \$ 4.00                                  |                                                                       |                                 |
| Outstanding at December 31, 2014 | 738,889              | \$ 4.26                                  | 6.42                                                                  | \$ 1,248                        |

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|                                                  |         |         |      |          |
|--------------------------------------------------|---------|---------|------|----------|
| Exercisable at December 31, 2014                 | 448,639 | \$ 2.95 | 5.03 | \$ 1,348 |
| Vested and expected to vest at December 31, 2014 | 738,889 | \$ 4.26 | 6.42 | \$ 1,248 |

The weighted-average grant-date fair value of options granted during the years ended December 31, 2012, 2013 and 2014 was \$4, \$ 6 and \$ 3.76, respectively. The aggregate intrinsic value in the table above represents the total intrinsic value that would have been received by the option holders had all option holders exercised their options on December 31, 2014. This amount is changed based on the market value of the Company's ordinary shares. Total intrinsic value of options exercised during the years ended December 31, 2012, 2013 and 2014 was \$ 572, \$ 529 and \$ 741, respectively. As of December 31, 2014, there was \$ 646 of unrecognized compensation cost related to non-vested share-based compensation arrangements granted under the Plans. This cost is expected to be recognized over a period of approximately three years.

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**NOTE 13:- EQUITY (Cont.)**

The options outstanding as of December 31, 2014, have been separated into ranges of exercise price categories, as follows:

| Exercise price | Options<br>outstanding | Weighted<br>average<br>remaining<br>contractual life<br>(years) | Weighted<br>average<br>exercise price | Options<br>exercisable | Weighted<br>average<br>exercise price<br>of exercisable<br>options |
|----------------|------------------------|-----------------------------------------------------------------|---------------------------------------|------------------------|--------------------------------------------------------------------|
| In \$          |                        |                                                                 |                                       |                        |                                                                    |
| 0-1            | 4,000                  | 4.24                                                            | \$ -                                  | 4,000                  | \$ -                                                               |
| 1.01-2         | 69,200                 | 1.85                                                            | \$ 1.20                               | 69,200                 | \$ 1.20                                                            |
| 2.01-3         | 173,667                | 4.80                                                            | \$ 2.30                               | 173,667                | \$ 2.30                                                            |
| 3.01-4         | 252,022                | 6.12                                                            | \$ 3.96                               | 180,522                | \$ 3.95                                                            |
| 4.01-5         | -                      | -                                                               | \$ -                                  | -                      | \$ -                                                               |
| 5.01-6         | 85,000                 | 8.61                                                            | \$ 6.00                               | 21,250                 | \$ 6.00                                                            |
| 6.01-7         | 75,000                 | 9.87                                                            | \$ 6.89                               | -                      | \$ -                                                               |
| 7.01-8         | -                      | -                                                               | \$ -                                  | -                      | \$ -                                                               |
| 8.01-9         | 80,000                 | 9.36                                                            | \$ 8.01                               | -                      | \$ -                                                               |
|                | 738,889                | 6.42                                                            | \$ 4.26                               | 448,639                | \$ 2.95                                                            |

d. Accumulated other comprehensive income:

|                                                                                | December 31, |         |           |
|--------------------------------------------------------------------------------|--------------|---------|-----------|
|                                                                                | 2012         | 2013    | 2014      |
| Accumulated realized and unrealized gain on available-for-sale securities, net | \$ 173       | \$ 138  | \$(121 )  |
| Accumulated foreign currency translation adjustments                           | (776)        | (327)   | (5,243)   |
| Accumulated unrealized gain (loss) on derivative instruments, net              | 17           | 17      | 17        |
| Total other comprehensive income                                               | \$(586)      | \$(172) | \$(5,347) |

e.

On September 4, 2012, the Company's Board of Directors adopted a dividend distribution policy, subject to any applicable law. According to this policy, each year the Company will distribute a dividend of up to 50% of its annual distributable profits. It is possible that the Board of Directors will decide, subject to the conditions stated above, to declare additional dividend distributions. The Company's Board of Directors may at its discretion and at any time, change, whether as a result of a one-time decision or a change in policy, the rate of dividend distributions and/or not to distribute a dividend, all at its discretion.

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**NOTE 13:- EQUITY (Cont.)**

In respect to the policy mentioned above, on September 10, 2012 and on February 14, 2013, the Company declared a dividend distribution of \$ 0.10 per share (\$ 3,661 in the aggregate) and \$ 0.12 per share (\$ 4,397 in the aggregate) which were paid on October 17, 2012 and on March 14, 2013, respectively. On August 12, 2013 the Company declared a dividend distribution of \$ 0.09 per share (\$ 3,390 in the aggregate) which was paid on September 3, 2013. On February 18, 2014, the Company declared a dividend distribution of \$ 0.12 per share (\$ 4,468 in the aggregate) which was paid on March 14, 2014. On August 19, 2014 the Company declared a dividend distribution of \$ 0.095 per share (\$ 4,195 in the aggregate) which was paid on September 4, 2014. On February 4, 2015, the Company declared a dividend distribution of \$ 0.081 per share (see also note 18).

On November 2014, a Company's subsidiary granted one of its executive options exercisable for 1,167 ordinary shares in its subsidiary. The options are vested in equal quarterly installments, over a four year period that commences in January 1, 2013 and concludes in March 31, 2016, if meeting a certain operational margin during 2013, 2014 and 2015. The exercise price of the options is NIS 1 per share. Total fair value of the grant was calculated based on the Company subsidiary's fair value on the grant date and totaled NIS 5,910 thousand (NIS 5 thousand per share).

**NOTE 14:- SELECTED STATEMENTS OF INCOME DATA**

**a. Research and development costs, net:**

|                                   | Year ended December 31, |         |         |
|-----------------------------------|-------------------------|---------|---------|
|                                   | 2012                    | 2013    | 2014    |
| Total costs                       | \$7,916                 | \$8,419 | \$9,017 |
| Less - capitalized software costs | (4,969)                 | (4,713) | (4,267) |
| Research and development, net     | \$2,947                 | \$3,706 | \$4,750 |

**b. Financial income (expenses), net:**

|                                                                          |      |         |           |
|--------------------------------------------------------------------------|------|---------|-----------|
| Interest income net of bank charges                                      | \$20 | \$(170) | \$(156 )  |
| Interest expenses related to liabilities in connection with acquisitions | (48) | (407)   | (152 )    |
| Interest income from debt instruments                                    | 49   | 46      | 91        |
| Loss arising from foreign currency translation and other                 | (11) | (153)   | (1,569)   |
| Financial income(expenses), net                                          | \$10 | \$(684) | \$(1,786) |

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**NOTE 15:- COMMITMENTS AND CONTINGENCIES**

**a. Lease commitments:**

Certain of the motor vehicles, facilities and equipment of the Company and its subsidiaries are rented under long-term operating lease agreements. Future minimum lease commitments under non-cancelable operating leases as of December 31, 2014, are as follows:

|                     |          |
|---------------------|----------|
| 2015                | \$ 1,798 |
| 2016                | 773      |
| 2017                | 578      |
| 2018 and thereafter | 583      |
|                     | \$3,732  |

Rent expenses for the years ended December 31, 2012, 2013 and 2014 were approximately \$ 1,701, \$ 1,911 and \$ 1,736, respectively.

The Company leases motor vehicles under a cancelable lease agreement. The Company has an option to be released from this lease agreement, which may result in penalties in a maximum amount of \$ 147.

The Company currently occupies approximately 59,546 square feet of space based on a lease agreement expiring in December, 2014. The Company has an option to terminate the lease agreement in Israel and India upon six months prior written notice.

The aggregated amount of lease commitment for the next 6 months in Israel and India mentioned above is approximately \$ 259.

b.

Guarantees and Collaterals:

The Company and certain of its subsidiaries have provided three of their clients with performance bank guarantees totaling \$ 295, which are linked to the New Israeli Shekels, all of which will be terminated during 2015 and 2016.

Several of the Company's subsidiaries have pledged their accounts receivables to a financial institution, with respect to a US dollar loan received in 2013 (see also note 11).

c.

From time to time, the Company and/or its subsidiaries are subject to legal, administrative and regulatory proceedings, claims, demands and investigations in the ordinary course of business, including claims with respect to intellectual property, contracts, employment and other matters. The Company accrues a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. Significant judgment is required in both the determination of probability and the determination as to whether a loss is reasonably estimable. These accruals are reviewed and adjusted to reflect the impact of negotiations, settlements, rulings, advice of legal counsel and other information and events pertaining to a particular matter.

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**NOTE 15:- COMMITMENTS AND CONTINGENCIES (Cont.)**

Lawsuits have been brought against the Company in the ordinary course of business. The Company intends to defend itself vigorously against those lawsuits.

In August 2009, a software company and one of its owners filed an arbitration proceeding against the company and one of its subsidiaries, claiming an alleged breach of a non-disclosure agreement between the parties. The plaintiffs sought damages in the amount of approximately NIS 52 million (approximately \$15 million). The arbitrator  
1. determined that both the company and its subsidiary breached the non-disclosure agreement. In January 2015 the arbitrator rendered his ruling and determined that the company should pay damages to the plaintiffs. The company financial results of operations include a net impact of \$1.6 million resulting from the arbitration. The company is considering its options following this ruling.

In addition to the above mentioned legal proceedings, the Company is also involved in various legal proceedings arising in the normal course of its business. Based upon the advice of counsel, the Company does not believe that  
2. the ultimate resolution of these matters will have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows.

**NOTE 16:- NET EARNINGS PER SHARE**

The following table sets forth the computation of basic and diluted net earnings per share:

|                                                                                                 | Year ended December 31, |            |            |
|-------------------------------------------------------------------------------------------------|-------------------------|------------|------------|
|                                                                                                 | 2012                    | 2013       | 2014       |
| Numerator for basic and diluted earnings per share - net income available to Magic shareholders | \$ 16,183               | \$ 15,880  | \$ 15,403  |
| Weighted average ordinary shares outstanding:                                                   |                         |            |            |
| Denominator for basic net earnings per share                                                    | 36,502,264              | 36,835,163 | 43,287,523 |

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|                                                |            |            |            |
|------------------------------------------------|------------|------------|------------|
| Effect of dilutive securities                  | 605,406    | 458,753    | 17,291     |
| Denominator for diluted net earnings per share | 37,107,670 | 37,293,916 | 43,304,814 |
| Basic and diluted earnings per share           | \$0.44     | \$0.43     | \$0.36     |

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**NOTE 17:- SEGMENT GEOGRAPHICAL INFORMATION AND MAJOR CUSTOMERS**

a. The Company reports its results on the basis of two reportable business segments: software services (which include proprietary and none proprietary software technology) and IT professional services.

The Company evaluates segment performance based on revenues and operating income of each segment. The accounting policies of the operating segments are the same as those described in the summary of significant accounting policies. This data is presented in accordance with ASC 280, "Segment Reporting."

Headquarters' general and administrative costs have not been allocated between the different segments.

**Software services**

The Company develops markets, sells and supports a proprietary and none proprietary application platform, software applications, business and process integration solutions and related services.

**IT professional services**

The Company offers advanced and flexible IT services in the areas of infrastructure design and delivery, application development, technology planning and implementation services, communications services and solutions, as well as supplemental staffing services.

There are no significant transactions between the two segments.

b. The following is information about reported segment results of operation:

|                                 | Software<br>services | IT<br>professional<br>services | Unallocated<br>expense | Total       |
|---------------------------------|----------------------|--------------------------------|------------------------|-------------|
| 2012                            |                      |                                |                        |             |
| Total revenues                  | \$ 65,410            | \$ 60,970                      | \$ -                   | \$ 126,380  |
| Expenses                        | 50,497               | 55,456                         | 4,019                  | 109,972     |
| Segment operating income (loss) | \$ 14,913            | \$ 5,514                       | \$ (4,019)             | ) \$ 16,408 |
| Depreciation and amortization   | \$ 5,937             | \$ 1,182                       | \$ 344                 | \$ 7,463    |

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NOTE 17:- SEGMENT GEOGRAPHICAL INFORMATION AND MAJOR CUSTOMERS (Cont.)

|                                 | Software<br>services | IT<br>professional<br>services | Unallocated<br>expense | Total     |
|---------------------------------|----------------------|--------------------------------|------------------------|-----------|
| 2013                            |                      |                                |                        |           |
| Total revenues                  | \$67,453             | \$ 77,505                      | \$ -                   | \$144,958 |
| Expenses                        | 53,164               | 68,846                         | 3,821                  | 125,831   |
| Segment operating income (loss) | \$ 14,289            | \$ 8,659                       | \$ (3,821 )            | \$ 19,127 |
| Depreciation and amortization   | \$ 5,917             | \$ 2,210                       | \$ 253                 | \$8,380   |
| 2014                            |                      |                                |                        |           |
| Total revenues                  | \$69,861             | \$ 94,443                      | \$ -                   | \$164,304 |
| Expenses                        | 54,464               | 84,873                         | 4,241                  | 143,578   |
| Segment operating income (loss) | \$ 15,397            | \$ 9,570                       | \$ (4,241 )            | \$ 20,726 |
| Depreciation and amortization   | \$ 6,065             | \$ 2,263                       | \$ 266                 | \$8,594   |

The Company's business is divided into the following geographic areas: Israel, Europe, the United States, Japan and other regions. Total revenues are attributed to geographic areas based on the location of the customers.

The following table presents total revenues classified according to geographical destination for the years ended December 31, 2012, 2013 and 2014:

|               | Year ended December 31, |          |          |
|---------------|-------------------------|----------|----------|
|               | 2012                    | 2013     | 2014     |
| Israel        | \$11,561                | \$24,006 | \$29,198 |
| Europe        | 29,139                  | 31,386   | 37,409   |
| United States | 64,591                  | 70,872   | 78,606   |
| Japan         | 12,661                  | 11,965   | 11,299   |

|       |            |            |            |
|-------|------------|------------|------------|
| Other | 8,428      | 6,729      | 3,927      |
|       | \$ 126,380 | \$ 144,958 | \$ 164,304 |

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**MAGIC SOFTWARE ENTERPRISES LTD.  
AND ITS SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
U.S. dollars in thousands (except share and per share data)**

NOTE 17:- SEGMENT GEOGRAPHICAL INFORMATION AND MAJOR CUSTOMERS (Cont.)

d. The Company's long-lived assets are located as follows:

|               | December 31, |          |
|---------------|--------------|----------|
|               | 2013         | 2014     |
| Israel        | \$54,656     | \$58,263 |
| Europe        | 3,117        | 1,523    |
| United States | 23,287       | 22,174   |
| Japan         | 5,180        | 4,786    |
| Other         | 3,395        | 3,291    |
|               | \$89,634     | \$90,039 |

e. The Company does not allocate its assets to its reportable segments; accordingly, asset information by reportable segments is not presented.

f. In 2012, 2013 and 2014, the Company had one customer, included in the IT professional services segment, which accounted for 19%, 13% and 10% of the group revenues, respectively.

NOTE 18:- SUBSEQUENT EVENTS

a. On February 25, 2015 the Company entered into a definitive agreement to acquire a 70% stake, with an option to increase the holding to 100%, in an Israeli-based company specializes in software professional services for mainframes and complex large-scale environments. The acquisition is subject to the fulfillment of certain conditions defined in the acquisition agreement.

b. On February 4, 2015, the Company declared a dividend distribution of \$ 0.081 per share (\$ 3,582 in the aggregate) which will be paid on March 11, 2015. The dividend distribution relates to the Company's earnings in the second half of 2014.



**MAGIC SOFTWARE ENTERPRISES LTD.  
AND ITS SUBSIDIARIES  
APPENDIX TO CONSOLIDATED FINANCIAL STATEMENTS**

**DETAILS OF SUBSIDIARIES AND AFFILIATE**

Details of the percentage of control of the share capital and voting rights of subsidiaries and an affiliate as of December 31, 2014:

| Name of Company                                                           | Percentage of ownership<br>and control<br>% | Place of incorporation |
|---------------------------------------------------------------------------|---------------------------------------------|------------------------|
| Magic Software Japan K.K.                                                 | 100                                         | Japan                  |
| Magic Software Enterprises Inc.                                           | 100                                         | U.S.A.                 |
| Magic Software Enterprises (UK) Ltd.                                      | 100                                         | U.K.                   |
| Hermes Logistics Technologies Limited.                                    | 100                                         | U.K.                   |
| Magic Software Enterprises Spain Ltd.                                     | 100                                         | Spain                  |
| Coretech Consulting Group Inc.                                            | 100                                         | U.S.A                  |
| Coretech Consulting Group LLC.                                            | 100                                         | U.S.A                  |
| Fusion Solutions LLC.                                                     | 100                                         | U.S.A                  |
| Xsell Resources Inc.                                                      | 100                                         | U.S.A                  |
| Magic Software Enterprises (Israel) Ltd.                                  | 100                                         | Israel                 |
| Magic Software Enterprises Netherlands B.V.                               | 100                                         | Netherlands            |
| Magic Software Enterprises France                                         | 100                                         | France                 |
| Magic Beheer B.V.                                                         | 100                                         | Netherlands            |
| Magic Benelux B.V.                                                        | 100                                         | Netherlands            |
| Magic Software Enterprises GMBH                                           | 100                                         | Germany                |
| Magic Software Enterprises India Pvt. Ltd.                                | 100                                         | India                  |
| Onyx Magyarorszag Szsoftverhaz .                                          | 100                                         | Hungary                |
| Magix Integration (Proprietary) Ltd                                       | 100                                         | South Africa           |
| Appbuilder Solutions Ltd                                                  | 100                                         | U.K.                   |
| Complete Business Solutions Ltd                                           | 96.3                                        | Israel                 |
| Comm-IT Technology Solutions Ltd                                          | 80                                          | Israel                 |
| Comm-IT Software Ltd                                                      | 100                                         | Israel                 |
| Comm-IT Embedded Ltd (shares held by<br>Comm-IT Technology Solutions Ltd. | 50.1                                        | Israel                 |
| Pilat (North America), Inc                                                | 100                                         | U.S.A                  |
| Pilat Europe Ltd                                                          | 100                                         | U.K.                   |
| Valinor Ltd                                                               | 100                                         | Israel                 |
| Dario Solutions IT Ltd                                                    | 100                                         | Israel                 |
| BridgeQuest Labs, Inc                                                     | 100                                         | U.S.A                  |
| BridgeQuest, Inc                                                          | 100                                         | U.S.A                  |

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|                                   |     |          |
|-----------------------------------|-----|----------|
| Allstates Consulting Services LLC | 100 | U.S.A    |
| Formula Telecom Solutions, Ltd    | 100 | Israel   |
| FTS Bulgaria (FTS Global Ltd.)    | 100 | Bulgaria |
| DataMind Technologies Ltd         | 80  | Israel   |

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*37 Broadhurst Gardens, London NW6 3QT Tel: 020 - 7624 2251 Fax: 020 - 7372 2328  
E - mail: lc@levy-cohen.co.uk*

**To the Board of Directors and Shareholders of**

**Magic Software Enterprises (UK) Limited**

We have audited the accompanying balance sheet of Magic Software Enterprises (UK) Limited (the “Company”) as of December 31, 2014 and 2013, and the related profit and loss account and changes in shareholders’ equity for each of the three years in the period ended December 31, 2014. 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 audit.

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. We were not engaged to perform an audit of the Company’s internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company’s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits and the reports of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits, the financial statements referred to above present fairly, in all material respects, the financial position of the Company at December 31, 2013 and 2012, and the related profit and loss account and changes in shareholders’ equity for each of the three years in the period ended December 31, 2014, in conformity with U.S. generally accepted accounting principles.

Yours sincerely,

LEVY COHEN & CO.

Registered Auditors and Certified  
Public Accountants

January 29, 2015

J. Cohen  
C.P.A. (ISR)

R. Shahmoon  
ACA

Registered to carry out audit work in the UK by The Institute of Chartered Accountants in England and Wales. Details about our audit registration can be viewed at [www.auditregister.org.uk](http://www.auditregister.org.uk) under reference no. C008178288.

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*37 Broadhurst Gardens, London NW6 3QT Tel: 020 - 7624 2251 Fax: 020 - 7372 2328  
E - mail: lc@levy-cohen.co.uk*

**To the Board of Directors and Shareholders of**

**Hermes Logistics Technologies Limited**

We have audited the accompanying balance sheet of Hermes Logistics Technologies Limited (the “Company”) as of December 31, 2014 and 2013, and the related profit and loss account and changes in shareholders’ equity for each of the three years in the period ended December 31, 2014. 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 audit.

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. We were not engaged to perform an audit of the Company’s internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company’s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits and the reports of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits, the financial statements referred to above present fairly, in all material respects, the financial position of the Company at December 31, 2014 and 2013, and the related profit and loss account and changes in shareholders’ equity for each of the three years in the period ended December 31, 2014, in conformity with U.S. generally accepted accounting principles.

Yours sincerely,

LEVY COHEN & CO.

Registered Auditors and Certified  
Public Accountants

March 13, 2015

J. Cohen  
C.P.A. (ISR)

R. Shahmoon  
ACA

Registered to carry out audit work in the UK by The Institute of Chartered Accountants in England and Wales. Details about our audit registration can be viewed at [www.auditregister.org.uk](http://www.auditregister.org.uk) under reference no. C008178288.

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

**To the Board of Directors and Shareholders of**

**Magic Software Japan K. K.**

We have audited the accompanying balance sheets of Magic Software Japan K.K. (the "Company") as of December 31, 2013 and 2014, and the related statements of operations and cash flows for each of the three years in the period ended December 31, 2014. 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. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2013 and 2014, and the related statements of operations and cash flows for each of the three years in the period ended December 31, 2014 in conformity with accounting principles generally accepted **in** the United States of America.

Tokyo, Japan  
January 28, 2015

KDA Audit Corporation

## SIGNATURES

The registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and that it has duly caused and authorized the undersigned to sign this annual report on its behalf.

Magic Software Enterprises LTD.

By: /s/ Guy Bernstein  
Name: Guy Bernstein  
Title: Chief Executive Officer

Dated: April 21, 2015