

MAGIC SOFTWARE ENTERPRISES LTD  
Form 20-F  
April 05, 2006

**SECURITIES AND EXCHANGE COMMISSION**

**Washington D.C. 20549**

**FORM 20-F**

**REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934**

**OR**

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

**For the fiscal year ended December 31, 2005**

**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 60218, Israel**

(Address of principal executive offices)

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

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

**Ordinary Shares, NIS 0.1 Par Value**

(Title of Class)

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**

**as of December 31, 2005**

31,070,499

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

Yes \_\_\_ No X

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 X

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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 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 Statements on Form S-8, Registration Nos. 333-13270, 333-11220, 333-1946, 333-10794, 333-113552 and 333-132221.

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## INTRODUCTION

Magic Software Enterprises Ltd. develops, markets and supports composite application development and deployment platforms with a service-oriented architecture, or SOA, including application integration and business process management, or BPM, with existing and legacy systems. Our products and services are available through a global network of subsidiaries, distributors and software solution providers in approximately 50 countries. As used in this annual report, the terms we, us, our, and Magic refer to Magic Software Enterprises Ltd. and its subsidiaries, unless otherwise indicated.

Over the last twenty years we have developed a fundamentally new application development and deployment

technology, which is a metadata driven, rule based platform and development framework. During that period, a broad community of independent software vendors, or ISVs, and customers worldwide, have been using our rapid application development and deployment technology and products. In 2002, we recognized that the software application market was changing. Organizations had built up a wide array of systems that needed to communicate with each other more efficiently in order to streamline business processes, improve productivity and ultimately reduce costs and increase business revenues. The demand for technology enablement was no longer coming exclusively from the information technology, or IT, department, but from businesses charged with improving operations. In order to address the needs of both developers and business users, we added to our eDeveloper two additional layers, orchestration and graphical process design, as well as an activity monitoring service, and created iBOLT, a single, unified and highly scalable development and business integration suite. iBOLT allows our customers to implement application integration layers, create service oriented architectures and manage end-to-end processes.

We have obtained trademark registrations in Africa, Austria, Australia, Bulgaria, Canada, Chile, China, Czech Republic, France, Germany, Hungary, Israel, Italy, Luxembourg, the Netherlands, Poland, Portugal, Romania, Slovakia, South Spain, Switzerland, Thailand, the United Kingdom and the United States. All other trademarks and trade names appearing in this annual report are owned by their respective holders.

Our consolidated financial statements appearing in this annual report are prepared in U.S. dollars and in accordance with U.S. 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. The representative exchange rate between the NIS and the dollar as published by the Bank of Israel on April 5, 2006 was NIS 4.67 per \$1.00.

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, 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, 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, anticipate, 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. You should read the selected consolidated financial data set forth below together with Item 5. Operating and Financial Review and Prospects as well as our consolidated financial statements and notes thereto appearing elsewhere in this annual report.

We have derived the following income statement data for the years ended December 31, 2003, 2004 and 2005 and the consolidated balance sheet data as of December 31, 2004 and 2005 from our audited consolidated financial statements and notes included elsewhere in this annual report. We have derived the consolidated income statement data for the years ended December 31, 2001 and 2002 and the consolidated balance sheet data as of December 31, 2001, 2002 and 2003 from our audited consolidated financial statements that are not included in this annual report.

**Income Statement Data:**

	<b>Year ended December 31,</b>				
	2001	2002	2003	2004	2005
	<b>(U.S. dollars in thousands, except share and per share data)</b>				
Revenues:					
Software	\$19,110	\$15,136	\$19,712	\$20,614	\$16,803
Applications	11,212	7,355	7,277	7,408	8,300
Maintenance and technical support	10,956	10,882	10,853	12,555	14,376
Consulting services	35,284	26,631	25,548	24,590	21,511
Total revenues	76,562	60,004	63,390	65,167	60,990
Cost of revenues:					
Software	4,187	3,318	3,943	4,742	4,412
Applications	2,399	2,334	1,162	1,720	4,071
Maintenance and technical support	4,334	4,100	2,580	3,199	2,679
Consulting services	25,622	19,239	16,454	15,818	15,514
Total cost of revenues	36,542	28,991	24,139	25,479	26,676
Gross profit	40,020	31,013	39,251	39,688	34,314
Operating expenses:					
Research and development, net	7,547	5,336	4,775	3,845	3,733
Sales, marketing, general and administrative	46,598	30,694	30,814	32,541	34,842
Restructuring and other non-recurring costs	6,613	1,123			---
Impairment expenses	20,081				----
Operating income (loss)	(40,819)	(6,140)	3,662	3,302	(4,261)
Financial (expense) income, net	575	958	307	912	(811)
Other income (expenses)	(2,199)		(42)		1,169
Income (loss) before taxes on income	(42,443)	(5,182)	3,927	4,214	(3,903)
Income taxes	(167)	(384)	230	281	491
	(42,610)	(5,566)	3,697	3,933	(4,394)
Equity in earnings (losses) of affiliates		(108)	(36)	79	19

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Minority interest in losses (earnings) of subsidiaries	(176)	11	(594)	78	(232)
Net income (loss)	\$(42,786)	\$(5,663)	\$3,067	\$ 4,090	\$(4,607)
Basic net earnings (loss) per share	\$(1.45)	\$(0.19)	\$0.10	\$ 0.13	\$(0.15)
Diluted net earnings (loss) per share	\$(1.45)	\$(0.19)	\$0.10	\$0.13	\$(0.15)
Shares used to compute basic earnings (loss) per share	29,604	29,690	29,624	31,029	31,124
Shares used to compute diluted earnings (loss) per share	29,604	29,690	29,909	32,426	31,124

Balance Sheet Data:

	<b>At December 31,</b>				
	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>
	<b>(U.S. dollars in thousands)</b>				
Working capital	\$28,007	\$23,200	\$16,798	\$19,852	\$13,471
Cash, cash equivalents, short term deposits and marketable securities	27,900	24,785	13,581	12,803	13,865
Total assets	94,612	84,522	77,800	80,285	73,723
Shareholders' equity	66,893	61,021	53,924	59,547	52,305

**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 have a history of losses and may not be able to achieve or sustain profitability in the future.*

In the year ended December 31, 2005 we recorded a net loss of \$4.6 million. We have incurred losses in three out of the last five years and we may not be able to achieve or sustain profitability in the future.

*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 and we expect these fluctuations to continue. 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 product 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;



- 

Seasonality, including the relatively low level of general business activity during the summer months in Europe;

- 

The mix of product sales;

- 

Exchange rate fluctuations; and

- 

General economic conditions.

Our customers ordinarily require the delivery of products promptly after we accept their orders. With the exception of contracts for services, we usually do not have a significant backlog of orders for our products. Consequently, revenues from our products in any quarter depend on orders received and accepted by the customers in that quarter.

The deferral of the placing and acceptance of any large order from one quarter to another could materially adversely affect our results of operations for the former quarter. Our customers sometimes require an acceptance test for services we provide and as a result, we may have a significant backlog of orders for our services. Our revenues from services depend on orders received and services provided by us and accepted by our customers in that quarter. In addition, we anticipate that our operating expenses will continue to increase significantly. 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 would be materially 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.

***Currency exchange rate fluctuations in the world markets in which we conduct business could have a material adverse affect on our business, results of operations and financial condition.***

Our financial statements are stated in U.S. dollars, our functional currency. Nevertheless, a substantial portion of our sales and expenses are incurred in other currencies, particularly Euros, Japanese yen, NIS and the British pound. We maintain substantial non-U.S. dollar balances of assets, including cash and accounts receivable, and liabilities, including accounts payable. Fluctuations in the value of the currencies in which we do business relative to the U.S. dollar may have a material adverse effect on 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. From time to time we use derivative or other instruments to hedge against part or all of our exposures.

***Our widespread operations may strain our management, operational and financial resources.***

Our widespread operations have significantly strained our management, operational and financial resources in the past. Any future growth may increase this strain. To manage future growth effectively, we must:

- 

Expand our operational, management, financial, marketing and research and development functions;

- 

Train, motivate, manage and retain qualified employees; and

- 

Hire additional personnel.

We may not succeed in managing future growth.

***We face intense competition in the markets for our application development and integration technologies and services, which are evolving into a new unified market for composite applications development and deployment.***

Many companies compete with us in the areas of software development tools, business integration and business process management, or BPM, tools, and in the applications and services markets in which we operate. We expect that 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.

Many of our existing and potential competitors are far larger, have substantially greater resources 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 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.

***We may not succeed in increasing our market share in the business integration and process management markets with our iBOLT products, or leverage our experience in the composite applications field.***

During 2003, we launched the iBOLT Integration Suite, which provides business integration and process management solutions to mid-size and large organizations. In 2004, we launched iBOLT Version 2.0, and in 2005 we released both iBOLT Version 2.5 and iBOLT Special Edition for SAP Business One. We are currently developing the next release of iBOLT, which we expect to release during the latter part of 2006.

The business integration and BPM markets in which we compete are extremely competitive and subject to rapid changes. Our competitors utilize varying approaches to the provision of technology to business integration and BPM markets. We may not have the resources, skills and product variety required to successfully increase our market share in these markets. We do not have a long history of selling products in the business integration and process management markets and we will have to devote substantial resources to educating prospective customers and the market about our products' benefits. In addition, even if we succeed in convincing prospective customers and the market that our products are effective and provide real business benefits, our target customers may not choose them for technical, cost, support or other reasons.

To succeed in these markets, we will need to:

- 

Further develop and improve our expertise in marketing and selling integration technology;

-

Recruit, develop and cultivate additional system integrators who will serve as market and sales channels of integration projects for prospective customers; and

•

Effectively establish and enhance relationships with technological partners and application vendors, which will extend our value proposition and assist us in reaching more customers.

***Our future success will be largely dependent on the acceptance of future releases of our eDeveloper application development and deployment product.***

Our future success will be in great measure dependent on the acceptance of future releases of our eDeveloper application development and deployment product. The acceptance of this product relies in part on the continued acceptance and growth of diverse platforms, systems and databases, where eDeveloper operates as the bridge for creating composite applications. In the future, organizations may not implement multiple environments to serve their computing needs.

***Changes in the ratio of revenues obtained from our own software license sales as compared to revenues from third party software licenses may adversely affect our gross profit margins.***

Our entrance into the business integration market prompted us to enter into an increasing number of technology alliances and sales of complementary technology components, such as integration adaptors. Historically, our revenues from software licenses were almost exclusively from wholly owned technology. In 2005, our gross profit margin from software license sales decreased, partially as a result of sales of third party licenses. Any future increase in the percentage of revenues derived from third party software licenses may adversely affect our gross profit margin.

***We derive a significant portion of our revenues from independent distributors who are under no obligation to purchase our products.***

We sell our products through our direct sales representatives, as well as through third parties that use our technology to develop solutions for their customers, referred to as Magic solution providers, and independent distributors. These independent distributors then resell our products to end-users. We are dependent upon the acceptance of our products by our 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 non-competitive products. The independent distributors may not continue, or may not give a high priority to, marketing and supporting our products. Our results of operations could be materially adversely affected by changes in the financial condition, business, marketing strategies, local and global economic conditions, or results of our independent distributors.

***We may lose independent distributors on whom we currently depend and we may not succeed in developing new distribution channels.***

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, particularly the loss of a major distributor, or our inability to establish effective distribution and sales channels for new markets, will impact our ability to sell our products and result in a loss of revenues and profits.

***Our efforts to increase our presence in the United States, Europe and Japan may not be profitable.***

Our success in becoming a stronger competitor in the sale of software development and deployment technology and a leading provider of applications is dependent upon our ability to increase our sales in the United States, Europe and Japan. Our efforts to increase our penetration to these markets are subject to risks inherent to such markets, including the high cost of doing business in such locations.

***Our products have a lengthy sales cycle.***

Our customers typically use our technology to develop, deploy and integrate applications that are critical to their businesses. As a result, the licensing and implementation of our technology 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 can be further extended for sales made through third party distributors.

***Rapid technological change may adversely affect the market acceptance of our products and services.***

We compete in a market that is characterized by rapid technological change. The introduction of new technologies 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 markets and changing customer requirements.

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

***We may be unable to attract, train and retain qualified engineering, administrative, operational, sales and technical support personnel.***

In the event our business grows, we will need to hire additional qualified engineering, administrative, operational, sales and technical support personnel. The process of locating, training and successfully integrating qualified personnel into our operations can be lengthy and expensive. We may not be able to compete effectively for the personnel we need. Competition for these employees in the industry in which we operate is intense around the world, especially in Israel, India and the United States. Any loss of members of senior management or key technical personnel, or any failure to attract or retain highly qualified employees as needed, could have a material adverse effect on our business, financial condition and results of operations.

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

Despite quality assurance testing performed by us, as well as by Magic solution providers 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 Magic solution providers over whom 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. Accordingly, we could fail to realize revenues and suffer damage to our reputation as a result of, or in defense of, a substantial claim.

***We rely on third party technology licenses.***

We incorporate software that we license from third parties in our technology. If we lose, or are unable to maintain any software licenses, we could suffer harm until equivalent software can be developed, identified, licensed and integrated. Loss of third party software licensing would materially adversely affect our business, financial condition and results of operations.

***Our proprietary technology is 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 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.

***Our products may infringe upon the intellectual property rights of others.***

Third parties may assert infringement claims against us or claims that we have violated a patent or infringed upon a copyright, trademark or other proprietary right belonging to them. In addition, any infringement claim, even one without merit, could result in the expenditure of significant financial and managerial resources to defend any such claims.

***We may encounter difficulties with our international operations and sales.***

While our principal executive offices are located in Israel, 94% of our sales in 2003, 95% of our sales in 2004 and 93% of our sales in 2005 were generated from other countries. This 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;

- 

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 in international markets as a result of one or more of these factors.

***We are controlled by Formula Systems (1985) Ltd.***

Formula Systems (1985) Ltd., whose shares trade on the NASDAQ National Market and the Tel Aviv Stock Exchange, or TASE, directly owns 15,620,348 or 50.19% of our outstanding ordinary shares. Formula Systems is and may continue to be in a position to exercise control over most matters requiring shareholder approval, including the election of our directors, approval of significant corporate transactions and the general ability to direct our affairs. Such concentration of ownership may have the effect of delaying or preventing a change in control.

***Compliance with corporate governance regulations could increase the cost of our operations.***

As a result of certain corporate governance scandals and the legislative and litigation environment resulting from those scandals, the costs of being a public company in general have increased in recent years. The Sarbanes-Oxley Act of 2002 requires changes in some of our corporate governance and securities disclosure or compliance practices. We expect that the on-going implementation of these regulations will further increase our legal compliance costs and will make some activities more time consuming. We are presently evaluating and monitoring regulatory developments and cannot estimate the magnitude of additional costs we may incur as a result of such developments. If we are required to implement Section 404 of the Sarbanes-Oxley Act of 2002, which governs internal controls and procedures for financial reporting, we will need to expend significant management time and financial resources to

comply with the applicable requirements. This and other proposed legislation may increase the fees of our professional advisors and our insurance premiums.

***The implementation of SFAS No. 123(R), which will require us to record compensation expense in connection with equity share based compensation granted as of the first quarter of 2006, may reduce our profitability.***

On December 16, 2004, the Financial Accounting Standards Board, or FASB, issued Statement No. 123 (revised 2004), Share-Based Payment, or SFAS No. 123(R), which is a revision of SFAS No. 123. Generally, the approach in SFAS No. 123(R) is similar to the approach described in SFAS No. 123. However, SFAS No. 123 permitted, but did not require, share-based payments to employees to be recognized on the basis of their fair values while SFAS No. 123(R) requires, as of the first quarter of 2006, all share-based payments to employees to be recognized on the basis of their fair values. SFAS No. 123(R) also revises, clarifies and expands guidance in several areas, including measuring fair value, classifying an award as equity or as a liability and attributing compensation cost to reporting periods. The adoption of SFAS No. 123(R) may have a significant effect on our results of operations in the future, if we grant in the future additional options to our employees or modify existing options. In addition, such adoption could limit our ability to use stock options as an incentive and retention tool, which could, in turn, negatively impact our ability to recruit employees and retain existing employees. However, related to previous grants, had we adopted SFAS 123(R) in 2005, the impact of that standard would have approximated \$2,599 as described in the disclosure of pro forma net income and earnings per share in our consolidated financial statements.

### **Risk Factors Related to Our Ordinary Shares**

***Our share price has been very 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 response to factors such as the following, some of which are beyond our control:

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Quarterly variations in our operating results;

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Operating results that vary from the expectations of securities analysts and investors;

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

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

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

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- Changes in the status of our intellectual property rights;
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- Announcements by third parties of significant claims or proceedings against us;
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- Additions or departures of key personnel;
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- Future sales of our ordinary shares;
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- Stock market price and volume fluctuations; and
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- General trends of the stock markets.

Domestic and international stock markets often experience extreme price and volume fluctuations. Market fluctuations, as well as general political and economic conditions, such as a recession or interest rate or currency rate fluctuations or political events or hostilities in or surrounding Israel, could adversely affect the market price of our ordinary shares.

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

***We do not anticipate paying cash dividends on our ordinary shares in the foreseeable future.***

We paid a one-time cash dividend of \$11,844,713 in February 2003; however, we currently intend to retain all future earnings for use in our business and to fund its growth and do not anticipate paying any further cash dividends on our ordinary shares in the foreseeable future under our current financial condition. The declaration of dividends is subject to the discretion of our Board of Directors and will depend on various factors, including our operating results, financial condition, future prospects and any other factors deemed relevant by our board of directors. You should not rely on an investment in our company if you require dividend income from your investment in our company. The success of your investment will likely depend entirely upon any future appreciation of the market price of our ordinary shares, which is uncertain and unpredictable. There is no guarantee that our ordinary shares will appreciate in value or even maintain the price at which you purchased your ordinary shares.

***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 National Market and on the Tel Aviv Stock Exchange. Trading in our ordinary shares on these markets is made in different currencies (U.S. dollars on the NASDAQ National Market, and New Israeli Shekels on the Tel Aviv Stock Exchange), 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 often 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.

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

#### ***Conducting business in Israel entails special risks.***

We are incorporated under the laws of, and our executive offices and research and development facilities are located in, the State of Israel. Although most of our sales are made to customers outside Israel, we are nonetheless directly influenced by the political, economic and military conditions affecting Israel. Specifically, we could be adversely affected by 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.

Since the establishment of the State of Israel in 1948, a number of armed conflicts have taken place between Israel and its Arab neighbors, and a state of hostility, varying from time to time in intensity and degree, has led to security and economic problems for Israel. Since September 2000, there has been a marked increase in violence, civil unrest and hostility, including armed clashes, between the State of Israel and the Palestinians, and acts of terror have been committed inside Israel and against Israeli targets in the West Bank and Gaza. These developments have adversely affected the regional peace process, placed the Israeli economy under significant stress, and have negatively influenced Israel's relationship with several Arab countries. In August 2005, Israel evacuated all Israeli settlements in the Gaza Strip and four settlements in the West Bank. In January 2006, Hamas won the elections in the Palestinian Authority and on March 28, 2006, elections to the Israeli parliament were held in Israel. The implications of these developments cannot at this time be foreseen. Any future armed conflict, political instability or violence in the region may have a negative effect on our business condition, harm our results of operations and adversely affect our share price.

Furthermore, there are a number of countries that restrict business with Israel or Israeli companies. Restrictive laws or policies of those countries directed towards Israel or Israeli businesses had, and may in the future continue to have, an adverse impact on our operations, our financial results or the expansion of our business. No predictions can be made as to whether or when a final resolution of the area's problems will be achieved or the nature thereof and to what extent the situation will impact Israel's economic development or our operations.

#### ***Our results of operations may be negatively 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.

#### ***Economic conditions in Israel have not been stable in recent years.***

In recent years Israel has been going through a period of recession in economic activity, resulting in low growth rates and growing unemployment. Although economic activity in Israel has improved recently, our operations could be adversely affected if the economic conditions in Israel begin to deteriorate once again.

***We may be adversely affected if the rate of inflation in Israel exceeds the rate of devaluation of the New Israeli Shekel against the U.S. dollar.***

A portion of our expenses, primarily labor expenses, is incurred in NIS. As a result, we are exposed to the risk that the rate of inflation in Israel will exceed the rate of devaluation of the NIS in relation to the U.S. dollar or that the timing of this devaluation lags behind inflation in Israel. In 2003, 2004 and 2005 the rate of devaluation of the NIS against the dollar was  $-(7.56)\%$ ,  $(1.62)\%$  and  $6.85\%$ , respectively, while in 2003 and 2004 the NIS appreciated in value in relation to the dollar by  $7.6\%$  and  $1.6\%$ , respectively.

We may be materially and adversely affected in the future if the rate of inflation in Israel exceeds the devaluation of the NIS against the U.S. dollar or if the timing of this devaluation lags behind increases in inflation in Israel.

***We currently benefit from government tax benefits, which may be discontinued or reduced in the future.***

We are currently eligible to receive tax benefits under Government of Israel programs. In order to maintain our eligibility for these tax benefits, we must continue to meet specific conditions, including making specified investments in fixed assets. If we fail to comply with these conditions in the future, the tax benefits received could be canceled and we could also be required to pay significantly increased taxes for prior years and for the future.

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

Service of process upon our directors and officers and the Israeli experts named herein, some of whom reside outside the United States, may be difficult to obtain within the United States. Furthermore, since substantially all of our assets, some of our directors and officers and the Israeli experts named in this annual report are located outside the United States, any judgment obtained in the United States against us or these individuals or entities may not be collectible within the United States.

There is doubt as to the enforceability of civil liabilities under the Securities Act and the Securities Exchange Act in original actions instituted in Israel. However, subject to certain time limitations and other conditions, Israeli courts may enforce final judgments of United States courts for liquidated amounts in civil matters, including judgments based upon the civil liability provisions of those Acts.

***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.***

Provisions of Israeli corporate and tax law may have the effect of delaying, preventing or making more difficult 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.

***Your rights and responsibilities as a shareholder will be governed by Israeli law and differ in some respects from the rights and responsibilities of shareholders under U.S. law.***

We are incorporated under Israeli law. The rights and responsibilities of holders of our ordinary shares are governed by our memorandum of association, our 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 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 on, among other things, amendments to a company's articles of association, increases in a company's authorized share capital,

mergers and interested party transactions requiring shareholder approval. In addition, a shareholder who knows that it possesses the power to determine the outcome of a shareholder vote or to appoint or prevent the appointment of a director or executive officer in the company has a duty of fairness toward the company. However, Israeli law does not define the substance of this duty of fairness. Because Israeli corporate law has undergone extensive revision in recent years, there is little case law available to assist in understanding the implications of these provisions that govern shareholder behavior.

*As a foreign private issuer whose shares are listed on the NASDAQ National 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 National Market, we are permitted to follow certain home country corporate governance practices instead of certain requirements of the NASDAQ Marketplace Rules, including the distribution of annual reports to shareholders, quorum at shareholders meetings and executive meetings of independent directors. In addition, we may follow Israeli law instead of the NASDAQ Marketplace Rules that 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 our company, certain transactions other than a public offering involving issuances of a 20% or more interest in our company and certain acquisitions of the stock or assets of another company. Currently, we do not follow NASDAQ requirements and instead follow Israeli law and practice with respect to the distribution of annual reports to shareholders and executive meetings of independent directors.

## **ITEM 1.**

### **INFORMATION ON THE COMPANY**

#### **A.**

### **HISTORY AND DEVELOPMENT OF THE COMPANY**

We were incorporated under the laws of the State of Israel in February 1983 as Magic Software (1983) Ltd. and we changed our name to Magic Software Enterprises Ltd. in 1991. 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 60218, Israel, and our telephone number is +972-3-538-9292. Our address on the Internet is [www.magicsoftware.com](http://www.magicsoftware.com). The information on our website is not incorporated by reference into this annual report.

We develop, market and support composite application development and deployment platforms with a service-oriented architecture, or SOA, including application integration and business process management, or BPM, with existing and legacy systems. These enable enterprises to accelerate the process of building and deploying applications that can be rapidly customized and integrated with existing systems.

Our technology and applications based on our technology are used by independent software vendors and thousands of enterprises in approximately 50 countries. We refer to these vendors and enterprises as the Magic community. We also provide maintenance and technical support as well as professional services to the Magic community.

We develop, market and support eDeveloper, a software development and deployment technology, and iBOLT, a technology for business integration and BPM.

eDeveloper enables the rapid development and deployment of business applications. The eDeveloper technology can be deployed on multiple platforms operating with interoperability under various information technology, or IT, architectures and can operate on multiple databases. During the last two years we have developed a new version of

eDeveloper. During the last two years we have developed a new version of eDeveloper, version ten (V10), which highlights SOA architecture. This new version of the eDeveloper provides enhanced support in industry standards, improved functionality and a composite application development environment. In May 2005, we provided a beta version to selected customers for testing. The same version was also previewed by the CRN Test Center and received the CRN Recommended label. In March 2006, we performed a controlled and limited release of eDeveloper V10.

iBOLT provides affordable business integration solutions to mid-sized and large enterprises and system integrators. As a comprehensive suite, iBOLT allows the simple integration and interoperability of diverse solutions, including legacy applications in a quick and efficient manner. In 2005, we released iBOLT Version 2.5. In addition, in 2005 we developed the iBOLT channel and entered into agreements with approximately 100 system integrators, consultancies and service providers, who acquired iBOLT skills and offer iBOLT based services to their customers. We are currently developing the next release of iBOLT, which we expect to release in the latter part of 2006.

In 2004, we entered into a partnership with SAP, an international provider of business software solutions. The agreement focused on providing a special edition of iBOLT as a collaborative platform for the SAP Business One product, an integrated business management solution designed specifically for small and midsize businesses. In January 2005, we launched iBOLT Special Edition for the SAP Business One product and subsequently expanded and intensified our joint activities with SAP worldwide. The iBOLT Special Edition was accepted by the SAP community with enthusiasm, and our company was awarded by SAP the ISV Partner Leadership in Innovation 2005 award for embodying SAP's applistructures (service oriented application components infrastructure) idea and bringing it to the market with the SAP Business One product.

In 2005, we signed a series of agreements with W4, a leading European provider of BPM software for human resources related processes. W4's BPM technology has over nine years of proven use by more than 260 public and private organizations worldwide, from various sectors, including banking, insurance, administration, industry, public services and telecommunications. W4 has embedded iBOLT into its BPM platform, W4 BPMSuite V6, which was launched in December 2005. We have added the W4 BPM engine to our extensive list of components, which enables iBOLT developers to seamlessly integrate human resources related activities as a component of any composite applications developed with the iBOLT Integration Suite.

During 2005, we also continued to work closely with IBM as an Advanced Partner of the IBM Partnerworld for Developer business partner program and as a Member Partner of IBM Partnerworld for Software. In the past, we have received the highest approval rating from IBM Alliance Shareholder/400 technical teams in Rochester for our adherence to IBM's e-business framework. The Level Four certification granted to us from IBM signifies that we are able to demonstrate our support for several different servers using standards established by IBM. This accomplishment helps foster our continued business relationship with IBM throughout the world. IBM has also awarded us with its ServerProven® certification for our eDeveloper product following a rigorous testing and evaluation process. Only those products that are validated by IBM to install quickly, start up easily and run reliably on IBM servers are awarded this certification, designed by IBM to help its customers easily identify complete solutions for their business-critical e-business needs.

In December 2005, we increased our holdings in our subsidiary, CarPro Systems Ltd. from 87.5% to 90.48%. CarPro Systems Ltd. develops, markets and sells CarPro™, a solution that includes more than 90% of the functions usually required by multi-facility car and truck rental companies worldwide.

In March 2006, we increased our holdings in our subsidiary Advanced Answers on Demand Holding Corporation from 83.88% to 100%. Advanced Answers on Demand Holding Corporation develops and markets application software targeted at the long-term care industry.

**B.**

## **BUSINESS OVERVIEW**

### **Industry Overview**

In recent years the multiplication of enterprise applications has lead to a level of complexity in enterprises' information system that is actually obstructing business progress and evolution, reducing business agility and is often resulting in multiple versions of similar data objects such as customer records. One of the main challenges the modern enterprise faces today is creating a single view of the truth, which is the better way to make effective and relevant business decisions. Business integration is employed to facilitate this. Traditionally, given their cost and complexity, business integration solutions were targeted at large enterprises. Consequently, business integration tools are mostly complex, require significant implementation resources, take a long time to implement and are costly. This constituted a barrier to small and medium enterprises, who could not afford to embark on such projects. Yet, given the critical need for business integration across the demand and supply chain, enterprises of all sizes require such solutions.

We recognized this trend and emerging need when we designed iBOLT, and are one of the first vendors to provide business integration solutions to small and medium enterprises.

Another major evolution in enterprises is the trend of reusing IT assets, such as enterprise applications, driving the move towards SOA (service-oriented architectures) and applistructures. Applistructures are the merger of enterprise-application and infrastructure technology. Due to the large investments in enterprise applications, such as enterprise resource planning and customer relationship management, on the one hand, and the accelerating business change, on the other, organizations need to find a way to continue to leverage and amortize their IT investments while increasing their ability to change business processes and support new ones. The software industry's response is a new breed and paradigm of application development, service oriented development of applications, or SODA, and composite applications, based on metadata, which is data that describes data (similar to a table of content describing a book), rather than traditional programming. We have developed and enhanced this paradigm over the last twenty years, and we believe that we have the one of the largest installed base of products employing such technology.

### **General**

We develop, market and support eDeveloper, a software development and deployment technology, and iBOLT, a technology for business integration and BPM. 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.

Our technology and solutions are especially in demand when time-to-market considerations are critical, budgets are tight, integration is required with multiple platforms, databases or existing systems and business processes, or a high degree of application maintenance and customization is anticipated.

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. Our proprietary development methodology enables developers to create better solutions in less time and with fewer resources.

Development communities have become increasingly focused on specific solutions, creating an even greater need for a development environment that provides open interfaces to leading technologies and standards. eDeveloper and iBOLT provide developers with the ability to rapidly build integrated applications in a more productive manner, lowering IT maintenance costs and decreasing time-to-market.

With the launch of iBOLT, we started a repositioning process from the application development field to the business integration and process management field, which are, presently converging, from a technology perspective, to the composite application field. Products in these filed require a service-oriented architecture, application integration capabilities, process management, orchestration capabilities, and information delivery capabilities. Our technology and products provide all of these capabilities.

### **The Magic Solution**

Our eDeveloper and iBOLT technologies offer system integrators, software developers and end-users of deployed applications the following benefits:

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*Real Time to Market.* We believe that our technology and products allow enterprises to prototype and develop, integrate and deploy complex, mission-critical components and applications rapidly and in a cost-effective manner. Most program functionality that usually requires repetitive, tedious coding is provided by our underlying core technology, eDeveloper. In today's dynamic and competitive business environment, the development community is under pressure to produce and integrate applications faster and with more meaningful business processes and information than ever before, while reducing costs. This requires organizations to build a service-oriented architecture and develop on top of it composite applications. Both eDeveloper and iBOLT enable organizations to meet these needs.

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*Scalability and Adaptability.* Applications developed and integrated with eDeveloper and iBOLT can be easily modified as business requirements change, computing environments evolve and end-user usage and transaction volumes increase. As a result, implementations of our technology can be quickly adapted to support increased functionality and wider use throughout an organization. Applications developed with our products can grow within an enterprise from the departmental level to the enterprise level by accommodating additional platforms, databases and operating systems and increased usage and application complexity. Our technology also enables partitioning of applications by allowing application logic to be distributed across a system in order to achieve optimal system performance and flexibility. Our eDeveloper and iBOLT technologies enable enterprises to respond quickly to unanticipated changes in their business requirements to protect their investments in software and hardware.

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*Portability.* We designed our products to enable enterprises to develop and integrate applications that can be used with most hardware platforms, operating systems and databases. Applications developed with our technology for one platform also can be deployed on other supported platforms. Simply changing the relevant parameters in an application and migrating the metadata accomplish porting a Magic based application from one platform to another. As a result, porting applications can be accomplished without the lengthy coding, compiling, linking and testing phases typically required with other development methodologies. Applications developed with our technology can also be partitioned across multiple platforms. Developers can therefore take advantage of the flexibility and performance advantages inherent in multi-tiered architectures. The portability of applications developed with our software development technology enables enterprises to migrate quickly to new computing environments without having to rewrite their applications.

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*Database Access and Technology Independence.* eDeveloper and iBOLT allow enterprises to access and manipulate data from multiple databases, each based on a different technology, into a single integrated application. Developers

and end-users can access multiple legacy and relational databases across the enterprise from within the same application and from within the same data view. Our technology can easily move data across platforms and convert the data from one database format to another.

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*Comprehensiveness.* Our technology delivers everything enterprises need in order to achieve the future of business integration, in a single product stack, including a composite application framework, SODA, enterprise service bus (ESB, or also referred to as a message broker), enterprise application integration, BPM, and service and business activity monitoring. Our single product stack provides small and medium enterprises as well as large enterprises with top tier power, which is simple to learn and fast to deliver value even with small business budgets.

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*Innovation and experience.* We provide a service oriented platform which includes application integration, business process management and composite applications, to rapidly develop, change and deploy solutions integrated with existing and legacy systems. We enable enterprises to increase their agility and rapidly adapt to business changes, by aligning their IT with their business operations, accelerating the evolution to a SOA through application integration and BPM. Our customers develop and deploy applications that are rapidly customized and integrated with existing and legacy systems. Our products are built on twenty years of research and development, as well as customer experience.

## **Strategy**

Our goal is to achieve a leadership position in the software development and business integration and deployment technology markets. We focus on providing technology, applications and services that enable enterprises to meet their business needs on time and budget. The key elements of our strategy to achieve this goal are:

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Target mid-size enterprises, with focus on organizations that require rapid solutions for critical projects at an affordable price;

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To focus our sales efforts on our core products iBOLT and eDeveloper.

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To focus our efforts on building a strong partner base of system integrators and resellers of our core technologies.

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To increase the number of software houses using eDeveloper to build their applications.

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To focus on the SAP alliance. The SAP Business One product environment is a broad horizontal market that offers an environment where our resources can be more effective than on the open market.

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To re-launch our alliance with IBM, specifically with the server divisions of the iSeries/AS/400 market, where we believe we have a strong competitive advantage. We intend to provide significant resources to increase our market share in the iSeries/AS/400 market.

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To focus on recruiting software partners, who will incorporate our iBOLT integration technology into their product offerings.

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To continue developing our position in the business process driven integration market with iBOLT, while enhancing our rules-engine technology to address the emerging market of composite application development.

## Products

The driving principles behind our technology are:

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Abstraction - to hide complexity and facilitate change;

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Automation of mundane tasks - to accelerate development and maintenance and reduce risk; and

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Interoperability - to support business logic across multiple hardware and software platforms, operating systems and geographies.

We design our tools for use by system architects, business analysts and consultants rather than by programmers. Over the years, we have enriched our technology with emerging features such as messaging, application partitioning, browser based rich client, graphical design studio for business processes, event and service provision and consumption, orchestration and many more.

We offer two complementary products that address the wide spectrum of composite applications.

*iBOLT Business Integration Suite*, is a flow oriented composite applications toolset, delivering a comprehensive, business-driven integration framework that empowers enterprises to dramatically improve business performance. iBOLT enables customers to easily design, develop and deploy automated business processes, including BPM and business activity monitoring. Increasing the usability and life span of existing legacy and other IT systems, iBOLT allows fast enterprise application integration, development and customization of diverse applications, systems and databases, assuring rapid return on invested capital and time-to-market, increased profitability, and customer satisfaction.



*eDeveloper* is an interactive composite applications toolset, delivering an extremely productive, state-of-the-art technology for developing and deploying web and client/server applications across and beyond the enterprise.

*eDeveloper* automates the mundane repetitive tasks of the software development cycle, drastically shortening the process, reducing project risk and minimizing human errors.

During the last two years we have developed a new version of *eDeveloper*, version ten (V10). In May 2005, we provided a beta version to selected customers for testing. The same version was also previewed by the CRN Test Center and received the CRN Recommended label. In March 2006, we performed a controlled and limited release of *eDeveloper* V10.

This new version of the *eDeveloper* V10, which highlights SOA architecture, provides enhanced support in industry standards, improved functionality and a composite application development environment. The new version of *eDeveloper* further enhances our position as provider of service oriented development of applications (SODA) technology and the feature set provided by our entire product line (*iBOLT* and *eDeveloper*) fully complies with the prevailing industry requirements of a comprehensive composite applications and SOA platform. Gartner, a leading global information technology industry research and analyst firm, defines an integrated services environment, or ISE, as an integrated development platform or framework that is focused on developing applications using a composite (assemble-first) metaphor based on SOA and process centricity through a lightweight BPM. According to Gartner, ISEs should have a productivity layer that makes developers more productive through hiding complexity (such as frameworks or prepackaged functions), automation (or code-generation or parameterization), and simplification (such as visual modeling), and forms the basic value proposition of an ISE. Gartner further describes ISE as intended to be used by developers and business analysts alike together, but is targeted at process-centric developers. Through these products, the focus of the user shifts from writing code to assembling and managing business processes. Through these processes, flexible business solutions can be assembled or composed. Recently, Gartner recognized us as a visionary ISE vendor.

Our technology, comprising both *iBOLT* and *eDeveloper*, is a comprehensive and proven ISE in the market. It can be applied to the full range of 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 ISEs, we offer a coherent and unified toolset stemming from the same proven metadata driven and rules based declarative technology, resulting in unprecedented cost savings through fast and easy implementation and reduced project risk.

### **Magic Software Vertical Solutions**

Some of our subsidiaries develop, market, and support vertical applications, including long-term care, criminal justice, and multi-facility car and truck rental management solutions.

*Advanced Answers on Demand Holding Corporation*, our wholly-owned subsidiary, develops and markets application software targeted at the long-term care industry. Its comprehensive solution is designed to meet the management information needs of retirement homes, nursing homes, assisted living facilities, continuing care retirement

communities, and home health and rehabilitation agencies.

*CarPro Systems Ltd.*, in which we have a 90.48% interest, develops, markets and sells CarPro™, a solution that includes more than 90% of the functions usually required by multi-facility car and truck rental companies worldwide. CarPro can manage such varied functions as purchasing and selling vehicles, reservations management, leasing and rental arrangements, and fleet control and management.

*Nextstep Infotech PVT. Ltd.*, our 40% held subsidiary, develops and markets Cheq Mate™, a banking application that provides most of the functionality required to run a retail bank branch, including support for various deposit types, advances, time deposits, bank guarantees, letters of credit and portfolio management.

*CoreTech Consulting Group LLC*, our wholly owned subsidiary, is an information technology consulting firm offering flexible and creative solutions in the areas of infrastructure design and delivery, application development, technology planning and implementation services, as well as supplemental staffing services.

*Hermes Logistics Technologies Ltd.*, (formerly *Magic eCargo*), our wholly-owned subsidiary, develops and markets a comprehensive solution for cargo handling and inventory control that is designed to increase productivity, improve efficiency, and reduce costs. Hermes handles many aspects of a cargo operation including inventory control, automated build-up of flights/manifesting, messaging to CARGO-IMP standards, customs clearance, weight and balance departure control systems, interfacing, scanning and verification of cargo, secured tracking and a comprehensive financial package for all aspects of billing and collecting fees.

*Magic BMS Informatikai Kft.*, our 19.9% held subsidiary, develops, markets and supports its own enterprise resource planning, or ERP, product, for medium sized companies. Among the company's customers are production and wholesale companies, including Sunbooks Kft., the largest book wholesale company in Hungary that operates solely on the web.

## **Services**

*Professional Services.* We provide a broad range of consulting and software development project management services to customers developing, deploying and integrating distributed applications. We believe that the availability of effective consulting services is an important factor in achieving widespread market acceptance.

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 both generating additional revenues and ensuring successful implementation of eDeveloper and iBOLT projects through knowledge transfer. Our consultants provide a value-added service on large development projects supporting existing teams in the design or implementation cycle, and maximizing the utilization of resources in large development environments. Our consultants help developers design prototype applications. Program components written by our consultants may also be added onto existing programs or programs in development. We also offer consulting services in rapid prototyping, multi-platform integration and migration to more efficient environments. Specialized consultants are also available to assist customers in all facets of migration from host character-based applications to distributed and Internet applications.

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 joint ventures with our Magic solution providers that use our technology to develop solutions for their customers, and distributors to deliver successful solutions in focused market sectors. We promote these solutions and help tailor them to enterprises. An integration of the acquired technology from a particular market sector with local expertise has proven to both save time and enable us to build solutions that better meet our customers' needs.

*Maintenance.* We offer our customers annual maintenance contracts providing for upgrades and new versions of our products for an annual fee.

*Technical 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 an online support system for the Magic community in the United States and Canada, which provides members of the Magic community with the ability to instantaneously enter, confirm and track support requests via the Internet. Magic eService was implemented by our technical support organization as a virtual support center which provides support to Magic solution providers and end-users worldwide.

*Training.* We conduct formal and organized training through our Magic University. Magic University staff members have developed several courses, pertaining to our principal products including our eDeveloper and iBOLT. Each of these courses includes 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.

Magic University also assists our professional services managers in designing and implementing custom-made client-site courses. These courses are conducted by certified instructors who are either our employees or employees of our distributors. In addition, we have been utilizing web-based training and demos more frequently for our employee training and customer demos.

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

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

	<b>Year ended December 31,</b>		
	<b>2003</b>	<b>2004</b>	<b>2005</b>
	<b>In thousands</b>		
Software sales	\$	\$ 28,022	\$ 25,103
	26,989		
Maintenance and technical support	10,853	12,555	14,376
Consulting services	25,548	24,590	21,511
Total revenues	\$ 63,390	\$ 65,167	\$ 60,990

	<b>Year ended December 31,</b>		
	<b>2003</b>	<b>2004</b>	<b>2005</b>
	<b>In thousands</b>		
Israel	\$	\$ 3,354	\$ 4,013
	3,643		
Europe	24,934	25,698	23,186
United States.	21,050	21,090	20,435
Japan	9,444	11,450	10,107
Other	4,319	3,575	3,249
Total revenues	\$	\$ 65,167	\$ 60,990
	63,390		

Industries that are significantly represented in our Magic community base include finance, retail, media, telecommunications, logistics, health care, manufacturing and government agencies. Our eDeveloper technology is used by a wide variety of developers that can be generally divided into two distinct segments: those performing in-house development (corporate IT departments) and Magic solution providers that use our technology to develop solutions for their customers. Magic solution providers include large system integrators that use our eDeveloper technology in large customized system projects and smaller independent developers that use our technology to perform development work for small to medium sized business clients. Magic solution providers that are packaged software publishers use our technology to write standard packaged software products that are sold to multiple clients, typically within a vertical industry segment or a horizontal business function.

Among the thousands of end-users running their business systems with our technology are the following: Adidas-Solomon, Allstate, Athlon Group, Burger King, Chase Manhattan Bank, Club Med, Compass Group PLC, Deka Bank, Euroclear, Fiat, Financial Times, GAP, Hitachi, John Menzies, Kodak, Marconi Mobile, NEC, Merrill Lynch, Matsushita, McKesson HBOC, Minolta, Nestle Nespresso, Nintendo, Philip Morris, the State of Washington, Vodafone, the United Nations and Victorinox.

### **Sales, Marketing and Distribution**

We market and support our products through our own direct sales force in Europe, India, Israel, Japan and the United States and through a network of distributors, Magic solution providers and system integrators in those countries and various other countries in Asia, Europe, Africa and Latin America. We sell and support our products directly through our subsidiaries in Israel, France, Germany, Hungary, India, Italy, Japan, the Netherlands, the United Kingdom and the United States, and through local distributors elsewhere.

*Direct Sales.* We maintain a direct sales force that pursues local accounts and software solution providers (value added-resellers, or VARs). They carry out strategic sales with a direct approach to decision makers, managing a constantly monitored consultative type of sales cycle. At March 19, 2006, we had approximately 32 sales personnel and also a team of sales engineers who provide pre-sale technical support, presentations and demonstrations in order to support most of these sales persons. Sales efforts are targeted at large enterprises performing internal application development and Magic solution providers that use our technology to develop solutions for their customers. We also employ an in-house and external telesales staff to sell to prospect accounts and to generate and qualify leads.

*Indirect Sales.* We are currently developing an indirect sales channel for iBOLT, the iBOLT channel, through system integrators, consultancies and service providers. In 2005, we dedicated three full time positions to develop this channel and by the end of the year we entered into agreements with approximately 100 entities, and generated revenue of close to \$1 million from iBOLT sales. We are augmenting our iBOLT channel team in 2006 and expect our revenues to increase as a result of the growth of this channel.

Some larger Magic solution providers may also resell development systems when selling applications requiring on-site development, maintenance, and diagnostics. We carry out marketing activities with our Magic solution providers, such as publishing solutions directories and newsletters. We have a marketing program that supports Magic solution providers by providing a wide range of features and advantages in the areas of application development, sales and marketing to them.

*Distributors.* In general, we distribute our products through local distributors in those countries where we do not have a sales subsidiary. A local distributor is typically a software marketing organization with the capability to add value with consulting, training, and support. Distributors are generally responsible for the localization of our software development technology and applications into their native language. 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 client 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 approximately 30 distributors in Europe, Latin America and Asia, many of whom also act as Magic solution providers.

*Marketing Activities.* We carry out a wide range of marketing activities aimed at generating awareness of our products and sales leads, including an extensive program of Internet-based Webcasts, exhibitions, advertising and public relations, attendance at trade shows and exhibitions, direct mail, response mail, telemarketing campaigns and user and distributor conferences and seminars. We also devote substantial efforts to marketing our products on the Internet. We regularly advertise our products in prominent trade publications. These activities are intended both to maintain the general public awareness of the products and to generate sales leads. We participate in many major industry trade shows and fairs worldwide. We conduct distributor and user conferences to update our worldwide affiliates and user base concerning our new releases, marketing strategies, pricing, technical information and the like. These events are conducted approximately once a year.

In order to foster improved relationships with our iBOLT channel partners, we periodically sponsor local events and other marketing programs and activities. On our corporate Internet site, we host an online solutions directory which highlights applications developed by our Magic solution providers, and an information sharing section which enables our Magic solution providers to participate alongside our representatives at trade shows and conferences. The Magic eNewsletter, an online publication that was developed as a public relations activity, is produced periodically and distributed to the Magic community and to potential customers. It includes articles that highlight our Magic solution providers.

### **Strategic Alliances**

The important strategic alliances formed by us to date include:

*SAP.* In 2004, we entered into a partnership with SAP that focused on providing a special edition of iBOLT as a collaboration platform for the SAP Business One product. While the agreement was signed between MSE Inc. and SAP America, the cooperation took place worldwide, in all the locations where the SAP Business One product has a significant presence. Our cooperation model was gradually introduced to the regional management for the SAP Business One product, who help us qualify and approach SAP business partners. We offer these partners the opportunity to resell and implement the iBOLT Special Edition in conjunction with the SAP Business One product. This activity started in the last quarter of 2004 in the United States on a trial basis. In January 2005, we launched iBOLT Special Edition for the SAP Business One product, and since then our joint activities have expanded and intensified worldwide. The SAP community accepted iBOLT with enthusiasm and we were awarded by SAP the ISV Partner Leadership in Innovation 2005 award for embodying SAP's applistructure idea and bringing it to the market with the SAP Business One product. In addition, in February 2006 we received initial approval for a global ISV agreement with SAP AG. We expect that the agreement will be signed in the near future.

In addition to the direct economic impact of iBOLT sales, we are experiencing the following benefits that arise from our partnership with SAP: (i) recognition and validation of our technology as a mainstream player in the business integration and composite application development domains; (ii) privileged access to a pre-qualified partner community that can also employ iBOLT in non-SAP related projects; and (iii) revitalization of our Magic solution providers community, by offering them access to the SAP Partner Program and branding of their existing applications.

*IBM.* During 2005, we continued to work closely with IBM as an Advanced Partner of the IBM Partnerworld for Developer business partner program and as a Member Partner of IBM Partnerworld for Software. In the past, we have received the highest approval rating from IBM Alliance Shareholder/400 technical teams in Rochester for our adherence to IBM's e-business framework. The Level Four certification granted to us from IBM signifies that we are able to demonstrate our support for several different servers using standards established by IBM. This accomplishment helps foster our continued business relationship with IBM throughout the world. IBM has also awarded us with its ServerProven® certification for our eDeveloper product following a rigorous testing and evaluation process. Only those products that are validated by IBM to install quickly, start up easily and run reliably on IBM servers are awarded this certification, designed by IBM to help its customers easily identify complete solutions for their business-critical e-business needs.

Magic Software Japan K.K. has an original equipment manufacturer, or OEM, agreement with IBM Japan for the sale of IBM's DB2 UDB. The product fits very well with Magic Software Japan K.K.'s market, supports Linux, UNIX, Windows and IBM business servers (eServer, iSeries) and is widely accepted as a standard of SQL (structured query language). IBM Japan's interest was fueled by Magic Software Japan K.K.'s strong experience in the midrange market.

*W4.* In 2005, we signed a series of agreements with W4, a leading European provider of BPM software for human resources related processes. W4's BPM technology has over nine years of proven use by more than 260 public and private organizations worldwide, from various sectors, including banking, insurance, administration, industry, public services and telecommunications. W4 has embedded iBOLT into its BPM platform, W4 BPMSuite V6, which was launched in December 2005. We have added the W4 BPM engine to our extensive list of components, which enables iBOLT developers to seamlessly integrate human resources related activities as a component of any composite applications developed with the iBOLT Integration Suite.

*IDS Scheer.* We have a marketing partnership with IDS Scheer, a world leader in business process modeling and monitoring software. This partnership complements and extends iBOLT in the areas of process modeling and process performance management, and provides IDS Scheer with a powerful technology (iBOLT) to enable their ARIS PPM product, especially in the small to medium business markets. PPM is a new alternative to business intelligence, which is, according to leading market research, expected to be one of the top growth markets for the next few years.

*Pervasive Software.* We have an OEM agreement with Pervasive Software to develop and market a bundled product comprised of Pervasive's Scalable SQL (structured query language) database engines and our eDeveloper technology.

The alliance provides for joint technical development and product integration channel development programs.

*iWay Software.* During 2003, we initiated a partnership with iWay Software to provide intelligent, prepackaged adapters for the iBOLT Integration Suite. iWay Software is an information builder company and a leading adapter vendor, engaged in acceleration of business integration. The availability of over 250 iWay Software adapters to the iBOLT Integration Suite enables organizations to connect to virtually any packaged application, mainframe and legacy system, traditional database, and to external data sources. iWay Software adapters interface seamlessly into the iBOLT environment without requiring complex coding or application modifications. The combination of iBOLT and iWay Software adapters allows enterprises to integrate their disparate proprietary applications and middleware, while supporting emerging messaging and business standards. This agreement expands our ability to deliver comprehensive cost-effective business integration solutions to our customers.

## **Competition**

The markets for our eDeveloper and iBOLT technologies and applications are characterized by rapidly changing technology, evolving industry standards, frequent new product introductions and rapidly changing customer requirements. These markets are therefore highly competitive and we expect competition to intensify in the future. We may not be able to compete effectively in these markets and may lose market share to our competitors.

With the introduction of eDeveloper V10 in early 2006, we are further shifting our activities from the integrated development environment market, in which we were competing with eDeveloper in the past, towards the service oriented architecture market, which we entered with iBOLT. This change was recognized by industry analyst firms like Gartner and Forrester Research. Our current list of competitors includes IBM, BEA, Microsoft, webMethods, TIBCO, Sun (SeeBeyond), Oracle, SAP, Computer Associates, Broadvision, FileNet, Progress, Pegasystems, Ultimus, Appian, ClearNova, Unify, GT Software, OutSystems, Bowstreet, Cordys, Above All, Agentis, and Skyway.

Additional competitors may enter each of our markets at any time. Moreover, our customers may seek to develop internally the products that we currently sell to them and thereafter compete with us.

Most of our competitors have greater financial, personnel and other resources than we do, which may limit our ability to compete effectively with them. These competitors may be able to respond more quickly to new or emerging technologies or changes in customer requirements. These competitors may also benefit from greater economies of scale, offer more aggressive pricing, devote greater resources to the promotion of their products or bundle their products into existing products in a manner that renders our technology partially or fully obsolete, thereby discouraging customers from purchasing our technology or applications.

We believe that the principal competitive factors affecting the market for our products include developer productivity, rapid results, product functionality, performance, reliability, 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 and, to a lesser degree, price.

## **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. However, in some accounts license agreements are required to be signed by the end-users. 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 Africa, Austria, Australia, Bulgaria, Canada, Chile, China, Czech Republic, France, Germany, Hungary, Israel, Italy, Luxembourg, the Netherlands, Poland, Portugal, Romania, Slovakia, South Spain, Switzerland, Thailand, 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 do not believe that patent laws are a significant source of protection for our products. 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.

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.

**A.**

**ORGANIZATIONAL STRUCTURE**

We are a member of the Formula Systems (1985) Ltd. (NASDAQ: FORTY), or Formula Systems, group. Formula Systems is an international IT company principally engaged, through its subsidiaries and affiliates, in providing software consulting services, developing proprietary software products and producing computer-based solutions. In addition, Formula Systems manages a venture capital fund, which invests in early stage companies that develop software products for the international market. Formula Systems, an Israeli corporation, beneficially owns a 50.19% equity interest in our ordinary shares.

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

Subsidiary Name	Country of Incorporation	Ownership Percentage
Magic Software Enterprises Inc.	United States	100%
CoreTech Consulting Group, LLC	United States	100%



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CoreTech Consulting Group, Inc.	United States	100%
MSE Holdings, Inc.	United States	100%
Magic Software Enterprises (UK) Ltd.	United Kingdom	100%
Hermes Logistics Technologies Limited	United Kingdom	100%
Magic Beheer B.V	Netherlands	100%
Magic Software Enterprises Netherlands B.V.	Netherlands	100%
Magic Software Enterprises Spain Ltd.	Spain	100%
Magic Software Enterprises GmbH	Germany	100%
Magic Software Enterprises France	France	100%
Magic Benelux B.V.	Netherlands	100%
Magic Software Enterprises (Israel) Ltd.	Israel	100%
Magic Software Enterprises Italy S.r.l	Italy	100%
Magic Software Japan K.K.	Japan	100%
Magic Software Enterprises India Pvt. Ltd.	India	100%
Onyx Magyarorszag Szsoftverhaz	Hungary	100%
CarPro Systems Ltd.	Israel	90.48%

Advanced Answers on Demand Holding Corporation	United States	100%
Nextstep Infotech Pvt. Ltd.	India	40%
Magic BMS Informatikai Kft.	Hungary	19.9%

**B.**

**PROPERTY, PLANTS AND EQUIPMENT**

**Facilities**

Our headquarters and principal administrative, finance, sales, marketing and research and development operations are located in an office building of approximately 38,590 square feet that we own in Or Yehuda, Israel, a suburb of Tel Aviv. The building was constructed on a parcel of land leased from the Israel Land Authority. The lease expires in 2040 and can be renewed for an additional period of 49 years.

Our Hungarian subsidiary owns a 4,754 square foot office in Budapest, Hungary.

Our U.S. subsidiaries lease approximately 23,261 square feet of office space in Laguna Hills, California; King of Prussia, Pennsylvania; and Fort Lauderdale, Florida. In addition, our subsidiaries also lease office space aggregating approximately 31,731 square feet in Paris, France; Munich, Germany; Pune, India; Bangalore, India; Milan, Italy; Tokyo, Japan; Houten, the Netherlands, and Bracknell, United Kingdom.

In the year ended December 31, 2005, we invested \$779,000 in capital assets, mainly in computers and peripheral equipment.

**ITEM 4A.**

**UNRESOLVED STAFF COMMENTS**

Not applicable.

**ITEM 2.**

**OPERATING AND FINANCIAL REVIEW AND PROSPECTS**

**A.**

**RESULTS OF OPERATIONS**

*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 develop, market and support software development, deployment and integration technologies and business solutions that enable enterprises to accelerate the process of building and deploying applications that can be rapidly customized and integrated with existing systems. We were incorporated under the laws of Israel in February 1983.

We have 18 wholly owned subsidiaries and one controlled subsidiary, incorporated in the United States, Europe, Asia and Israel. Our subsidiaries are engaged in developing, marketing and supporting vertical applications, as well as in selling and supporting our products. One of our subsidiaries provides software consulting services. Our ordinary shares are traded on the NASDAQ National Market under the symbol `MGIC` and on the Tel Aviv Stock Exchange.

## **Overview**

We develop, market and support our software development and deployment technology called eDeveloper, and technology for business integration and process management called iBOLT. Our technology enables enterprises to accelerate the process of building, deploying and integrating business software applications that can be rapidly customized to meet current and future needs. Our technology and applications based on our technology are used by software solution providers and thousands of enterprises in approximately 50 countries. We refer to these vendors and enterprises as the Magic community. We also provide maintenance and technical support as well as professional services to the Magic community.

We began operations in 1986 and completed an initial public offering of our ordinary shares in the United States in August 1991. In the first quarter of 2000, we completed a follow-on offering of 4,000,000 of our ordinary shares in the United States at \$25.00 per share. Of these shares, 3,500,000 ordinary shares were offered by us and 500,000 ordinary shares were offered by our major shareholder, Formula Group (1985) Ltd. Our net proceeds from the offering, after deducting the underwriting discount and expenses, were \$79.6 million. We paid a one-time cash dividend of \$11,844,713 in February 2003.

## **General**

Our consolidated financial statements appearing in this annual report are prepared in U.S. dollars and in accordance with generally accepted accounting principles in the United States, 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.

Transactions and balances originally denominated in dollars are presented at their original amounts. Transactions and balances in other currencies are remeasured into dollars in accordance with the principles set forth in Financial Accounting Standards Board Statement No. 52. The majority of our sales are made outside Israel and a substantial part of them are in dollars. In addition, substantial portions of our costs are 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 using the foreign exchange rate at the 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. All balance sheet accounts have been translated using the exchange rates in effect at the balance sheet date. Statement of operations amounts have been translated using the average exchange rate for the period. The resulting translation adjustments are reported as a component of shareholders' equity in accumulated other comprehensive income (loss).

## **Discussion of 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 accounting principles generally accepted in the United States

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***

To date, we have derived our revenues from licensing the rights to use our software, maintenance and technical support and providing professional services. We sell our products primarily through our direct sales force and indirectly through distributors.

We account for software sales in accordance with Statement of Position, or SOP, No. 97-2, Software Revenue Recognition, as amended by Statement of Position 98-9, Modifications of SOP 97-2, Software Revenue Recognition with Respect to Certain Transactions, or SOP No. 97-2. Revenue is recognized when the following four criteria are met: (i) persuasive evidence of an arrangement exists; (ii) delivery has occurred; (iii) the fee is fixed or determinable; and (iv) collection is probable.

SOP No. 97-2 generally requires revenue earned from software arrangements involving multiple elements to be allocated to each element based on the relative fair values of the elements determined by the vendor's specific objective evidence, or VSOE, of fair value. Revenue is recognized under the "residual method" when VSOE of fair value exists for all undelivered elements and VSOE of fair value does not exist for all of the delivered elements, and when all SOP No. 97-2 criteria for revenue recognition are met, as described above. The VSOE of fair value of the undelivered elements included in multiple element arrangement (maintenance, support and services) is determined based on the price charged for the undelivered element when sold separately.

Revenue from license fees is recognized when persuasive evidence of an agreement exists, delivery of the product has occurred, no significant obligations with regard to implementation remain, the fee is fixed or determinable, and collectibility is probable. We do not generally 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.

Maintenance and technical support revenue is deferred and recognized on a straight-line basis over the term of the maintenance and support agreement. Revenue from consulting services consists of billable hours for services provided, and is recognized as the services are rendered.

Arrangements that include consulting services are evaluated to determine whether those services are essential to the functionality of other elements of the arrangement. When services are considered essential, revenue under the arrangement is recognized using contract accounting based on Statement of Position No. 81-1, "Accounting for Performance of Construction-Type and Certain Production-Type Contracts," or SOP 81-1, on a percentage of completion method based on input 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. As of December 31, 2005, no such estimated losses were identified.

When consulting services are not considered essential, the revenue allocable to the consulting services is recognized as the services are performed. In most cases to date, 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.

### ***Other Intangible Assets***

Intangible assets are comprised of distribution rights, acquired technology and customer relations, and are amortized over their 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 customer relations are amortized on a straight line basis over a period of an average of five years.

Certain software development costs are capitalized subsequent to the establishment of technological feasibility in accordance with SFAS No. 86 "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed." Based on our product development process and that of our subsidiaries, technological feasibility is established upon completion of a detailed program design.

Research and development costs incurred in the process of developing product improvements or new products, are generally charged to expenses as incurred.

Significant costs incurred by us and our subsidiaries between completion of the detailed program design and the point at which the product is ready for general release, have been capitalized.

Capitalized software costs are amortized by the greater of the amount computed using the: (i) ratio that current gross revenues from sales of the software to the total of current and anticipated future gross revenues from sales of that software, or (ii) the straight-line method over the estimated useful life of the product (three to five years). We assess the recoverability of this intangible asset on a regular basis by determining whether the amortization of the asset over its remaining life can be recovered through undiscounted future operating cash flows from the specific software product sold. As of December 31, 2005, no impairment losses have been identified.

### ***Goodwill***

Goodwill and intangible assets with an identifiable useful life are no longer amortized but are subject to annual impairment tests based on estimated fair value in accordance with SFAS No. 142 "Goodwill and Other Intangible Assets," or SFAS No. 142." We conduct our annual test of impairment for goodwill in December of each year. In addition we test for impairment periodically whenever events or circumstances occur subsequent to our annual impairment tests that indicate that the asset might be impaired. Indicators we consider important which could trigger an impairment include, but are not limited to, significant underperformance relative to historical or projected future operating results, significant changes in the manner of use of acquired assets or the strategy for our overall business, significant negative industry or economic trends, a significant decline in our stock price for a sustained period and our market capitalization relative to net book value.

We have three reporting units. Goodwill attributable to each of the reporting unit is measured separately. The first step of the goodwill impairment test compares the carrying value of each reporting unit with its fair value on that date. Since the fair value of the reporting units exceeded their carrying amount, no impairment was identified in 2005.

### ***Impairment of long-lived assets***

We review our long-lived assets for impairment in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," or SFAS No. 144, 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 value 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. As of December 31, 2005, no impairment losses have been identified.

### ***Marketable Securities***

We account for investments in marketable securities in accordance with SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities, or SFAS No. 115. Our management determines the appropriate classification of its investments in marketable debt securities at the time of purchase and reevaluates such determinations at each balance sheet date. Debt securities are classified as available for sale and reported at fair value.

Debt securities that are designated as available-for-sale 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. As of December 31, 2005, the unrealized losses in our investments in available-for-sale marketable securities were caused by interest rate increases and the devaluation of the Euro. We believe that we have the ability to hold our current marketable securities until they recover. We expect that our marketable securities will not be exercised at a price less than the amortized cost of our investment. Based on our intent to hold our marketable securities until they recover and the partial recovery of the securities' market during the first quarter of 2006, no impairment has been identified as of December 31, 2005.

### **Recently Issued Accounting Standards**

In November 2004, the Financial Accounting Standards Board, or FASB, issued Statement of Financial Accounting Standard, or SFAS, No. 151, "Inventory Costs, an Amendment of ARB No. 43, Chapter 4," or SFAS No. 151. SFAS No. 151 amends Accounting Research Bulletin, No. 43, Chapter 4, to clarify that abnormal amounts of idle facility expense, freight handling costs and wasted materials (spoilage) should be recognized as current-period charges. In addition, SFAS No. 151 requires that the allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. SFAS No. 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. We do not expect that the adoption of SFAS No. 151 will have a material effect on our financial position or results of operations.

In December 2004, the FASB issued SFAS No. 153, "Exchanges of Non-monetary Assets, an Amendment of APB Opinion No. 29," or SFAS 153. The guidance in APB Opinion No. 29, "Accounting for Non-monetary Transactions," or APB 29, is based on the principle that exchanges of non-monetary assets should be measured based on the fair value of the assets exchanged. APB 29 included certain exceptions to that principle. SFAS 153 amends APB 29 to eliminate the exception for non-monetary exchanges of similar productive assets and replaces it with a general exception for exchanges of non-monetary assets that do not have commercial substance. A non-monetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS 153 is effective for non-monetary assets exchanges occurring in fiscal periods beginning after June 15, 2005. We do not expect that the adoption of SFAS 153 will have a material effect on our financial position or results of operations.

On December 16, 2004, the FASB issued Statement No. 123 (revised 2004), "Share-Based Payment," or SFAS 123(R), which is a revision of FASB Statement No. 123, "Accounting for Stock-Based Compensation," or SFAS 123. Generally, the approach in SFAS 123(R) is similar to the approach described in SFAS 123. However, SFAS 123 permitted, but did not require, share-based payments to employees to be recognized based on their fair values while SFAS 123(R) requires all share-based payments to employees to be recognized based on their fair values. SFAS 123(R) also revises, clarifies and expands guidance in several areas, including measuring fair value, classifying an award as equity or as a liability and attributing compensation cost to reporting periods. SFAS 123(R) became effective for us in the first fiscal year beginning after January 1, 2006. The impact of the adoption of SFAS 123(R) with respect to future grants cannot be predicted at this time, as it depends on levels of share-based payments for future grant. However, had we adopted SFAS 123(R) in the last three fiscal years with respect to previous grants, the impact of that Standard would have approximated the impact of SFAS 123, as described in the disclosure of the pro forma net income (loss) and net earnings (loss) per share in Note 2u to our consolidated financial statements.

In March 2005, the Securities and Exchange Commission, or SEC, released SEC Staff Accounting Bulletin No. 107, "Share-Based Payment," or SAB 107. SAB 107 provides the SEC staff's position regarding the application of Standard 123(R) and contains interpretive guidance related to the interaction between Standard 123(R) and certain SEC rules and regulations, and also provides the SEC staff's views regarding the valuation of share-based payment arrangements for public companies. SAB 107 highlights the importance of disclosures made relating to the accounting for share-based payment transactions.

### Significant Expenses

*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 software. Cost of revenues for maintenance and technical support and professional services consists primarily of personnel expenses and other related costs.

*Research and Development Expenses, Net.* Research and development costs consist primarily of salaries of employees engaged in on-going research and development activities 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		
	2003	2004	2005
	(U.S. dollars in thousands)		
Gross research and development costs	\$7,086	\$7,317	\$7,642
Less capitalization of software development costs	<u>(2,311)</u>	<u>(3,472)</u>	<u>(3,909)</u>
Research and development expenses, net	<u>\$4,775</u>	<u>\$ 3,845</u>	<u>\$3,733</u>

*Selling and Marketing Expenses.* Selling and marketing expenses consist primarily of compensation and related expenses for sales and marketing personnel, sales commissions, marketing programs, web site related expenses, public relations, promotional materials, travel expenses and trade show exhibit expenses.

*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, provisions for doubtful accounts, and other general corporate expenses.

The following table presents selected consolidated statement of operations data for the periods indicated:

	Year ended December 31,		
	2003	2004	2005
	(U.S. dollars in thousands, except share and per share data)		

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Revenues:			
Software	\$19,712	\$20,614	\$16,803
Applications	7,277	7,408	8,300
Maintenance and technical support	10,853	12,555	14,376
Consulting services	25,548	24,590	21,511
Total revenues	63,390	65,167	60,990
Cost of revenues:			
Software	3,943	4,742	4,412
Applications	1,162	1,720	4,071
Maintenance and technical support	2,580	3,199	2,679
Consulting services	16,454	15,818	15,514
Total cost of revenues	24,139	25,479	26,676
Gross profit	39,251	39,688	34,314
Operating expenses:			
Research and development, net	4,775	3,845	3,733
Sales and marketing, net	15,138	17,157	18,510
General and administrative	15,676	15,384	16,332
Total operating expenses	35,589	36,386	38,575



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Operating income (loss)	3,662	3,302	(4,261)
Financial income (expenses), net	307	912	(811)
Other income (expenses)	(42)	-	1,169
Income (loss) before taxes on income	3,927	4,214	(3,903)
Income taxes	230	281	491
	3,697	3,933	(4,394)
Equity in earnings (losses) of affiliates	(36)	79	19
Minority interest in losses (earnings) of consolidated subsidiaries	(594)	78	(232)
Net income (loss)	\$3,067	\$4,090	\$(4,607)
Basic earnings (loss) per share	\$(0.10)	\$ 0.13	\$(0.15)
Diluted earnings (loss) per share	\$(0.10)	\$ 0.13	\$(0.15)
Shares used to compute basic earnings (loss) per share	29,624	31,029	31,124
Shares used to compute diluted earnings (loss) per share	29,909	32,426	31,124

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

**Year ended December 31,**

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	<b>2003</b>	<b>2004</b>	<b>2005</b>
Revenues:			
Software	31.1%	31.6%	27.5%
Applications	11.5	11.4	13.6
Maintenance and technical support	17.1	19.3	23.6
Consulting services	40.3	37.7	35.3
Total revenues	100.0%	100.0%	100.0%
Cost of revenues:			
Software	6.2	7.3	7.2
Applications	1.8	2.6	6.7
Maintenance and technical support	4.1	4.9	4.4
Consulting services	26.0	24.3	25.4
Total cost of revenues	38.1	39.1	43.7
Gross profit	61.9	60.9	56.3
Operating expenses:			
Research and development, net	7.5	5.9	6.1
Selling and marketing, net	23.9	26.3	30.3
General and administrative	24.7	23.6	26.8

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Total operating expenses	56.1	55.8	63.2
Operating income (loss)	5.8	5.1	(7.0)
Other income (expenses)	(0.1)	-	1.9
Financial income (expenses), net	(0.5)	(1.4)	(1.3)
Income (loss) before taxes on income	6.2	6.5	(6.4)
Income taxes	0.4	0.4	0.8
Equity in earnings (losses) of affiliates	(0.1)	0.1	0.0
Minority interest in (earnings) losses of consolidated subsidiaries	(0.9)	0.1	(0.4)
Net income (loss)	4.8%	6.3%	)7.6%)

***Year Ended December 31, 2005 Compared With Year Ended December 31, 2004***

*Revenues.* Total revenues decreased by 6% to \$61.0 million in 2005 from \$65.2 million in the year ended December 31, 2004. Software sales decreased by 18% to \$16.8 million in the year ended December 31, 2005 from \$20.6 million in the year ended December 31, 2004. Revenues from maintenance and technical support increased by 14% to \$14.37 million in the year ended December 31, 2005 from \$12.6 million in the year ended December 31, 2004, as a result of our entering into maintenance and support contracts with more customers in 2005. Revenues from professional services decreased by 13% to \$21.5 million in the year ended December 31, 2005 from \$24.6 million in the year ended December 31, 2004, as a result of our long term strategy to gradually reduce our revenues from professional services by using third parties to deliver projects. We expect that our total revenues will moderately increase in 2006.

*Cost of Revenues.* Cost of revenues increased by 5% to \$26.7 million in the year ended December 31, 2005 from \$25.5 million in the year ended December 31, 2004. Cost of revenues for software sales decreased by 6% to \$4.4 million in the year ended December 31, 2005 from \$4.7 million in the year ended December 31, 2004. Cost of revenues for applications increased by 141% to \$4.1 million in the year ended December 31, 2005 from \$1.7 million in the year ended December 31, 2004, partly as a result of an increase in our application revenues and lower margins in some sales made in 2005. Cost of revenues for maintenance and technical support decreased by 16% to \$2.7 million in the year ended December 31, 2005 from \$3.2 million in the year ended December 31, 2004. Cost of revenues for professional services decreased by 2% to \$15.5 million in the year ended December 31, 2005 from \$15.8 million in

the year ended December 31, 2004, primarily due to the decrease in our revenues from professional services. We expect that our cost of revenues will slightly increase in 2006, in accordance with the increase in revenues.

*Gross Profit.* Gross profit decreased by 14% to \$34.3 in the year ended December 31, 2005 from \$39.7 million in the year ended December 31, 2004. Our gross margin (gross profit as a percentage of total revenues) on software sales decreased to 56% in the year ended December 31, 2005 from 61% in the year ended December 31, 2004. Our gross margin on applications decreased to 51% in the year ended December 31, 2005 from 77% in the year ended December 31, 2004, principally as a result of an increase in third party applications in 2005, which increased our costs, as well as lower revenues in 2005 compared to 2004, while a portion of the expenses remained at the 2004 level. Our gross margin on maintenance and technical support increased to 81% in the year ended December 31, 2005 compared to 75% in the year ended December 31, 2004, and our gross margin on professional services decreased to 28% in the year ended December 31, 2005, compared to 36% in the year ended December 31, 2005.

*Research and Development Expenses, Net.* Total research and development expenses increased by 4% to \$7.6 million in the year ended December 31, 2005 from \$7.3 million in the year ended December 31, 2004. Net research and development expenses decreased by 3% to \$3.7 million in the year ended December 31, 2005 from \$3.8 million in the year ended December 31, 2004. In 2005, we capitalized \$3.9 million of software development costs, as compared to \$3.5 million capitalized in 2004. The increase in total research and development expenses in 2005 was due to work performed in connection with the expected release of eDeveloper version 10 in 2006 as well as our new version of iBOLT. Net research and development expenses as a percentage of revenues increased to 6.1% in the year ended December 31, 2005 from 6% in the year ended December 31, 2004. We do not expect a material change in our net research and development expenses as percentage of our revenues in 2006.

*Selling and Marketing Expenses, Net.* Selling and marketing expenses increased by 8% to \$18.5 million in the year ended December 31, 2005 from \$17.2 million in the year ended December 31, 2004 reflecting the growth of our marketing activities for both our eDeveloper and iBOLT products. Selling and marketing expenses as a percentage of revenues increased to 30.3% in the year ended December 31, 2005 from 26.3% in the year ended December 31, 2004, due to increased marketing activities for both our eDeveloper and iBolt products and a decrease in revenues in 2005 compared to 2004. We do not expect a material change in our selling and marketing expenses as percentage of our revenues in 2006.

*General and Administrative Expenses.* General and administrative expenses increased by 6% to \$16.3 million in the year ended December 31, 2005 from \$15.4 million in the year ended December 31, 2004.

*Other Income.* We recorded a net income of \$1,169 in 2005 relating to life insurance that we received following the death of Mr. Barry Scutillo, the former chief executive officer of our subsidiary Advanced Answers On Demand Holding Corporation in June 2004. We did not have any other income in 2004.

*Financial Income (Expenses) Net.* Our financial expenses were \$0.8 million in the year ended December 31, 2005 compared to financial income of \$0.9 million in the year ended December 31, 2004. This was due to the devaluation of certain currencies in which we had assets that were denominated or to which assets were tied, against the U.S. dollar.

*Income Taxes.* We incurred income taxes of \$0.5 million in the year ended December 31, 2005, out of which \$0.1 million is attributable to prior years, and \$0.4 million were incurred in 2005. These taxes are primarily attributable to taxes accrued in the United States and Israel.

*Equity in Gains (Losses) of Affiliates.* In the year ended December 31, 2005, we recognized a gain of \$0.02 million, while we recognized a gain of \$0.08 million in the year ended December 31, 2004.

*Minority Interest in Profits (Losses) of Consolidated Subsidiaries.* Minority interest in the profits of our consolidated subsidiaries represents the minority shareholders' share of the profits (losses) of some of certain majority owned subsidiaries. In the year ended December 31, 2005, we recognized a loss of (\$0.2) million as compared to income of \$0.08 million in the year ended December 31, 2004.

***Year Ended December 31, 2004 Compared With Year Ended December 31, 2003***

*Revenues.* Total revenues increased by 3% to \$65.2 million in the year ended December 31, 2004 from \$63.4 million in the year ended December 31, 2003. Software sales increased by 5% to \$20.6 million in the year ended December 31, 2004 from \$19.7 million in the year ended December 31, 2003. This increase was principally attributable to an increase in iBOLT license sales. Revenues from applications increased slightly to \$7.4 million in the year ended December 31, 2004 from \$7.3 million in the year ended December 31, 2003. Revenues from maintenance and technical support increased by 16% to \$12.6 million in the year ended December 31, 2004, from \$10.9 million in the year ended December 31, 2003 as a result of new plans for total customer care introduced during the year ended December 31, 2004. Revenues from professional services decreased by 4% to \$24.6 million in the year ended December 31, 2004 from \$25.5 million in the year ended December 31, 2003, reflecting a reduction in demand for such services.

*Cost of Revenues.* Cost of revenues increased by 6% to \$25.5 million in the year ended December 31, 2004 from \$24.1 million in the year ended December 31, 2003. Cost of revenues for software sales increased by 21% to \$4.7 million in the year ended December 31, 2004 from \$3.9 million in the year ended December 31, 2003. This increase was partly due to higher amortization costs related to capitalized research and development. Cost of revenues for applications increased by 42% to \$1.7 million in the year ended December 31, 2004 from \$1.2 million in the year ended December 31, 2003, principally as a result of a change in our product mix, with an increase in 2004 of sales of products having lower gross margins. Cost of revenues for maintenance and technical support increased by 23% to \$3.2 million in the year ended December 31, 2004 from \$2.6 million in the year ended December 31, 2003. Cost of revenues for professional services decreased by 4% to \$15.8 million in the year ended December 31, 2004 from \$16.4 million in the year ended December 31, 2003. The decrease was attributable to our lower professional services revenues in the year ended December 31, 2004 compared to the year ended December 31, 2003.

*Gross Profit.* Gross profit increased slightly by 1% to \$39.7 million in the year ended December 31, 2004 from \$39.3 million in the year ended December 31, 2003. Our gross margin (gross profit as a percentage of total revenues) on software sales decreased to 77% in the year ended December 31, 2004 from 80% in the year ended December 31, 2003. Our gross margin on applications decreased to 77% in the year ended December 31, 2004 from 84% in the year ended December 31, 2003 principally as a result of a change in our product mix. Our gross margin on maintenance and technical support decreased slightly to 75% in the year ended December 31, 2004 compared to 76% in the year ended December 31, 2003, and our gross margin on professional services remained at 36% in the year ended December 31, 2004, the same as in the year ended December 31, 2003.

*Research and Development Expenses, Net.* Total research and development expenses increased by 3% to \$7.3 million in the year ended December 31, 2004 from \$7.1 million in the year ended December 31, 2003. Net research and development expenses decreased by 21% to \$3.8 million in the year ended December 31, 2004 from \$4.8 million in the year ended December 31, 2003. In the year ended December 31, 2004 we capitalized \$3.48 million of software development costs, as compared to \$2.3 million capitalized in the year ended December 31, 2003. The increase was due to higher capitalization cost related to the eDeveloper product line, since a major version was being developed during 2005, as well as the iBOLT and Hermes products. On December 31, 2004, we employed 149 persons in research and development, of which 61 persons were in Israel, 68 persons were based in our research and development facility in India and the rest in Japan and the United States. Net research and development expenses as a percentage of revenues decreased to 6% in the year ended December 31, 2004 from 8% in the year ended December 31, 2003.

*Selling and Marketing Expenses, Net.* Selling and marketing expenses increased by 14% to \$17.2 million in the year ended December 31, 2004 from \$15.1 million in the year ended December 31, 2003 reflecting the overall growth in our the year ended December 31, 2004 revenues and investments in the introduction of the new iBOLT product.

Selling and marketing expenses as a percentage of revenues increased slightly to 26% in the year ended December 31, 2004 from 24% in the year ended December 31, 2003.

*General and Administrative Expenses.* General and administrative expenses decreased slightly by 2% to \$15.4 million in the year ended December 31, 2004 from \$15.7 million in the year ended December 31, 2003.

*Financial Income, Net.* Our financial income increased to \$0.9 million in the year ended December 31, 2004 from \$0.3 million in the year ended December 31, 2003, principally as a result of the devaluation of the dollar against the Euro and the Yen.

*Income Taxes.* We incurred income taxes of \$0.3 million in the year ended December 31, 2004, out of which \$0.1 million were incurred in prior years, and \$0.2 million were incurred in 2004. These taxes are primarily attributable to taxes accrued in the United States and Israel.

*Equity in Gains (Losses) of Affiliates.* In the year ended December 31, 2004, we recognized a gain of \$0.08 million, while we recognized a loss of \$0.04 million in the year ended December 31, 2003.

*Minority Interest in Profits (Losses) of Consolidated Subsidiaries.* Minority interest in the profits of our consolidated subsidiaries represents the minority shareholders' share of the profits (losses) of some of our majority owned subsidiaries. In the year ended December 31, 2004, we recognized income of \$0.08 million as compared to expenses of \$0.59 million in the year ended December 31, 2003.

## Quarterly Results of Operations

The following tables set forth unaudited quarterly results of operations in U.S. dollars and as a percentage of revenues for each of the eight fiscal quarters ended December 31, 2005. We have prepared this information on a basis consistent with our audited consolidated financial statements included in this annual report and include all necessary adjustments, consisting only of normal recurring accruals that we consider necessary for a fair presentation of the information for the periods indicated. The results of operations for any quarter are not necessarily indicative of results for any future periods.

	Three months ended							
	Mar. 31, 2004	June 30, 2004	Sep. 30, 2004	Dec. 31, 2004	Mar. 31, 2005	June 30, 2005	Sep. 30, 2005	Dec. 31, 2005
	(U.S. dollars in thousands)							
Revenues:								
Software	\$5,461	\$ 5,481	\$4,712	\$4,960	\$4,870	\$4,408	\$3,798	\$3,727
Applications	1,664	1,778	1,317	2,649	2,207	1,894	2,196	2,003
Maintenance and technical support	2,795	3,070	3,213	3,477	3,546	3,858	3,607	3,365

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Consulting services	6,534	6,338	5,773	5,945	4,881	5,542	5,167	5,921
Total revenues	16,454	16,667	15,015	17,031	15,504	15,702	14,768	15,016
Cost of revenues:								
Software	1,247	1,099	1,113	1,282	761	1,273	1,042	1,336
Applications	620	416	197	487	747	911	1,145	1,268
Maintenance and technical support	803	892	698	806	873	740	585	481
Consulting services	3,769	4,074	3,704	4,271	3,797	3,821	3,729	4,167
Total cost of revenues	6,440	6,481	5,712	6,846	6,178	6,745	6,501	7,252
Gross profit	10,014	10,186	9,303	10,185	9,326	8,957	8,267	7,764
Operating expenses:								
Research and development, net	1,205	869	736	1,035	1,054	953	826	900
Selling and marketing, net	4,351	4,451	3,897	4,459	4,845	4,867	4,188	4,610
General and administrative	3,865	3,971	3,758	3,789	3,822	4,142	4,470	3,898
Total operating expenses	9,421	9,291	8,391	9,283	9,721	9,962	9,484	9,408
Operating income (loss)	593	895	912	902	(395)	(1,005)	(1,217)	(1,644)
Financial income (expenses), net	(114)	(40)	44	1,023	)320)	(47)	(252)	(192)

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Other income	-	-	-		1,169	-	-	-
Income (loss) before taxes on income	479	855	956	1,925	454	(1,052)	(1,469)	(1,836)
Income taxes	-	-	67	214	231	54	143	63
Equity in earnings (losses) of affiliates	-	-						
		90	(17)	6	53	(2)	21	(53)
Minority interest in earnings (losses) of subsidiaries	(239)	31	126	5	112	52	29	39
Net income (loss)	\$718	\$914	\$746	\$1,712	\$164	(\$1,160)	(\$1,620)	(\$1,991)

Three months ended

	Mar. 31, 2004	Jun. 30, 2004	Sep. 30, 2004	Dec. 31, 2004	Mar. 31, 2005	Jun. 30, 2005	Sep. 30, 2005	Dec. 31, 2005
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(As percentage of total revenues)

Revenues:								
Software	33.2%	32.9%	31.4%	29.1%	31.4%	28.1%	25.7%	24.8%
Applications	10.1%	10.7%	8.8%	15.6%	14.2%	12.1%	14.9%	13.3%
Maintenance and technical support	17.0%	18.4%	21.4%	20.4%	22.9%	24.5%	24.4%	22.4%
Consulting services	39.7%	38.0%	38.4%	34.9%	31.5%	35.3%	35.0%	39.5%
Total revenues	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%



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Cost of revenues: Software	7.6%	6.6%	7.4%	7.5%	4.9%	8.2%	7.1%	8.9%
Applications	3.8%	2.5%	1.3%	2.9%	4.8%	5.8%	7.8%	8.4%
Maintenance and technical support	4.9%	5.4%	4.6%	4.7%	5.6%	4.7%	4.0%	3.2%
Consulting services	22.8%	24.4%	24.7%	25.1%	24.5%	24.3%	25.3%	27.8%
Total cost of revenues	39.1%	38.9%	38.0%	40.2%	39.8%	43.0%	44.0%	48.3%
Gross profit	60.9%	61.1%	62.0%	59.8%	60.2%	57.0%	56.0%	51.7%
Operating expenses: Research and development, net	7.3%	5.2%	4.9%	6.1%	6.8%	6.1%	5.6%	6.0%
Selling and marketing, net	26.4%	26.7%	26.0%	26.2%	31.3%	31.0%	28.4%	30.7%
General and administrative	23.6%	23.8%	25.0%	22.2%	24.7%	26.4%	30.3%	26.0%
Total operating expenses	57.3%	55.7%	55.9%	54.5%	62.7%	63.4%	64.2%	62.7%
Operating income (loss)	3.6%	5.4%	6.1%	5.3%	(2.5%)	(6.4%)	(8.2%)	(10.9%)
Financial income (expenses), net	(0.7)%	(0.3)%	0.3%	6.0%	(2.1%)	(0.3%)	(1.7%)	(1.3%)
Other income	-	-	-	-	7.5%	-	-	-
Income (loss) before taxes on income	2.9%	5.1%	6.4%	11.3%	2.9%	(6.7%)	(10.0%)	(12.2%)

Income taxes	-	-	0.4%	1.2%	1.5%	0.3%	1.0%	0.4%
Equity in earnings (losses) of affiliates	-							
		0.5%	(0.2)%	0.0%	0.3%	0.0%	0.1%	(0.4)%
Minority interest in losses (earnings) of subsidiaries								
	(1.5)%	0.1%	0.8%	0.0%	0.7%	0.3%	0.2%	0.3%
Net income (loss)	4.4%	5.5%	5.0%	10.1%	1.1%	(7.4%)	(11.0%)	(13.3%)

Our quarterly results of operations have varied significantly in the past as a result of various factors, part of which are beyond our control. Accordingly, revenues and net income, if any, in any particular period may be lower than revenues and net income, if any, in a preceding or comparable period. Period-to-period comparisons of our result of operations may not be meaningful, and you should not rely upon them as indications of our future performance.

### **Seasonality**

Our operating results are generally not characterized by a seasonal pattern.

### **Conditions in Israel**

We are incorporated under the laws of, and our principal executive offices and manufacturing and research and development facilities are located in the State of Israel. Accordingly, we are directly affected by political, economic and military conditions in Israel. Specifically, we could be adversely affected by 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, and a significant downturn in the economic or financial condition of Israel.

### ***Political Conditions***

Since the establishment of the State of Israel in 1948, a number of armed conflicts have taken place between Israel and its Arab neighbors, and a state of hostility, varying from time to time in intensity and degree, has led to security and economic problems for Israel. Since September 2000, there has been a marked increase in violence, civil unrest and hostility, including armed clashes, between the State of Israel and the Palestinians, and acts of terror have been committed inside Israel and against Israeli targets in the West Bank and Gaza. These developments have adversely affected the regional peace process, placed the Israeli economy under significant stress, and have negatively influenced Israel's relationship with several Arab countries. In August 2005, Israel evacuated all Israeli settlements in the Gaza Strip and four settlements in the West Bank. In January 2006, Hamas won the elections in the Palestinian Authority and on March 28, 2006, elections to the Israeli parliament were held in Israel. The implications of these developments cannot at this time be foreseen. Any future armed conflict, political instability or violence in the region may have a negative effect on our business condition, harm our results of operations and adversely affect our share price.

Furthermore, there are a number of countries that restrict business with Israel or Israeli companies. Restrictive laws or policies of those countries directed towards Israel or Israeli businesses may have an adverse impact on our operations, our financial results or the expansion of our business. No predictions can be made as to whether or when a final resolution of the area's problems will be achieved or the nature thereof and to what extent the situation will impact Israel's economic development or our operations. In addition, some of our directors, executive officers and employees in Israel are obligated to annual reserve duty in the Israeli Defense Forces and are 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.

To date, no executive officer or key employee has been recruited for military service for any significant time period. Any further deterioration of the hostilities between Israel and the Palestinian Authority into a full-scale conflict might require more significant military reserve service by some of our employees, which may have a material adverse effect on our business.

### ***Economic Conditions***

In recent years Israel has been going through a period of recession in economic activity, resulting in low growth rates and growing unemployment. Our operations could be adversely affected if the economic conditions in Israel continue to deteriorate.

### **Trade Agreements**

Israel is a member of the United Nations, the International Monetary Fund, the International Bank for Reconstruction and Development and the International Finance Corporation. Israel is a signatory to the General Agreement on Tariffs and Trade, which provides for reciprocal lowering of trade barriers among its members. In addition, Israel has been granted preferences under the Generalized System of Preferences from the United States, Australia, and Canada. These preferences allow Israel to export products covered by such programs either duty-free or at reduced tariffs.

Israel and the European Union Community concluded a Free Trade Agreement in July 1975 which confers certain advantages on Israeli exports to most European countries and obligates Israel to lower its tariffs on imports from these countries over a number of years. In 1985, Israel and the United States entered into an agreement to establish a free trade area. The free trade area has eliminated all tariff and specified non-tariff barriers on most trade between the two countries. On January 1, 1993, an agreement between Israel and the European Free Trade Association, known as EFTA, which includes Austria, Finland, Iceland, Liechtenstein, Norway, Sweden and Switzerland, established a free-trade zone between Israel and the EFTA nations. In November 1995, Israel entered into a new agreement with the European Union, which includes redefinition of rules of origin and other improvements, including providing for Israel to become a member of the research and technology programs of the European Union. In recent years, Israel has established commercial and trade relations with a number of other nations, including China, India, Russia, Turkey and other nations in Eastern Europe and Asia.

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

Our financial statements are denominated in U.S. dollars. Nevertheless, a majority of our sales are made, and a majority of our expenses are incurred, in other currencies, particularly Euros, Japanese yen, NIS and the British pound. We maintain substantial non-U.S. dollar balances of assets, including cash and accounts receivable, and liabilities, including accounts payable. Fluctuations in the value of the currencies in which we do business relative to the U.S. dollar could have a material adverse effect on 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.

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.

When the rate of inflation in Israel exceeds the rate of devaluation of the NIS against the dollar, companies experience increases in the dollar cost of their operations in Israel. Unless offset by a devaluation of the NIS, inflation in Israel will have a negative effect on our profitability, as we receive payments in dollars or dollar-linked NIS for most of our sales, while we incur a portion of our expenses in NIS.

The following table sets forth, for the periods indicated, information with respect to the rate of inflation in Israel, the rate of devaluation of the NIS against the U.S. dollar, and the rate of inflation in Israel adjusted for such devaluation:

<b>Year ended</b>	<b>Israeli inflation</b>			
	<b>Israeli consumer price index</b>	<b>Israeli inflation rate %</b>	<b>Israeli devaluation rate %</b>	<b>adjusted for devaluation %</b>
2001	101.6	1.4	9.3	(7.8)
2002	108.2	6.5	7.3	(0.7)
2003	99.4	(8.1)	(9.2)	(7.6)
2004	100.6	1.2	(1.6)	2.8
2005	103.0	2.4	6.8	(4.4)

A devaluation of the NIS in relation to the U.S. dollar has the effect of reducing the U.S. dollar amount of any of our expenses or liabilities which are payable in NIS (unless such expenses or payables are linked to the U.S. dollar). Such devaluation also has the effect of decreasing the U.S. dollar value of any asset, which consists of NIS or receivables payable in NIS (unless such receivables are linked to the U.S. dollar). Conversely, any increase in the value of the NIS in relation to the U.S. dollar has the effect of increasing the U.S. dollar value of any unlinked NIS assets and the U.S. dollar amounts of any unlinked NIS liabilities and expenses.

Because exchange rates between the NIS and the U.S. dollar fluctuate continuously, with a historically declining trend in the value of the NIS, 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 materially adversely affected by currency fluctuations.

### **Corporate Tax Rate**

In 2005, Israeli companies were subject to income tax at the rate of 34% of taxable income. However, eight investment programs at our facility in Or Yehuda have been granted approved enterprise status under the Law for Encouragement of Capital Investments, 1959 commonly referred to as the Investment Law, and we are, therefore, eligible for some 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 of 25%. However, these benefits will not be available to us with respect to any income derived by our non-Israeli subsidiaries.

On April 1, 2005, an amendment to the Investment Law came into effect that has significantly changed the provisions of the Investment Law. The amendment limits the scope of enterprises which may be approved by the Investment Center Investment Center of the Ministry of Industry and Trade of the State of Israel, or the Investment Center, by setting criteria for the approval of a facility as an approved enterprise, such as provisions generally requiring that at least 25% of the approved enterprise's income will be derived from export. Additionally, the amendment enacted major changes in the manner in which tax benefits are awarded under the Investment Law so that companies no longer require Investment Center approval in order to qualify for tax benefits.

However, the April 2005 amendment to the Investment Law provides that terms and benefits included in any certificate of approval granted prior to the amendment will remain subject to the provisions of the law as they were on the date of such approval. Therefore, our existing approved enterprise programs will generally not be subject to the provisions of the April 2005 amendment. As a result of the amendment, tax-exempt income will subject us to taxes upon distribution or liquidation and we may be required to record deferred tax liability with respect to such tax-exempt income. As of December 31, 2005, we did not generate income under the provision of the amended Investment Law.