M A G I C

S O F T W A R E   E N T E R P R I S E S   L T D

A N N U A L   R E P O R T   A N D   A C C O U N T S   1 9 9 7

C O N T E N T S

H I G H L I G H T S

- Release of Magic Enterprise Edition V8
- Release of Magic/400 (Client and Server) for IBM's AS/400 Advanced Series
- Release of Magic/ System Architect link with Popkin Software and Systems
- Magic support announced for IBM's DB2 Universal Database
- New distributorships achieved in Mexico, Turkey, Brazil, and Romania
- New joint venture subsidiaries established in India and Japan
- Magic Enterprise Edition recognized as "enterprise-level" by analysts Datapro, SDG, Hurwitz Group, Butler Group, Ovum, OSA, Computerwire, and Aberdeen Group
- Partnership agreement signed with Mercury Interactive to create an open API
- Magic wins Crossroads' A-List Award for real mission-critical computing
- Magic wins "Cream of the Crop" Award from Computerwire
- Magic wins 1997 DB/EXPO RealWare award
- User Conference in Turkey with over 400 participants from over 40 countries

FINANCIAL HIGHLIGHTS

INCOME STATEMENT DATA (U.S. dollars in thousands except per share amounts) (December 31)

	1996	1997
Sales	36,416	37,432
Research and development costs	2,611	3,348
Operating income	2,537	(9,676)
Income before taxes	2,016	(10,164)
Taxes on income	456	476
Net income	1,398	(10,454)
Earnings per share	0,30	(2,15)
Weighted average number of shares outstanding	4,720	4,978

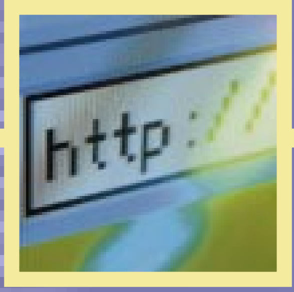
BALANCE SHEET DATA (U.S. dollars in thousands except per share amounts) (December 31)

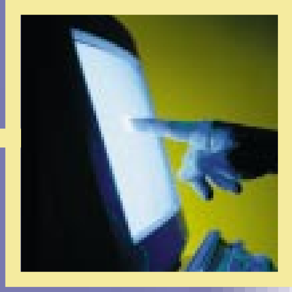
	1996	1997
Working capital	9,820	(550)
Total assets	34,007	29,192
Short-term debt including current maturities	990	3,345
Payable to parent and affiliated companies	0	691
Shareholders' equity	21,956	11,436

ABOUT THE COMPANY

Magic Software Enterprises develops, markets and supports a highly productive development and deployment environment for client/server and Web applications.

In Magic, the time it takes to build and maintain mission-critical applications is drastically reduced. The developer builds sophisticated, strategic applications by using a unique, table-driven, engine-based programming paradigm, which totally eliminates the repetitive and tedious aspects of coding.





“Magic has been proven the most rapid development tool on the market”

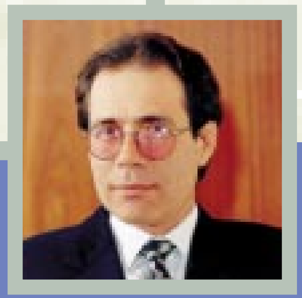
Magic has been proven the most rapid development tool on the market at industry developer competitions, customer sites, and in analyst evaluations. Magic's single development paradigm across a wide range of platforms and architectures means that an organization needs only one tool and one set of development skills, 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 Software Enterprises was established in 1986. Today, it is a public company with over 300 employees worldwide. 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 70,000 development units and 700,000 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 Clearnet Communications, Gannett Media, Rolls Royce, Hughes Direct TV, John Menzies, Cap Gemini, Keyport Life Insurance, Hitachi, Matsushita (National Panasonic), Advantage Rent a Car, Tulip Computers, and Fritz Industries.

LETTER TO THE SHAREHOLDERS

David Assia



Jack Dunietz

Dear Shareholders:

Unfortunately 1997 was a year of flat growth and large losses. Revenues for the year increased to $37.4 million in 1997 from $36.4 million in 1996. Gross profit for the year was $22.7 million or 61%, down from $25.2 million or 69%, and operating income showed a $9.7 million loss as compared to a $2.5 million profit in 1996.

Operating losses were attributable to a number of causes. Large organizations increasingly shifted resources from internal to external IT development projects, from the departmental to the enterprise level, and towards software solutions for Year 2000 issues. Weaker sales throughout Asia and particularly Japan inevitably had their effect — Far Eastern markets accounted for only ten* per cent of our business, instead of the customary twenty* percent.

“Open Systems Advisors placed Magic on its prestigious Crossroads 98 A-List”

In recent years we have made major investments in research and development to bring Magic's core technology to the enterprise and Internet markets. Judging by the acceptance throughout the industry press and analysts of Magic as a RAD tool of choice for enterprise and Internet development, this investment is paying off. The product “delivers developer productivity far superior to its competitors, not only for developing applications for the enterprise, but, most importantly today, for the Internet,” said the Gartner Group. Open Systems Advisors placed Magic on its prestigious Crossroads 98 A-List Award Winners for real mission-critical computing. Magic won the 1997 DB/EXPO RealWare award for the category of Client/Server Computing in Support of Mission-Critical Business Operations.

We made progress with our entry into enterprise markets, with sales to Kalamazoo, The Municipality of Malaga, Fritz Industries, Cap Gemini, Keyport Life Insurance, Opus Technology, Sumitomo, Crown Agents, Honda of America, Chase Manhattan Bank Global Investment Services and AT&T Healthcare.

Our complementary strategic direction towards e-commerce markets advanced in 1997 with the development of dynamic Magic-based Web sites in the US, Canada, France, Germany, Switzerland, and Israel.

Magic continues to strengthen its worldwide channel of distribution. 1997 and early 1998 saw the opening of new joint venture subsidiaries in Japan and India, the achievement of new distributorships in Mexico, Turkey, and Romania, and the opening of a new sales office in New York.

The Company went through a major restructuring during the last quarter of the year, with the goal of a return to profitability by the end of 1998. Organizational changes included the appointment of Jack Dunietz as President and CEO, Shabtai Shaanani as Corporate VP Sales and Marketing, and John O' Leary as CEO of MSE Inc.

The market sectors that Magic addresses are challenging for providers across the board. Although competition is tough, there are opportunities for Magic to successfully market its core advantages in our key markets, as we focus on our niche sectors of solutions for the enterprise, Internet, and AS/400 markets. We look forward to a year of transition and consolidation.

Yours sincerely,

David Assia
Chairman of the Board

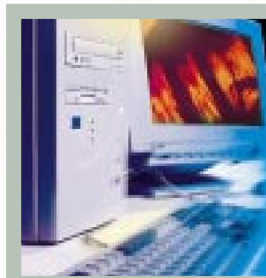
Jack Dunietz
President & CEO

*Approximate figures.

T I N Y

Name: Tiny Computers
Headquarters: London, UK
Business: Direct and value-added PC manufacturer
Product: OT2000 system

“The development speed of Magic is truly impressive”



Tiny Computers, the UK’s leading direct and value-added PC manufacturer, picked Magic to build its new business-critical order processing OT2000 system. Tiny, unique in the PC supply, implementation and support marketplace, mixes a just-in-time manufacturing strategy with consulting services, making it the first value-added direct PC manufacturer for corporate customers. Their Magic-based application handles order processing, production, stock control, dispatch, control and service.

“The development speed of Magic is truly impressive. We have to develop and deploy new systems in very tight time scales and have been overwhelmed at just how easily and quickly we have accomplished this.”

Paul Kemp
IT Director, Tiny Computers

T S U M U R A

Name: Tsumura
Headquarters: Chiyoda, Japan
Business: Manufacturing/retail of oriental medicine and bath products
Product: Sales management, accounting, and manufacturing control

“We chose Magic because its productivity is so high”

Tsumura, a leading Japanese manufacturer/retailer of oriental medicine and bath products, has an annual turnover of more than $673m and over 3,200 employees. When they needed to downsize from mainframes to a client/server and Intranet-based system, they turned to Magic. Tsumura’s new Magic-based system lets them link corporate data up to the Intranet, port to client/server, and reengineer non-compliant data for the Year 2000. The new enterprise-wide system handles sales management, accounting, and manufacturing control applications.

“We chose Magic for this complex, enterprise-wide product, because its productivity is so high.”

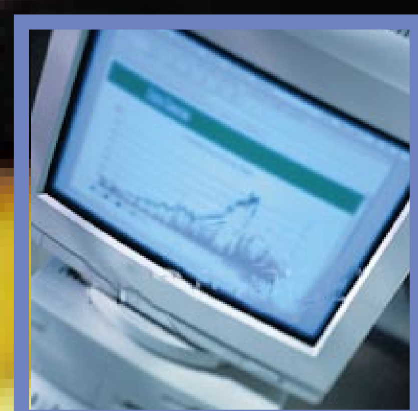
Hideo Sato
Information Systems
Planning Manager, Tsumura

ツムラ

C A P G E M I N I F I N A N C E

Name: Cap Gemini Finance
Headquarters: Paris, France
Business: Software development
Product: Credence — packaged software for the financial sector

“Superior portability and impressive Internet technology”



Cap Gemini Finance is a division of Cap Gemini, the leading software house in France, and one of the top ten worldwide. Cap Gemini Finance develops and markets its Magic-based “Credence,” a set of software packages designed to perform strategic accounting functions in banks, insurance, and manufacturing organizations.

“Our strategic decision to purchase Magic was based on its superior portability, mainframe connectivity and impressive Internet/Intranet technology. The availability of Magic on multiple platforms and databases fulfilled the demands of our market and the needs of our product range.”

Christian Renard, Skills Center Manager, Cap Gemini Finance.

CAP GEMINI

Name: CCIM
Headquarters: Chicago, USA
Business: Real estate association
Product: E-commerce Web Site

“Magic’s Internet performance is so impressive”

InfoPower, a US-based Magic Solutions Provider, developed a dynamic Web site with Magic for the CCIM Commercial Real Estate Network, an international real estate association with more than 10,000 members. The site automates a vast array of functions, including commercial property listings and searches, product purchases and secure payment, membership dues payment, course registration, membership search and information maintenance.

“Performance is so impressive. We are taking thousands of Internet hits per day and Magic Enterprise Edition is there without a problem. We have no unexplained down time.”

Ross Petit
Project manager, InfoPower

The following discussion and analysis 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. This discussion and analysis should be read in conjunction with the Company's Consolidated Financial Statements and notes thereto included elsewhere in this Report.

The Company's consolidated financial statements are stated in U.S. dollars and prepared in accordance with Israeli GAAP and U.S. 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 of gains and losses are included in financial income and expense.

D I S C U S S I O N

ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

Results of Operations
Year Ended December 31, 1997, Compared to Year Ended December 31, 1996

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 until 1993 were from its DOS-based development tool, typically sold to independent developers and small departments and workgroups of large corporations.

In 1994, the Company began to experience a number of changes in its business environment, which impacted on its operating and financial performance. As a result of the widespread acceptance of the Windows operating system, sales of the DOS version of Magic began to decline. As a result, the Company began focusing on sales 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.

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 in 1996. In 1996, the Company had sales of $36.0 million and net income of $1.5 million.

Sales of the Company's tools for the UNIX, VMS, IBM AS/400, Windows, and other client/server environments into the enterprise market generally require a longer sales cycle and a greater degree of up-front support. In order to facilitate this, 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 product's 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, as well as an increase in sales, marketing, and research and development expenses.

ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

In 1997 the following market trends, among others, had a substantial adverse effect on the Company's financial condition and results of operations:

- An increasing tendency of IT executives in large enterprise organizations (the Company's prime target market) to outsource ready-made software solutions rather than develop them in-house. This tendency adversely affected the AD tool market as a whole.
- A shift in the purchasing habits of enterprise customers from products to services. The shift to services required a corresponding increase in human resources, a difficult task in the prevailing worldwide shortage of highly skilled programmers.
- Increasing competition from popular low-end products, particularly Visual Basic, and from large solution providers such as SAP, BAAN, Oracle application development tools, and PeopleSoft.
- The allocation of large portions of IT budgets to the solution of problems relating to the Year 2000 crisis.

These trends had a negative impact on the gross margin of the Company, which decreased to 61% in 1997 from 69% in 1996. The Company addressed these trends in its release of Magic Enterprise Edition Version 8, designed specifically for the enterprise market, as well as by increased emphasis on its service activities which accounted for 39% of sales in 1997 compared to 23% of sales in 1996.

In 1997, the Company incurred a net loss of approximately $10.5 million. Of such amount, approximately $5.4 million was attributable to a restructuring plan implemented by the Company and to a non-recurring cost. As part of its restructuring plan, the Company terminated distribution agreements in certain areas, reduced the number of its employees and withdrew one product line. At such time, the Board of Directors appointed Jack Dunietz, a director and a founder of the Company, to serve as Acting Chief Executive Officer. Among the restructuring costs were (i) approximately $2.0 million with respect to the write-off of capitalized computer software development costs, (ii) approximately $1.3 million of expenses relating to the termination of distribution agreements, (iii) approximately $800,000 of expenses relating to the termination of the employment of employees, and (iv) other expenses of approximately $300,000. In addition, the Company incurred non-recurring expenses of approximately $1.0 million. The Company reached an agreement with the Chief Scientist pursuant to which the Company will pay royalties on all of its consolidated revenues

ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

on a going-forward basis. As a result, the Company provided for the full amount of the royalty commitment of approximately $1.0 million.

Accounting Matters

Revenues from software sales are recognized upon shipment and resolution of any material vendor obligations. Royalties from software sales by Wacom, the Company's 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)		
	1995	1996	1997
Total research and development costs	$4,495	$6,950	$6,758
Less royalty bearing grants	(167)	(1,922)	(285)
Less capitalization of software	(1,450)	(2,417)	(3,125)
Research and development, net	**$2,878**	**$2,611**	**$3,348**

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 technical 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.

ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

Results of Operations

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

	1995	1996	1997
Revenues:			
Software sales	78%	77%	64%
Services	22	23	36
Total revenues	**100**	**100**	**100**
Cost of revenues:			
Software sales	12	11	12
Services	18	20	28
Total cost of revenues	**30**	**31**	**40**
Gross profit	**70**	**69**	**60**
Operating expenses:			
Research and development, net	11	7	9
Selling and marketing, net	45	44	47
General and administrative expenses	15	11	16
Restructuring and other non-recurring expenses	0	0	14
Total operating expenses	**71**	**62**	**86**
Operating income (loss)	(1)	7	(26)
Financial income (expenses), net	0	(1)	(1)
Income before income taxes (loss)	(1)	6	(27)
Income taxes	(1)	(2)	(1)
Equity in earnings of an affiliate	0	0	0
Minority interest in losses of consolidated subsidiary	0	0	1
Net (loss) income	**(2)%**	**4%**	**(27)%**

ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

Year Ended December 31, 1997 Compared with Year Ended December 31, 1996

Total Revenues. Revenues consist primarily of: (i) software sales and (ii) services (including consulting services, maintenance, support, and training). Total revenues increased 3% to $37.4 million in 1997 from $36.4 million in 1996. Software sales decreased 15% to $24.0 million in 1997 from $28.1 million in 1996. This decrease was principally attributable to the shift in product sales from the department level to the enterprise level and a change in the buying habits of the Company's larger customers. Revenues from services increased 61% to $13.4 million in 1997 from $8.3 million in 1996. This growth, mainly in Europe, reflects the Company's increased efforts to grow its fee-based consulting and training services to external contractors.

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 Chief Scientist); and (iv) pre-sale technical support costs. Cost of services consists primarily of personnel expenses and other related costs. Cost of revenues increased 32% to $14.7 million in 1997 from $11.1 million in 1996. Costs of software sales increased 5% in 1997 to $4.3 million from $4.1 million in 1996.

Gross profit. Gross profit decreased 10% to $22.7 million in 1997 from $25.2 million in 1996. In 1997, the Company's gross margin (gross profit as a percentage of total revenues) on software sales decreased to 81% from 85% in 1996. The Company's gross margin on services increased to 22% in 1997 from 15% in 1996. 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 decreased to $6.8 million in 1997 from $6.9 million in 1996. The decrease was primarily a result of the decreased expenses associated with the postponing of additional development of the next generation "Leapfrog" product. Net research and development costs increased to $3.3 million in 1997 from $2.6 million

ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

in 1996 primarily because of a decrease in grants from the Chief Scientist. The Company did not receive any grants from the Chief Scientist in 1997 as compared to $1.5 million in 1996. The Company expects that its total research and development costs as a percentage of sales will decrease 10% in 1998 as compared to 1997.

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 9.8% to $17.5 million in 1997 from $16.0 million in 1996. Selling and marketing expenses as a percentage of sales increased to 46.8% in 1997 from 43.8% in 1996, principally as a result of the decrease in software sales. The Company accrued grants of $156,000 in 1997 from the BIRD-F. The Company expects that selling and marketing expenses will increase in 1998 as a result of the planned increase in marketing and sales efforts for the Company's new products, but are expected to 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 $6.1 million in 1997 from $4.1 million in 1996. 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 increased to 16% in 1997 as compared to 11% in 1996. The Company expects that, as a result of the continued growth in the Company's operations, general and administrative expenses as a percentage of sales will increase 18% in 1998.

Financial Income (Expenses), Net. Financial expenses consist of interest expense from borrowings and currency transaction adjustments and financial income consists of income on cash and cash equivalent balances. The Company's financial expenses

ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

were $488,000 in 1997 as compared to financial expenses of $521,000 in 1996.

Income Taxes. The Company incurred income taxes of $476,000 in 1997 and $456,000 in 1996. 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 1998.

Equity in Results of an Affiliate. Equity in earnings of an affiliate represents the Company's proportionate share of Micronova and Magic Thailand. In 1997, the Company recognized a loss of $13,000 from its 42% minority interest in Micronova as compared to a loss of $115,000 in 1996, and recognized a loss of $38,000 from its 20% minority interest in Magic Thailand.

Minority Interest in Profits of Consolidated Subsidiary. Minority interest in profits of a consolidated subsidiary represents the minority shareholders' share of the profits of the subsidiaries, Magic Benelux and Magic Italy, in which the Company currently holds 84% and 81% interests, respectively. In 1997, the Company recognized a minority interest of $237,001 from the losses attributed to the minority shareholders of Magic Benelux and Magic Italy as compared to $47,000 in profits attributed to the minority shareholders in 1996.

Net Income (Loss). As the result of the foregoing, the Company had a net loss of $10,454,000 (or ($2.15) per share, based on 4,853,150 shares outstanding) for the year ended December 31, 1997 as compared to a net income of $1,398,000 (or $0.30 per share, based on 4,720,429 shares outstanding) in the year ended December 31, 1996.

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

Total Revenues. 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 in 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.

ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

Cost of Revenues. 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.

Research and Development, Net. 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 Chief Scientist and accruals of grants from BIRD-F and IBM. Grants from the Chief Scientist increased to $1.5 million in 1996 from $242,000 in 1995. The increase is attributable to grants, which the Chief Scientist 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.

Selling and Marketing, Net. 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.

General and Administrative. 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.

Financial Income (Expenses), Net. Financial expense was $521,000 in 1996 as compared to financial expense of $66,000 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.

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 in which the Company holds 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 a loss of $123,000 in 1995.

Net Income (Loss). As a result of the foregoing, the Company had a net income of $1,398,000 (or $0.30 per share, based on 4,720,429 shares outstanding) in the year ended December 31, 1996, compared to a net loss of $438,000 (or ($0.10) per share, based on 4,303,051 shares outstanding) in the year ended December 31, 1995.

Quarterly Results of Operations

The following tables set forth certain unaudited quarterly financial information for the two years ended December 31, 1997. 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.

1996 QUARTER ENDED 1997

(In thousands, except per share data)

	March 31, 1996	June 30, 1996	Sept. 30, 1996	Dec. 31, 1996	March 31, 1997	June 30, 1997	Sept. 30, 1997	Dec. 31, 1997
Revenues:								
Software sales	$5,437	$7,439	$6,968	$8,241	$6,778	$5,272	$5,841	$6,135
Services	1,959	1,615	2,152	2,605	2,787	3,814	3,307	3,498
Total revenues	**7,396**	**9,054**	**9,120**	**10,846**	**9,565**	**9,086**	**9,148**	**9,633**
Cost of revenues:								
Software sales	927	968	1,031	1,159	1,287	1,195	759	1,086
Services	1,454	1,531	1,825	2,298	2,079	2,942	2,660	2,721
Total cost of revenues	**2,381**	**2,499**	**2,858**	**3,457**	**3,366**	**4,137**	**3,419**	**3,807**
Gross profit	**5,015**	**6,555**	**6,264**	**7,389**	**6,200**	**4,948**	**5,729**	**5,825**
Operating expenses:								
Research and development, net	327	1,106	650	528	714	930	848	856
Selling and marketing, net	3,397	3,336	4,487	4,743	4,448	4,486	3,484	5,102
General and administrative	893	1,146	1,006	1,089	1,218	1,406	1,684	1,782
Restructuring and other non-recurring costs	-	-	-	-	-	2,703	-	2,718
Total operating expenses	**4,617**	**5,588**	**6,143**	**6,349**	**6,380**	**9,525**	**6,016**	**10,455**
Operating income (loss)	398	967	121	1,040	182	4,575	287	4,632
Financial income (expenses), net	(107)	(254)	(118)	(42)	(210)	(106)	(113)	(59)
Capital gain	-	-	-	11	-	-	-	5
Income (loss) before income taxes	(291)	713	3	1,009	(385)	(4,689)	(400)	(4,621)
Income taxes	175	119	161	1	144	84	124	124
Equity in earnings (loss) of an affiliate	2	(46)	(78)	7	2	(62)	(30)	39
Minority interest in losses (earnings) of a consolidated subsidiary	0	0	(2)	(45)	33	54	(24)	174
Net income (loss)	118	548	(238)	970	494	4,781	578	4,602
Net income (loss) per share	$0.03	$0.12	($0.05)	$0.19	($0.10)	($0.98)	($0.12)	($0.09)

Quarterly Results of Operations

	1996	QUARTER ENDED				1997		
	(In thousands, except per share data)							
	March 31,	June 30,	Sept. 30,	Dec. 31,	March 31,	June 30,	Sept. 30,	Dec. 31,
Revenues:								
Software sales	74%	82%	76%	76%	71%	58%	64%	64%
Services	26%	18%	24%	24%	39%	42%	36%	36%
Total revenues	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**
Cost of revenues:								
Software sales	13	11	11	11	13	13	8	11
Services	20	17	20	21	22	32	29	29
Total cost of revenues	**33**	**28**	**31**	**32**	**35**	**45**	**37**	**40**
Gross profit	67	72	69	68	65	54	63	60
Operating expenses:								
Research and development, net	4	12	7	5	7	10	9	9
Selling and marketing, net	46	37	49	44	46	49	38	53
General and administrative	12	13	11	10	13	15	18	19
Restructuring and other non-								
recurring costs	--	--	--	--	--	30	--	28
Total operating expenses	**62**	**62**	**67**	**59**	**66**	**104**	**65**	**109**
Operating income (loss)	5	10	2	9	(1)	(50)	(3)	(49)
Financial income (expenses), net	(1)	(3)	(1)	0	(1)	(1)	(1)	(1)
Capital gain	0	0	0	0	0		0	0
Income (loss) before income taxes		4	7	1	9			
Income taxes	(2)	(1)	(3)	0	2	1	1	1
Equity in earnings (loss) of an affiliate	0	0	1	0	(1)	0	0	0
Minority interest in losses (earnings) of								
a consolidated subsidiary	0	0	0	0	0	1	(1)	2
Net income (loss)	2.9%	6%	(3)%	9%	5%	53%	6%	48%

LIQUIDITY

AND

CAPITAL

RESOURCES

Liquidity and Capital Resources

At December 31, 1997, the Company had $1.38 million in cash and cash equivalents and a working capital deficit of $519,000 as compared to $2.4 million in cash and cash equivalents and $9.8 million in working capital at December 31, 1996.

In 1997, the Company had a net loss of approximately $10.5 million. Such loss included $5.4 million in non-recurring charges, of which $2.4 million was on account of sales restructuring cost, $2.0 million in write-off of capitalized software development and a provision of $1.0 million payment to the Office of Chief Scientist of the Ministry of Industry and Trade.

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 loan of 50 million Japanese Yen ($500,000) 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 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 April 1998, the Company completed a private transaction pursuant to which it sold to Formula Systems (1985) Ltd. ("Formula"), an Israeli software company, 800,000 Ordinary Shares of the Company (representing approximately 15% of the Company's Ordinary Shares) in consideration of $4.0 million. The Company also issued to Formula 1,400,000 warrants having an exercise price of $5.00 per share, of which 600,000 warrants will expire on September 30, 1998 and 800,000 warrants will expire on June 30, 1999. If Formula does not exercise the 600,000 warrants until September 30, 1998, its right to exercise the 800,000 warrants will expire. The Company further granted to Formula a right of first refusal in the event of the issuance of additional securities by the Company for the period ending June 30, 1999.

The Company anticipates that its cash requirements for the foreseeable future will be satisfied by cash flows from operations, existing cash, as well as proceeds from the exercise of the warrants issued to Formula or issuance of securities to other investors 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 $2.0 million in 1998.

The Year 2000 Issue

Some of the Company's older computer programs were written using two digits rather than four to define the applicable year. As a result, those computer programs have time sensitive software that recognize a date using "00 " as the year 1900 rather than the year 2000. This could cause a system failure or miscalculations causing disruptions of operations, including, among other things, a temporary inability to process transactions, send invoices, or engage in similar normal business activities.

Significant uncertainty exists in the software industry concerning the potential effects associated with Year 2000 compliance. Magic's releases starting with version 5.0 are designed to be Year 2000 compliant. Earlier releases prior to version 5.0 are not Year 2000 compliant. There can be no assurance that the Company's software products that are designed to be Year 2000 compliant contain all necessary date code changes.

The Company believes that Year 2000 issues may affect the purchasing patterns of customers and potential customers in a variety of ways. Many companies are expending significant resources to correct or patch their current software systems for Year 2000 compliance. These expenditures may result in reduced funds available to purchase software products such as those offered by the Company. Potential customers may also choose to defer purchasing Year 2000 compliant products until they believe it is absolutely necessary, thus resulting in potentially stalled market sales within the industry. Conversely, Year 2000 issues may cause other companies to accelerate purchases, thereby causing an increase in short-term demand and a consequent decrease in long-term demand for software products.

Effective Corporate Tax Rate

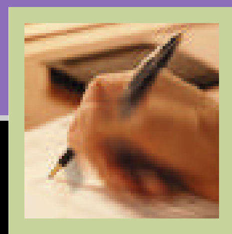
The production facilities of the Company have been granted Approved Enterprise status under the Law for Encouragement of Capital Investments, 1959 and consequently are eligible for certain tax benefits for the first several years in which they generate taxable income. The Company has elected to participate 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. See Note 10 to Notes to Consolidated Financial Statements. 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 3% for both 1996 and 1997.

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 two years ended December 31, 1996, the rate of inflation in Israel exceeded the rate of devaluation of the dollar against the NIS. In 1995 and 1996 the rate of inflation in Israel was 8.1% and 10.6%, respectively, while the rate of devaluation was 3.9% and 3.7%, respectively. In 1997, the rate of inflation was 7.0% while the rate of devaluation was 8.7%.

I N D E X



ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

R E P O R T

TO THE SHAREHOLDERS OF MAGIC SOFTWARE ENTERPRISES LTD.

We have audited the accompanying consolidated balance sheets of Magic Software Enterprises Ltd. and its subsidiaries as of December 31, 1996 and 1997, 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, 1997. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of certain subsidiaries, which statements reflect total assets constituting 21% and 23% as of December 31, 1996 and 1997, respectively, and total revenues constituting 19%, 37% and 35% of the related consolidated totals for the years in the period ended December 31, 1997. These statements were audited by other auditors whose reports have been furnished to us, and our opinion, insofar as it relates to data included for these subsidiaries, is based solely on the reports of the other auditors.

We conducted our audits in accordance with generally accepted auditing standards in Israel and in the United States including those prescribed by the Israeli Auditors Regulations (Mode of Performance), 1973. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management as well as evaluating the overall financial statement presentation. We believe that our audits and the reports of the other auditors provide a reasonable basis for our opinion.

In our opinion, based upon our audits and the reports of other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries as of December 31, 1996 and 1997, and the consolidated results of their operations and cash flows for each of the three years in the period ended December 31, 1997, in conformity with generally accepted accounting principles in Israel. As applicable to the Company's financial statements, generally accepted accounting principles in the United States and in Israel are identical in all material respects.

Kost, Levary and Forer

KOST, LEVARY and FORER

Certified Public Accountants (Israel)
A member of Ernst & Young International

Tel-Aviv, Israel

CONSOLIDATED BALANCE SHEETS (IN THOUSANDS OF US DOLLARS)

	December 31, 1996	December 31, 1997
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 2,410	$ 1,380
Trade receivables (net of allowance for doubtful accounts of $ 234 in 1996 and $670 in 1997)	14,816	12,339
Related parties (Note 13d)	290	-
Other receivables and prepaid expenses (Note 3)	2,197	1,956
Inventories	516	234
Total current assets	20,229	15,909
LONG-TERM INVESTMENTS:		
Investments in affiliates (Note 4)	441	336
Severance pay fund (Note 9)	979	716
	1,420	1,052
MINORITY INTEREST	29	237
FIXED ASSETS (Note 5):		
Cost	9,350	10,014
Less - accumulated depreciation	2,950	4,065
	6,400	5,949
OTHER ASSETS, NET (Note 6)	5,929	6,045
	$34,007	$29,192

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

CONSOLIDATED BALANCE SHEETS (IN THOUSANDS OF US DOLLARS)

	December 31, 1996	December 31, 1997
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Short-term bank credit (Note 7)	$ 990	$ 3,345
Trade payables	1,855	2,931
Related parties (Note 13d)	-	691
Accrued liabilities and other (Note 8)	7,593	9,461
Total current liabilities	10,438	16,428
ACCRUED SEVERANCE PAY (Note 9)	1,549	1,293
MINORITY INTEREST	64	35
SHAREHOLDERS' EQUITY (Note 11):		
Share capital:		
Authorized: 10,000,000 Ordinary Shares of NIS 0.1 par value; Issued and outstanding: 4,847,774 shares and 4,853,150 shares as of December 31, 1996 and 1997, respectively	178	183
Additional paid-in capital	17,080	17,213
Cumulative foreign currency translation adjustments	23	(181)
Retained earnings (accumulated deficit)	4,675	(5,779)
Total shareholders' equity	21,956	11,436
	$34,007	$29,192

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

CONSOLIDATED STATEMENTS OF OPERATIONS (IN THOUSANDS OF US DOLLARS, EXCEPT PER SHARE AMOUNTS)

	Year ended December 31,		
	1995	1996	1997
REVENUES (NOTE 12A):			
Software sales	$19,856	$28,085	$ 24,026
Services	5,528	8,331	13,406
Total revenues	25,384	36,416	37,432
Cost of revenues:			
Software sales	3,103	4,085	4,327
Services	4,484	7,108	10,402
Total cost of revenues	7,587	11,193	14,729
Gross profit	17,797	25,223	22,703
Operating expenses:			
Research and development, net (Note 12d)	2,878	2,611	3,348
Selling and marketing, net	11,391	15,963	17,520
General and administrative	3,757	4,112	6,090
Restructuring and other non-recurring costs (Note 1c)	-	-	5,421
Total operating expenses	18,026	22,686	32,379
Operating income (loss)	(229)	2,537	(9,676)
Financial expenses, net (Note 12e)	(66)	(521)	(488)
Income (loss) before taxes on income	(295)	2,016	(10,164)
Taxes on income (Note 10)	333	456	476
	(628)	1,560	(10,640)
Equity in the earnings (losses) of an affiliate	67	(115)	(51)
Minority interest in losses (earnings) of a consolidated subsidiary	123	(47)	237
Net income (loss)	$ (438)	$ 1,398	$(10,454)
Earnings (loss) per share (Note 15):			
Basic earnings (loss) per share	$ (0.10)	$ 0.30	$ (2.15)
Diluted earnings (loss) per share	$ (0.10)	$ 0.29	$ (2.15)

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

STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (IN THOUSANDS OF US DOLLARS)

	Share capital	Additional paid-in capital	Cumulative foreign currency translation adjustments	Retained earnings (accumulated deficit)	Total shareholders' equity
BALANCE AS OF JANUARY 1, 1995	$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 deferred compensation	-	234	-	-	234
Net loss	-	-	-	(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 deferred compensation	-	102	-	-	102
Foreign currency translation adjustments	-	-	23	-	23
Net income	-	-	-	1,398	1,398
Balance as of December 31, 1996	178	17,080	23	4,675	21,956
Stock options exercised	5	61	-	-	66
Amortization of deferred compensation	-	72	-	-	72
Foreign currency translation adjustments	-	-	(204)	-	(204)
Net loss	-	-	-	(10,454)	(10,454)
Balance as of December 31, 1997	$183	$17,213	$(181)	$(5,779)	$11,436

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

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

CONSOLIDATED STATEMENTS OF CASH FLOWS (IN THOUSANDS OF US DOLLARS)

	Year ended December 31,		
	1995	1996	1997
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income (loss) for the year	$(438)	$1,398	$(10,454)
Adjustments to reconcile net income (loss) to net cash provided by operating activities			
Write off of capitalized computer software development costs	-	-	1,950
Depreciation and amortization	1,243	1,849	2,508
Capital loss (gain) on sale of fixed assets	13	(11)	-
Equity in losses (earnings) of an affiliate	(67)	115	51
Minority interest in earnings (losses) of a consolidated subsidiary	(123)	47	(237)
Amortization of deferred compensation	234	102	72
Erosion of long-term loans	-	(54)	-
Increase in accrued severance pay, net	77	152	7
Decrease (increase) in deferred income taxes, net	-	(166)	66
Decrease in trading marketable securities	1,066	191	-
Decrease (increase) in trade receivables	(3,403)	(3,588)	1,983
Decrease (increase) in related parties	433	(387)	981
Decrease (increase) in other receivables and prepaid expenses	(543)	(648)	175
Decrease (increase) in inventories	(68)	(250)	282
Increase in trade payables	497	472	1,216
Increase in accrued liabilities and other	1,587	2,474	2,423
Net cash provided by operating activities	508	1,696	1,023
Cash flows from investing activities:			
Capitalized software costs	(1,450)	(2,417)	(3,125)
Purchase of fixed assets	(1,345)	(1,800)	(1,204)
Additional investment in a subsidiary	-	(210)	(306)
Proceeds from sale of fixed assets	17	96	238
Proceeds from investments	28	-	-
Long-term investments	-	-	(52)
Net cash used in investing activities	(2,750)	(4,331)	(4,449)

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

CONSOLIDATED STATEMENTS OF CASH FLOWS (IN THOUSANDS OF US DOLLARS)

	Year ended December 31, 1995	1996	1997
CASH FLOWS FROM FINANCING ACTIVITIES:			
Proceeds from the exercise of stock options	40	317	66
Proceeds from long-term loans	485	-	-
Proceeds from issuance of shares, net	-	5,007	-
Changes in bank credits, net	935	(911)	2,400
Net cash provided by financing activities	1,460	4,413	2,466
Effect of exchange rate changes on cash and cash equivalents	-	(1)	(70)
Increase (decrease) in cash and equivalents	(782)	1,777	(1,030)
Cash and cash equivalents at the beginning of the year	1,415	633	2,410
Cash and equivalents at the end of the year	$ 633	$2,410	$1,380
Supplemental disclosures of cash flow information:			
Net cash paid during the year for:			
Income taxes	$ 333	$ 658	$ 403
Interest	$ 69	$ 243	$ 237
Non-cash activities:			
Investment in an affiliate for shares issued	$ 507	-	-
Additional investment in a subsidiary in consideration of decrease in minority interest and other payables	-	$ 415	-

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (IN THOUSANDS OF US DOLLARS)

NOTE 1:- GENERAL

a. MAGIC SOFTWARE ENTERPRISES LTD. (the "Company") designs, develops, markets and supports 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 1996, 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. See Note 16 subsequent events.

c. Restructuring and other non-recurring costs:

During 1997, the Company incurred costs of $ 4,395 in implementing its restructuring plan. The restructuring plan included terminating distributor agreements in certain areas, reduction in numbers of personnel and the existing one product line.

In addition, the Company reached an agreement with the Office of the Chief Scientist in the Israeli Ministry of Industry and Trade ("OCS") according to which the Company will pay royalties on all of the Company consolidated revenues. As a result, the Company provided for the full amount of the royalty commitment, which amounted to $ 1,026.

The following is a breakdown of the costs incurred:

	Year ended December 31, 1997
Write off of capitalized computer software development costs	$1,950
Employee termination expenses	789
Termination of distributor agreements	1,362
Others	294
Total restructuring	4,395
Non-recurring	1,026
	$5,421

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements have been prepared in accordance with generally accepted accounting principles in Israel ("Israel GAAP") which as applicable to these consolidated financial statements, are identical in all material respects to GAAP in the United States.

a. 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.

b. Financial statements in United States dollars:

The majority of the Company's sales are made outside Israel in U.S. dollars ("dollars"). In addition, a substantial portion of the Company's costs is incurred in dollars. Since the dollar is the primary currency of the economic environment in which the Company and its subsidiaries operate, the dollar is the functional currency of each and, accordingly, monetary accounts maintained in currencies other than the dollar are remeasured using the applicable foreign currency exchange rate at balance sheet date. Operational accounts and non-monetary balance sheet foreign currency remeasurement are reported in financial expenses, net. For affiliates, the functional currency has been determined to be the local currency, and therefore, assets and liabilities are translated at year-end exchange rates; statement of operations items are translated at average rates prevailing during the year. Such translation adjustments are recorded as separate component of shareholders' equity's.

c. Principles of consolidation:

The consolidated financial statements include the accounts of the Company and its subsidiaries. Significant intercompany balances and transactions have been eliminated in consolidation.

d. Cash equivalents:

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

e. Marketable securities:

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.

f. 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.

g. Investment in affiliates:

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

h. 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:

	%
Buildings	4
Computers and peripheral equipment	20 - 33
Office furniture and equipment	6 - 15
Motor vehicles	15

i. 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.

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.

j. Goodwill:

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

k. Income taxes:

The Company follows the asset and liability method of accounting for income taxes in accordance with Israeli accounting principles. Under Israeli accounting principles deferred income taxes are provided for differences resulting from changes in the Israeli Consumer Price Index ("CPI") (the basis for the Company's tax reporting) and changes in the exchange rate of the NIS to the dollar. Statement No. 109 of the FASB, "Accounting for Income Taxes", does not allow deferred income taxes to be recognized for this difference, which with respect to the Company's financial statements is immaterial in all periods presented.

l. Earnings (loss) per share:

As of December 31, 1997, the Statement of Financial Accounting Standards ("SFAS") No. 128, "Earnings Per Share" replaced the calculation of primary and fully-diluted earnings per share with basic and diluted earnings per share. Unlike primary earnings per share, basic earnings per share excludes the dilutive effects of options, warrants and convertible securities. Diluted earnings per share is very similar to the previously reported fully-diluted earnings per share. All earnings per share amounts for all periods presented have been restated to conform to SFAS No. 128 requirements.

m. Stock Based Compensation

The Company has elected to follow Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued 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.

The Company has adopted SFAS No. 123, "Accounting for Stock-Based Compensation" with respect to warrants issued to non-employees. SFAS No. 123 requires use of option valuation models to measure the fair value of the warrants at the grant date.

n. Revenue recognition:

Revenues from software sales are recognized upon shipment and resolution of any material vendor obligations. 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.

o. Royalty-bearing grants:

Through December 31, 1996, royalty-bearing grants from the Government of Israel and others for funding certain approved research projects and for funding marketing activity were recognized at the time the Company was entitled to such grants on the basis of the related costs incurred.

In March 1997, the Company reached an agreement with the OCS concerning grants for certain approved research projects, according to which the Company has agreed to pay royalties on all of its consolidated revenue. As a result, the Company has provided for the full amount of the royalty liability.

p. Advertising costs:

Advertising expenses are charged to the statement of operations as incurred.

q. Concentrations of credit risks:

Financial instruments which potentially subject the Company to concentrations of credit risk consist principally of cash and cash equivalents, and accounts receivable. The Company's cash and cash equivalents are invested primarily in deposits with major banks worldwide. At times, such deposits in the U.S. may be in excess of insured limits. 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 trade accounts receivable are derived from sales to customers located primarily in the U.S., Europe, South-East Asia and Israel. During 1997 the Company wrote off bad debts in an amount of $ 380. The allowance for doubtful accounts is determined with respect to specific debts doubtful of collection.

r. Fair value of financial instruments:

The carrying amounts reported in the balance sheet of cash and cash equivalents, and short-term loans, approximate their fair value, due to the short term maturity of these instruments.

s. Impact of recently issued accounting standards:

In June 1997, the FASB issued SFAS No. 130, "Reporting Comprehensive Income", and SFAS No. 131, "Disclosure About Segments of an Enterprise and Related Information". These statements are effective for fiscal years beginning after December 15, 1997. These statements do not have measurement effects on the financial statements. However, they do require additional disclosure.

In October 1997, the AICPA issued SOP 97-2, "Software Revenue Recognition", which changes the requirements for revenue recognition effective for transactions that the Company will enter into beginning January 1, 1998. The Company does not anticipate that the "SOP" will have a material effect on the Company's financial results.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (IN THOUSANDS OF US DOLLARS)

NOTE 3:- OTHER ACCOUNTS RECEIVABLE AND PREPAID EXPENSES

	December 31, 1996	December 31, 1997
Claims from the Government of Israel for grants and participations	$ 546	$ -
Prepaid expenses and other	799	1,202
Employee loans(1)	786	754
Deferred income taxes	66	-
	$2,197	$1,956
(1)Including loans to directors, linked to the Israeli CPI, with no maturity date	$ 213	$ 138

NOTE 4:- INVESTMENTS IN AFFILIATES

a. Investment in affiliates are comprised as follows:

	1996	1997
Equity:		
Cost of shares	$ 544	$ 596
Goodwill	(269)	(269)
Post acquisition losses	(25)	(76)
Foreign currency translation adjustments	12	(4)
	262	247
Goodwill:		
Cost	269	269
Amortization	(90)	(180)
	179	89
	$ 441	$ 336

b. In October 1995, the Company acquired from Mashov its 42% holdings in 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 1996, the Company acquired from other shareholders an additional 33% holding in Magic Benelux B.V. (consolidated company) ("Magic B.V.") for $ 595 of which $ 306 has been paid in 1997.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (IN THOUSANDS OF US DOLLARS)

In January 1998, the Company acquired an additional 16% holding in Magic B.V. for $387 and thus acquired a 100% interest of which, $ 100 was exchanged for 19,373 ordinary shares of the Company, $ 93 was paid in cash and the balance of $ 194 is to be paid in 16 equal installments.

NOTE 5:- FIXED ASSETS

	December 31,	
	1996	1997
Cost:		
Buildings	$3,453	$3,658
Computers and peripheral equipment	4,753	5,145
Office furniture and equipment	833	867
Motor vehicles	311	344
	9,350	10,014
Accumulated depreciation:		
Buildings	361	438
Computers and peripheral equipment	2,218	3,187
Office furniture and equipment	264	365
Motor vehicles	107	75
	2,950	4,065
Depreciated cost	$6,400	$5,949

As for charges, see Note 14e.

NOTE 6:- OTHER ASSETS

Cost:		
Capitalized software [1]	$6,623	$7,798
Goodwill	1,213	1,213
	7,836	9,011
Accumulated amortization:		
Capitalized software	1,709	2,617
Goodwill	198	349
	1,907	2,966
Other assets, net	$5,929	$6,045

[1] See Note 1c.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (IN THOUSANDS OF US DOLLARS)

NOTE 7:- SHORT-TERM BANK CREDIT

All short-term credit from banks is comprised of the quick-turnover bank overdrafts of various subsidiaries of the Company, and loans from banks for a period of less than one year. Interest rates vary from 4.8% to 7.27%.

NOTE 8:- ACCRUED LIABILITIES AND OTHER

	December 31,	
	1996	1997
Employees and payroll accruals	$2,401	$2,273
Accrued expenses	1,919	3,239
Deferred revenues	1,228	1,987
Office of the Chief Scientist (see Note 1c)	836	1,862
Other	1,209	100
	$7,593	$9,461

NOTE 9:- ACCRUED SEVERANCE PAY, NET

The Company's liability for severance pay, pursuant to Israeli law, is fully provided. Part of the liability is funded through insurance policies which are not under the control of the Company. Severance pay expenses for the years ended December 31, 1995, 1996 and 1997 were $342, $ 448 and $ 482, respectively.

NOTE 10: TAXES ON INCOME

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

The Company's production facilities in Israel have been granted status as an "Approved Enterprise" under the above law. The main benefit arising from such status is the reduction in tax rates on income derived from "Approved Enterprises". The Company is entitled to a 7-10-year period of benefits and to an additional reduction in tax rates to 20-25%.

Five expansion projects have been granted status as "Approved Enterprises" under the aforementioned Law.

The five 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 ended 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 ended 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.
5. The fifth program entitles the Company to a tax exemption for two year period ending December 31, 2001, and is subject to a reduced tax rate of 20% for the eight year period ending December 31, 2007.

If a dividend were to be 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, 1997, the Company has an accumulated deficit and therefore does not have income tax liability.

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:

1995 - 37%, 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 CPI. The Company's financial statements are presented in dollars. The difference between the annual change in the Israeli CPI and in the new Israeli shekel ("NIS") 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 (Taxes), 1969:

The Company is an "industrial company", as defined by this 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 claim public issuance expenses and amortization of patents and other intangible property rights as a deduction for tax purposes.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (IN THOUSANDS OF US DOLLARS)

d. Non-Israeli subsidiaries:

Non-Israeli subsidiaries are taxed based upon tax laws in their countries of domicile.

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

Income (loss) before taxes on income:

	Year ended December 31,		
	1995	1996	1997
Domestic	$ 2,046	$ 5,021	$ (5,151)
Foreign	(2,341)	(3,005)	(5,013)
	$ (295)	$ 2,016	$(10,164)

f. The provision for taxes, is comprised of the following:

	1995	1996	1997
Current:			
Domestic	333	620	406
Foreign	-	2	4
	$ 333	$ 622	$ 410
Deferred:			
Domestic	-	(166)	66
Foreign	-	-	-
	$ -	$ (166)	$ 66

g. Deferred tax assets (liabilities) are comprised of the following:

	December 31,	
	1996	1997
Deferred tax assets:		
Depreciation and amortization	$ 477	$ 602
Net operating loss carry forwards	(3,410)	(6,714)
Allowances and reserves	(450)	(855)
	(3,383)	(6,967)
Less: valuation allowance	3,449	6,967
Net deferred tax	$ 66	-

The Company has 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 future.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (IN THOUSANDS OF US DOLLARS)

h. Reconciliation of the theoretical tax expense (benefit) to the actual tax expense (benefit):

A reconciliation of theoretical tax expense, assuming all income is taxed at the statutory rate applicable to the income of companies in Israel (36%, 36% and 37% for the years ended December 31, 1997, 1996 and 1995, respectively), and the actual tax expense, is as follows:

	Year ended December 31,		
	1995	1996	1997
Income (loss) before taxes on income, as reported in the consolidated statements of operations	$(295)	$2,016	$(10,164)
Statutory tax rate in Israel	37%	36%	36%
Theoretical tax expense (benefit)	(109)	726	(3,659)
Increase (decrease) in taxes resulting from:			
"Approved Enterprise" (benefit) (1)	(796)	(1,197)	-
Losses and other items for which deferred taxes were not recognized	866	1,000	3,518
Tax adjustment in respect of inflation in Israel	107	(253)	(266)
Non-deductible expenses	356	373	883
Special items taxed at lower rates	(91)	-	-
Adjustment of deferred taxes anticipated in tax rate	-	(193)	-
Taxes on income in the statements of operations	$ 333	$ 456	$ 476
(1)Per share amounts of the benefit resulting from the exemption.	$0.08	$ 0.24	$ -

i. Final tax assessments:

The Company has received final tax assessments through taxable year 1992. The subsidiaries have not been assessed.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (IN THOUSANDS OF US DOLLARS)

NOTE 11:- 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"), as amended, 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 exceeding 10 years.

Under the Plan, 1,700,000 Ordinary Shares of the Company were reserved for issuance. 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:

	Year ended December 31,					
	1995		1996		1997	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
Outstanding at the beginning of the year	595,263	$6.82	666,517	$6.77	790,416	7.32
Granted	332,600	6.64	243,250	8.66	369,322	6.58
Exercised	(58,982)	6.50	(11,915)	8.40	(5,376)	8.73
Forfeited *)	(202,364)	6.79	(107,436)	6.80	(190,627)	7.28
Outstanding at the end of the year	666,517	$6.77	790,416	$7.32	963,735	7.11
Exercisable at the end of the year	169,940	$6.82	356,379	$7.31	438,328	7.21
Weighted average remaining contractual life (years)	666,517	3.46	790,416	4.24	963,735	5.15

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

Exercise prices for options outstanding as of December 31, 1997 ranged from $5.125 to $16.00.

Pro-forma information regarding net income and earnings per share is required by SFAS No. 123 (for grants issued after December 1994), and has been determined as if the Company had accounted for its employee stock options 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, 1996 and 1997: risk-free interest rates of 5.50% - 6.00%, dividend yields of 0%. Volatility factors of the expected market price of the Company's ordinary shares of 0.804 for 1995 and 1996, and 0.532 for 1997 and a weighted-average expected life of the option of four years.

The weighted average fair values at grant dates of options granted during 1995, 1996 and 1997, were $ 6.64, $ 8.66 and $ 6.58, 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. The Company's proforma information is as follows:

	1995	1996	1997
	U.S. dollars (In thousands, except per share amounts)		
As reported net, income (loss) for the year	$ (438)	$1,398	$(10,454)
Pro-forma net income (loss)	$ (812)	$ 524	$(11,612)
Pro-forma basic earnings (loss) per share	$(0.19)	$ 0.11	$ (2.39)
Pro-forma diluted earning (loss) per share	$(0.19)	$ 0.11	$ (2.39)
Shares used in calculating pro-forma basic earnings (loss) per share	4,303	4,720	4,853
Shares used in calculating earning (loss) per share	4,303	4,795	4,853

The total compensation expense included in the pro-forma information for 1995 1996 and 1997 is $ 374, $ 874, and $ 1,158, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (IN THOUSANDS OF US DOLLARS)

c. Dividends:

Dividends on Ordinary Shares if any, will be paid in NIS. Dividends paid to shareholders outside Israel will be converted into dollars, on the basis of the exchange rate prevailing at the date of payment.

NOTE 12:- SELECTED STATEMENTS OF OPERATIONS DATA

a. Summary of operation within geographic areas:

	Year ended December 31,		
	1995	1996	1997
Sales to unaffiliated customers:			
Israel	$14,331	$16,197	$13,478
North America	4,731	6,943	6,336
Europe	6,322	13,276	17,618
	$25,384	$36,416	$37,432
Transfers between geographic destinations:			
Israel	$ 3,304	$ 6,805	$ 5,362
Operating income (loss):			
Israel	$ 3,412	$ 6,225	$ (5,529)
North America	(1,651)	(3,404)	(3,065)
Europe	(1,960)	(55)	(967)
Adjustments and eliminations	(30)	(229)	(115)
	$ (229)	$ 2,537	$ (9,676)
Identifiable assets:			
Israel	$27,181	$32,425	$34,658
North America	2,365	4,576	1,968
Europe	3,650	7,986	10,350
Eliminations	(9,254)	(12,742)	(19,109)
	$23,942	$32,245	$27,867

b. Data on major distributors, percentage of total revenues:

Wacom Co. Ltd.	20%	18%	10%

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (IN THOUSANDS OF US DOLLARS)

c. Sales by geographical markets:

	Year ended December 31,		
	1995	1996	1997
Israel	$ 1,983	$ 3,257	$ 4,101
Europe	11,316	16,206	20,818
North America	4,731	6,784	5,945
Japan	5,076	6,659	5,151
Others	2,278	3,510	1,417
	$25,384	$36,416	$37,432

d. Research and development costs:

	1995	1996	1997
Total costs	$ 4,495	$ 6,950	$ 6,758
Less - royalty bearing grants	(167)	(1,922)	(285)
Less - capitalization of software costs	(1,450)	(2,417)	(3,125)
Research and development, net	$ 2,878	$ 2,611	$ 3,348

e. Financial expenses, net:

	1995	1996	1997
Interest and bank charges	$ (163)	$ (413)	$ (240)
Income (losses) arising from foreign currency transactions	115	(108)	(248)
Loss from marketable securities	(18)	-	-
Financial expenses, net	$ (66)	$ (521)	$ (488)

NOTE 13:- RELATED PARTIES - TRANSACTIONS AND BALANCES

a. In 1995, the Company signed an agreement 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 $ 190.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (IN THOUSANDS OF US DOLLARS)

b. Transactions with related parties:

	Year ended December 31,		
	1995	1996	1997
General and administrative expenses (including rent)	$ 292	$ 436	$ 798
Financial expenses, net	$ 45	$ 169	$ 473

c. See Note 4 regarding acquisition of a company from Mashov.

d. Balances accounts with related parties are linked to foreign currency, in part, bearing no interest.

NOTE 14:- COMMITMENTS AND CONTINGENT LIABILITIES

a. Under the Company's research and development agreements with the OCS as they relate to part of the products, and the Bi-national Industrial Research and Development Foundation ("BIRD-F"), the Company is required to pay royalties - linked to the dollar - at the rate of 3%-5% of sales of the consolidated products developed with funds provided by either the OCS or BIRD-F, up to an amount equal to 100% as to the OCS's participation and 150% as to BIRD-F's participation through their research and development grants which have been received by the Company.

   As of December 31, 1997, the Company has a contingent obligation to pay $ 1,609 in royalties to the OCS.

   As of December 31, 1997, the Company has a contingent obligation to pay $ 466 in royalties to the BIRD-F.

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 dollar.

   The Company received grants amounting to $ 360, $288 and $ 0 for the years ending December 31, 1995, 1996 and 1997, respectively.

   As of December 31, 1997, the Company had a contingent obligation to pay $ 562 in respect of royalties relating to these grants.

c. Lease commitments:

   The Company leases part of its facilities from Mashov (see Note 13a). Certain subsidiaries rent facilities under operating leases for periods which ended in 1997.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (IN THOUSANDS OF US DOLLARS)

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

1998	$ 559
1999	400
2000	126
	$1,085

Rent expenses for the years ended December 31, 1995, 1996 and 1997 were approximately $ 643, $ 694 and $ 915, respectively.

d. Guarantees:

The Company has guarantees to a third party amounting to $ 500.

e. Charges:

As collateral for the Company's liabilities, a charge has been placed on the Company's plant, fixed assets and rights of any kind, in favor of the bank.

f. 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 advisors, the outcome of these claims and lawsuits is 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.

NOTE 15:- EARNINGS (LOSS) PER SHARE

The following table sets forth the computation of historical basic and diluted earning per share:

	Year ended December 31,		
	1995	1996	1997
Numerator:			
Net income (loss)	$ (438)	$1,398	$(10,454)
Numerator for basic earnings per share - income available to common stockholders	$ (438)	$1,398	$(10,454)
Numerator for diluted earning per share - income available to common stockholders after assumed conversion	$ (438)	$1,398	$(10,454)
Denominator:			
Denominator for basic earning per share -			
weighted average shares (in thousands)	4,303	4,720	4,853
Effect of dilutive securities (in thousands)	-	75	-
Denominator for diluted earnings per share - adjusted weighted average shares and assumed conversions (in thousands)	4,303	4,795	4,853
Basic earnings (loss) per share	$(0.10)	$ 0.30	$ (2.15)
Diluted earnings (loss) per share	$(0.10)	$ 0.29	$ (2.15)

NOTE 16: - SUBSEQUENT EVENTS

On April 21, 1998, the Company's shareholders approved a share purchase agreement with Formula Systems (1985) Ltd. ("Formula"). Pursuant to the agreement, Formula purchased 800,000 Ordinary Shares of the Company for a consideration of $ 4,000 and also received 600,000 warrants with an exercise price of $ 5.00 per share, expiring on September 30, 1998, and an additional 800,000 warrants, at an exercise price of $ 5.00 per share, expiring on June 30, 1999. In connection with this investment in the Company, Formula will receive Board representation and a right of first refusal in the event of a sale of stock to a third party. Such right of first refusal will expire on June 30, 1999.

Upon completion of the transaction, assuming full exercise of the warrants to purchase 1.4 million shares, Formula will own 31.2% of the Ordinary Shares.

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Chairman

Jack Dunietz
President & CEO

Danny Goldstein
Director

Yigal Berman
Director

Gad Ariav
Director

Nechemia Peres
Director

Yohai Shaked
Senior Vice President and Director

Israel Teiblum
CFO

Shabtai Shaanani
Corporate Vice President
Sales & Marketing

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Chief Executive Officer
Magic Software Enterprises Inc.

John Milway
Vice President
Northern Europe

Nachman Chefner
Vice President
Southern Europe

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Form 20-F
Copies of MSE´s Annual Report on Form 20-F as filed with the Securities and Exchange Commission may be obtained by shareholders without charge upon request.