MAGIC SOFTWARE ENTERPRISES LTD
Form 20-F/A
September 26, 2007

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON D.C. 20549

FORM 20-F/A

AMENDMENT NO. 1

[_] REGISTRATION STATEMENT PURSUANT TO SECTION 12(B) OR (G) OF THE SECURITIES EXCHANGE ACT OF 1934

OR

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2006

OR

[_] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE TRANSITION PERIOD FROM ___________ TO ___________

[_] 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:

Title of each class	Name of each exchange on which registered
ORDINARY SHARES, NIS 0.1 PAR VALUE	NASDAQ GLOBAL MARKET

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

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

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

ORDINARY SHARES, PAR VALUE NIS 0.01 PER SHARE...............31,323,845
(as of December 31, 2006)

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]

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

Yes [X]   No [_]

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

Large accelerated filer [_] Accelerated filer [_] Non-accelerated filer [X]

Indicate by check mark which financial statement item the registrant has elected to follow:

Item 17 [_]   Item 18 [X]

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 [X]

This annual report on Form 20-F/A 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.

EXPLANATORY NOTE

This Amendment No. 1 on Form 20-F/A is being filed solely to correct Item 18 of Magic Software Enterprises Ltd.'s Annual Report on Form 20-F for the fiscal year ended December 31, 2006, which was filed on June 26, 2007.

Item 18 has been corrected to include the auditors' reports of the Registrant's substantial subsidiaries for the fiscal year ended December 31, 2006, which were inadvertently omitted from the original Form 20-F.

This Amendment is not intended to revise other information presented in the Registrant's Annual Report on Form 20-F for the fiscal year ended December 31, 2006 as originally filed and all such other information in the original filing remains unchanged.

This Amendment does not reflect events occurring after the filing of the original Form 20-F and does not modify or update the disclosure therein in any way other than as required to reflect the amendment discussed above. As a result, this Amendment continues to speak as of June 26, 2006.

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PART III

ITEM 17. FINANCIAL STATEMENTS

Not applicable.

ITEM 18. FINANCIAL STATEMENTS

ITEM 19. EXHIBITS

INDEX TO EXHIBITS

EXHIBIT	DESCRIPTION
3.1	Memorandum of Association of the Registrant(1)
3.2	Articles of Association of the Registrant(2)
4.1	Specimen of Ordinary Share Certificate(3)

8	List of Subsidiaries of the Registrant*
10.1	1991 Employee Stock Option Plan, as amended(4)
10.2	2000 Employee Stock Option Plan(5)
12.1	Certification of Acting Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended
12.2	Certification of Acting Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended
13.1	Certification of Acting Chief Executive Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

13.2	Certification of Acting Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
15.1	Consent of Kost Forer Gabbay & Kasierer, a Member of Ernst & Young Global
15.2	Consent of Levy Cohen & Co., Chartered Accountants (relating to Magic Software Enterprises (UK) Limited)
15.3	Consent of Levy Cohen & Co., Chartered Accountants (relating to Hermes Logistics Technologies Limited)
15.4	Consent of ASG Audit Corporation, a Member of Grant Thornton International (relating to Magic Software Japan K.K.)
15.5	Consent of KDA Audit Corporation (relating to Magic Software Japan K.K.)
15.6	Consent of Mock & Partners International, Registered Accountants (relating to Magic Benelux B.V.)
15.7	Consent of Maria Negyeffy, Registered Auditors (relating to Magic (Onyx) Magyarorszag Szoftverhaz Kft.)
15.8	Consent of Federico Pozzi, Registered Auditors (relating to Magic Italy Srl.)

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* Previously filed.

(1) Filed as Exhibit 3.2 to the registrant's registration statement on Form F-1, registration number 33-41486, and incorporated herein by reference.

(2) Filed as Exhibit 3.1 to the registrant's registration statement on Form F-1, registration number 33-41486, and incorporated herein by reference.

(3) Filed as Exhibit 4.1 to the registrant's registration statement on Form

F-1, registration number 33-41486, and incorporated herein by reference.

(4) Filed as Exhibit 10.1 to the registrant's annual report on Form 20-F for the year ended December 31, 2000 , and incorporated herein by reference.

(5) Filed as Exhibit 10.2 to the registrant's annual report on Form 20-F for the year ended December 31, 2000, and incorporated herein by reference.

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MAGIC SOFTWARE ENTERPRISES LTD. AND ITS SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2006

IN U.S. DOLLARS

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

TO THE SHAREHOLDERS OF

MAGIC SOFTWARE ENTERPRISES LTD.

We have audited the accompanying consolidated balance sheets of Magic Software Enterprises Ltd. (the "Company") and its subsidiaries as of December 31, 2005 and 2006, and the related consolidated statements of operations, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2006. These financial statements are the responsibility of Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of certain subsidiaries, which statements reflect total assets of 10% and 18% as of December 31, 2005 and 2006, respectively, and total revenues of 39%, 18% and 33% for each of the three years in the period ended

December 31, 2006. Those statements were audited by other auditors whose reports have been furnished to us, and our opinion, insofar as it relates to the amounts included for those subsidiaries, is based solely on the reports of the other auditors.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits and the reports of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the reports of the other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries at December 31, 2005 and 2006, and the related consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 2 to the consolidated financial statements, the company adopted the provision of Statement of Financial Accounting Standard No. 123(R), "Share-Based Payment", effective January 1, 2006.

As discussed in Note 2 to the consolidated financial statements, on December 31, 2006, the Company initially applied the provisions of Staff Accounting Bulletin No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements", and recorded a cumulative effect adjustment to beginning accumulated deficit at January 1, 2006 and adjustments to property and equipment as of December 31, 2005.

/s/ Kost Forer Gabbay & Kasierer
KOST FORER GABBAY & KASIERER
A Member of Ernst & Young Global

Tel-Aviv, Israel
June 26, 2007

MAGIC SOFTWARE ENTERPRISES LTD.
AND ITS SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

U.S. DOLLARS IN THOUSANDS

	DECEMBER 31,	
	2005	2006
ASSETS		

CURRENT ASSETS:		
Cash and cash equivalents	$ 9,116	$ 8,162
Short-term bank deposits	368	69
Marketable securities (Note 3)	4,381	4,649
Trade receivables (net of allowance for doubtful accounts of $ 2,210 and $ 1,836 at December 31, 2005 and 2006, respectively)	14,572	12,365
Other accounts receivable and prepaid expenses (Note 4)	2,832	2,472
Inventory	400	328
TOTAL current assets	31,669	28,045
LONG-TERM INVESTMENTS:		
Long-term lease deposits	805	576
Investments in affiliated companies	198	213
Severance pay fund	2,135	2,176
TOTAL long-term investments	3,138	2,965
PROPERTY AND EQUIPMENT, NET (Note 5)	6,955	6,414
OTHER INTANGIBLE ASSETS, NET (Note 6)	11,199	10,863
GOODWILL (Note 7)	20,762	21,624
	$73,723	$69,911

The accompanying notes are an integral part of the consolidated financial statements.

MAGIC SOFTWARE ENTERPRISES LTD.
AND ITS SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

U.S. DOLLARS IN THOUSANDS (EXCEPT SHARE AND PER SHARE DATA)

	DECEMBER 31,	
	2005	200
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Short-term credit and current maturities of long-term loans (Note 8)	$ 4,183	$ 4
Trade payables	3,319	3
Accrued expenses and other accounts payable (Note 9)	10,696	11

TOTAL current liabilities	18,198	19
ACCRUED SEVERANCE PAY	2,527	2
LONG-TERM LOANS (Note 10)	165	
MINORITY INTEREST	528	
COMMITMENTS AND CONTINGENCIES (Note 15)		
SHAREHOLDERS' EQUITY (Note 12):		
Share capital:		
Authorized: 50,000,000 Ordinary shares of NIS 0.1 par value at December 31, 2005 and 2006; Issued: 32,345,867 and 32,599,213 shares at December 31, 2005 and 2006, respectively; Outstanding: 31,070,499 and 31,323,845 shares at December 31, 2005 and 2006, respectively	829	
Additional paid-in capital	106,072	106
Accumulated other comprehensive loss	(1,514)	(1
Treasury shares, at cost: 1,275,368 Ordinary shares at December 31, 2005 and 2006.	(6,772)	(6
Accumulated deficit	(46,310)	(51
TOTAL shareholders' equity	52,305	47
	$ 73,723	$ 69

The accompanying notes are an integral part of the consolidated financial statements.

MAGIC SOFTWARE ENTERPRISES LTD.
AND ITS SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

U.S. DOLLARS IN THOUSANDS (EXCEPT PER SHARE DATA)

	YEAR ENDED DECEMBER 31,		
	2004	2005	2006
Revenues (Note 13):			
Software sales	$ 28,022	$ 25,103	$ 22,336
Maintenance and technical support	12,555	14,376	14,935
Consulting services	24,590	21,511	24,454

TOTAL revenues	65,167	60,990	61,725
Cost of revenues:			
Software sales	6,462	8,483	7,016
Maintenance and technical support	3,199	2,679	3,615
Consulting services	15,818	15,514	18,087
TOTAL cost of revenues	25,479	26,676	28,718
Gross profit	39,688	34,314	33,007
Operating costs and expenses:			
Research and development, net (Note 14a)	3,845	3,733	3,942
Selling and marketing	17,157	18,510	16,777
General and administrative	15,384	16,332	15,572
Restructuring and Impairment	-	-	2,157
TOTAL operating expenses, net	36,386	38,575	38,448
Operating income (loss)	3,302	(4,261)	(5,441)
Financial income (expenses), net (Note 14b)	912	(811)	410
Other income, net (Note 1f)	-	1,169	278
Income (loss) before taxes on income	4,214	(3,903)	(4,753)
Taxes on income (Note 11)	281	491	325
	3,933	(4,394)	(5,078)
Equity in earnings of affiliates	79	19	15
Minority interest in losses (earnings) of subsidiaries	78	(232)	57
Net income (loss)	$ 4,090	$ (4,607)	$ (5,006)
Basic and diluted net earnings (loss) per share (Note 16)	$ 0.13	$ (0.15)	$ (0.16)

The accompanying notes are an integral part of the consolidated financial statements.

MAGIC SOFTWARE ENTERPRISES LTD.
AND ITS SUBSIDIARIES

STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

U.S. DOLLARS IN THOUSANDS

	SHARE CAPITAL	ADDITIONAL PAID-IN CAPITAL	ACCU C COMP INC
Balance as of January 1, 2004	$ 805	$104,765	$
Other comprehensive income:			
Foreign currency translation adjustments	-	-	
Unrealized gains from available-for-sale securities, net	-	-	
Net income	-	-	
Total comprehensive income			
Exercise of stock options and warrants	22	1,227	
Purchase of Treasury shares	-	-	
Balance as of December 31, 2004	827	105,992	
Realized losses from available-for-sale securities	-	-	
Other comprehensive loss:			
Foreign currency translation adjustments	-	-	
Unrealized losses from available-for-sale securities	-	-	
Net loss	-	-	
Total comprehensive loss			
Exercise of stock options	2	80	
Purchase of Treasury shares	-	-	
Balance as of December 31, 2005	829	106,072	
Effect of SAB 108			
Stock based compensation expenses		27	
Realized losses from available-for-sale securities	-	-	
Other comprehensive loss:			
Foreign currency translation adjustments	-	-	
Unrealized gain from available-for-sale securities	-	-	
Net loss	-	-	
Total comprehensive loss			
Exercise of stock options	5	276	
Balance as of December 31, 2006	$ 834	$106,375	$

The accompanying notes are an integral part of the consolidated financial statements.

MAGIC SOFTWARE ENTERPRISES LTD.
AND ITS SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. DOLLARS IN THOUSANDS

	YEAR ENDED DECEMBER	
	2004	2005
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	$ 4,090	$ (4,607)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	4,649	5,139
Equity in earnings of affiliates	(79)	(19)
Minority interest in earnings (losses) of subsidiaries	(78)	232
Accrued severance pay, net	37	(30)
Loss (gain) on sale of property and equipment	(9)	16
Stock-based compensation expenses	-	-
Amortization of premiums and accrued interest on marketable securities, net	(53)	67
Loss (gain) on sale of marketable securities	(28)	68
Gain on sale of subsidiary's operation	-	-
Impairment of intangible asset	-	-
Decrease in trade receivables	126	4,569
Decrease (increase) in related parties receivables	5	(28)
Decrease (increase) in other accounts receivable and prepaid expenses	(76)	471
Decrease (increase) in inventory	(181)	(20)
Increase (decrease) in trade payables	(488)	646
Increase (decrease) in accrued expenses and other accounts payable	(2,642)	(907)
Net cash provided by operating activities	5,273	5,597
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capitalized software development costs	(3,472)	(3,909)
Purchase of property and equipment	(1,006)	(1,123)
Purchase of intangible assets	(374)	-
Additional investment in subsidiaries (See note 1b-d)	(1,626)	-
Proceeds from sale of subsidiary's operation	-	-
Proceeds from sale of property and equipment	23	18
Proceeds from sale of marketable securities	777	664
Purchase of marketable securities	(5,921)	(199)
Change in short-term and long-term deposits	(317)	(599)
Net cash used in investing activities	(11,916)	(5,148)

The accompanying notes are an integral part of the consolidated financial statements.

MAGIC SOFTWARE ENTERPRISES LTD.
AND ITS SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. DOLLARS IN THOUSANDS

	YEAR ENDED DECEMBER 31,		
	2004	2005	2006
CASH FLOWS FROM FINANCING ACTIVITIES:			
Proceeds from exercise of stock options and warrants	$ 1,249	$ 82	$ 2
Purchase of Treasury shares	(102)	(897)	
Short-term credit, net	(108)	1,979	3
Repayment of long-term loan	(359)	(54)	(1
Proceeds from long-term loans	126	164	1
Dividend to minority in subsidiary	-	(509)	
Net cash provided by financing activities	806	765	6
Effect of exchange rate changes on cash and cash equivalents	(164)	322	(2
Increase (decrease) in cash and cash equivalents	(6,001)	1,536	(9
Cash and cash equivalents at beginning of the year	13,581	7,580	9,1
Cash and cash equivalents at end of the year	$ 7,580	$ 9,116	$ 8,1
SUPPLEMENTAL DISCLOSURE OF CASH FLOW ACTIVITIES:			
NET CASH PAID DURING THE YEAR FOR:			
Income taxes	$ 281	$ 424	$ 4
Interest	$ 74	$ 102	$ 2

The accompanying notes are an integral part of the consolidated financial statements.

MAGIC SOFTWARE ENTERPRISES LTD.
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS

NOTE 1:- GENERAL

a. Magic Software Enterprises Ltd. (the "Company"), an Israeli corporation, and its subsidiaries ("the Group") develops, markets and supports software development and deployment technology ("the Magic technology") and applications developed using this Magic technology. Magic technology enables enterprises to accelerate the process of building and deploying software applications that can be rapidly customized and integrated with existing systems. The principal markets of the Company and its subsidiaries are Europe, Israel, the U.S. and Japan (see Note 13).

As for information about the Company's holdings in subsidiaries and affiliated company, see Appendix A.

b. During 2004, in consideration of $ 1,240, the Company purchased an additional 20.96% equity interest in Advanced Answer on Demand Holdings Corp. ("AAOD"), a private Florida based company that provides integrated software solutions for the long-term healthcare industry. As a result, the Company's interest in AAOD's share capital increased to 83.89%.

In February 2006, in consideration of $ 1,910, the Company purchased an additional 16.11% equity interest in AAOD. As a result, the Company's interest in AAOD's share capital increased to 100%. The purchase price was allocated, as follows:

Customer relations *)	$ 314
Acquired technology*)	216
Goodwill	990
Minority interest	390
Total net assets acquired	$ 1,910

*) The customer relations and acquired technology are amortized on a straight-line basis over a period of five years.

c. During 2004, the Company purchased an additional equity interest of 26% in Onyx Szoftverhaz Hungary, bringing its holding to 100% in consideration of $ 290. The excess of the cost over the net amounts assigned to the fair value of assets acquired and liabilities assumed was recorded as goodwill at the total amount of $ 69.

d. During 2004, the Company purchased an additional equity interest of 12.5% from the minority in CarPro Systems Ltd., ("CarPro") bringing it's holding to 87.5%, in consideration of $ 96.

During 2005, the Company invested an additional amount of approximately $ 214 in CarPro equity, bringing its holding to 90.48%.

U.S. DOLLARS IN THOUSANDS

NOTE 1:- GENERAL (CONT.)

On December 7, 2006, the Company has recorded a net gain of $278 relating to the sale of CarPro's assets and liabilities, including the intellectual property (the RentPro and LeasePro software) and its customer base, to its distributor CarPro Systems International B.V. (the "Buyer"),. Additionally Magic Software Enterprises sold to the buyer a substantial number of licenses for Magic Software's products for continued use in the ongoing maintenance and enhancement of the CarPro software products. The combined sales price is $ 1,750 to be paid over a period of five years. The Company recognized the consideration from the sale of Carpro's operations on a cash basis and net of related expenses (including goodwill and other intangible assets write-offs).

e. During 2002, Magic U.K., a subsidiary of the Company established a joint venture company in the U.K., known as Hermes Logistics Technologies Ltd. Holding ("Hermes"), which owns the Intellectual Property ("IP") of the Hermes application.

In 2004, the subsidiary purchased the remaining 49% interest in Hermes and increased its holdings to 100% for a cash consideration of approximately $ 354, which was recorded as other intangible assets, and committed to pay royalties to the seller in the amount of 1.75% of gross sales of the Hermes application for a period of 5 years (see Note 15e).

f. The Company has recorded a net income of $1,169 in 2005 relating to life insurance that the Company received in 2005 following the death of the former chief executive officer of the subsidiary AAOD in June 2004.

g. On August 16, 2006, Magic's board of directors approved a comprehensive global Restructuring plan (the "Plan"). The Plan establishes the terms of the benefit arrangement, including the benefits that employees will receive upon termination. In accordance with Statement of Financial Accounting Standard No. 146, "Accounting for Costs Associated with Exit or Disposal Activities" ("SFAS No. 146") the Company recorded $ 1,365 related to one-time termination benefits provided to terminated employees. As of December 31, 2006, all termination benefits were paid and substantially all terminated employees no longer provide services to the Company. In addition the Company wrote- off certain intangible assets related to the restructuring plan and incurred other exit costs in the amounts of $ 309 and $ 483 respectively.

NOTE 2: - SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the U.S. ("U.S. GAAP"), applied on a consistent basis, as follows:

USE OF ESTIMATES

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

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NOTE 2: - SIGNIFICANT ACCOUNTING POLICIES (CONT.)

FINANCIAL STATEMENTS IN UNITED STATES DOLLARS

A substantial portion of the revenues of the Company and certain of its subsidiaries is generated in U.S. dollars ("dollar"). In addition, a substantial portion of the Company's costs is incurred in dollars. The Company's management believes that the dollar is the currency of the primary economic environment in which the Company and its subsidiaries operate. Thus, the functional and reporting currency of the Company and certain of its subsidiaries is the dollar.

Accordingly, monetary accounts maintained in currencies other than the dollar are remeasured into dollars in accordance with SFAS No. 52, "Foreign Currency Translation" ("SFAS No. 52"). All transaction gains and losses of the remeasurement of monetary balance sheet items are reflected in the statements of operations as financial income or expenses, as appropriate.

The financial statements of foreign subsidiaries and of certain entities that are reported using the equity method of accounting, whose functional currency is not the U.S. dollar, have been translated into dollars. All balance sheet amounts have been translated using the exchange rates in effect at each balance sheet dates. Statement of operation amounts have been translated using the average exchange rate prevailing during each year. Such translation adjustments are reported as a component of accumulated other comprehensive income (loss) in shareholders' equity.

PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include the accounts of the Company and its wholly and majority owned subsidiaries. Intercompany balances and transactions including profit from intercompany sales not yet realized outside the Group, have been eliminated upon consolidation.

CASH EQUIVALENTS:

Cash equivalents are short-term highly liquid investments that are readily convertible to cash with maturities of three months or less, at the date acquired.

SHORT-TERM DEPOSITS

Short-term deposits include deposits with original maturities of more than three months and less than one year which presented at cost, including accrued interest. The deposits are in U.S. dollars and in New Israeli Shekels and bear interest at an average annual rate of 4.94% and 4.24%, respectively.

U.S. DOLLARS IN THOUSANDS

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

MARKETABLE SECURITIES

The Company accounts for investments in marketable securities in accordance with SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities ("SFAS No. 115"). 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.

INVENTORIES

Inventories consist of software packaging, discs, printed materials, hardware devices and third party licenses, and are stated at the lower of cost or market value. Cost is determined by the "first-in, first-out" method.

Inventory write-offs are provided to cover risks arising from slow-moving items, technological obsolescence, excess inventories, and for market prices lower than cost. In 2006, the Company wrote off approximately $ 237 of slow-moving inventory of license, which was not part of the core business of the Company, related to the reorganization plan which was approved by the Company's management and Board of Directors during the third quarter of 2006.

INVESTMENTS IN AFFILIATED COMPANIES

In these financial statements, affiliated companies are companies held to the extent of 20% or more (which are not subsidiaries), where the Company can exercise significant influence over operating and financial policy of the affiliate. The investment in affiliated companies is accounted for by the equity method. Profits on inter-company sales, not realized outside the Group, were eliminated.

Management periodically reviews the carrying value of the investments. If this review indicates that the cost is not recoverable, the carrying value is reduced to its estimated fair value. As of December 31, 2005 and 2006, no impairment indicators have been identified.

PROPERTY AND EQUIPMENT NET

Property and equipment are stated at cost, net of accumulated depreciation. Depreciation is computed by the straight-line method over the estimated useful lives of the assets at the following estimated useful lives:

MAGIC SOFTWARE ENTERPRISES LTD.
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS

NOTE 2: - SIGNIFICANT ACCOUNTING POLICIES (CONT.)

	YEARS
Buildings	25
Computers and peripheral equipment	3
Office furniture and equipment	7 - 15
Motor vehicles	7
Software for internal use	3
Leasehold improvements	Over the shorter of the lease term or useful economic life

The Group accounts for costs of computer software developed or obtained for internal use in accordance with Statement of Position No. 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use ("SOP No. 98-1"). The SOP requires the capitalization of certain costs incurred in connection with developing or obtaining internal use software.

During the year 2006, the Company capitalized $ 140 of software cost, related to the ERP (enterprise resource planning) system. Capitalized software costs are amortized by the straight-line method over their estimated useful life of three years. In September 2006, as part of the restructuring process held by the Company, the Software project was postponed.

IMPAIRMENT OF LONG-LIVED ASSETS

The Company's long-lived assets are reviewed for impairment in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144") whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the future undiscounted cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. As of December 31, 2005, no impairment indicators have been identified. For the year 2006 see Note 1g.

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 five years.

MAGIC SOFTWARE ENTERPRISES LTD.
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

GOODWILL

Under SFAS No. 142, "Goodwill and Other Intangible Assets," 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. The Company conducts its annual test of impairment for goodwill in December of each year. In addition the Company tests for impairment periodically whenever events or circumstances occur subsequent to its annual impairment tests that indicate that the asset might be impaired. Indicators the Company considered 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 the acquired assets or the strategy for its overall business, significant negative industry or economic trends, a significant decline in its stock price for a sustained period and its market capitalization relative to net book value.

The Company has three reporting units. The goodwill of each reporting unit was measured separately. The first step of the goodwill impairment test compared 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 2006.

REVENUE RECOGNITION

To date, the Company has derived its revenues from licensing the rights to use its software, maintenance and technical support and providing professional services. The Company sells its products primarily through its direct sales force and indirectly through distributors.

The Company accounts for software sales in accordance with Statement of Position 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" ("SOP No. 97-2"). SOP No. 97-2 generally requires revenues 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 (VSOE) of fair value. Revenues are 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. 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.

Revenues from license fees are 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. The Company generally does not grant a right of return to its customers. When a right of return exists, the Company defers revenue until the right of return expires, at which time revenue is recognized provided that all other revenue recognition criteria are met.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

Maintenance and technical support revenues are 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, 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, revenues under the arrangement are recognized using contract accounting based on Statement of Position No. 81-1, "Accounting for Performance of Construction-Type and Certain Production-Type Contracts" ("SOP 81-1") on a percentage of completion method based on inputs measures. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are first determined, in the amount of the estimated loss for the entire contract. As of December 31, 2006, no such estimated losses were identified.

When consulting services are not considered essential, the revenues allocable to the consulting services are recognized as the services are performed. In most cases, the Company had 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.

RESEARCH AND DEVELOPMENT COSTS

SFAS No. 86 "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed", ("SFAS No. 86") requires capitalization of certain software development costs subsequent to the establishment of technological feasibility. Based on the Company and its subsidiaries product development process, technological feasibility is established upon completion of a detailed program design and working model.

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

Significant costs incurred by the Company and its subsidiaries between completion of the detailed program design and a working model, and the point at which the product is ready for general release, have been capitalized.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

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). The Company assesses 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 and 2006, no impairment losses have been identified.

SEVERANCE PAY

Pursuant to Section 14 of the Severance Compensation Act, 1963 ("Section 14"), certain employees of the Company who elected to be included under this section, are entitled only to monthly deposits, at a rate of 8.33% of their monthly salary, made in their name with insurance companies. Payments in accordance with Section 14 release the Company from any future severance payments in respect of those employees. Deposits under Section 14 are not recorded as an asset in the Company's balance sheet.

The liability of the Israeli companies for severance pay (for those who elected not to be included under Section 14) is calculated pursuant to Israel's Severance Pay Law, based on the most recent salary of the employees multiplied by the number of years of employment, as of the balance sheet date. Employees are entitled to one month's salary for each year of employment or a portion thereof. The Company's liability for all of its employees in Israel is fully provided by monthly deposits with insurance policies and by an accrual. The value of these policies is recorded as an asset in the Company's balance sheet.

The deposited funds include profits accumulated up to the balance sheet date. The deposited funds may be withdrawn only upon the fulfillment of the obligation pursuant to Israel's Severance Pay Law or labor agreements. The value of the deposited funds is based on the cash surrendered value of these policies, and includes immaterial profits.

Severance expenses for the years ended December 31, 2004, 2005 and 2006 amounted to approximately $ 389, $ 453 and $ 463, respectively.

ADVERTISING EXPENSES

Advertising expenses are charged to selling and marketing expenses, as incurred. Advertising expenses for the years ended December 31, 2004, 2005 and 2006 were $ 46, $ 119 and $ 87, respectively.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

INCOME TAXES

The Company and its subsidiaries account for income taxes in accordance with SFAS No. 109, "Accounting for Income Taxes" ("SFAS No. 109"). This Statement prescribes the use of the liability method whereby deferred tax assets and liability account balances are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. The Company and its subsidiaries provide a valuation allowance, if necessary, to reduce deferred tax assets to their estimated realizable value.

TREASURY SHARES

The Company repurchases its Ordinary shares from time to time in the open market and holds such shares as Treasury shares. The Company applies the "cost method" and presents the cost to repurchase such shares as a reduction in shareholders' equity. As of December 31, 2006, the Company did not sell any of the shares.

BASIC AND DILUTED NET EARNINGS (LOSS) PER SHARE

Basic net earnings (net loss) per share is computed based on the weighted average number of Ordinary shares outstanding during each year. Diluted earnings per share are computed based on the weighted average number of Ordinary shares outstanding during each year, plus dilutive potential Ordinary shares considered outstanding during the year, in accordance with SFAS No. 128, "Earnings Per Share" ("SFAS No. 128").

Part of the outstanding stock options and warrants has been excluded from the calculation of the diluted earnings (net loss) per share because such securities are anti-dilutive for 2004, 2005 and 2006. The total weighted average number of shares related to the outstanding options and warrants excluded from the calculations of diluted earnings (net loss) per share was 209,161, 1,298,186 and 883,884 for the years ended December 31, 2004, 2005 and 2006, respectively.

ACCOUNTING FOR STOCK-BASED COMPENSATION

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment" ("SFAS 123(R)") which requires the measurement and recognition of compensation expense based on estimated fair values for all share-based payment awards made to employees and directors. SFAS 123(R) supersedes Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25"), for periods beginning in fiscal 2006. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 ("SAB 107") relating to SFAS 123(R). The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R).

U.S. DOLLARS IN THOUSANDS

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

SFAS 123(R) requires companies to estimate the fair value of equity-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as an expense over the requisite service periods in the Company's consolidated income statement. Prior to the adoption of SFAS 123(R), the Company accounted for equity-based awards to employees and directors using the intrinsic value method in accordance with APB 25 as allowed under Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123").

The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard starting from January 1, 2006, the first day of the Company's fiscal year 2006. Under that transition method, since all the unvested options had been accelerated prior to the adoption of statement 123(R), (see note 12), compensation cost recognized in the year ended December 31, 2006, includes compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of Statement 123(R). Results for prior periods have not been restated.

The Company recognizes compensation expenses for the value of its awards, which have graded vesting based on the straight line method over the requisite service period of each of the awards, net of estimated forfeitures. Estimated forfeitures are based on actual historical pre-vesting forfeitures.

As a result of adopting SFAS 123(R) on January 1, 2006, the Company's income before income taxes and net income for the year ended December 31, 2006, is $ 27 lower than if it had continued to account for stock-based compensation under APB 25.

Prior to January 1, 2006, the Company applied the intrinsic value method of accounting for stock options as prescribed by APB 25, whereby compensation expense is equal to the excess, if any, of the quoted market price of the stock over the exercise price at the grant date of the award.

The Pro-forma table below illustrates the effect of the Company's stock based compensation expense on net income and basic and diluted earnings per share for 2005 and 2004, had the Company applied the fair value recognition provisions of SFAS 123.

The fair value for options granted in 2004 and 2005 is amortized over their vesting period and estimated at the date of grant using a Black-Scholes options pricing model with the following weighted average assumptions:

U.S. DOLLARS IN THOUSANDS

	2004	2005
Dividend yield	0%	0%
Expected volatility	67.3%	80%
Risk-free interest	2.8%	3.9%
Expected life (in years)	3	5

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

The pro-forma table below reflects the Company's stock based compensation expense, net income (loss) and basic and diluted earnings per share for the years ended December 31 2004 and 2005, had the Company applied the fair value recognition provisions of SFAS 123, as follows:

	YEAR ENDED DECEMBER 31,	
	2004	2005
Net income (loss) - as reported	$ 4,090	$(4,607)
Add: stock-based compensation expense recognized under APB 25	-	-
Deduct: stock-based compensation expense determined under fair value method for all awards	(820)	(2,599)
Pro forma net income (loss):	$ 3,270	$(7,206)
Net earnings (loss) per share:		
Basic and diluted earnings (loss) per share, as reported	$ 0.13	$ (0.15)
Pro forma basic and diluted earnings (loss) per share	$ 0.10	$ (0.23)

The Company estimates the fair value of stock options granted using the Black-Scholes-Merton option-pricing model. The option-pricing model requires a number of assumptions, of which the most significant are, expected stock price volatility, and the expected option term. Expected volatility was calculated based upon actual historical stock price movements over the most recent periods ending on the grant date, equal to the expected option term. The expected option term represents the period that the Company's stock options are expected to be outstanding and was determined based on historical experience of similar options, giving consideration to the contractual terms of the stock options. The Company has historically not paid dividends and has no foreseeable plans to issue dividends. The risk-free interest rate is based on the yield from U.S. Treasury zero-coupon bonds with an equivalent term.

U.S. DOLLARS IN THOUSANDS

The following weighted assumptions were used in the model for 2006:

	2006
Dividend yield	0%
Expected volatility	64%
Risk-free interest	4.7%
Expected life (in years)	5 years

For purpose of pro-forma disclosures stock based compensation is amortized over the vesting period using the straight line method. Pro-forma compensation expense under SFAS 123, among other computational differences, does not consider potential pre-vesting forfeitures. Because of these differences, the pro-forma stock based compensation expense presented above for the prior years ended December 31 2004 and 2005 under SFAS 123 and the stock based compensation expense recognized during the current year ended December 31, 2006 under SFAS 123(R) are not directly comparable.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

During the year ended December 31 2006, the Company recognized stock-based compensation expense related to employee stock options in the amount of $ 27, that were recorded as General and administrative expenses.

As of December 31, 2006, the total unrecognized estimated compensation costs related to non-vested stock options granted prior to that date was $ 7, which is expected to be recognized over a period of up to 2.25 years. The Company recorded cash received from the exercise of stock options of $ 281.

The Company accounts for stock option and warrant grants issued to non-employee using the guidance of SFAS No. 123(R), "Accounting for Stock-Based Compensation" and EITF No. 96-18: "Accounting for Equity Instruments that are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services," whereby the fair value of such option and warrant grants is determined using the Black-Scholes options pricing model at the earlier of the date at which the non-employee's performance is completed or a performance commitment is reached.

CONCENTRATIONS OF CREDIT RISK

Financial instruments which potentially subject the Company and its subsidiaries to concentration of credit risk consist principally of cash and cash equivalents, marketable securities and trade receivables.

The Company's cash and cash equivalents are invested primarily in deposits with major banks worldwide, however, such cash and cash equivalents in the

United States may be in excess of insured limits and are not insured in other jurisdictions. Management believes that the financial institutions that hold the Company's investments are financially sound, and accordingly, minimal credit risk exists with respect to these investments.

The Company's marketable securities include investments in debentures of corporations, foreign banks, governments and commercial debentures. Management believes that those corporations and governments are financially sound and that the portfolios are well-diversified, and accordingly, minimal credit risk exists with respect to these marketable securities.

Trade receivables of the Company and its subsidiaries are derived from sales to customers located primarily in the U.S., Europe, Japan and Israel. The Company performs ongoing credit evaluations of its customers and to date has not experienced any material losses. An allowance for doubtful accounts is determined with respect to those amounts that the Company has determined to be doubtful of collection. Moreover, in some of the subsidiaries there is an additional general allowance (based on a percentage of accounts receivables or revenue) which depends on the nature of the local market and local law requirements. The doubtful accounts expenses for the years ended December 31, 2005 and 2006 were $ 1,212 and $ 607, respectively.

U.S. DOLLARS IN THOUSANDS

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

DERIVATIVE INSTRUMENTS

Statement of Financial Accounting Standard No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS No. 133"), requires companies to recognize all of their derivative instruments as either assets or liabilities in the statement of financial position at fair value.

The Company entered into a forward transaction for the sale of $ 1,250 at a future price of Euro 1.3225 per $ 1 as at December 1, 2006. During 2006, the Company recorded a net income of $ 6 related to this forward transaction.

Besides the aforementioned foreign exchange contract, the Company and its subsidiaries have no off-balance-sheet concentration of credit risk such as option contracts or other foreign hedging arrangements.

FAIR VALUE OF FINANCIAL INSTRUMENTS

The following methods and assumptions were used by the Company and its subsidiaries in estimating their fair value disclosures for financial instruments:

The carrying amounts of cash and cash equivalents, trade receivables and other accounts receivable, short-term bank credit, trade payables and other accounts payable approximate their fair value due to the short-term maturity of these instruments.

The fair values for marketable securities are presented based on quoted market prices (see also Note 3).

The carrying amount of the Company's long-term borrowing approximates its fair value. The fair value was estimated using discounted cash flow analyses, based on the Company's incremental borrowing rates for similar type of borrowing arrangements.

IMPACT OF RECENTLY ISSUED ACCOUNTING STANDARDS:

a. In September 2006, the SEC staff issued Staff Accounting Bulletin No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements." ("SAB 108") SAB 108 was issued in order to eliminate the diversity of practice surrounding how public companies quantify financial statement misstatements.

Traditionally, there have been two widely-recognized methods for quantifying the effects of financial statement misstatements: the "roll-over" method and the "iron curtain" method. The roll-over method focuses primarily on the impact of a misstatement on the income statement--including the reversing effect of prior year misstatements--but its use can lead to the accumulation of misstatements in the balance sheet. The iron-curtain method, on the other hand, focuses primarily on the effect of correcting the period-end balance sheet with less emphasis on the reversing effects of prior year errors on the income statement. Prior to our application of the guidance in SAB 108, we used the roll-over method for quantifying financial statement misstatements.

In SAB 108, the SEC staff established an approach that requires quantification of financial statement misstatements based on the effects of the misstatements on each of the company's financial statements and the related financial statement disclosures. This model is commonly referred to as a "dual approach" because it requires quantification of errors under both the iron curtain and the roll-over methods.

SAB 108 permits existing public companies to initially apply its provisions either by (i) restating prior financial statements as if the "dual approach" had always been applied or (ii) recording the cumulative effect of initially applying the "dual approach" as adjustments to the carrying values of assets and liabilities as of January 1, 2006 with an offsetting adjustment recorded to the opening balance of retained earnings.

We elected to record the effects of applying SAB 108 using the cumulative effect transition method.

The following table summarizes the effects (up to January 1, 2006) of applying the guidance in SAB 108 (in thousands):

	PERIOD IN WHICH THE MISSTATEMENT ORIGINATED			
		YEAR ENDED DECEMBER 31,		
	CUMULATIVE PRIOR TO JANUARY 1, 2004	2004	2005	ADJUSTMENT RECORDED AS OF JANUARY 1, 2006
	U.S $ IN THOUSANDS			
Accrued depreciation of land lease rights (1)	112	14	14	140
Impact on net income (loss)	112	14	14	
accumulated deficit (2)				140

(1) Prior to these financial statements the Company has not amortized its lease rights in land related to its headquarters in Or Yehuda, Israel. The accumulated amortization as at December 31, 2005 of $140 has been recorded against accumulated deficit.

(2) Represents the net increase in the accumulated deficit recorded as of January 1, 2006 to record the initial application of SAB 108.

b. In September 2006, the FASB issued Statement of Financial Accounting Standards (SFAS) 157, ``Fair Value Measurements.'' SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP) and expands disclosures about fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The Company is currently evaluating the effect that the adoption of SFAS 157 will have on its financial position and results of operations.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (CONT.)

c. In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" (SFAS No. 159). SFAS No. 159 permits companies to choose to measure certain financial instruments and certain other items at fair value. The standard requires that unrealized gains and losses on items for which the fair value option has been elected be reported in earnings. SFAS No. 159 is effective for the Company beginning in the first quarter of fiscal year 2008, although earlier adoption is permitted. The Company is currently evaluating the impact that SFAS No. 159 will have on its consolidated financial statements

U.S. DOLLARS IN THOUSANDS

RECLASSIFICATION:

Certain amounts from prior years have been reclassified to conform to current period presentation.

NOTE 3:- MARKETABLE SECURITIES

The Company invests in marketable debt securities, which are classified as available-for-sale. The following is a summary of marketable debt securities:

	DECEMBER 31,				
	2005				
	AMORTIZED COST	UNREALIZED LOSSES	UNREALIZED GAINS	MARKET VALUE	AMORTIZED COST
AVAILABLE-FOR-SALE:					
Governmental debentures	$1,662	$ (81)	$ -	$1,581	$1,641
Commercial debentures	2,473	(125)	2	2,350	2,842
Equity funds	486	(36)	-	450	249
TOTAL available-for-sale marketable securities	$4,621	$ (242)	$ 2	$4,381	$4,732

During 2005 and 2006, the Company recorded proceeds from sales of marketable securities in the amount of $ 664 and $ 226, respectively and related losses of $ 68 and $ 10, respectively, in financial income, net.

NOTE 3:- MARKETABLE SECURITIES (CONT.)

The amortized costs of available-for-sale debt securities at December 31, 2006, by contractual maturities, are shown below:

	UNREALIZED GAINS (LOSSES)			
	AMORTIZED COST	GAINS	LOSSES	ESTIMATED FAIR VALUE
Due in one year or less	$ 928	$ -	$ (28)	$ 900
Due between one year to five years	3,199	10	(59)	3,150

U.S. DOLLARS IN THOUSANDS

Due in more than five years	605	-	(6)	599
	$ 4,732	$ 10	$ (93)	$ 4,649

The actual maturity dates may differ from the contractual maturities because debtors may have the right to call or prepay obligations without penalties.

The unrealized losses in the Company's investments in available-for-sale marketable securities were caused by interest rate increases and devaluation of the Euro. It is expected that the securities would not be settled at a price less than the amortized cost of the Company's investment. Based on the partial recovery in the securities' market value after the balance sheet date and the ability and intent of the Company to hold these investments until recovery, the debentures were not considered to be other than temporarily impaired at December 31, 2006.

NOTE 4: - OTHER ACCOUNTS RECEIVABLE AND PREPAID EXPENSES

	DECEMBER 31,	
	2005	2006
Short-term deposits and other accounts receivable	$ 968	$ 890
Prepaid expenses	876	870
Government authorities	875	642
Employee loans	42	70
Related party receivables	71	-
	$2,832	$2,472

NOTE 5:- PROPERTY AND EQUIPMENT

	DECEMBER 31,	
	2005	2006
Cost:		
Buildings and leasehold improvements	$ 6,910	$ 6,868
Computers and peripheral equipment	10,688	11,116
Office furniture and equipment	3,106	3,056
Motor vehicles	446	356
Software for internal use	2,083	2,236
	23,233	23,632

U.S. DOLLARS IN THOUSANDS

Accumulated depreciation:		
Buildings and leasehold improvements	2,282	2,682
Computers and peripheral equipment	10,208	10,608
Office furniture and equipment	2,334	2,317
Motor vehicles	228	215
Software for internal use	1,226	1,396
	16,278	17,218
Depreciated cost	$ 6,955	$ 6,414

Depreciation expenses amounted to $ 1,430, $ 1,492 and $ 1,428 for the years ended December 31, 2004, 2005 and 2006, respectively. As for charges, see Note 15c.

NOTE 6:- OTHER INTANGIBLE ASSETS

a. Intangible assets:

	DECEMBER 31,	
	2005	2006
Original amounts:		
Capitalized software costs	$31,508	$32,672
Acquired technology and other	1,828	2,196
	33,336	34,868
Accumulated amortization:		
Capitalized software costs	21,348	22,606
Acquired technology and other	789	1,399
	22,137	24,005
Amortized cost	$11,199	$10,863

b. Amortization expenses amounted to $ 3,219, $ 3,647 and $ 4,036 for the years ended December 31, 2004, 2005 and 2006, respectively.

NOTE 6:- OTHER INTANGIBLE ASSETS (CONT.)

c. Estimated acquired technology and other intangible assets amortization expenses for the years ended:

U.S. DOLLARS IN THOUSANDS

DECEMBER 31,	
2007	$ 119
2008	119
2009 and thereafter	13

NOTE 7:- GOODWILL

The changes in the carrying amount of goodwill for the two years ended December 31, 2006 are as follows:

Balance as of January 1, 2005	$ 21,684
Foreign currency translation adjustments	(922)
Acquisition of additional interest in subsidiaries (see Note 1)	-
Balance as of December 31, 2005	20,762
Foreign currency translation adjustments	990
Sale of Subsidiary's operations (see note 1d)	(160)
Acquisition of additional interest in subsidiary (see Note 1b)	32
Balance as of December 31, 2006	$ 21,624

NOTE 8:- SHORT-TERM CREDIT AND CURRENT MATURITIES OF LONG-TERM LOANS

a. Classified by currency, linkage terms and interest rates, the credit and loans are as follows:

	INTEREST RATE		DECEMBER 31,	
	2005	2006	2005	2006
	%			
Short-term bank loans:				
In, or linked to, U.S. dollars	6	-	$2,318	$ -
In, or linked to, Euro	3.75-5.68	5.5	1,405	3,184
In other currencies	1.63	2.13-6.75	341	975
			4,064	4,159
Short-term bank credit:				
In other currencies	-	-	-	111
			-	111

U.S. DOLLARS IN THOUSANDS

Short-term credit (1):				
In, or linked to, U.S. dollar	5.6-6.6	5.6-6.6	66	185
			66	185
Current maturities of long-term loans			53	59
			$4,183	$4,514

(1) Financing arrangement in regard to the ERP system.

b. Contractual restrictions and financial covenants:

For the purpose of obtaining credit and/or other bank services from banking institutions, the Company is committed towards the banking institutions as follow:

1. The Company is committed that the amount of cash and cash equivalents and short term investment will not be at any time below the amount of $ 6.5 million.

2. The Company is committed that at any time the rate of shareholders' equity of the Company will not drop below 45% of total balance sheet. In addition, shareholders equity will not drop at any time below the amount of $ 36 million.

3. The Company is committed that the total of its financial obligations (i.e., short and long terms from banking institutions or commitments due to debentures) will not exceed $7 million and 10% of total balance sheet.

4. The Company is committed not to pledge under any form of general floating charge and for any purpose any of the Companies' assets and/or part of it in favor of any third party, without receiving the banking institutions' advance and written consent.

NOTE 8:- SHORT-TERM CREDIT AND CURRENT MATURITIES OF LONG-TERM LOANS (CONT.)

If the Company does not comply with all or part of the financial ratios, or upon the occurrence of certain events as specified in the agreement, the bank will be allowed to request the immediate repayment of the aforementioned credit.

As of December 31, 2006, the Company was complied with some of the financial covenants and received a waiver from the banks for those financial covenants the Company did not comply with.

U.S. DOLLARS IN THOUSANDS

c. Credit line:

As of December 31, 2006, the Company used $ 2.2 million of its credit facility with the First International Bank of Israel Ltd. and $ 3 million with the Poalim Bank Ltd. As of December 31, 2006, the Company has an unutilized credit line of $ 0.3 million and $ 0.7 million in the First International Bank of Israel Ltd. and the Poalim Bank Ltd., respectively.

NOTE 9:- ACCRUED EXPENSES AND OTHER ACCOUNTS PAYABLE

	DECEMBER 31,	
	2005	2006
Employees and payroll accruals	$ 4,019	$ 4,351
Accrued expenses	2,287	2,109
Deferred revenues	3,442	4,132
Government authorities and other	948	807
	$10,696	$11,399

NOTE 10:- LONG-TERM LOANS

Long-term loans are composed as follows:

	INTEREST RATE		DECEMBER 31,	
	2005	2006	2005	2006
	%			
In U.S. dollar	5.6-6.6	5.6-6.6	$ 94	$ 95
In Yens	4.37	3.70	85	169
In euros	9.35	-	6	
In other currencies	10.97	14	33	28
Less - current maturities			(53)	(59)
			$ 165	$ 233

NOTE 11:- TAXES ON INCOME

a. Tax benefits under the Law for the Encouragement of Capital Investments, 1959 (the "Law"):

Seven expansion programs of the Company have been granted "Approved Enterprise" status under the Law. For these expansion programs, the Company has elected the alternative benefits track, waiving grants in return for tax exemptions. Pursuant thereto, the income of the Company derived from the following "Approved Enterprise" expansion programs is tax-exempt for the periods stated below and will be eligible for reduced tax rates thereafter (such reduced tax rates are dependent on the level of foreign investments in the Company), as described below.

1. The period of the benefits for the first program and its four extensions has already ended as of December 31, 2006.

2. The fifth program entitles the Company to a tax exemption for a four-year period ended December 31, 2000, and is subject to a reduced tax rate of 25% for an additional period of six years. The period of benefits for this program has not yet commenced.

3. In each of January 1998, November 1998 and November 2002, the Company received approvals for other expansions of its "Approved Enterprise" status, which entitles the Company to a two-year tax exemption period for each expansion and to a reduced tax rate of 25% for an additional period of five to eight years. The period of benefits for those expansions has not yet commenced.

The tax benefit periods provided by the fifth, sixth, seventh and eighth programs end at the earlier of 12 years from the commencement of production, or 14 years from receipt of the approval. As the Company currently has no taxable income, these benefits have not yet commenced.

The benefits available to an enterprise are conditional upon the fulfillment of conditions stipulated in the Law and its regulations and the criteria set forth in the specific letters of approval. In the event that the Company does not meet these conditions, it would be required to refund the amount of tax benefits, with the addition of interest and linkage adjustment to the Israeli Consumer Price Index ("CPI"). In the opinion of the Company's management, the Company has been in full compliance with the conditions of the above programs through December 31, 2006, and with respect to the first eight programs, has received written confirmation to this effect from the Investment Center.

If dividends were to be distributed out of tax-exempt profits deriving from an "Approved Enterprise", the Company would be liable for corporate tax at a rate of 25%. The Company does not anticipate paying dividends in the foreseeable future.

NOTE 11:- TAXES ON INCOME (CONT.)

Income from sources other than the "Approved Enterprise" during the benefit period will be subject to tax at the regular corporate tax rate (see Note 11d below).

On April 1, 2005, an amendment to the Investment Law came into effect ("the Amendment") and has significantly changed the provisions of the Investment Law. The Amendment limits the scope of enterprises which may be approved by 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.

As a result of the April 2005 amendment, tax-exempt income generated under the provisions of the new law will subject us to taxes upon distribution of the tax-exempt income to shareholders or liquidation of the company, and we may be required to record a deferred tax liability with respect to such tax-exempt income.

However, the Investment Law provides that terms and benefits included in any certificate of approval already granted will remain subject to the provisions of the law as they were on the date of such approval. Therefore, the Company's existing Approved Enterprise will generally not be subject to the provisions of the Amendment. As a result of the amendment, tax-exempt income generated under the provisions of the new law, will subject the Company to taxes upon distribution or liquidation and the Company may be required to record deferred tax liability with respect to such tax-exempt income. As of December 31, 2006, the Company did not generate income under the provision of the new law.

b. Tax benefits under the Law for the Encouragement of Industry (Taxes), 1969 ("the Encouragement Law"):

The Company is an "industrial company", as defined by the Encouragement Law and, as such, is entitled to certain tax benefits, mainly accelerated depreciation of machinery and equipment, as prescribed by regulations published under the Inflationary Adjustments Law, the right to deduct public issuance expenses and patents and other intangible property rights for tax purposes, and the right to file, under specified conditions, a consolidated tax return with additional related Israeli "industrial companies".

c. Measurement of taxable income under the Income Tax (Inflationary Adjustments) Law, 1985:

Results for tax purposes in Israel are measured and reflected in real terms in accordance with the change in the CPI. As explained in Note 2b, the consolidated financial statements are presented in dollars. The differences between the change in the Israeli CPI and in the NIS/dollar exchange rate causes a difference between taxable income or loss and the income or loss before taxes reflected in the consolidated financial statements. In accordance with paragraph 9(f) of SFAS No. 109, "Accounting for Income Taxes" ("SFAS No. 109"), the

NOTE 11:- TAXES ON INCOME (CONT.)

Company has not provided deferred income taxes on this difference between the reporting currency and the tax bases of assets and liabilities.

d. Tax rates:

Until December 31, 2003, the regular tax rate applicable to income of companies (which are not entitled to benefits due to "approved enterprise", as described above) was 36%. In June 2004, an amendment to the Income Tax Ordinance (No. 140 and Temporary Provision), 2004 was passed by the "Knesset" (Israeli parliament) and on July 25, 2005, another law was passed, the amendment to the Income Tax Ordinance (No. 147) 2005, according to which the corporate tax rate is to be progressively reduced to the following tax rates: 2004 - 35%, 2005 - 34%, 2006 - 31%, 2007 - 29%, 2008 - 27%, 2009 - 26%, 2010 and thereafter - 25%.

e. The Company received final tax assessments for the 1997 to 2002 tax years. As of today, the Company filed an appeal with the court on one issue left open. The issue is being deliberated in the Tel - Aviv district court. The next hearing was set to September 2008. Since the Company's management, based on the opinion of its legal advisors, believes that the probability of an unfavorable outcome for the Company on this matter is remote, no provision was recorded in the financial statements in respect of this matter (all other items determined by the tax authorities as increasing the Company's taxable income, were offset against net operating loss carryforward). In the remote case that the tax authorities position will be accepted, the Company will lose most of its carryforward losses as of December 31, 2002, and as a result, will have to pay approximately $ 700.

f. Net operating losses carryforward:

Through December 31, 2005 and 2006, the Company and its Israeli subsidiaries had operating loss carryforwards of approximately $ 23,102 and $ 26,438, respectively, which can be carried forward and offset against taxable income in the future for an indefinite period.

Through December 31, 2005 and 2006, Magic Software Enterprises Inc., CoreTech Consulting Inc. and AAOD had federal net operating tax loss carryforward of approximately $ 14,497, and $ 11,747, respectively which can be carried forward and offset against taxable income for 15-20 years and will expire from 2011 to 2026.

The Company's subsidiaries in Europe and Japan had estimated total available tax loss carryforward of $ 10,847 and $ 1,119 respectively in 2005 and $ 15,695 and $ 2,358, in 2006 respectively, in 2006 to offset against future taxable income for 15-20 years and 5 years, respectively.

U.S. DOLLARS IN THOUSANDS

NOTE 11:- TAXES ON INCOME (CONT.)

g. Income (loss) before taxes on income:

	YEAR ENDED DECEMBER 31,		
	2004	2005	2006
Domestic	$ 3,069	$(6,379)	$(2,414)
Foreign	1,145	2,476	(2,339)
	$ 4,214	$(3,903)	$(4,753)

h. Taxes on income:

Taxes on income consist of the following:

	YEAR ENDED DECEMBER 31,		
	2004	2005	2006
Current:			
Domestic	$ 99	$ 63	$ 1
Foreign	182	428	324
Taxes on income	$281	$491	$325

i. Deferred income taxes:

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company and its subsidiaries deferred tax assets are as follows:

	DECEMBER 31,	
	2005	2006
Net Operating Loss carryforward	$ 15,938	$ 16,598
Allowances and reserves	812	829
	16,750	17,427
Less: valuation allowance	(16,750)	(17,427)
Net deferred tax assets	$ -	$ -

U.S. DOLLARS IN THOUSANDS

The Company and its subsidiaries provided a 100% valuation allowance against the deferred tax assets in respect of its tax losses carryforward and other temporary differences due to uncertainty concerning its ability to realize these deferred tax assets in the foreseeable future.

NOTE 11:- TAXES ON INCOME (CONT.)

j. Reconciliation of the theoretical tax expense to the actual tax expense:

Reconciliation between the theoretical tax expense, assuming all income is taxed at the statutory rate applicable to the income of companies in Israel and the actual tax expenses is as follows:

	YEAR ENDED DECEMBER 31,		
	2004	2005	200
Income (loss) before taxes on income, as reported in the consolidated statements of operations	$ 4,214	$(3,903)	$(4,
Statutory tax rate	35%	34%	
Theoretical tax expense (benefit)	$ 1,475	$(1,327)	$(1,
Utilization of tax losses carryforward for which a valuation allowance was provided	(1,544)	(1,121)	(
Deferred taxes assets for which valuation allowance was provided	-	2,647	1,
Non-deductible expenses and other	113	120	
Tax in respect of previous years	281	138	
Tax adjustment in respect of inflation in Israel and other	(44)	34	
Actual tax expense	$ 281	$ 491	$

U.S. DOLLARS IN THOUSANDS (EXCEPT SHARE AND PER SHARE DATA)

NOTE 12:- SHAREHOLDERS' EQUITY

a. The Ordinary shares of the Company are traded on both the Nasdaq National Market in the United States and the Tel-Aviv Stock Exchange in Israel.

b. Treasury shares

The Company's Board of Directors resolved to authorize and empower the Company to repurchase its shares from time to time on the open market. Accordingly, through the end of 2006, the Company repurchased 1,275,368 of its shares for an aggregate amount of $6,772.

c. Stock Option Plan:

Under the Company's 1991 and 2000, Stock Option Plans ("the plans"), as amended, options may be granted to employees, officers, directors and consultants of the Company and its subsidiaries.

Pursuant to the plans, the Company reserved for issuance 6,750,000 and 4,600,000 Ordinary shares, respectively. As of December 31, 2006, an aggregate of 2,258,753 Ordinary shares of the Company are still available for future grant.

Each option granted under the plans is exercisable until the earlier of 10 years from the date of the grant of the option or the expiration dates of the respective option plans. The 1991 plan expired on July 31, 2001 and the 2000 plan will expire on November 5, 2010. The exercise price of the options granted under the plans may not be less than 65% of the market price of such shares on the grant date of the award. The Company grants options to its employees at an exercise price that is equal to the share market price at the grant date. The options vest primarily over three years. Any option, which is forfeited or canceled before expiration, becomes available for future grants.

On December 29, 2005, the Company has adopted an amendment to 2000 Employee Stock Option Plan to provide for the issuance hereunder of an additional 600,000 Ordinary shares.

As of December 29, 2005, all of the unvested out-of-the-money options, which amounted to 611,517, with an average exercise price of $ 3.46 per share with related vesting period from January 1, 2006 through March 2009 had been accelerated. The shares which may be purchased by exercise of the accelerated options shall be subject to a holding period according to which the employees shall only be entitled to sell a monthly fraction of such numbers of shares (1/36 per month).

The Company's decision to accelerate the vesting of those options and to grant fully vested options was based primarily upon the issuance of SFAS No. 123R, which requires the Company to treat all unvested stock options as compensation expense effective January 1, 2006. The Company believes that the acceleration of vesting of those options will enable the Company to avoid recognizing stock-based compensation expense associated with these options in future periods. Additional purposes of the fully vested grant and for the acceleration were to make the options more attractive to the recipients, and to avoid discrimination between groups of option holders, respectively.

MAGIC SOFTWARE ENTERPRISES LTD.
AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS (EXCEPT SHARE AND PER SHARE DATA)

NOTE 12:- SHAREHOLDERS' EQUITY (CONT.)

The acceleration had no impact on the Company's statement of operations, however the impact of vesting accelerating on proforma stock-based compensation required to be disclosed in the financial statement footnotes under the provisions of SFAS No. 123, was to increase such disclosed compensation cost by approximately $ 1,021.

A summary of the Company's stock option activity and related information for the year ended December 31, 2006, is as follows:

	NUMBER OF OPTIONS	WEIGHTED-AVERAGE EXERCISE PRICE	WEIGHTED-AVERAGE REMAINING CONTRACTUAL TERM (IN YEARS)	AGGREGATE INTRINSIC VALUE
Outstanding at January 1, 2006	3,061,216	$2.62		
Granted	62,000	$1.69		
Exercised	(253,346)	$1.11		
Forfeited	(517,238)	$3.41		
Outstanding at December 31,2006	2,352,632	$2.52	6.67	$ 1,405
Vested and expected to vest	2,336,982	$3.20	6.65	$ 1,396
Exercisable at December 31,2006	2,290,032	$5.24	6.60	$ 1,370

The weighted-average grant-date fair value of options granted during the twelve months ended December 31, 2006 was $ 0.98. The aggregate intrinsic value in the table above represents the total intrinsic value (the difference between the fair market value of the Company ordinary shares on December 31, 2006 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on December 31, 2006. This amount is changed based on the fair market value of the Company's shares. Total intrinsic value of options exercised for the twelve months ended December 31, 2006 was $ 161. As of December 31, 2006, there was $ 7,052 of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under the Company's stock option plans. That cost is expected to be recognized over a period of approximately 3 years. Total grant-date fair value of vested options for the twelve months ended December 31, 2006 $ 0 as a result of the acceleration in December 29, 2005.

MAGIC SOFTWARE ENTERPRISES LTD.
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. DOLLARS IN THOUSANDS (EXCEPT SHARE AND PER SHARE DATA)

NOTE 12:- SHAREHOLDERS' EQUITY (CONT.)

The following table is a summary of the Company's stock option activity during 2004, 2005 and 2006:

	YEAR ENDED DECEMBER 31, 2004		YEAR ENDED DECEMBER 31, 2005		D
	NUMBER OF OPTIONS	WEIGHTED AVERAGE EXERCISE PRICE	NUMBER OF OPTIONS	WEIGHTED AVERAGE EXERCISE PRICE	NU OF O
Outstanding at the beginning of the year	3,346,406	$ 2.26	2,513,237	$ 2.95	3,0
Granted	406,601	$ 4.84	820,028	$ 1.70	
Exercised	(973,551)	$ 1.28	(80,604)	$ 1.04	(1
Forfeited	(266,219)	$ 3.6	(191,445)	$ 3.54	(6
Outstanding at the end of the year	2,513,237	$ 2.95	3,061,216	$ 2.62	2,3
Exercisable at the end of the year	1,423,970	$ 2.28	3,061,216	$ 2.62	2,2
Weighted average fair value of options granted during the year		$ 2.2		$ 1.1	

The options outstanding as of December 31, 2006, have been separated into ranges of exercise price categories, as follows:

EXERCISE PRICE	OPTIONS OUTSTANDING AS OF DECEMBER 31, 2006	WEIGHTED AVERAGE REMAINING CONTRACTUAL LIFE (YEARS)	WEIGHTED AVERAGE EXERCISE PRICE	OPTIONS EXERCISABLE AS OF DECEMBER 31, 2006	WEIGHTED AVERAGE EXERCISE PRI OF EXERCISAB OPTIONS
0-1	214,355	6	$ 0.83	214,355	$ 0.83
1-2	1,253,793	7	$ 1.37	1,191,793	$ 1.36
2-3	15,600	3	$ 2.48	15,600	$ 2.48
3-4	466,333	7	$ 3.82	466,333	$ 3.82
4-5	230,840	7	$ 4.13	230,840	$ 4.13
5-6	135,500	7	$ 5.95	135,500	$ 5.95
6-7	711	3	$ 6.14	711	$ 6.14

U.S. DOLLARS IN THOUSANDS (EXCEPT SHARE AND PER SHARE DATA)

10-11	26,500	3	$ 10.16	26,500	$ 10.16
18-19	9,000	3	$ 18.79	9,000	$ 18.79
	2,352,632	7	$ 2.52	2,290,632	$ 2.54

The fair value on grant date of options which became vested during the year ended December 31, 2006 amounted to $ 0 as there was no vesting of options during the year.

d. Warrants to service providers:

In April 2003, the Company issued 110,000 warrants as a consideration of the purchase of its distribution activity in Switzerland.

NOTE 12:- SHAREHOLDERS' EQUITY (CONT.)

The warrants were exercisable into the Company's Ordinary shares for a period of four years, at an exercise price of $ 0.6565 per share. These warrants were exercised in April 2004.

During the year ended December 31, 2006, 50,000 warrants were granted to Peter Gyenes, a consultant of the Company. Those warrants were not exercised or forfeited.

The fair value of warrants which became vested during the year ended December 31, 2006 amounted to $ 24 thousand.

The fair value for the warrants to service providers was estimated on the date of grant using Black-Scholes option pricing model, with the following weighted-average assumptions for the year ended December 31, 2006 weighted average volatility of 58.3% risk-free interest rates of 4.7% dividend yields of 0% and a weighted average life of the options of 3 years.

e. Dividends:

The Company does not intend to pay cash dividends in the foreseeable future.

f. Accumulated other comprehensive loss

	YEAR ENDED DECEMBER 31,	
	2005	2006
Accumulated unrealized loss on available-for-sale securities	(240)	(83)
Accumulated foreign currency		

U.S. DOLLARS IN THOUSANDS

translation adjustments	(1,274)	(1,254)
Total other comprehensive loss	$(1,514)	$(1,337)

NOTE 13:- GEOGRAPHIC INFORMATION

Summary information about geographic areas:

The Company manages its business on the basis of one reportable segment (see Note 1 for a brief description of the Company's business). The Company's business is divided into the following geographic areas: Israel, Europe, the U.S.A., Japan and other regions. Total revenues are attributed to geographic areas based on the location of the customers.

This data is presented in accordance with SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information" ("SFAS No. 131").

The following table presents total revenues classified according to geographical destination for the years ended December 31, 2004, 2005 and 2006:

	YEAR ENDED DECEMBER 31,		
	2004	2005	2006
Israel	$ 3,354	$ 4,013	$ 4,307
Europe	25,698	23,186	21,887
U.S.A.	21,090	20,435	23,236
Japan	11,450	10,107	10,223
Other	3,575	3,249	2,072
	$65,167	$60,990	$61,725

The Company's long-lived assets are as follows:

	DECEMBER 31,	
	2005	2006
Israel	$5,239	$4,990
Europe	751	679
U.S.A.	561	467
Japan	280	313
Other	124	105

U.S. DOLLARS IN THOUSANDS

$6,955	$6,554

NOTE 14:- SELECTED STATEMENTS OF OPERATIONS DATA

a. Research and development costs:

	YEAR ENDED DECEMBER 31,		
	2004	2005	2006
Total costs	$ 7,317	$ 7,642	$ 7,477
Less - capitalized software costs	(3,472)	(3,909)	(3,535)
Research and development, net	$ 3,845	$ 3,733	$ 3,942

b. Financial income (expenses), net:

Interest and bank charges	$ (157)	$ (117)	$ (49)
Gain (loss) arising from foreign currency transactions	1,069	(694)	459
Financial income (expenses),net	$ 912	$ (811)	$ 410

NOTE 15:- COMMITMENTS AND CONTINGENCIES

a. Lease commitments:

Certain of the facilities, motor vehicles and equipment of the Company and its subsidiaries are rented under long-term operating lease agreements. Future minimum lease commitments under non-cancelable operating leases as of December 31, 2006, are as follows:

2007	2,670
2008	2,298
2009	1,751
2010 and thereafter	1,064
	7,783

Rent expenses for the years ended December 31, 2004, 2005 and 2006, were approximately $ 1,844, $ 1490 and $ 1,585, respectively.

b. Guarantees:

The Company has provided two of its clients with bank guarantees totaling $ 41, which is linked to the NIS and valid through July 2007.

NOTE 15:- COMMITMENTS AND CONTINGENCIES (CONT.)

c. Charges:

As collateral for a subsidiary's line of credit, a charge was recorded on the subsidiary's trade receivables.

In respect of a lease agreement, the Company placed a lien on the leased computer equipment.

d. Legal proceedings:

Lawsuits have been lodged against the Company in the ordinary course of business in insignificant amounts. The Company intends to defend itself vigorously against those lawsuits. Management cannot predict the outcome of the lawsuits nor can they make any estimate of the amount of damages; therefore, no provision has been made for the lawsuits.

1. In June 2004, an Israeli Company has filed a lawsuit against the Company in the Tel-Aviv District Court in the amount of NIS 8 million (approximately $ 1,840), with a possibility to increase the lawsuit's amount to approximately NIS 17 million (approximately $ 3,900), for recovery of damages caused to plaintiff by the Company's failure to integrate a software system. During the last three years, the parties tried to settle the case with an external mediator. This attempt failed recently and the parties returned to the court to proceed with the court proceedings. Preliminary court proceedings have commenced, such as disclosure of documents and questionnaires. As of December 31, 2006, the Company's management, based on its legal advisors opinion, cannot predict the outcome of the lawsuit nor can they make any estimate of the amount of damages; therefore, no provision has been made for the lawsuit.

2. In February 2006, a client of the Company's subsidiary, CarPro Systems Ltd., has filed in the Magistrate's court in Tel Aviv, Israel, a lawsuit against the subsidiary, claiming an alleged breach of the agreement between the parties, in the amount of $ 257. The claim had been moved to arbitration, which will commence in August 2007. The lawsuit is in its initial stages, therefore the Company's management, based on its legal advisors opinion, cannot predict the outcome of the lawsuit nor can they make any

estimate of the amount of damages; therefore, no provision has been made for the lawsuit.

3. In May 2005, a client of the Company's subsidiary, Magic Software Enterprises (Israel) Ltd., filed a lawsuit against the subsidiary claiming an alleged breach of the agreement between the parties. The plaintiff is seeking damages in the amount of $ 336. The claim was moved to arbitration. The Company's management, due to the preliminary stage of this litigation and based on its legal advisors opinion, cannot predict the outcome of the lawsuit nor can they make any estimate of the amount of damages; therefore, no provision has been made for the lawsuit.

NOTE 15:- COMMITMENTS AND CONTINGENCIES (CONT.)

4. In March 2006, a client of the Company's subsidiary, Magic Software Enterprises France, filed a lawsuit against the subsidiary in the commercial court in Paris claiming an alleged breach of the agreement between the parties. The plaintiff is seeking damages in the amount of (euro) 548,000 (approximately $ 708). The Company's management, due to the preliminary stage of this litigation and based on its legal advisors opinion, cannot predict the outcome of the lawsuit nor can they make any estimate of the amount of damages; therefore, no provision has been made for the lawsuit.

e. Royalty commitments:

1. The Government of Israel, through the Fund for the Encouragement of Marketing Activities ("the Fund"), awarded the Company grants for participation in its foreign marketing expenses. The Company received an aggregate amount of grants of $ 1,526 for the years up to and including 2005. The Company is committed to pay royalties at the rate of 3% of the increase in exports, up to the amount of the grants. As of December 31, 2006, the remaining contingent obligation of the Company amounted to $ 442.

2. The Company is committed to pay royalties to Enformia Software Ltd. ("Enformia") in the amount of 40% regarding any sale of products related to the IP purchased from Enformia and to comply with all of the terms required by the Office of the Chief Scientist ("OCS") in connection with its grants to Enformia.

   As of December 31, 2005 and 2006, the aggregate contingent liability to the OCS, in regard to Enformia products, amounted to $ 52 and $ 42, respectively. Through December 31, 2005 and 2006, the Company has paid and accrued royalties to Enformia, in regard to sales of its product, in the amount of $ 114 and $ 84, respectively.

U.S. DOLLARS IN THOUSANDS

3. The Company is committed to pay royalties of 1.75% of gross sales of the Hermes application, including license fees and all services fees for a period of 5 years until end of 2008. Through December 31, 2006, the Company has paid and accrued royalties to Hermes, in regard to sales of the product, in the amount of $9 (see Note 1e).

NOTE 16:- NET EARNINGS (LOSS) PER SHARE

The following table sets forth the computation of basic and diluted net earnings (loss) per share:

	YEAR ENDED DECEMBER 31,		
	2004	2005	
Numerator for basic and diluted earnings (loss) per share - net income (loss) available to shareholders	$ 4,090	$ (4,607)	$
Weighted average shares outstanding:			
Denominator for basic net earnings (loss) per share	31,029	31,124	
Effect of dilutive securities	1,397	*) -	
Denominator for diluted net earnings (loss) per share	32,426	31,124	
Basic and diluted net earnings (loss) per share	$ 0.13	$ (0.15)	$

*) Anti dilutive.

NOTE 17:- RELATED PARTIES

In July 2005, the Company signed a memorandum of understanding with a related party, to implement the ERP system in a total consideration of $ 670. In 2005 and 2006, the Company performed only part of the project in the amount of $ 235 and $ 263, respectively.

NOTE 18:- SUBSEQUENT EVENTS (NOT AUDITED)

In July 2006, the FASB issued FASB Interpretation No. 48 "Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109" ("FIN 48"). FIN 48 clarifies the accounting for income taxes by prescribing the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 utilizes a two-step approach for evaluating tax positions. Recognition (step one) occurs when an enterprise concludes that a tax position, based solely on its technical merits, is more-likely-than-not to be sustained upon examination. Measurement (step two) is only addressed if step one has been satisfied (i.e., the position is more-likely-than-not to be sustained). Under step two, the tax benefit is measured as the largest amount of benefit, determined on a cumulative probability basis that is more-likely-than-not to be realized upon ultimate settlement.

U.S. DOLLARS IN THOUSANDS

NOTE 18:- SUBSEQUENT EVENTS (NOT AUDITED) (CONT.)

FIN 48 applies to all tax positions related to income taxes subject to the Financial Accounting Standard Board Statement No. 109, "Accounting for income taxes" ("FAS 109"). This includes tax positions considered to be "routine" as well as those with a high degree of uncertainty.

FIN 48 has expanded disclosure requirements, which include a tabular roll forward of the beginning and ending aggregate unrecognized tax benefits as well as specific detail related to tax uncertainties for which it is reasonably possible the amount of unrecognized tax benefit will significantly increase or decrease within twelve months. These disclosures are required at each annual reporting period unless a significant change occurs in an interim period.

FIN 48 is effective for fiscal years beginning after December 15, 2006. The cumulative effect of applying FIN 48 will be reported as an adjustment to the opening balance of retained earnings. The Company does not expect that the adoption of FIN 48 will have a significant impact on the Company's financial position and results of operations.

DETAILS OF SUBSIDIARIES AND AFFILIATE

Details of the percentage of control of the share capital and voting rights of subsidiaries and an affiliated company as of December 31, 2006:

NAME OF COMPANY	PERCENTAGE OF OWNERSHIP AND CONTROL	PLACE OF INCORPORATION
	%	

Magic Software Japan K.K.	100	Japan
Magic Software Enterprises Inc.	100	U.S.A.
Magic Software Enterprises (UK) Ltd.	100	U.K.
Hermes Logistics Technologies Limited	100	U.K.
Magic Software Enterprises Spain Ltd.	100	Spain
Coretech Consulting Group Inc.	100	U.S.A
Coretech Consulting Group LLC	100	U.S.A
MSE Holdings, INC	100	U.S.A
Magic Software Enterprises (Israel) Ltd.	100	Israel
Magic Software Enterprises Italy S.r.l.	100	Italy
Magic Software Enterprises Netherlands B.V.	100	Netherlands
Magic Software Enterprises France	100	France
Magic Beheer B.V.	100	Netherlands
Magic Benelux B.V.	100	Netherlands
Magic Software Enterprises GMBH	100	Germany
Magic Software Enterprises India Pvt. Ltd.	100	India
Onyx Magyarorszag Szsoftverhaz*)	100	Hungary
CarPro Systems Ltd. *)	90.48	Israel
Advanced Answers On Demand Holding Corp. *)	100	U.S.A
Nextstep Infotech Prt. Ltd.	40	India

*) See Note 1.

REPORT OF INDEPENDENT AUDITORS

TO THE SHAREHOLDERS OF

MAGIC SOFTWARE ENTERPRISES (UK) LIMITED

We have audited the accompanying balance sheets of MAGIC SOFTWARE ENTERPRISES (UK) LIMITED (the "Company") as of December 31, 2005 and 2006, and the related statements of operations, changes in shareholders' equity for each of the three years in the period ended December 31, 2006. These financial statements are the responsibility of Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits and the reports of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits, the financial statements referred to above present fairly, in all material respects, the financial position of the Company and at December 31, 2005 and 2006, and the related results of their operations for each of the three years in, the period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles.

/s/ LEVY COHEN & CO.

LEVY COHEN & CO.
Registered Auditors

8th February 2007

REPORT OF INDEPENDENT AUDITORS

TO THE SHAREHOLDERS OF

HERMES LOGISTICS TECHNOLOGIES LIMITED

We have audited the accompanying balance sheets of HERMES LOGISTICS TECHNOLOGIES LIMITED (the "Company") as of December 31, 2005 and 2006, and the related statements of operations, changes in shareholders' equity for each of the three years in the period ended December 31, 2006. These financial statements are the responsibility of Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits and the reports of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits, the financial statements referred to above present fairly, in all material respects, the financial position of the Company and at December 31, 2005 and 2006, and the related results of their operations for each of the three years in the period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles.

/s/ LEVY COHEN & CO.

LEVY COHEN & CO.
Registered Auditors

8th February 2007

GRANT THORNTON ASG [GRANT THORNTON LOGO]
Certified Public Accountants

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of
Magic Software Japan K. K.

We have audited the accompanying balance sheet of Magic Software Japan K. K. (the "Company") as of December 31, 2004, and the related statements of income and accumulated deficit, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion based on our audit.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Magic Software Japan K. K. as of December 31, 2004, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles in the United States of America.

/s/ Grant Thornton ASG

Tokyo, Japan
January 21, 2005

[K.D.A. LOGO]

KDA AUDIT CORPORATION

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

TO THE BOARD OF DIRECTORS AND SHAREHOLDERS OF

MAGIC SOFTWARE JAPAN K.K.

We have audited the accompanying balance sheet of Magic Software Japan K.K. (the "Company") as of December 31, 2006, and the related statements of income and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2006, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Tokyo, Japan
January 26, 2007

/s/ KDA Audit Corporation

KDA Audit Corporation
(A Member of Baker Tilly International)

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MOCK & PARTNERS INTERNATIONAL
REGISTERACCOUNTANTS

AUDITORS' REPORT

INTRODUCTION

We have audited the financial statements of Magic Beheer B.V., for the period until December 31st, 2006. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

SCOPE

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

OPINION

In our opinion, the financial statements give a true and fair view of the financial position of the company as at December 31st, 2006 and of the result for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Amsterdam, February 27th 2007

Mock & Partners International

/s/ H.J.S. Mock
Drs. H.J.S. Mock RA

Rapenburgerstreat 109, 1011 VL Amsterdam. Tel: 020 6381881, Fax: 020 6272624

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REPORT OF INDEPENDENT AUDITORS

TO THE SHAREHOLDERS OF MAGIC SOFTWARE ENTERPRISES LTD.

MAGIC (ONYX) MAGYARORSZAG SZOFTVERHAZ KFT.

We have audited the accompanying consolidated balance sheets of Magic (Onyx) Magyarorszag Szoftverhaz Kft. (the "Company") as of December 31, 2005 and 2006, and the related consolidated statements of operations, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2006. These financial statements are the responsibility of Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits and the reports of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries at December 31, 2005 and 2006, and the related consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles.

Budapest, 25 February, 2007

/s/ Maria Negyessy

Maria Negyessy
Reg. Auditors

[STUDIO NASSINI ASSOCIATI LOGO]

DOTTORI COMMERCIALISTI

Damiano Nassini, Giovanni Nulli, Federico Pozzi, Alessandro Masetti Zannini

Brescia, 21st February 2007

REPORT OF INDEPENDENT AUDITORS

TO THE SHAREHOLDERS OF

MAGIC SOFTWARE ENTERPRISES ITALY SRL

We have audited the accompanying consolidated balance sheets of Magic Software Enterprises Italy Srl (the "Company") as of December 31, 2005 and 2006, and the related consolidated statements of operations, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2006. These financial statements are the responsibility of Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits and the reports of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries at December 31, 2005 and 2006, and the related consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles.

Yours Truly

/s/ Federico Pozzi

Federico Pozzi

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[TIAG LOGO]

ARGENTINA, AUSTRALIA, AUSTRIA, BELGIUM, CANADA (BRITHIS COLUMBIA, ONTARIO, QUEBEC), CHINA, CYPRUS, EGYPT, ENGLAND, FRANCE, GERMANY, GUATEMALA, HONG KONG, INDIA, IRELAND, JAPAN, KENYA, LEBANON, LUXENBOURG, MALAYSIA, MALTA, MAURITIUS, MEXICO, NETHERLANDS, PAKISTAN, POLAND, SCOTLAND, SINGAPORE, SPAIN, SWITZERLAND, TURKEY, USA (ALABAMA, ARIZONA, CALIFORNIA, ILLINOIS, NEW JERSEY, NEW YORK, NORTH CAROLINA, OKLAHOMA, PENNSYLVANIA, TEXAS, UTAH, WASHINGTON,)

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S I G N A T U R E S

The registrant hereby certifies that it meets all of the requirements for filing on Form 20-F/A and that it has duly caused and authorized the undersigned to sign this annual report on its behalf.

MAGIC SOFTWARE ENTERPRISES LTD.

By: /s/ David Assia

Name: David Assia
Title: Chairman of the Board of Directors

Dated: September 24, 2007