Financial Highlights

Income Statement Data

	Year Ended December 31st				
	1992	**1993**	**1994**	**1995**	**1996**
	(US dollars in thousands, except per share data)				
Sales	10,037	16,864	21,372	25,384	36,416
Research and development costs	776	1,245	2,158	2,878	2,611
Operating income (loss)	1,492	2,733	(49)	(229)	2,526
Income (loss) before taxes	1,996	3,462	(1,298)	(295)	2,016
Taxes on income	684	932	190	333	456
Net income (loss)	$ 1,312	$ 2,530	$(1,400)	$ (438)	$ 1,398
Net income (loss) per share	$ 0.37	$ 0.65	$ (0.34)	$ (0.10)	$0.30
Weighted average number of shares outstanding	3,578	3,901	4,158	4,303	4,720

BALANCE SHEET DATA:

	December 31st				
	1992	**1993**	**1994**	**1995**	**1996**
Working capital	$ 9,736	$11,595	$ 7,376	$ 6,213	$9,820
Total assets	13,439	19,666	20,436	24,559	34,007
Total debt	24	190	535	1,955	990
Shareholders' equity	11,027	15,661	14,889	15,109	21,956

*Reclassified

To our Shareholders,

Once again, we are delighted to report a year of record revenues and solid growth for Magic Software Enterprises. 1996 firmly consolidated the return to profitability recorded at the end of 1995. Sales rose 43 percent to $36.4 million, gross profits rose 28 percent to $25.2 million, and record returns were posted in every quarter of the year. This substantial growth was mainly attributable to Magic's success in achieving significant penetration of large enterprise accounts.

Magic Version 7.0 was released to unanimous industry acclaim. The Gartner Group recommended that Magic be considered "when RAD is important and productivity must be high", and rated the chances of Magic becoming a major client/server vendor as very high. The Patricia Seybold Group declared that Magic "delivers significant productivity benefits". Datapro Information Services Group stated that "Magic management has a clear vision of future technology trends and product development, and a product that really delivers developer productivity.....", For the fifth consecutive year, Magic won the RAD Developers competition held at Database & Client/Server World in Chicago. PC Week awarded Magic its prestigious Analyst's Choice.

Magic made significant moves towards becoming a major player in the US tools market, in the form of large account penetration and strengthened alliances with Digital and IBM. With the support of IBM Rochester we penetrated the AS/400 market worldwide and believe that Magic could become this market's leading tool.

Strengthening our position in Europe and the Americas, 1996 saw the opening of new Magic subsidiaries in Italy and Brazil, and new sales offices in Boston and San Francisco. Magic's successful 1996 World Wide User Conference in Dana Point, California, brought together over 500 key users.

The release of Magic WebLink successfully marked the first stage in Magic's phased Internet strategy. Magic WebLink applications have been successfully deployed in many large installations, including Gannet Media (USA), Hutchison Telecom (France), and San Joaquin County's Public Health Services (USA).

The latest phases in our Internet strategy, MagicWeb and Magic Enterprise Edition V8, to be released in 1997, provide the technological advantage, which, along with our strategic investment in marketing and sales, will position Magic as an enterprise tool vendor for the year 2000 and beyond.

Magic's entry into this market has begun in earnest with sales to such large corporations as WH Smith, John Menzies, Nestle Coffee Specialties (Nespresso), AT&T Health Care Services, and Hughes Galaxy. We look forward to a similarly magical rate of revenue growth and further consolidation of our position as a major player in the enterprise tools market in 1997.

Yours sincerely,

David Assia
Chairman & CEO

Eli Gonen
President & COO

About the Company

Magic Software Enterprises revolutionized the world of application development with a new type of highly productive development environment for client/server and Web applications. Magic is recognized throughout the industry for those strengths which deliver significant technical, economic, and competitive advantage to the enterprise.

In Magic, the developer builds sophisticated, strategic applications without performing the low level coding procedures required by conventional tools. The time it takes to build and maintain mission-critical applications is drastically reduced by using a unique totally table-driven, engine-based programming paradigm which totally eliminates the repetitive and tedious aspects of coding.

Magic has been definitively proven the most rapid development tool on the market at Industry Developer Competitions, Customer Sites, and in Analyst Evaluations. Magic's single development paradigm across a wide range of platforms and architectures, means that the organization needs only one tool, regardless of platform, architecture, and deployment environment. Magic's decisive technological advantage has proven the competitive advantage of many MIS departments and Independent Software Vendors. Its rapidity and portability let them deliver working prototype applications in days rather than weeks or months, directly resulting in reduced project costs, time-frames, and ongoing maintenance overhead.

Magic's products and services are available through a global network of subsidiaries, distributors, and Magic Solutions Partners in more than 50 countries. With over 60,000 development units and 500,000 end-user deployment units sold to date, a large and growing installed base of programmers and end users are using Magic's tremendous productivity benefits to add competitive advantage to their organizations.

These include corporate IS system staff, consultants, VARs, systems integrators, independent developers and packaged software publishers. Magic applications perform strategic functions in some of the world's most prestigious organizations and institutions including WH Smith, Irdeto, Hughes Direct TV, John Menzies, Pizza Hut, Sony, Chase Manhattan Bank, Advantage Rent a Car, Tulip Computers, and Seminis Vegetable.

MANAGEMENT DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

Introduction

The foregoing description of the Company's business, as well as the remaining sections of this Annual Report, contain various forward looking statements which reflect the Company's current views with respect to future events and financial results.

The Company's consolidated financial statements are stated in dollars and prepared in accordance with U.S. and Israeli GAAP, which, as applicable to these financial statements, are practically identical in all material respects. The currency of the primary economic environment in which the operations of the Company are conducted is the U.S. dollar which is the functional and reporting currency of the Company and its subsidiaries. Transactions and balances originally denominated in U.S. dollars are presented at their original amounts. Transactions and balances in other currencies are remeasured into dollars in accordance with the principles set forth in Financial Accounting Standards Board ("FASB") Statement No. 52. Remeasurement gains and losses are included in financial income and expense.

Results of Operations
Year Ended December 31, 1996, Compared to Year Ended December 31, 1995.

The Company was established in 1983 and completed an initial public offering of its Ordinary Shares in the United States in August 1991. From 1989 until the first quarter of 1994, the Company operated on a profitable basis. Revenues increased from $5.4 million in 1991 to $16.9 million in 1993. Most of the Company's sales up until that time were of its DOS based development tool, typically sold to independent developers and small departments and workgroups within large corporations.

Beginning in 1994, the Company began to experience a number of changes in its business environment which impacted upon its operating and financial performance. With the widespread acceptance of the Windows operating system, sales of the DOS version of Magic began to decline. As a consequence, the Company reoriented its sales focus to cross platform client/server environments which tend to be installed in large departments or on an enterprise-wide basis. In addition, the Company accelerated its development of a Windows compatible product, which was released in September 1995.

In order to facilitate the sales of its tools for the UNIX, VMS, Windows and other client/server environments, which generally require a longer sales cycle and a greater degree of up-front support, the Company increased its sales force in a number of countries, including the United Kingdom, Germany and France, and began to offer an increasing amount of fee-based consulting services and technical support throughout the produce life cycle. The cumulative impact of these changes was a decline in the Company's rate of growth, an increase in services as a percentage of revenues, and an increase in sales, marketing and research and development expenses.

With the introduction and shipment of its Windows-based product, Magic 6, and its ability to offer advanced client/server functionality, the Company began to realize accelerated sales growth and a return to profitability.

Revenues from software sales are recognized upon shipment and resolution of any material vendor obligations. Royalties from software sales by the distributor in Japan are recognized on a quarterly basis. Service revenues from customer maintenance fees for ongoing customer support and product updates are recognized ratably over the period of the contract. Training and consulting revenues are recognized when earned.

The following table sets forth the total research and development costs, the amount of royalty-bearing grants received from the Government of Israel, software development costs capitalized, and the net research and development expenses for the periods indicated:

	Year Ended December 31st		
	1994	**1995**	**1996**
Total research and development costs	$3,834	$4,495	$6,950
Less royalty bearing grants	(435)	(167)	(1,922)
Less capitalization of software	(1,241)	(1,450)	(2,417)
Research and development, net	$2,158	$2,878	$2,611

Research and development costs, net of government and other grants, are charged to income as incurred until technological feasibility is established. Technological feasibility is established upon completion of a detailed program design. Costs incurred by the Company subsequent to the establishment of technological feasibility are capitalized in accordance with Statement of Financial Accounting Standards ("SFAS") No. 86. Capitalized software costs are amortized by the greater of (i) the ratio that current gross revenues from sales of the software bear to the total of current and anticipated future gross revenues from sales of the software or (ii) the straight-line method over the remaining estimated useful life of the product (not greater than five years). The Company assesses the recoverability of this intangible asset by determining whether the amortization of the asset over its remaining life can be recovered through undiscounted future operating cash flows from the specific product.

Royalty-bearing grants from the Government of Israel and others for funding certain approved research projects and marketing activities are recognized at the time the Company is entitled to such grants on the basis of the related costs incurred.

The Company's consolidated financial statements are stated in dollars and prepared in accordance with U.S. and Israeli GAAP, which, as applicable to these financial statements, are practically identical in all material respects. The currency of the primary economic environment in which the operations of the Company are conducted is the U.S. dollar which is the functional and reporting currency of the Company and its subsidiaries. Transactions and balances originally denominated in U.S. dollars are presented at their original amounts. Transactions and balances in other currencies are remeasured into dollars in accordance with the principles set forth in Financial Accounting Standards Board ("FASB") Statement No. 52. Remeasurement gains and losses are included in financial income and expense.

Results of Operations

The following table sets forth, for the periods indicated, selected financial information for the Company as a percentage of total revenue:

	Year Ended December 31st		
	1994	1995	1996
Revenues:			
Software sales	88%	78%	77%
Services	12	22	23
Total revenues	100	100	100
Cost of revenues:			
Software sales	17	12	11
Services	6	18	20
Total cost of revenues	23	30	31
Gross profit	77	70	69
Operating expenses:			
Research and development, net	11	11	7
Selling and marketing, net	50	45	44
General and administrative expenses	13	15	11
Total operating expenses	74	71	62
Operating income (loss)	0	(1)	7
Financial income (expenses), net	0	0	(1)
(Loss) gain from marketable securities	(6)	0	0
(Loss) income before income taxes	(6)	(1)	6
Income taxes	(1)	(1)	(2)
Equity in earnings of an affiliate	0	0	0
Minority interest in losses of consolidated subsidiary	0	0	0
Net (loss) income	(7)%	(2)%	4%

Years Ended December 31, 1996 Compared with Year Ended December 31, 1995

Total Revenues. Revenues consist primarily of: (i) software sales and (ii) services (including consulting services, maintenance, support, and training). Total revenues increased 43% to $36.4 million in 1996 from $25.4 million in 1995. Software sales increased 41% to $28.1 million in 1996 from $19.9 million in 1995. This increase was principally attributable to the continuing growth in sales of Windows-based products which were initially released in September 1995, and increased product penetration of the Company's main markets in Europe, Asia and North America, which were partially offset by the significant decline in sales of DOS-based products. Revenues from services increased 50.9% to $8.3 million in 1996 from $5.5 million in 1995. This growth, mainly in Europe, reflects the Company's increased efforts to grow its fee-based consulting and training services.

Cost of Revenues. Cost of software sales consists primarily of: (i) amortization of capitalized software; (ii) software production costs (including media, packaging, freight and documentation); (iii) certain royalties and licenses payable to third parties (including the OCS); and (iv) pre-sale technical support costs. Cost of services consists primarily of personnel expenses and other related costs. Cost of revenues increased 47% to $11.2 million in 1996 from $7.6 million in 1995. Costs of software sales increased 32% in 1996 to $4.1 million from $3.1 million in 1995.

Gross profit increased 42% to $25.2 million in 1996 from $17.8 million in 1995. In 1996, the Company's gross margin (gross profit as a percentage of total revenues) on software sales increased to 85% from 84% in 1995. The Company's gross margin on services decreased to 15% in 1996 from 19% in 1995. The Company expects its gross margin to vary in the future due to changes in the composition of its revenue and its product and customer mix.

Research and Development, Net. Research and development costs consist primarily of salaries of employees engaged in on-going research and development activities and other related costs. Grants for research and development and the capitalization of software development expenses are applied as reductions to total research and development costs to calculate net research and development expenses.

Total research and development costs increased to $6.9 million in 1996 from $4.5 million in 1995. The increase was primarily a result of the increased expenses associated with the development of Magic 7, new database gateways and the next generation "Leapfrog" product. Net research and development costs decreased to $2.6 million in 1996 from $2.9 million in 1995 primarily because of an increase in grants from the OCS and accruals of grants from BIRD-F and IBM. Grants from the OCS increased to $1.5 million in 1996 from $242,000 in 1995. The increase is attributable to grants which the OCS approved for the Magic 7 project, the Leapfrog project and for Magic Gateways. In June 1996, the Company was notified by BIRD-F that it had approved the funding of the lesser of approximately $468,000 or 50% of the development and marketing costs associated with the Magic Server/400 project for the AS/400 platform. The Company had budgeted approximately $935,000 for this project for the nine month period ending December 31, 1996. The Company accrued research and development fund grants of $224,000 from the BIRD-F in 1996. In December 1995, the Company entered into a product development and marketing alliance with IBM's AS/400 division. According to the agreement, IBM agreed to provide $250,000 in funding for the development costs associated with Magic Server/400 platform. The Company accrued research and development grants of $246,000 from IBM in 1996. In addition, the Company capitalized $2.4 million of software development costs (34% of total research and development costs) in 1996 as compared to $1.5 million (32% of total research and development costs) in 1995. The Company expects that its total research and development costs as a percentage of sales will increase in 1997 as compared to 1996.

Selling and Marketing, Net. Selling and marketing expenses consist of costs relating to promotion, advertising, trade shows and exhibitions, compensation, sales support, travel and related expenses and royalties payable to the Israeli Government's Fund for the Encouragement of Marketing Activities (the “Marketing Fund”). Selling and marketing expenses increased 42% to $16.0 million in 1996 from $11.3 million in 1995. Selling and marketing expenses as a percentage of sales decreased to 43.8% in 1996 as compared to 44.9% in 1995, principally as a result of the growth in sales. The Company accrued grants of $37,000 and $150,000 in 1996 from the Marketing Fund and BIRD-F, respectively. The Company expects that selling and marketing expenses will increase in 1997 as a result of the planned increase in marketing and sales efforts for the Company's new products, but will decrease as a percentage of sales.

General and Administrative. General and administrative expenses consist of compensation costs for administration, finance and general management personnel and office maintenance and administrative costs. General and administrative expenses increased to $4.1 million in 1996 from $3.8 million in 1995. The increase was primarily attributable to the costs associated with the Company’s increased activities in the United States, the Netherlands and the United Kingdom and the overall growth in the Company's operations. General and administrative expenses as a percentage of revenues decreased to 11% in 1996 as compared to 15% in 1995. The Company expects that general and administrative expenses as a percentage of sales will increase in 1997 as a result of the continued growth in the Company's operations.

Financial Income (Expenses), Net. Financial expenses consist of interest expense from borrowing and currency transaction adjustments and financial income consists of income on cash and cash equivalent balances. Financial expense was $521,000 in 1996 as compared to financial expense of $48,000 in 1995, reflecting the Company’s higher level of borrowings in 1996. The Company repaid approximately $1.9 million of debt from the proceeds of its 1996 offering.

Income Taxes. The Company incurred income taxes of $456,000 in 1996 and $333,000 in 1995. These taxes are attributable to withholding taxes paid in Japan on the royalty payments received by the Company from its Japanese distributor. The Company did not pay any taxes in Israel in either period. The Company expects that it will continue to be unable to offset its withholding taxes in Japan against taxable income in Israel in 1997.

Equity in Results of an Affiliate. Equity in earnings of an affiliate represent the Company's proportionate share of the net income (loss) of Micronova, an Israeli VAR in which the Company acquired a 42% equity interest in September 1995. In 1996, the Company recognized loss of $115,000 from its 42% minority interest in Micronova as compared to income of $67,000 in 1995.

Minority Interest in Profits of Consolidated Subsidiary. Minority interest in profits of a consolidated subsidiary represents the minority shareholders' share of the profits of Magic Benelux B.V. (“Magic Benelux”), a Netherlands-based subsidiary in which the Company currently has an 84% interest. In 1996, the Company recognized a minority interest of $47,000 from the profits distributed to the minority shareholders of Magic Benelux as compared to $123,000 in 1995.

Year Ended December 31, 1995 Compared with Year Ended December 31, 1994

Total Revenues. Total revenues increased 19% to $25.4 million in 1995 from $21.4 million in 1994. Software sales increased 5% to $19.8 million in 1995 from $18.8 million in 1994. This increase was principally attributable to the introduction of Magic 6 for Windows in September 1995, which offset a significant decline in DOS-based products. Revenues from services increased 111% to $5.5 million in 1995 from $2.6 million in 1994. In 1995, the Company began to place a greater emphasis on its fee-based consulting services in an attempt to generate additional revenues as well as ensuring successful implementation of Magic products, thus enhancing software sales.

Cost of Revenues. Cost of revenues increased 33% to $7.6 million in 1995 from $5.7 million in 1994. The Company’s gross margin decreased to 70% in 1995 from 73% in 1994. In 1995, the Company's gross margin on software sales increased to 84% from 80% in 1994 reflecting the increase in sales of higher margin server and Windows products and a decline in lower margin DOS products. The Company's gross margin on services decreased to 19% in 1995 from 21% in 1994.

Research and Development, Net. Total research and development costs increased 17% to $4.5 million in 1995 from $3.8 million in 1994, reflecting the increased expenses associated with the development of the Company's Windows products and its next generation “Leapfrog” product. These expenses were partially offset by grants from the OCS totaling $167,000 in 1995 as compared to $435,000 in 1994. The decrease in the amount of grants from the OCS arose from an accrual of approximately $175,000 in the first quarter of 1996 which was attributable to research and development activities conducted in 1995, but for which the Company did not receive approval until after it published its 1995 year-end results. In addition, the Company capitalized $1.5 million of software development costs (32% of total research and development costs) in 1995 as compared to $1.2 million (32% of total research and development costs) in 1994.

Selling and Marketing, Net. Selling and marketing expenses increased 6.5% to $11.4 million in 1995 from $10.7 million in 1994 as a result of the Company's increased marketing efforts associated with the introduction of its Windows products. Such expenses were partially offset by Marketing Fund grants which totaled $360,000 in 1995 as compared to $43,000 in 1994 when the Company was not eligible to receive such grants. Selling and marketing expenses declined as a percentage of total revenues from 50% in 1994 to 45% in 1995.

General and Administrative. General and administrative expenses increased 31% to $3.8 million in 1995 from $2.9 million in 1994. The increase was primarily a result of increased operations in the United States, the Netherlands, France and the United Kingdom and the overall growth in the Company's operations.

Financial Income (Expenses), Net. Financial expense was $48,000 in 1995 as compared to financial income of $47,000 in 1994.

Gain (Loss) from Marketable Securities. In 1994, the Company's portfolio of marketable securities consisted of corporate and government notes and bonds, mutual funds, and equity securities traded on the Tel Aviv Stock Exchange. As a result of the decline in the Israeli stock market and an increase in interest rates in the United States, the Company recorded a loss of $1.3 million on its portfolio of marketable securities during 1994. Since that time, the Company has completely eliminated its portfolio of marketable securities. In 1995, the Company recorded a small loss of $18,000 on its portfolio of marketable securities, the value of which had declined to $191,000 at December 31, 1995.

Income Taxes. Taxes on income were $333,000 in 1995 and $190,000 in 1994. The increase was attributable to the higher amount of withholding taxes paid in Japan on the Company's royalty income from its Japanese distributor.

Equity in Earnings of an Affiliate. In 1995, the Company recognized income of $67,000 from its 42% minority interest in Micronova.

Minority Interest in Losses of Consolidated Subsidiary. In 1995, the Company recognized a minority interest of $123,000 from the losses allocated to the minority shareholders of its subsidiary, Magic Benelux, as compared to minority interest of $88,000 in 1994.

Quarterly Results of Operations

The following tables set forth certain unaudited quarterly financial information for the two years ended December 31, 1996. The data has been prepared on a basis consistent with the Company's audited financial statements included elsewhere in this Report and include all necessary adjustments, consisting only of normal recurring accruals that the Company considers necessary for a fair presentation. The operating results for any quarter are not necessarily indicative of results for any future periods.

QUARTER ENDED

	1995				1996			
	March 31,	June 30,	Sept. 30,	Dec. 31,	March 31,	June 30,	Sept. 30,	Dec. 31,
	(In thousands, except per share data)							
Revenues:								
Software sales	$3,983	$4,261	$4,666	$6,946	$5,437	$7,439	$6,968	$8,241
Services	893	1,049	1,630	1,956	1,959	1,615	2,152	2,605
Total revenues	4,876	5,310	6,296	8,902	7,396	9,054	9,120	10,846
Cost of revenues:								
Software sales	665	339	670	1,429	927	968	1,031	1,159
Services	690	946	1,417	1,431	1,454	1,531	1,825	2,298
Total cost of revenues	1,355	1,285	2,087	2,860	2,381	2,499	2,858	3,457
Gross profit	3,521	4,025	4,209	6,042	5,015	6,555	6,264	7,389
Operating expenses:								
Research and development, net	659	636	703	880	327	1,106	650	528
Selling and marketing, net	2,635	3,271	2,265	3,220	3,397	3,336	4,487	4,743
General and administrative	891	1,003	876	987	893	1,146	1,006	1,089
Total operating expenses	4,185	4,910	3,844	5,087	4,617	5,588	6,143	6,349
Operating income (loss)	(664)	(885)	365	955	398	967	121	1040
Financial income (expenses), net	27	5	(15)	(65)	(107)	(249)	(123)	(42)
Gain (loss) from marketable securities	(54)	(3)	(7)	46	0	(5)	5	0
Capital gain	0	0	0	0	0	0	0	11
Income (loss) before income taxes	(691)	(883)	343	936	(291)	713	3	1,009
Income taxes	115	162	205	149	175	119	161	1
Equity in earnings of an affiliate	0	0	0	67	2	(46)	(78)	7
Minority interest in losses of a consolidated subsidiary	108	158	(8)	(135)	0	0	(2)	(45)
Net income (loss)	(698)	(887)	130	1,017	118	548	(238)	970
Net income (loss) per share	($0.17)	($0.21)	$0.03	$0.23	$0.03	$0.12	($0.05	$0.19

QUARTER ENDED	1995				1996			
	March 31,	June 30,	Sept. 30,	Dec. 31,	March 31,	June 30,	Sept. 30,	Dec. 31,
Revenues:								
Software sales	82%	80%	74%	78%	74%	82%	76%	76%
Services	18	20	26	22	26	18	24	24
Total revenues	100	100	100	100	100	100	100	100
Cost of revenues:								
Software sales	14	6	11	16	13	11	11	11
Services	14	18	23	16	20	17	20	21
Total cost of revenues	28	24	33	32	33	28	31	32
Gross profit	72	76	67	68	67	72	69	68
Operating expenses:								
Research and development, net	14	12	11	10	4	12	7	5
Selling and marketing, net	54	62	36	36	46	37	49	44
General and administrative	18	19	14	11	12	13	11	10
Total operating expenses	86	93	61	57	62	62	67	59
Operating income (loss)	(14)	(17)	6	11	5	10	2	9
Financial income (expenses), net	1	0	0	(1)	(1)	(3)	(1)	0
Gain (loss) from marketable securities	(1)	0	0	1	0	0	0	0
Capital gain	0	0	0	0	0	0	0	0
Income (loss) before income taxes	(14)	(17)	6	11	4	7	1	9
Income taxes	(2)	(3)	(4)	(2)	(2)	(1)	(3)	0
Equity in earnings of an affiliate	0	0	0	0	0	0	1	0
Minority interest in losses of a consolidated subsidiary	2	3	0	(2)	0	0	0	0
Net income (loss)	(14)%	(17)%	2%	11%	2.9%	6%	(3)%	9%

Liquidity and Capital Resources

At December 31, 1996, the Company had $2.4 million in cash and cash equivalents and working capital of $9.9 million as compared to $633,000 in cash and cash equivalents and $6.2 million in working capital at December 31, 1995. In August 1996, the Company raised additional equity capital in a total amount of $5.7 million (approximately $5.0 million net proceeds) through an offering of 600,000 Ordinary Shares. The Company repaid approximately $1.9 million of debt from the proceeds of the offering.

One of the factors affecting the Company's working capital is the payment cycle on its sales. As the Company's sales increase, its accounts receivable are likely to increase proportionally. The Company generally requires its resellers to pay for goods shipped within 30 to 60 days of receipt. As a result of the international nature of its sales, this often results in payment from 60 to 90 days after shipment. In addition, the Company's agreement with its largest distributor, Wacom, provides for billing on a quarterly basis.

In November 1995, the Company obtained a two-year 50 million Japanese Yen ($500,000) loan from Wacom. The loan bears interest at 5 1/2% payable quarterly. Both interest and principal are payable in Yen. At December 31, 1996, the balance of the loan (principal and accrued interest thereon) was 52.4 million Yen. In May 1997, the Company reduced the loan from Wacom by 45.7 million Yen. The Company has not engaged in any hedging transactions with respect to this loan, since Wacom pays most of its bills to the Company in Yen.

In December 1995, the Company obtained a $1 million line of credit from the First International Bank of Israel, denominated in non-linked NIS and bearing interest at a nominal rate of 17.25%, which credit line was subsequently increased to $1.675 million in June 1996. The Company's U.S. subsidiary, Magic Inc., had a $225,000 line of credit bearing interest at prime plus 1% with the Silicon Valley Bank. The two lines of credit were repaid with a portion of the proceeds of the 1996 offering.

The Company anticipates that its cash requirements for the foreseeable future will be satisfied by cash flows from operations, existing cash, as well as anticipated government grants and, if needed, short-term borrowings. The Company has no significant financial commitments outstanding other than those relating to the development and introduction of new products. The Company currently anticipates that its capital expenditures, principally computers and related equipment, will total approximately $400,000 in 1997.

Effective Corporate Tax Rate

The production facilities of the Company have been granted Approved Enterprise status under the Law for Encouragement of Capital Investments, 1959 and consequently are eligible for certain tax benefits for the first several years in which they generate taxable income. The Company has elected to participate in the Alternative Benefits Program with respect to its current Approved Enterprises. The income derived from facilities granted Approved Enterprise status is exempt from income tax in Israel for two to four years commencing in the year in which the specific Approved Enterprise first generates taxable income. Following such periods, the "Approved Enterprises" are subject to corporate tax at reduced rate of 25% for the following three to six years. After August 1991 at least 25% of the Company's shares have been held by non-Israeli residents and according to the Law for the Encouragement of Foreign Investments, the Company is entitled to 10 years of reduced corporate tax. As a result of its Approved Enterprise status, the Company's operations in Israel were subject to reduced tax rates of approximately 10% and 3% for 1996 and 1995, respectively.

Under Israeli tax law, the results of the Company's foreign subsidiaries cannot be consolidated with the operations of the parent company, which, in the case of the Company, have been historically profitable. The Company's royalty income from Wacom is subject to a 10% withholding tax in Japan. Under Israeli tax law, the Company is only permitted to offset withheld amounts against its tax liability in Israel for the same year as the taxes were withheld. As a result of its reduced tax rate in Israel the Company did not have sufficient income in recent years to offset the amounts withheld in Japan. The Company expects that its inability to consolidate its operations for tax purposes will continue to negatively impact its overall tax rate.

Impact of Inflation and Devaluation on Results of Operations, Liabilities and Assets

The dollar cost of the Company's operations in Israel is influenced by the extent to which any increase in the rate of inflation in Israel is not offset (or is offset on a lagging basis) by a devaluation of the NIS in relation to the dollar. During the three years ended December 31, 1996, the rate of inflation in Israel exceeded the rate of devaluation of the dollar against the NIS. In 1994, 1995 and 1996 the rate of inflation in Israel was 14.5% and 8.1% and 10.6%, respectively, while the rate of devaluation was 1%, 3.9% and 3.7%, respectively.

DRAFT: 24.6.97

MAGIC SOFTWARE ENTERPRISES LTD. AND ITS SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS AS OF DECEMBER 31, 1996

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KOST LEVARY & FORER
A MEMBER OF
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Report of Independent Auditors

To the Shareholders of

MAGIC SOFTWARE ENTERPRISES LTD.

We have audited the consolidated balance sheets of Magic Software Enterprises Ltd. and its subsidiaries as of December 31, 1995 and 1996, 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, 1996. These financial statements are the responsibility of the Company's Board of Directors and 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 constituting 10% and 9% as of December 31, 1995 and 1996, respectively, and total revenues constituting 13%, 19% and 37% of the related consolidated totals for the three years in the period ended December 31, 1996. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to data included for these subsidiaries, is based solely on the report of the other auditors.

We conducted our audits in accordance with generally accepted auditing standards in Israel, including those prescribed by the Israeli Auditors Regulations (Mode of Performance), 1973, which do not differ in any significant respect from United States generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, either originating within the financial statements themselves, or due to any misleading statement included therein. 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 the Board of Directors and management as well as evaluating the overall financial statement presentation. We believe that our audits and report of other auditors provide a reasonable basis for our opinion.

In our opinion, based upon our audits and the report of other auditors, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries as of December 31, 1995 and 1996, and the related consolidated results of their operations, and cash flows for each of the three years in the period ended December 31, 1996, in conformity with accounting principles generally accepted in Israel. As applicable to the Company's financial statements, accounting principles generally accepted in the United States and in Israel are substantially identical in all material aspects.

Tel-Aviv, Israel
February 24, 1997

KOST, LEVARY and FORER
Certified Public Accountants (Israel)
A member of Ernst & Young International

CONSOLIDATED BALANCE SHEETS

U.S. Dollars (in thousands)

	December 31, 1995	December 31, 1996
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 633	$ 2,410
Marketable securities	191	-
Trade receivables (net of allowance for doubtful accounts of $ 584 in 1995 and $ 234 in 1996)	11,244	14,816
Receivables - parent and affiliated companies	-	290
Other receivables and prepaid expenses (Note 4)	1,707	2,226
Inventories	266	516
Total current assets	14,041	20,258
INVESTMENTS IN AN AFFILIATE (Note 5)	451	441
SEVERANCE PAY FUND, (Note 6)	617	979
FIXED ASSETS (Note 7):		
Cost	7,712	9,350
Less - accumulated depreciation	1,930	2,950
	5,782	6,400
OTHER ASSETS, net (Note 8)	3,668	5,929
	$ 24,559	$ 34,007

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

CONSOLIDATED BALANCE SHEETS

U.S. Dollars (in thousands)

	December 31, 1995	December 31, 1996
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Credit from banks and others (Note 10)	$ 1,470	$ 990
Trade payables	1,391	1,855
Payables - parent and affiliated companies (Note 3)	97	-
Accrued and other expenses (Note 9)	4,870	7,593
Total current liabilities	7,828	10,438
LONG-TERM LOAN (Note 10)	485	-
ACCRUED SEVERANCE PAY, (Note 6)	1,035	1,549
DEFERRED INCOME TAXES (Note 11)	102	-
MINORITY INTERESTS	-	64
SHAREHOLDERS' EQUITY (Note 12):		
Share capital: Authorized: 10,000,000 Ordinary Shares of NIS 0.1 par value; Issued and outstanding: 4,215,226 shares and 4,847,774 shares as of December 31, 1995 and 1996, respectively	158	178
Additional paid-in capital	11,674	17,080
Cumulative foreign currency translation adjustments	-	23
Retained earnings	3,277	4,675
Total shareholders' equity	15,109	21,956
	$ 24,559	$ 34,007

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

CONSOLIDATED STATEMENTS OF OPERATIONS

U.S. Dollars (in thousands) except per share amounts

	Year ended December 31,		
	1994	1995	1996
Revenues (Note 13):			
Software sales	$ 18,764	$ 19,856	$ 28,085
Services	2,608	5,528	8,331
Total revenues	21,372	25,384	36,416
Cost of revenues:			
Software sales	3,604	3,103	4,085
Services	2,068	4,484	7,108
Total cost of revenues	5,672	7,587	11,193
Gross profit	15,700	17,797	25,223
Operating expenses:			
Research and development, net (Note 13d)	2,158	2,878	2,611
Selling and marketing, net	10,712	11,391	15,963
General and administrative	2,879	3,757	4,112
Total operating expenses	15,749	18,026	22,686
Operating income (loss)	(49)	(229)	2,537
Financial income (expenses), net (Note 13e)	47	(48)	(521)
Loss from marketable securities	(1,296)	(18)	-
Income (loss) before taxes on income	(1,298)	(295)	2,016
Taxes on income (Note 11)	190	333	456
	(1,488)	(628)	1,560
Equity in earnings (losses) of an affiliate	-	67	(115)
Minority interest in losses (earnings) of subsidiaries	88	123	(47)
Net income (loss)	$ (1,400)	$ (438)	$ 1,398
Net earnings (loss) per share	$ (0.34)	$ (0.10)	$ 0.30
Weighted average number of shares outstanding	4,158	4,303	4,720

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

STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

U.S. Dollars (in thousands)

	Share capital	Additional paid-in capital	Cumulative foreign currency translation adjustments	Retained earnings	Total shareholders' equity
Balance as of January 1, 1994	$ 146	$ 10,400	-	$ 5,115	$ 15,661
Stock options exercised (1)	3	391	-	-	394
Amortization of unearned compensation for stock options issued to employees	-	234		-	234
Loss for the year	-	-	-	(1,400)	(1,400)
Balance as of December 31, 1994	149	11,025	-	3,715	14,889
Stock options exercised (1)	7	33	-	-	40
Issuance of shares to Mashov for its holdings in an affiliate	2	382	-	-	384
Amortization of unearned compensation for stock options issued to employees	-	234		-	234
Loss for the year	-	-	-	(438)	(438)
Balance as of December 31, 1995	158	11,674	-	3,277	15,109
Issuance of shares, net	19	4,988	-	-	5,007
Stock options exercised	1	316	-	-	317
Amortization of unearned compensation for stock options issued to employees	-	102	-	-	102
Cumulative foreign currency translation adjustments	-	-	23	-	23
Net income for the year	-	-	-	1,398	1,398
Balance as of December 31, 1996	$ 178	$ 17,080	$ 23	$ 4,675	$ 21,956

(1) Net of loans granted to employees and directors.

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

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. Dollars (in thousands)

	Year ended December 31,		
	1994	1995	1996
Cash flows from operating activities:			
Net income (loss) for the year	$ (1,400)	$ (438)	$ 1,398
Adjustments to reconcile net income (loss) to net cash provided by operating activities			
Depreciation and amortization	1,041	1,243	1,849
Capital loss (gain) on sale of fixed assets	3	13	(11)
Equity in losses (earnings) of an affiliate	-	(67)	115
Minority interest in income (losses) of a consolidated subsidiary	(88)	(123)	47
Amortization of unearned compensation for stock options issued to employees	234	234	102
Erosion of long-term loans	-	-	(54)
Increase in accrued severance pay, net	64	77	152
Increase (decrease) in deferred income taxes	3	-	(166)
Decrease in trading marketable securities	3,797	1,066	-
Increase in trade receivables	(872)	(3,403)	(3,588)
Decrease (increase) in parent and affiliated companies	(445)	433	(387)
Decrease (increase) in other receivables and prepaid expenses	420	(543)	(648)
Decrease (increase) in inventories	264	(68)	(250)
Increase (decrease) in trade payables	(124)	497	472
Increase in accrued and other expenses	565	1,587	2,474
Net cash provided by operating activities	3,462	508	1,505
Cash flows from investing activities:			
Proceeds from investments	68	28	-
Capitalized software costs	(1,241)	(1,450)	(2,417)
Purchase of fixed assets	(2,869)	(1,345)	(1,800)
Proceeds from sale of marketable securities	561	-	191
Investment in a subsidiary (1)	(572)	-	(210)
Proceeds from sale of fixed assets	129	17	96
Net cash used in investing activities	(3,924)	(2,750)	(4,140)

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

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. Dollars (in thousands)

	Year ended December 31,		
	1994	1995	1996
Cash flows from financing activities:			
Proceeds from the exercise of stock options	394	40	317
Proceeds from long-term loans	-	485	-
Proceeds from issuance of shares	-	-	5,007
Short-term bank credits debt, net	272	935	(911)
Net cash provided by financing activities	666	1,460	4,413
Effect of exchange rate changes on cash and cash equivalents	-	-	(1)
Net increase (decrease) in cash and equivalents	204	(782)	1,777
Cash and cash equivalents at the beginning of the year	1,211	1,415	633
Cash and equivalents at the end of the year	$ 1,415	$ 633	$ 2,410
Supplemental disclosures of cash flow information:			
Net cash paid during the year for:			
Income taxes	$ 495	$ 333	$ 658
Interest	$ 60	$ 69	$ 243
Non-cash activities:			
Investment in an affiliate for shares issued		$ 507	
Additional investment in a subsidiary in consideration of decrease in minority interests and other payables			$ 415

(1) Purchase of Magic Beheer B.V., a subsidiary:	
Working capital	$ 7
Fixed assets, net	26
Minority interest	(27)
Goodwill	618
Investment in affiliate	(52)
	$ 572

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

U.S. Dollars (in thousands)

NOTE 1:- GENERAL

a. Magic Software Enterprises Ltd. and its subsidiaries ("the Company") design, develop, market and support a family of software products used for the rapid application development and deployment ("RADD") of departmental and enterprise client/server applications. The Company's family of Magic products enables the organization to accelerate the process of building highly flexible, mission-critical software applications. Magic operates on a large variety of platforms.

The Company distributes its products and services in approximately 50 countries worldwide. The Company markets and supports its products primarily through its own direct sales force in Europe, the United States and Israel, and through a network of distributors and value added retailers ("VARs") in these and a variety of other countries in Asia and Latin America.

b. Through August 1996 the Company was 51% owned by Mashov Computers Ltd. (Mashov). In August the Company issued additional shares in a public offering and as a result Mashov’s holdings in the Company were reduced to 44.4%. Under a voting agreement Mashov controls 50.5% of the voting stock of the company and therefore the company continues to be a consolidated subsidiary of Mashov.

c. Revenues from the Company's distributor in Japan are as follows:

	1994	1995	1996
Wacom Co. Ltd.	23%	20%	18%

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES

The financial statements have been prepared in accordance with accounting principles generally accepted in Israel ("Israel GAAP"). Israel GAAP and accounting principles generally accepted in the United States ("U.S GAAP") as applicable to the financial statements of the Company, are substantially identical in all material respects.

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

a. Financial statements in United States dollars:

The consolidated financial statements are presented in U.S. dollars because the U.S. dollar is the currency of the primary economic environment in which the Company conducts its operations. The functional currency of the subsidiaries is their local currency.
Transactions and balances originally denominated in dollars are presented at their original amounts. Non-dollar transactions and balances have been remeasured into U.S. dollars in accordance with the requirements of Statement No. 52 of the Financial Accounting Standard ("SFAS"). All transaction gains and losses from remeasurement of monetary balance sheet items denominated in non-dollar currencies are reflected in the statements of operations as financial income or expenses, as appropriate. Assets and liabilities in, or linked to, non-dollar currencies are included on the basis of the representative exchange rates prevailing at balance sheet dates.

For the subsidiaries whose functional currency has been determined to be the local currency, assets and liabilities are translated at year-end exchange rates and statement of operations items are translated at average rates prevailing during the year. Such translation adjustments are recorded as a separate component of shareholders' equity.

b. Consolidated financial statements:

1. The consolidated financial statements include the accounts of the Company and its subsidiaries (see Note 16). Significant intercompany balances and transactions have been eliminated in consolidation.

2. Minority interests are liable for a subsidiary's losses, up to an amount equal to their pledge.

c. Cash equivalents:

Cash equivalents include short-term, highly liquid investments that are readily convertible to cash and with original maturities of three months or less when purchased.

d. Marketable securities:

Effective January 1, 1993, the Company classifies certain marketable securities as "trading securities", in accordance with FASB Statement No. 115. Unrealized holding gains and losses related to trading securities are included in the statement of operations.

e. Inventories:

Inventories are comprised of software packaging, diskettes, printed materials and hardware production devices, and are stated at the lower of cost or market value. Cost is determined by the "first-in, first-out" method.

U.S. Dollars (in thousands)

f. Investment in affiliate:

The Company’s 42% investment in M.N.S. Micronova Systems Ltd. is presented by the equity method of accounting. The investment in which the Company holds less than 20% of the voting shares is stated at cost.

g. Fixed assets:

Fixed assets are stated at cost. Depreciation is computed by the straight-line method over the estimated useful lives of the assets at the following annual rates:

	%
Land and building	0-4
Computers and peripheral equipment	20
Office furniture and equipment	6 - 15
Motor vehicles	15

h. Research and development costs:

Research and development costs net of grants are charged to income as incurred. Statement of Financial Accounting Standards ("SFAS") No. 86 "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed", requires capitalization of certain software development costs subsequent to the establishment of technological feasibility.

Based on the Company's product development process, technological feasibility is established upon completion of a detailed program design. Costs incurred by the Company between completion of the detailed program design and the point at which the product is ready for general release have been capitalized.

The amount of software costs capitalized for the years ended December 31, 1994, 1995 and 1996 was $ 1,241, $ 1,450 and $ 2,417, respectively.

Capitalized software costs are amortized by the greater of (i) the ratio of 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 remaining estimated useful life of the product (not greater than five years). The Company assesses the recoverability of this intangible asset by determining whether the amortization of the asset over its remaining life can be recovered through undiscounted future operating cash flows from the specific product.

i. Royalty-bearing grants:

Royalty-bearing grants from the Government of Israel and others for funding certain approved research projects and for funding marketing activity are recognized at the time the Company is entitled to such grants on the basis of the related costs incurred.

j. Goodwill:

The excess of purchase price over the value of net assets acquired is included in other assets and is amortized over a 10-5 year period.

k. Income taxes:

Income taxes are provided for by the assets and liability method in accordance with FASB Statement No. 109. ”Accounting for Income Taxes”

l. Revenue recognition:

Revenues from software sales are recognized upon shipment and resolution of any material vendor obligations. Royalties from software sales by the distributor in Japan are recognized on a quarterly basis. Service revenues from customer maintenance fees for ongoing customer support and product updates are recognized ratably over the period of the contract. Training and consulting revenues are recognized when earned. The Company's standard licensing arrangements provide a 60-day warranty period which entitles the user to customer support at no charge.

m. Advertising expenses:

Advertising costs are charged to expenses as incurred and amounted to $985 in 1996.

n. Concentration of credit risks:

Financial instruments which potentially subject the Company to concentrations of credit risk consist principally of cash equivalents, and accounts receivable. The Company’s trade accounts receivable are derived from sales to customers located primarily in the U.S., Europe South East Asia and Israel. The Company performs ongoing credit evaluations of its customers and to date has not experienced any material losses. The allowance for doubtful accounts is determined with respect to specific debts doubtful of collection.

o. Earnings (loss) per share:

Earnings (loss) per share are computed based on the weighted average number of shares outstanding during each period, including share equivalents (stock options and warrants), which have a dilutive effect.

p. Accounting for share options issued to employees:

The Company has elected to follow Accounting Principles Board Opinion No. 25, “Accounting for Stock to Employees” (APB 25”) in accounting for its employee stock options plans. Under APB 25, when the exercise price of the Company’s employee stock options equals the market price of the underlying stock on the date of grant, no compensation expense is recognized.

U.S. Dollars (in thousands)

q. Fair value of financial instruments:

Cash and cash equivalents, marketable securities and short-term loans. The carrying amounts reported in the balance sheet approximate their fair value.

r. Reclassifications:

Certain reclassifications, none of which affected net income, have been made to the prior years' amounts, in order to conform to the current year's presentation.

NOTE 3:- TRANSACTIONS WITH RELATED PARTIES

a. The Company signed two agreements with Mashov whereby the Company agreed to lease 41% of the building owned by Mashov for a period of five years. The annual lease expense is $ 170.

b. Transactions with related parties:

	Year ended December 31,		
	1994	1995	1996
General and administrative expenses (including rent)	$ 243	$ 292	$ 436
Financial expenses, net	$ 47	$ 45	$ 169

c. See Note 5 regarding acquisition of a company from Mashov.

NOTE 4:- OTHER RECEIVABLES AND PREPAID EXPENSES

	December 31,	
	1995	1996
Government of Israel for grants and participations	$ 474	$ 546
Prepaid expenses and other	532	799
Employee loans (1)	514	786
Deferred income tax	-	66
Minority interests	187	29

		$ 1,707	$ 2,226
(1)	Including loans to directors	$ 96	$ 213

U.S. Dollars (in thousands)

NOTE 5:- INVESTMENTS IN AN AFFILIATE

a. Investment in affiliates are comprised as follows:

Equity:

	December 31,	
	1995	1996
Cost of shares	$ 451	$ 544
Goodwill	(269)	(269)
Post acquisition losses	-	(25)
Foreign currency translation adjustments	-	12
	182	262
Goodwill:		
Cost	269	269
Amortization	-	(90)
	269	179
	$ 451	$ 441

b. In October 1995, the Company acquired from Mashov its 42% holdings in M.N.S. Micronova Systems Ltd. ("Micronova"), in exchange for 60,938 ordinary shares of the Company, which had a market value of $ 507. The excess of the amount paid by the Company over the book value of Micronova in Mashov's books, aggregating $ 123 has been deducted from shareholders' equity. In addition, the Company has a guarantee amounting $ 500 to a bank in favor of Micronova.

c. In January 1996, the Company entered into a joint venture agreement with Betagro Computers Ltd. in Thailand. The joint venture will be principally engaged in importing and distributing Magic software products. The Company invested $ 40 for a 20% ownership.

U.S. Dollars (in thousands)

d. The Company acquired from other shareholders an additional 33% holding in Magic B.V. (consolidated company) for $ 595 of which $ 306 has been paid in 1997.

e. During 1996, the Company acquired a 10% holding in Magic Belgium for the consideration of $ 50. The acquisition is presented by the cost method.

NOTE 6:- ACCRUED SEVERANCE PAY

The Company's liability for severance pay, pursuant to Israeli law, is fully provided. Part of the liability is funded though insurance policies which are not under the control of the Company. Severance pay expense for the years ended December 31, 1994, 1995 and 1996 was $219, $ 342 and $ 448, respectively.

NOTE 7:- FIXED ASSETS

	December 31,	
	1995	1996
Cost:		
Land and building	$ 3,453	$ 3,453
Computers and peripheral equipment	3,431	4,753
Office furniture and equipment	573	833
Motor vehicles	255	311
	7,712	9,350
Accumulated depreciation:		
Land and Building	224	361
Computers and peripheral equipment	1,387	2,218
Office furniture and equipment	222	264
Motor vehicles	97	107
	1,930	2,950
Depreciated cost	$ 5,782	$ 6,400

U.S. Dollars (in thousands)

NOTE 8:- OTHER ASSETS

	December 31, 1995	December 31, 1996
Cost:		
Capitalized software	$ 4,206	$ 6,623
Goodwill	618	1,213
	4,824	7,836
Accumulated amortization:		
Capitalized software	1,048	1,709
Goodwill	108	198
	1,156	1,907
	$ 3,668	$ 5,929

NOTE 9:- ACCRUED AND OTHER EXPENSES

	1995	1996
Employees and payroll accruals	$ 981	$ 2,401
Accrued expenses	1,673	2,755
Deferred revenues	1,500	1,228
Other	716	1,209
	$ 4,870	$ 7,593

NOTE 10:- CREDIT FROM BANKS AND OTHERS

a. Short-term bank debt:

All short-term bank debt is comprised of quick turnover bank overdrafts of various subsidiaries of the Company with no maturity dates.

b. Long-term loan:

On November 15, 1995, the Company received a two-year loan from Wacom Co. amounting to 50 million Japanese yen. The loan is linked to the Japanese yen and bears interest at an annual rate of 5.5%, which is payable quarterly, and is due November 15, 1997**.** In May 1997 the Company paid to Wacom 45.7 million yen.

NOTE 11:- INCOME TAXES

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

The Company's production facilities have been granted the status of "Approved Enterprise" under the Law. Income derived from such enterprise during a period of seven years from the year in which this enterprise first realizes taxable income, is subject to corporate tax of 25% (which ended December 31, 1995).

Four expansion projects have been granted "Approved Enterprise" status under the aforementioned Law.

According to the provisions of this Law, the Company has chosen to enjoy "Alternative Benefits" - waiver of grants in return for tax exemption - and, accordingly, the Company's income is tax-exempt for a period of two to four years commencing with the year it first earns taxable income. The tax exemption relates only to income derived from the expansion project. In the remaining three to five years of benefits, the Company will be subject to a corporate tax of 25%.

The four expansion programs are as follows:

1) Income derived from the first program was tax-exempt for the two year period ended December 31, 1991, and was subject to a reduced tax rate of 25% for the five-year period ending December 31, 1996.

2) The second program was tax-exempt for the four year period ended December 31, 1995 and is subject to a reduced tax rate of 25% for the six year period ending December 31, 2001.

3) The third program entitles the Company to a tax-exemption for the four year period ending December 31, 1997, and is subject to a reduced tax rate of 25% for the six year period ending December 31, 2003.

4) The fourth program entitles the Company to a tax-exemption for the four year period ending December 31, 2000, and is subject to a reduced tax rate of 25% for the six year period ending December 31, 2006.

If a dividend is distributed out of tax-exempt profits deriving from the expansion program, the Company will be liable to corporate tax at the rate of 25%. As of December 31, 1996, retained earnings included approximately $ 2,400 of tax exempt profits earned by the Company's

"Approved Enterprise". The Company has not provided income taxes on these tax exempt profits because they have been permanently reinvested in the Company's business.

The tax exempt income earned by the Company's "Approved Enterprise" can be distributed to shareholders without a tax liability to the Company only upon the complete liquidation of the Company. If the retained tax exempt income is distributed in a manner other than upon the complete liquidation of the Company, it would be taxed at the corporate tax rate applicable to such income if the Company had not chosen the alternative tax benefits (currently - 25% for an "Approved Enterprise") and an income tax liability of approximately $ 864 would be incurred.

The Law also entitles the Company to claim accelerated depreciation on buildings, machinery and equipment used by the "Approved Enterprise" during the first five tax years.

Should the Company and its Israeli subsidiary derive income from sources other than the approved enterprises during the relevant benefit periods, such income will be taxable at regular corporate tax rates as follows:

1994 - 38%, 1995 - 37% and 1996 and thereafter - 36%.

b. Measurement of results for tax purposes:

Results for tax purposes are measured on real basis adjusted to the increase in the Israeli Consumer Price Index ("CPI"). The Company's financial statements are presented in U.S. dollars. The difference between the annual change in the Israeli CPI and in the new Israeli shekel ("NIS")/U.S. dollar exchange rate results in a difference between taxable income and the income before taxes reflected by the financial statements. Such differences are immaterial in these financial statements.

c. Tax benefits under the Law for the Encouragement of Industry (Taxation), 1969:

The Company currently qualifies as an "industrial company" under the above law and as such is entitled to certain tax benefits, mainly the right to claim for tax purposes expenses incurred in public issuance of securities.

U.S. Dollars (in thousands)

d. A reconciliation of the theoretical tax expense, assuming all income is taxed at the statutory rate applicable to income of the Company and the actual tax expense, is as follows:

	Year ended December 31,		
	1994	1995	1996
Theoretical tax expense (benefit), (38%-1994, 37% - 1995 and 36%-1996)	$ (494)	$ (109)	$ 726
Increase (decrease) in taxes:			
Special items taxed at lower rates	80	(91)	-
Tax adjustments in respect of inflation in Israel	(459)	107	(253)
Tax exempt income during the benefit period (1)	(500)	(796)	(1,197)
Nondeductible expenses and foreign withholding taxes	688	356	373
Adjustment deferred taxes of anticipated in tax rate	-	-	(193)
Losses in subsidiaries for which deferred tax benefits were not recognized	875	866	1,000
Taxes on income in the statements of operations	$ 190	$ 333	$ 456
(1) Per share amounts of the tax benefit resulting from the exemption under the Law	$ 0.12	$ 0.08	$ 0.24

e. The provision for taxes, which is all domestic, comprises the following:

	1994	1995	1996
Current taxes	$ 187	$ 333	$ 622
Deferred taxes	3	-	(166)
	$ 190	$ 333	$ 456

U.S. Dollars (in thousands)

f. The domestic and foreign components of income (loss) before taxes are as follows:

	Year ended December 31,		
	1994	1995	1996
Domestic	$ 3,163	$ 2,046	$ 5,021
Foreign	(4,461)	(2,341)	(3,005)
	$ (1,298)	$ (295)	$ 2,016

g. Temporary differences comprising the net deferred tax liability on the balance sheet are as follows:

	December 31,	
	1995	1996
Depreciation and amortization	$ 445	$ 477
Net operating loss carryforwards	(2,426)	(3,410)
Allowances and reserves	(343)	(450)
Net deferred tax asset before valuation allowance	(2,324)	(3,383)
Valuation allowance	2,426	3,317
Net deferred tax liability	$ 102	$ (66)

h. Tax assessments:

The Company has received final assessments up to and including the tax year ended December 31, 1992. The subsidiaries have not been assessed.

NOTE 12:- SHAREHOLDERS' EQUITY

a. The Ordinary Shares of the Company are quoted on Nasdaq in the United States.

b. Stock Option Plan:

Under the Company's 1991 Stock Option Plan (the "Plan"), options may be granted to employees, officers, directors and consultants of the Company or any subsidiary. The options granted under the Plan may not be less than 75% of the fair market value of the Company's Ordinary Shares on the date of the grant and are granted for periods not to exceed 10 years.

U.S. Dollars (in thousands)

Under the Plan, 1,400,000 Ordinary Shares of the Company were reserved for issuance. Any options which are canceled or not exercised within the option period become available for future grants. The Plan will terminate on August 14, 2001, unless previously terminated by the Board of Directors.

The following table is a summary of activity for the Company's stock options plan:

	1994		1995		1996	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
Outstanding at beginning of year	540,340	$ 6.87	595,263	$ 6.82	666,517	$ 6.77
Granted	292,846	6.65	332,600	6.64	243,250	8.66
Exercised	(71,523)	6.50	(58,982)	6.50	(11,915)	8.40
Forfeited *)	(166,400)	6.81	(202,364)	6.79	(107,436)	6.80
Outstanding at end of year	595,263	$ 6.82	666,517	$ 6.77	790,416	$ 7.32
Exercisable at end of year	269,206	$ 6.83	169,940	$ 6.82	356,379	$ 7.31

*) Forfeited options are returned to the pool of outstanding options.

Exercise prices for options outstanding as of December 31, 1996 ranged from $6.5 to $18.00.

U.S. Dollars (in thousands)

Under SFAS 123, pro-forma information regarding net income and earnings per share is required (for grants issued after December 1994), and has been determined as if the Company had accounted for its employee stock option under the fair value method of that Statement. The fair value for these options was estimated at the date of grant using a Black-Scholes Option Valuation Model with the following weighted-average assumptions for 1995 and 1996: risk-free interest rates of 6.00%, dividend yields of 0%, volatility factors of the expected market price of the Company's ordinary shares of 0.804 and a weighted-average expected life of an option of four years.

The weighted average fair values at grant dates of options granted during 1995 and 1996 were $ 6.64 and $ 8.66, respectively.

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions, including the expected stock price volatility. Because the Company's stock options have characteristics significantly different from those traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its stock options.

For purposes of pro-forma disclosure, the estimated fair value of the options is amortized as an expense over the options' vesting period. Because FAS 123 is applicable only to options granted subsequent to December 31, 1994, its pro-forma effect will not be fully reflected until 1997.

Pro-forma information under SFAS 123:

	Year ended December 31,	
	1995	1996
Pro-forma net income (loss)	$ (812)	$ 524
Pro-forma earnings (loss) per share	$ (0.19)	$ 0.11

The total compensation expense included in the pro-forma information for 1995 and 1996 is $ 374 and $ 874, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
U.S. Dollars (in thousands)

NOTE 13:- SELECTED STATEMENTS OF OPERATIONS DATA

a. Summary of operations in geographic areas:

	Year ended December 31, 1994	1995	1996
Sales to unaffiliated customers:			
Israel	$ 13,888	$ 14,331	$ 16,197
North America	4,628	4,731	6,943
Europe	2,856	6,322	13,276
	$ 21,372	$ 25,384	$ 36,416
Net of transfers between geographic areas:			
Israel	$ 2,102	$ 3,304	$ 6,805
Operating income (loss):			
Israel	$ 3,470	$ 3,412	$ 6,225
North America	(2,194)	(1,651)	(3,404)
Europe	(1,267)	(1,960)	(55)
Adjustments and elimination's	(58)	(30)	(240)
	$ (49)	$ (229)	$ 2,526
Identifiable assets:			
Israel	$ 24,458	$ 27,181	$ 32,425
North America	2,250	2,365	4,576
Europe	2,461	3,650	7,986
Eliminations	(9,125)	(9,254)	(12,742)
	$ 20,044	$ 23,942	$ 32,245

U.S. Dollars (in thousands)

c. Sales by geographical markets:

	Year ended December 31,		
	1994	1995	1996
Israel	$ 2,475	$ 1,983	$ 3,257
Europe	6,139	11,316	16,206
North America	4,628	4,731	6,784
Japan	4,916	5,076	6,659
Others	3,214	2,278	3,510
	$ 21,372	$ 25,384	$ 36,416

d. Research and development costs:

	1994	1995	1996
Total costs	$ 3,834	$ 4,495	$ 6,950
Less - royalty bearing grants	(435)	(167)	(1,922)
Less - capitalization of software expenses	(1,241)	(1,450)	(2,417)
Research and development, net	$ 2,158	$ 2,878	$ 2,611

e. Financial income (expenses), net:

	1994	1995	1996
Interest and bank charges	(46)	(163)	(413)
Income (losses) arising from foreign currency transactions	93	115	(108)
Financial (expenses) income, net	47	(48)	(521)

NOTE 14:- COMMITMENTS AND CONTINGENT LIABILITIES

a. Under the Company's research and development agreements with the Office of the Chief Scientist ("OCS") and Bi-national Industrial Research and Development Foundation ("BIRD-F"), the Company is required to pay royalties at the rate of 3%-5% of sales of the consolidated products developed with funds provided by the OCS and BIRD-F, up to an amount equal to 100% to the OCS and 150% to

BIRD-F research and development grants linked to the U.S. dollar that have been received by the Company.

As of December 31, 1996, the Company had a contingent obligation to pay $ 1,342 in royalties relating to these grants.

U.S. Dollars (in thousands)

b. The Israeli Government, through the Fund for Encouraging Marketing Activities, awarded the Company grants for participation in marketing expenses overseas. The Company is required to pay royalties at the rate of 3% of the increase in overseas sales, up to an amount equal to 100% of the grants received linked to the U.S. dollar.

The Company received grants amounting to $ 43, $360 and $ 288 for the years ending December 31, 1994, 1995 and 1996, respectively.

As of December 31, 1996, the Company had a contingent obligation to pay $ 813 in royalties relating to these grants.

c. Lease commitments:

The Company leases part of its facilities from Mashov (see Note 2). Certain subsidiaries rent facilities under operating leases for periods ending in 1997.

Future minimum lease commitments under non-cancelable operating leases for the years ending December 31, are as follows:

1997	$ 329
1998	170
1999	170
2000	126
	$ 795

Rent expense for the years ended December 31, 1994, 1995 and 1996 was approximately $ 524, $ 643 and $ 694, respectively.

d. Guarantees:

The Company has guarantees to a third party amounting to $ 40.

e. Legal proceedings:

The Company becomes involved from time to time in various claims and lawsuits incidental to the ordinary course of its business. According to its legal counsel, the outcome of these claims and lawsuits are uncertain. Management believes that the outcome of any pending claims or proceedings will not have a materially adverse effect on the Company or its business.

U.S. Dollars (in thousands)

NOTE 15:- INVESTEE COMPANIES

a. Consolidated companies

Name of the Company	Percentage of ownership
Magic Software Enterprises Inc. (United States)	100%
Magic Software Enterprises (U.K.) Limited (United Kingdom)	
Magic Beheer B.V. (Holland)	84%
Magic Software Enterprises (Deutschland) GmbH (Germany)	100%
Magic Software Enterprises S.A.R.L. (France)	100%
Magic Europe B.V. (Holland)	100%
Magic Financing Ltd. (Israel)	100%
Magic Italia S.R.L.	51%
Magic Software Brazil Ltd.	100%

b. Affiliates:

Name of the Company	Percentage of ownership
M.N.S. Micronova Systems Ltd.	42%
Magic Thailand	20%
Magic Belgium	10%

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