

MAGIC SOFTWARE ENTERPRISES LTD  
Form 20-F/A  
May 13, 2013

**SECURITIES AND EXCHANGE COMMISSION**

**Washington D.C. 20549**

**FORM 20-F/A**

**Amendment No. 1**

**OR**

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

**For the fiscal year ended December 31, 2012**

**OR**

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

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

**OR**

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

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

**Commission file number: 0-19415**

**MAGIC SOFTWARE ENTERPRISES LTD.**

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

**Israel**

(Jurisdiction of incorporation or organization)

**5 Haplada Street, Or Yehuda 60218, Israel**

(Address of principal executive offices)

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

**5 Haplada Street, Or Yehuda 60218, Israel**

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

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

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

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

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

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

**Ordinary Shares, par value NIS 0.1 per share.....36,626,728** (as of December 31, 2012)

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

Yes  No

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

Yes  No

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

Yes  No

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

Yes  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

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

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

Item 17  Item 18

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

Yes  No

This annual report on Form 20-F is incorporated by reference into the registrant's Registration Statements on Form S-8, File Nos. 333-13270, 333-113552, 333-132221 and 333-149553.



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**EXPLANATORY NOTE**

This Amendment No. 1 (the “Amendment”) to the Annual Report on Form 20-F of Magic Software Enterprises Ltd. (the “Company”) amends the registrant’s Annual Report on Form 20-F for the year ended December 31, 2012 that was filed with the Securities and Exchange Commission on April 24, 2013 (the “Original 20-F”).

This Amendment does not reflect a change in the results of operations of the Company or in any information in the Original 20-F other than:

to furnish Exhibit 101 to the Original 20-F, which contains the XBRL Interactive Data Files required to be submitted and posted pursuant to Rule 405 of Regulation S-T; and

to correct typographical errors contained in the Report of Independent Registered Public Accounting Firm of Kost Forer Gabbay & Kasierer regarding the Company’s consolidated financial statements appearing in the Form 20-F. The report inadvertently showed “XXX” on pages F-2 and F-4 instead of the date April 24, 2013, consistent with the manually signed report.

In order to comply with certain requirements of the SEC’s rules in connection with the filing of this Amendment No. 1, this Amendment No. 1 includes Item 18 “Financial Statements.” This Amendment does not reflect events occurring after the filing of the Original 20-F or modify or update the disclosure contained therein in any way other than as required to reflect the amendments discussed above.

Consistent with the rules of the SEC, the certifications of the Company’s principal executive officer and principal financial officer as of the date of this Amendment No. 1 are attached as exhibits to this Amendment No. 1. The only change in these certifications from the certifications of the Company’s principal executive officer and principal financial officer filed as exhibits to the Form 20-F is their date.

Pursuant to Rule 12b-15 promulgated under the Securities Exchange Act of 1934, as amended, the complete text of Exhibit 101 of the Original 20-F in its entirety is attached to this Amendment.



ITEM 18. FINANCIAL STATEMENTS

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ITEM 19. EXHIBITS

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Exhibit    Description

12.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as amended
12.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as amended
13.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
13.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS*	XBRL Instance Document
101.SCH*	XBRL Taxonomy Extension Schema Document
101.PRE*	XBRL Taxonomy Presentation Linkbase Document
101.CAL*	XBRL Taxonomy Calculation Linkbase Document
101.LAB*	XBRL Taxonomy Label Linkbase Document
101.DEF*	XBRL Taxonomy Extension Definition Linkbase Document

Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not \* filed for the purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.



**MAGIC SOFTWARE ENTERPRISES LTD. AND ITS SUBSIDIARIES**

**CONSOLIDATED FINANCIAL STATEMENTS**

**AS OF DECEMBER 31, 2012**

**U.S. DOLLARS IN THOUSANDS**

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**Kost Forer Gabbay & Kasierer**

3 Aminadav St.  
Tel-Aviv 6706703, Israel

Tel: 972 (3)6232525  
Fax: 972 (3)5622555  
www.ey.com

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

**To the Shareholders and the Board of Directors of**

**MAGIC SOFTWARE ENTERPRISES LTD.**

We have audited the accompanying consolidated balance sheets of Magic Software Enterprises Ltd. ("the Company") and its subsidiaries as of December 31, 2011 and 2012, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2012. These financial statements are the responsibility of Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of certain subsidiaries, which statements reflect total assets of 6% and 8% as of December 31, 2011 and 2012, respectively, and total revenues of 24%, 17% and 16% for the years ended December 31, 2010, 2011 and 2012, respectively of the related consolidated totals. Those statements were audited by other auditors whose reports have been furnished to us, and our opinion, insofar as it relates to the amounts included for those subsidiaries, is based solely on the reports of the other auditors.

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

In our opinion, based on our audits and the reports of the other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries as of December 31, 2011 and 2012, and the related consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2012, in conformity with U.S. generally accepted accounting principles.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2012, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated April 24, 2013 expressed an unqualified opinion thereon.

*/s/ Kost Forer Gabbay & Kasierer*  
Tel-Aviv, Israel KOST FORER GABBAY & KASIERER  
April 24, 2013 A Member of Ernst & Young Global

**Kost Forer Gabbay & Kasierer**

3 Aminadav St.  
Tel-Aviv 6706703, Israel

Tel: 972 (3)6232525  
Fax: 972 (3)5622555  
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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

**To the Shareholders and the Board of Directors of**

**MAGIC SOFTWARE ENTERPRISES LTD.**

We have audited Magic Software Enterprises Ltd. ("the Company") internal control over financial reporting as of December 31, 2012, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission ("the COSO criteria"). The Company's management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Annual Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2012, based on the COSO criteria.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of the Company and its subsidiaries as of December 31, 2011 and 2012, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2012 and our report dated April 24, 2013 expressed an unqualified opinion thereon.

/s/ Kost Forer Gabbay & Kasierer  
Tel-Aviv, Israel KOST FORER GABBAY & KASIERER  
April, 24 2013 A Member of Ernst & Young Global

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**MAGIC SOFTWARE ENTERPRISES LTD.  
AND ITS SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEETS**  
**U.S. dollars in thousands**

	December 31,	
	2011	2012
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$28,711	\$37,744
Short-term bank deposits	2,170	-
Available-for-sale marketable securities (Note 4)	1,241	890
Trade receivables (net of allowance for doubtful accounts of \$ 1,927 and \$ 2,103 at December 31, 2011 and 2012, respectively)	24,946	28,367
Other accounts receivable and prepaid expenses (Note 6)	6,401	6,696
<u>Total</u> current assets	63,469	73,697
<b>LONG-TERM RECEIVABLES:</b>		
Severance pay fund	351	351
Other long-term receivables	3,824	2,287
<u>Total</u> long-term receivables	4,175	2,638
PROPERTY AND EQUIPMENT, NET (Note 7)	2,029	1,898
INTANGIBLE ASSETS, NET (Note 8)	27,401	29,661
GOODWILL (Note 9)	38,897	44,344
<u>Total</u> assets	\$135,971	\$152,238

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

**MAGIC SOFTWARE ENTERPRISES LTD.  
AND ITS SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEETS**

**U.S. dollars in thousands (except share and per share data)**

	December 31,	
	2011	2012
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Trade payables	\$3,545	\$4,722
Accrued expenses and other accounts payable (Note 10)	15,752	17,537
Deferred tax liability	2,509	2,355
Deferred revenues	5,359	4,160
<u>Total</u> current liabilities	27,165	28,774
ACCRUED SEVERANCE PAY	1,087	1,245
LONG TERM LIABILITIES:	744	750
LIABILITIES DUE TO ACQUISITION ACTIVITIES (Note 3)	1,350	1,192
COMMITMENTS AND CONTINGENCIES (Note 14)		
REDEEMABLE NON-CONTROLLING INTEREST	-	2,160
<b>SHAREHOLDERS' EQUITY (Note 12):</b>		
Magic Software Enterprises Shareholders' equity:		
Share capital:		
Ordinary shares of NIS 0.1 par value - Authorized: 50,000,000 shares at December 31, 2011 and 2012; Issued and Outstanding: 36,490,020 and 36,626,728 shares at December 31, 2011 and 2012, respectively	808	811
Additional paid-in capital	124,616	125,288
Accumulated other comprehensive loss	(19 )	(586 )
Accumulated deficit	(20,249 )	(7,727 )
Total Magic shareholders' equity	105,156	117,786
Non-controlling interests	469	331
<u>Total</u> shareholders' equity	105,625	118,117
<u>Total</u> liabilities, redeemable non-controlling interest and shareholders' equity	\$135,971	\$152,238

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



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**MAGIC SOFTWARE ENTERPRISES LTD.  
AND ITS SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF INCOME  
U.S. dollars in thousands (except per share data)**

	Year ended December 31,		
	2010	2011	2012
Revenues (Note 16):			
Software	\$20,111	\$23,110	\$23,684
Maintenance and technical support	14,407	16,751	22,384
Consulting services	54,060	73,467	80,312
<u>Total</u> revenues	88,578	113,328	126,380
Cost of revenues:			
Software	5,320	5,771	7,439
Maintenance and technical support	2,070	2,250	3,238
Consulting services	44,058	59,237	62,716
<u>Total</u> cost of revenues	51,448	67,258	73,393
Gross profit	37,130	46,070	52,987
Operating costs and expenses:			
Research and development, net (Note 13a)	2,072	2,047	2,947
Selling and marketing	17,526	20,147	22,990
General and administrative	8,194	9,159	10,642
<u>Total</u> operating costs and expenses	27,792	31,353	36,579
Operating income	9,338	14,717	16,408
Financial income (expenses), net (Note 13b)	(224 )	221	10
Other income, net	159	125	136
Income before taxes on income	9,273	15,063	16,554
Taxes on income (tax benefit) (Note 11)	(102 )	(203 )	94
Net income	9,375	15,266	16,460
Change in redeemable non-controlling interests	-	-	253
Net income attributable to non-controlling interests	-	222	24
Net income attributable to Magic Software Enterprises Shareholders	\$9,375	\$15,044	\$16,183
Net earnings per share attributable to Magic Software Enterprises' shareholders (Note 15):			
Basic and diluted earnings per share	\$0.29	\$0.41	\$0.44

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

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**MAGIC SOFTWARE ENTERPRISES LTD.  
AND ITS SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
U.S. dollars in thousands (except per share data)**

	Year ended December 31,		
	2010	2011	2012
Net income	\$9,375	\$15,266	\$16,460
Other comprehensive income (loss), net of tax			
Foreign currency translation adjustments, net	416	(423 )	(621 )
Unrealized gain from derivative instruments, net	6	(23 )	29
Unrealized loss from available-for-sale securities, net	(49 )	(73 )	28
Total other comprehensive income (loss), net of tax	373	(519 )	(564 )
Total comprehensive income	9,748	14,747	15,896
Comprehensive income attributable to redeemable non-controlling interests	-	-	280
Comprehensive income attributable to non-controlling interests	-	(169 )	27
Comprehensive income attributable to Magic Software Enterprises' shareholders	\$9,748	\$14,578	\$15,643

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

**MAGIC SOFTWARE ENTERPRISES LTD.  
AND ITS SUBSIDIARIES  
STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY  
U.S. dollars in thousands (except per share data)**

	Share capital number	Share capital amount	Additional paid-in capital	Accumulated other comprehensive income (loss)	Accumulated deficit	Non controlling interests	Total equity
Balance as of January 1, 2010	31,936,426	\$ 683	\$ 101,099	\$ 74	\$ (44,668 )	\$ -	\$57,188
Exercise of stock options	685,564	19	1,320	-	-	-	1,339
Issuance of Ordinary shares and warrants (net of issuance expenses \$ 1,080)	3,287,616	92	20,198	-	-	-	20,290
Stock-based compensation expenses	-	-	300	-	-	-	300
Other comprehensive income	-	-	-	373	-	-	373
Net income	-	-	-	-	9,375	-	9,375
Balance as of December 31, 2010	35,909,606	794	122,917	447	(35,293 )	-	88,865
Exercise of stock options	580,414	14	861	-	-	-	875
Stock-based compensation expenses	-	-	633	-	-	-	633
Cost related to issuance of Ordinary shares	-	-	(21 )	-	-	-	(21 )
Non-controlling interest as part of acquisitions	-	-	-	-	-	1,766	1,766
Acquisition of non-controlling interests in Magix (see Note 3)	-	-	226	-	-	(1,466 )	(1,240 )
Other comprehensive income	-	-	-	(466 )	-	(53 )	(519 )
Net income	-	-	-	-	15,044	222	15,266
Balance as of December 31, 2011	36,490,020	808	124,616	(19 )	(20,249 )	469	105,625
Exercise of stock options	136,708	3	306	-	-	-	309
Stock-based compensation expenses	-	-	515	-	-	-	515
Dividend	-	-	-	-	(3,661 )	-	(3,661 )
Acquisition of non-controlling interests in Xsell (see Note 3)	-	-	(149 )	-	-	(165 )	(314 )
Other comprehensive income	-	-	-	(567 )	-	3	(564 )
Net income	-	-	-	-	16,183	24	16,207
Balance as of December 31, 2012	36,626,728	\$ 811	\$ 125,288	\$ (586 )	\$ (7,727 )	\$ 331	\$118,117

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

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**MAGIC SOFTWARE ENTERPRISES LTD.  
AND ITS SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
U.S. dollars in thousands**

	Year ended December 31,		
	2010	2011	2012
Cash flows from operating activities:			
Net income	\$9,375	\$15,266	\$16,460
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	4,566	5,040	7,444
Interest expenses related to liabilities in connection with acquisitions	173	112	48
Accrued severance pay, net	11	143	8
Loss on sale of property and equipment	-	10	-
Stock-based compensation expenses	300	633	515
Amortization of marketable securities premium, accretion of discount	(17 )	(14 )	-
Loss on sale and maturity of marketable securities	3	-	-
Gain on sale of subsidiary's operation	(146 )	(136 )	(136 )
Decrease (increase) in trade receivables, net	(198 )	(5,405 )	11
Decrease (increase) in other long term and short term accounts receivable and prepaid expenses	241	(1,753 )	145
Increase in trade payables	26	446	780
Increase (decrease) in accrued expenses and other accounts payable	(288 )	953	(2,279 )
Increase (decrease) in deferred revenues	(85 )	1,593	(1,131 )
Change in deferred income taxes, net	436	(1,650 )	1,083
Net cash provided by operating activities	14,397	15,238	22,948

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

**MAGIC SOFTWARE ENTERPRISES LTD.  
AND ITS SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
U.S. dollars in thousands**

	Year ended December 31,		
	2010	2011	2012
Cash flows from investing activities:			
Capitalized software development costs	(3,595 )	(5,222 )	(4,969 )
Purchase of property and equipment	(583 )	(497 )	(510 )
Cash paid in conjunction with acquisitions, net of acquired cash	(10,225)	(23,640)	(7,627 )
Proceeds from sale of subsidiary's operation	146	136	136
Proceeds from sale of property and equipment	414	-	-
Proceeds from sale of marketable securities	361	-	-
Proceeds from maturity of marketable securities	830	1,557	343
Investment in marketable securities	(393 )	-	-
Prepayment on investment	(1,160 )	-	-
Proceeds from short-term bank deposits	15,077	21,974	3,601
Change in loans to employees and other deposits ,net	28	17	(34 )
Investment in short-term bank deposit	(1,291 )	(24,153)	(1,366 )
Net cash used in investing activities	(391 )	(29,828)	(10,426)
Cash flows from financing activities:			
Proceeds from exercise of options by employees	1,339	875	309
Issuance (expense on issuance) of Ordinary shares	20,290	(21 )	-
Dividend paid	(15,974)	-	(3,661 )
Short-term credit, net	(717 )	20	14
Purchase of non-controlling interest	-	(1,377 )	(87 )
Repayment of long-term loans	(23 )	-	-
Net cash provided by (used in) financing activities	4,915	(503 )	(3,425 )
Effect of exchange rate changes on cash and cash equivalents	390	143	(64 )
Increase (decrease) in cash and cash equivalents	19,311	(14,950)	9,033
Cash and cash equivalents at the beginning of the year	24,350	43,661	28,711
Cash and cash equivalents at end of the year	\$43,661	\$28,711	\$37,744

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





**MAGIC SOFTWARE ENTERPRISES LTD.  
AND ITS SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
U.S. dollars in thousands**

	Year ended December 31,		
	2010	2011	2012
Supplementary information on investing and financing activities not involving cash flows:			
Non-cash activities:			
Deferred acquisition payment	\$4,645	\$-	\$3,103
Contingent acquisition payment	\$414	\$750	\$1,192
Supplemental disclosure of cash flow activities:			
Cash paid during the year for:			
Income taxes	\$709	\$1,015	\$1,250
Interest	\$131	\$8	\$17

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

**MAGIC SOFTWARE ENTERPRISES LTD.  
AND ITS SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
U.S. dollars in thousands (except share and per share data)**

**NOTE 1:- GENERAL**

Magic Software Enterprises Ltd. ("the Company"), an Israeli company, and its subsidiaries ("the Group") develop, market, sale and support software development and deployment technology ("the Magic technology") and software solutions developed using the Magic technology. Magic technology enables enterprises to accelerate the process of building and deploying software applications that can be rapidly customized and integrated with existing systems. Through its subsidiaries, the Company provides flexible and comprehensive range of consulting and staffing services in the areas of infrastructure design and delivery, application development, technology planning and implementation services. The Company reports its results on the basis of two reportable business segments: software services (which include proprietary and non-proprietary software and related services) and IT professional services, each of which is comprised of two reporting units (see Note 16 for further details). The principal markets of the Group are Europe, United States, Japan and Israel (see Note 16).

For information about the Company's holdings in subsidiaries and affiliates, see Appendix A to the consolidated financial statements.

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES**

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

**Use of estimates**

The preparation of the consolidated financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. The Company's management believes that the estimates, judgments and assumptions used are reasonable based upon information available at the time they are made. Actual results could differ from those estimates. The most significant assumptions are employed in estimates used in determining values of goodwill and identifiable intangible assets and their subsequent impairment analysis, revenue recognition, tax assets and tax positions, legal contingencies, research and development capitalization and stock-based compensation costs. Actual results could differ from those estimates.

**Financial statements in United States dollars**

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

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**MAGIC SOFTWARE ENTERPRISES LTD.  
AND ITS SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
U.S. dollars in thousands (except share and per share data)**

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Accordingly, monetary accounts maintained in currencies other than the dollar are remeasured into dollars in accordance with the Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 830, "Foreign Currency Matters". All transaction gains and losses of the remeasurement of monetary balance sheet items are reflected in the statements of income as financial income or expenses, as appropriate.

For those foreign subsidiaries whose functional currency is not the dollar, all balance sheet amounts have been translated using the exchange rates in effect at each balance sheet date. Statement of income amounts have been translated using the average exchange rate prevailing during each year. Such translation adjustments are reported as a component of other comprehensive income (loss) in equity.

**Principles of consolidation**

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

Changes in the parent's ownership interest in a subsidiary with no change of control are treated as equity transactions, with any difference between the amount of consideration paid and the change in the carrying amount of the non-controlling interest, recognized in equity.

Non-controlling interests of subsidiaries represent the non-controlling shareholders' share of the total comprehensive income (loss) of the subsidiaries and fair value of the net assets upon the acquisition of the subsidiaries. The non-controlling interests are presented in equity separately from the equity attributable to the equity holders of the Company. Redeemable non-controlling interests are classified as mezzanine equity, separate from permanent equity, on the consolidated balance sheets and measured at each reporting period at the higher of their redemption amount or the Non controlling interest book value, in accordance with the requirements of ASC 810 "Consolidation" and ASC 480-10-S99-3A, "Distinguishing Liabilities from Equity".

The following table provides a reconciliation of the redeemable non-controlling interests:

January 1, 2012	\$-
Redeemable non-controlling interests (see Note 3f)	1,880
Net income attributable to redeemable non-controlling interests	253
Foreign currency translation adjustments	27
December 31, 2012	\$2,160

**Cash and cash equivalents**

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

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U.S. dollars in thousands (except share and per share data)**

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

**Short-term deposits and restricted deposits**

Short-term deposits include deposits with original maturities of more than three months and less than one year. Such deposits are presented at cost (including accrued interest) which approximates their fair value. Restricted deposits are used to secure certain Group's ongoing projects and are classified under other receivables.

As of December 31, 2011, short-term deposits were in U.S. dollars and Hungarian Forint and bearing interest at an average annual rate of 2.4% and 4.4%, respectively. As of December 31, 2012, Short-term deposits amounted to \$0. The restricted deposits as of December 31, 2011 and 2012 amounted to \$0 and \$196, respectively.

**Marketable securities**

The Company accounts for investments in marketable securities in accordance with ASC 320, "Investments - Debt and Equity Securities". Management determines the appropriate classification of its investments in marketable debt and equity securities at the time of purchase and reevaluates such determinations at each balance sheet date. Debt and equity securities are classified as available-for-sale and reported at fair value, with unrealized gains and losses reported in accumulated other comprehensive income (loss), as a separate component of shareholders' equity.

Realized gains and losses on sales of investments, as determined on a specific identification basis, are included in financial income, net, together with accretion (amortization) of discount (premium), and interest or dividends.

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

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

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



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**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

For debt securities that are deemed other-than-temporary impaired, the amount of impairment recognized in the statement of operations is limited to the amount related to "credit losses" (the difference between the amortized cost of the security and the present value of the cash flows expected to be collected), while impairment related to other factors is recognized in other comprehensive income. No other than temporary impairments have been recognized in all periods presented.

**Property and equipment, net**

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

	Years
Computers and peripheral equipment	3
Office furniture and equipment	7 - 15 (mainly 7)
Motor vehicles	7
Software	3 – 5 (mainly 5)
Leasehold improvements	Over the shorter of the lease term or useful economic life

**Business combinations**

The Company accounts for business combinations under ASC 805, "Business Combinations". ASC 805 requires recognition of assets acquired, liabilities assumed, non-controlling interest and redeemable non-controlling interest in the acquiree at the acquisition date, measured at their fair values as of that date. ASC 805 also requires the fair value

of acquired in-process research and development to be recorded as intangibles with indefinite lives, (until their completion or abandonment), contingent consideration to be recorded on the acquisition date and restructuring and acquisition-related deal costs of the acquirer to be expensed as incurred. As required by ASC 820, "Fair Value Measurements and disclosures" the Company applies assumptions that marketplace participants would consider in determining the fair value of assets acquired, liabilities assumed, non-controlling interest and redeemable non-controlling interest in the acquiree at the acquisition date. Any excess of the fair value of net assets acquired over purchase price and any subsequent changes in estimated contingencies are to be recorded in earnings. In addition, changes in valuation allowance related to acquired deferred tax assets and in acquired income tax position are to be recognized in earnings.

### **Variable interest entities**

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

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**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

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

Effective as of January 1, 2010, the Company applies updated guidance for the consolidation of VIEs. The guidance qualitative approach, based on which enterprise has both (1) the power to direct the economically significant activities of the entity and (2) the obligation to absorb losses of, or the right to receive benefits from, the entity that could potentially be significant to the variable interest entity. Determination about whether an enterprise should consolidate a VIE is required to be evaluated continuously as changes to existing relationships or future transactions.

One of the Company's U.S. based consulting and staffing services business acquired through one of its wholly owned subsidiaries on January 17, 2010 (see Note 3a) is considered to be a VIE. The subsidiary is the primary beneficiary of the VIE, as a result of the fact that it holds the power to direct the activities of the acquired business, which significantly impacts its economic performance, and has the right to receive benefits accruing from the acquired business.

**Research and development costs**

Research and development costs incurred in the process of software development before establishment of technological feasibility are charged to expenses as incurred. Costs incurred subsequent to the establishment of technological feasibility are capitalized according to the principles set forth in ASC 985-20, "Costs of Software to be Sold, Leased or Marketed".

The Company and its subsidiaries establish technological feasibility upon completion of a detailed program design or working model.

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

Capitalized software costs are amortized on a product by product basis by the straight-line method over the estimated useful life of the software product (between 2-5 years). The Company assesses the recoverability of these intangible assets on a regular basis by determining whether the amortization of the asset over its remaining economical useful life can be recovered through undiscounted future operating cash flows from the specific software product sold. During the years ended December 31, 2010, 2011 and 2012, no such unrecoverable amounts were identified.

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NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

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

The Company's long-lived assets are reviewed for impairment in accordance with ASC 360, "Property, Plant and Equipment" whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the future undiscounted cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets.

As required by ASC 820, "Fair Value Measurements and disclosures" the Company applies assumptions that marketplace participants would consider in determining the fair value of long-lived assets (or asset groups).

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

During the years ended December 31, 2010, 2011 and 2012, no impairment was identified.

**Goodwill**

Goodwill represents the excess of the purchase price in a business combination over the fair value of the net tangible and intangible assets acquired. Under ASC 350, "Intangibles - Goodwill and Other", goodwill is subject to an annual impairment test or more frequently if impairment indicators are present. Goodwill impairment is deemed to exist if the net book value of a reporting unit exceeds its estimated fair value. As of December 31, 2012, the Company operates in two operating segments each comprised of two reporting units.

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**U.S. dollars in thousands (except share and per share data)**

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

For the Company's 2010 and 2011 annual impairment tests and as required by ASC 350, the Company compared the fair value of each of its reporting units to its carrying value ('step 1'). If the fair value exceeded the carrying value of the reporting unit net assets, goodwill is considered not impaired, and no further testing is required. If the carrying value exceeded the fair value of the reporting unit, then the implied fair value of goodwill is determined by subtracting the fair value of all the identifiable net assets from the fair value of the reporting unit. An impairment loss is recorded for the excess, if any, of the carrying value of goodwill over its implied fair value ('step 2').

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

In 2010 and 2011 in order to determine the fair value of its two reporting units, the Company implemented an 'income approach'. Under the income approach expected future cash flows are discounted to their present value using an appropriate rate of return. Judgments and assumptions related to future cash flows (projected revenues, operating expenses, and capital expenditures), future short-term and long-term growth rates, and weighted average cost of capital, are believed to be similar to those of market participants and to represent both the specific risks associated with the business, and capital market conditions, are inherent in developing the discounted cash flow model.

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

The Company adopted the provisions of ASU 2011-08 to each of its reporting units, for its annual impairment test in 2012. This analysis determines that no indicators of impairment existed primarily because (1) the Company's market capitalization has consistently exceeded its book value by a sufficient margin, (2) the Company's overall financial

performance has been stable since its respective acquisitions, and (3) forecasts of operating income and cash flows generated by the Company's reporting units appear sufficient to support the book values of the net assets of each reporting unit.

The Company performed annual impairment tests during the fourth quarter of each of 2010, 2011 and 2012 and did not identify any impairment losses (see Note 9).

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**U.S. dollars in thousands (except share and per share data)**

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

**Revenue recognition**

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

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

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

Maintenance and support revenue included in multiple element arrangements is deferred and recognized on a straight-line basis over the term of the maintenance and support agreement.

As required by ASC 985-605, the Company allocates revenues to the software component of its multiple-element arrangements using the residual method when vendor specific objective evidence ("VSOE") of fair value exists for the undelivered elements of the support and maintenance agreements. VSOE is based on the price charged when an element is sold separately or renewed. Under the residual method, the fair value of the undelivered elements is deferred and the remaining portion of the arrangement fee is allocated to the delivered elements and is recognized as

revenue.

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

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

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**U.S. dollars in thousands (except share and per share data)**

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

Arrangements that include professional services bundled with licensed software and other software related elements, are evaluated to determine whether those services are essential to the functionality of other elements of the arrangement. When services are considered essential to the software, revenues under the arrangement are recognized using contract accounting based on ASC 605-35, "Construction-Type and Production-Type Contracts", on a percentage of completion method based on inputs measures. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are first determined, in the amount of the estimated loss for the entire contract. During the years ended December 31, 2010, 2011 and 2012, no such estimated losses were identified.

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

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

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

**Severance pay**

The Company's and its Israeli subsidiary's obligation for severance pay with respect to their Israeli employees (for the period for which the employees were not included under Section 14 of the Severance Pay Law, 1963) is calculated pursuant to the Israeli Severance Pay Law based on the most recent salary of the employees multiplied by the number

of years of employment as of the balance sheet date, and are presented on an undiscounted basis (referred to as the "Shut Down Method"). Employees are entitled to one month's salary for each year of employment or a portion thereof. The Company's obligation for all of its Israeli employees is fully provided for by monthly deposits with insurance policies and by an accrual.

The carrying value of deposited funds includes profits (losses) accumulated up to the balance sheet date. The deposited funds may be withdrawn only upon the fulfillment of the obligations pursuant to the Israeli Severance Pay Law or labor agreements and are recorded as an asset in the Company's consolidated balance sheet.

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**MAGIC SOFTWARE ENTERPRISES LTD.**

**AND ITS SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**U.S. dollars in thousands (except share and per share data)**

**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

The Company and its Israeli subsidiary's agreements with most of their Israeli employees are in accordance with Section 14 of the Severance Pay Law -1963, mandating that upon termination of such employees' employment, all the amounts accrued in their insurance policies shall be released to them instead of severance compensation. Upon release of deposited amounts to the employee, no additional liability exists between the parties regarding the matter of severance pay and no additional payments shall be made by the Company to the employee. Further, the related obligation and amounts deposited on behalf of such obligation are not stated on the balance sheet, as the Company is legally released from obligation to employees once the deposit amounts have been paid.

Severance expenses for the years ended December 31, 2010, 2011 and 2012 amounted to approximately \$ 461, \$ 609 and \$ 829, respectively.

**Advertising expenses**

Advertising expenses are charged to selling and marketing expenses, as incurred. Advertising expenses for the years ended December 31, 2010, 2011 and 2012 amounted to \$ 320, \$ 313 and \$ 556, respectively.

**Income taxes**

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

The Company utilizes a two-step approach for recognizing and measuring uncertain tax positions accounted for in accordance with an amendment of ASC 740 "Income Taxes." Under the first step the Company evaluates a tax position taken or expected to be taken in a tax return by determining if the weight of available evidence indicates that it is more likely than not that, based on its technical merits, the tax position will be sustained on audit, including resolution of any related appeals or litigation processes. The second step is to measure the tax benefit as the largest amount that is more than 50% likely to be realized upon ultimate settlement with the tax authorities. The Company accrued interest and penalties related to unrecognized tax benefits in its provisions for income taxes.

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**MAGIC SOFTWARE ENTERPRISES LTD.**

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NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

**Basic and diluted net earnings per share**

Basic net earnings per share are computed based on the weighted average number of ordinary shares outstanding during each year. Diluted net earnings per share are computed based on the weighted average number of ordinary shares outstanding during each year, plus dilutive potential ordinary shares considered outstanding during the year, in accordance with ASC 260, "Earnings Per Share."

A portion of the outstanding stock options have been excluded from the calculation of the diluted earnings per share because such securities are anti-dilutive. The total weighted average number of Ordinary shares related to the outstanding options excluded from the calculations of diluted earnings per share was 615,838, 550,430 and 669,887 for the years ended December 31, 2010, 2011 and 2012, respectively.

**Stock-based compensation**

The Company accounts for stock-based compensation in accordance with ASC 718, "Compensation - Stock Compensation" which requires companies to estimate the fair value of equity-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as an expense over the requisite service periods in the Company's consolidated statement of income.

The Company recognizes compensation expenses for the value of its awards, which have graded vesting based on the accelerated method over the requisite service period of each of the awards, net of estimated forfeitures.

The Company measures and recognizes compensation expense for share-based awards based on estimated fair values on the date of grant using the Binomial option-pricing model ("the Binomial model"). The Binomial model for option pricing requires a number of assumptions, of which the most significant are the suboptimal exercise factor and expected stock price volatility. The suboptimal exercise factor is estimated based on employees' historical option exercise behavior.

The suboptimal exercise factor is the ratio by which the stock price must increase over the exercise price before employees are expected to exercise their stock options. Expected volatility is based upon actual historical stock price movements and was calculated as of the grant dates for different periods, since the Binomial model can be used for different expected volatilities for different periods. The risk-free interest rate is based on the yield from U.S. Treasury zero-coupon bonds with an equivalent term to the contractual term of the options. Historically the Company did not hold any foreseeable plans to pay dividends and therefore used an expected dividend yield of zero in its past years option pricing models. In September 2012, the Company adopted a dividend distribution policy according to which it will distribute in each year a dividend of up to 50% of its annual distributable profits. Therefore, the Company will use an expected dividend yield for its future grants.



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**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

The expected term of options granted is derived from the output of the option valuation model and represents the period of time that options granted are expected to be outstanding. Estimated forfeitures are based on actual historical pre-vesting forfeitures.

For awards with performance conditions, compensation cost is recognized over the requisite service period if it is 'probable' that the performance conditions will be satisfied, as defined in ASC 450-20-20, "Loss Contingencies."

During 2012, no options were granted or modified.

The fair value for the Company's stock options granted to employees and directors was estimated using the following weighted-average assumptions:

	2010	2011
Dividend yield	0%	0%
Expected volatility	61.2% - 62.8%	63.3% - 65.3%
Risk-free interest rate	2.53%-3.71%	2.1%
Expected forfeiture (employees)	9.7%	8.4%
Expected forfeiture (executives)	7.1%	5.2%
Contractual term of up to	10 years	10 years
Suboptimal exercise multiple (employees)	2.3	2.7
Suboptimal exercise multiple (executives)	3	3.2

During the years ended December 31, 2010, 2011 and 2012, the Company recognized stock-based compensation expense related to employee stock options in the amount of \$ 300, \$ 633 and \$ 515, respectively, as follows:

	Year ended December 31,		
	2010	2011	2012
Cost of revenue	\$ 2	\$ 4	\$ 16
Research and development	61	54	114
Selling and marketing	75	92	82
General and administrative	162	483	303
Total stock-based compensation expense	\$ 300	\$ 633	\$ 515

**Concentrations of credit risk**

Financial instruments that potentially subject the Company and its subsidiaries to concentration of credit risk consist principally of cash and cash equivalents, short-term deposits, marketable securities, trade receivables and foreign currency derivative contracts.

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**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

The Company's cash and cash equivalents and short-term deposits are invested primarily in deposits with major banks worldwide, mainly in the United States and Israel, however, such cash and cash equivalents and short-term deposits in the United States may be in excess of insured limits and are not insured in other jurisdictions. The Company believes that such institutions are of high rating and therefore bear low risk.

The Company's marketable securities include investments in commercial and government bonds and foreign banks. The Company's marketable securities are considered to be highly liquid and have a high credit standing. In addition, management considered its portfolios in foreign banks to be well-diversified (also refer to Note 4).

Trade receivables of the Company and its subsidiaries are derived from sales to customers located primarily in the United States, Europe, Japan, South Africa and Israel. The Company performs ongoing credit evaluations of its customers and to date, has not experienced any material losses. An allowance for doubtful accounts is determined with respect to those amounts that the Company has determined to be doubtful of collection. The expense related to doubtful accounts for the years ended December 31, 2010, 2011 and 2012 was \$ 204, \$ 136 and \$ 420, respectively.

The Company has entered into foreign exchange forward contracts intended to protect against the changes in value of forecasted non-dollar currency cash flows related to salary and related expenses. These derivative instruments are designed to offset the Company's non-dollar currency exposure (see "Derivative instruments" below).

**Fair value measurements**

The Company accounts for certain assets and liabilities at fair value under ASC 820, "Fair Value Measurements and Disclosures". Fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or

a liability. As a basis for considering such assumptions, ASC 820 establishes a three-tier value hierarchy, which prioritizes the inputs used in the valuation methodologies in measuring fair value:

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

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

Level 3 - Unobservable inputs which are supported by little or no market activity;

The fair value hierarchy also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The Company categorized each of its fair value measurements in one of these three levels of hierarchy.

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**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

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

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

**Comprehensive income (loss)**

The Company accounts for comprehensive income (loss) in accordance with ASC 220, "Comprehensive Income." This Statement establishes standards for the reporting and display of comprehensive income and its components in a full set of general purpose financial statements. Comprehensive income (loss) generally represents all changes in equity during the period except those resulting from investments by, or distributions to, shareholders. The Company determined that its items of other comprehensive income (loss) relate to gain and loss on foreign currency translation adjustments, unrealized gain and loss on derivative instruments designated as hedges and unrealized gain and loss on available-for-sale marketable securities.

**Derivative instruments**

A significant portion of the Company's revenues, expenses and earnings is exposed to changes in foreign exchange rates. Depending on market conditions, foreign exchange risk is also managed through the use of derivative financial instruments. These financial instruments serve to protect net income against the impact of the translation into U.S. dollars of certain foreign exchange-denominated transactions. The derivative instruments hedge or offset exposures to Euro, Japanese Yen and NIS exchange rate fluctuations.

ASC 815, "Derivatives and Hedging," requires companies to recognize all of their derivative instruments as either assets or liabilities in their balance sheet at fair value. Derivative instruments that are designated and qualify as hedges of forecasted transactions (i.e., cash flow hedges) are carried at fair value with the effective portion of a derivative's gain or loss recorded in other comprehensive income and subsequently recognized in earnings in the same period or periods in which the hedged forecasted transaction affects earnings. For derivative instruments that are not designated and qualified as hedging instruments, the gains or losses on the derivative instruments are recognized in current earnings during the period of the change in fair values.

The derivative instruments used by the Company are designed to reduce the market risk associated with the exposure of its underlying transactions to fluctuations in currency exchange rates.

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**NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

The Company has instituted a foreign currency cash flow hedging program in order to hedge against the risk of overall changes in future cash flows. The Company hedges portions of its forecasted expenses denominated in NIS with currency forwards contracts and put and call options. These forward and option contracts are designated as cash flow hedges.

For derivative instruments that are designated and qualify as a cash flow hedge (i.e., hedging the exposure to variability in expected future cash flows that is attributable to a particular risk), the effective portion of the gain or loss on the derivative instrument is reported as a component of other comprehensive income and reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. The remaining gain or loss on the derivative instrument in excess of the cumulative change in the present value of future cash flows of the hedged item, if any, is recognized in current earnings during the period of change.

For derivative instruments not designated as hedging instruments, the gain or loss is recognized in current earnings during the period of change.

The notional principal of foreign exchange contracts to purchase NIS with U.S. dollars was \$ 2,591 and \$ 519 as of December 31, 2011 and 2012, respectively. The notional principal of foreign exchange contracts to purchase U.S. dollars with Euros was \$ 506 as of December 31, 2011 and \$ 0 as of December 31, 2012, respectively. The notional principal of foreign exchange contracts to purchase U.S. dollars with Japanese Yen was none as of December 31, 2011 and \$ 1,276 as of December 31, 2012, respectively.

At December 31, 2012, the effective portion of the Company's cash flow hedges before tax effect was \$ 16, all of which is expected to be reclassified from accumulated other comprehensive income to operating expenses within the next 12 months.

The following tables present fair value amounts and gains and losses of derivative instruments and related hedged items:

		Fair values of derivative instruments	
		Assets	
		December 31,	
		2011	2012
		Balance sheet item	
Assets			
Derivatives not designated as hedging	"Other accounts receivable and prepaid expenses"	\$ 54	\$ 140
Cash flow hedging:			
Foreign exchange option contracts	" Other accounts receivable and prepaid expenses"	-	16
Liabilities			
Cash flow hedging:			
Foreign exchange option contracts	"Accrued expenses and other accounts payable "	(12 )	-
Total derivatives		\$ 42	\$ 156

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**MAGIC SOFTWARE ENTERPRISES LTD.****AND ITS SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands (except share and per share data)**

## NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

	Loss recognized in other comprehensive income 2012 (Effective portion)	Statements of income item	Gain (loss) recognized in the statements of income Year ended December 31,		
			2010	2011	2012
Cash flow hedging:					
Foreign exchange forward and option contracts	29	"Operating expenses"	\$ (55 )	\$ 63	\$ -
Derivatives not designated as hedging:					
Foreign exchange forward contracts		"Financial expenses, net"	4	59	245
Total derivatives			\$ (51 )	\$ 122	\$ 245

**Reclassification**

Certain amounts in prior years' financial statements have been reclassified to conform with the current year's presentation (see Note 3).

**Impact of recently issued accounting standards**

In February 2013, the FASB issued ASU No. 2013-02, "Reporting of Amounts Reclassified out of Accumulated Other Comprehensive Income." Under ASU 2013-02, an entity is required to provide information about the amounts reclassified out of Accumulated Other Comprehensive Income ("AOCI") by component. In addition, an entity is

required to present, either on the face of the financial statements or in the notes, significant amounts reclassified out of AOCI by the respective line items of net income, but only if the amount reclassified is required to be reclassified in its entirety in the same reporting period. For amounts that are not required to be reclassified in their entirety to net income, an entity is required to cross-reference to other disclosures that provide additional details about those amounts. ASU 2013-02 does not change the current requirements for reporting net income or other comprehensive income in the financial statements. ASU 2013-02 is effective for the Company on January 1, 2013. Since this standard only impacts presentation and disclosure requirements, its adoption did not have a material impact on the Company's consolidated results of operations or financial condition.

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**MAGIC SOFTWARE ENTERPRISES LTD.**

**AND ITS SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**U.S. dollars in thousands (except share and per share data)**

**NOTE 3:- BUSINESS COMBINATION, SIGNIFICANT TRANSACTION AND SALE OF BUSINESS**

The Company purchased a consulting and staffing services business of a U.S.-based IT services company on January 17, 2010, for a total consideration of \$ 13,684, of which \$ 8,625 was paid upon closing and the remaining contingent payment of \$ 5,400 has been paid as of December 31, 2012.

In accordance with ASC 805-30-35-1 the Company re-measured the contingent consideration based on the fair value at each reporting date until the contingency is resolved or the payment is made, while the changes in fair value are recognized in earnings in the financial expenses using the interest method over the period. The deferred payment was recorded at present value and was amortized using the interest method during the relevant period into financial expenses. As a result, since the acquisition the Company recorded financial expenses of \$ 173, \$ 112 and \$ 48 during 2010, 2011 and 2012, respectively.

The acquired business provides a comprehensive range of consulting and staffing services for the telecom, network communications and the information technology industry.

The acquisition was accounted for by the purchase method. The results of operations were included in the consolidated financial statements of the Company commencing January 17, 2010. The consideration for the acquisition was attributed to net assets on the basis of fair value of assets acquired and liabilities assumed, based on an appraisal performed by management, which included a number of factors, including the assistance of independent appraisers.

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed:

Working capital, including deferred tax liability	\$3,926
Fixed assets	54
Goodwill	4,831
Customer relationships	4,873

Total assets acquired	13,684
Liabilities due to acquisition activities	5,059
Net assets acquired	\$8,625

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**MAGIC SOFTWARE ENTERPRISES LTD.**

**AND ITS SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**U.S. dollars in thousands (except share and per share data)**

**NOTE 3:- BUSINESS COMBINATION, SIGNIFICANT TRANSACTION AND SALE OF BUSINESS (Cont.)**

Identifiable intangible assets, including customer relationship were valued using a variation of the income approach known as the "Multi-Period Excess Earnings Approach." This method utilized a forecast of expected cash inflows, cash outflows and contributory charges for economic returns on tangible and intangible assets employed.

An amount of \$ 4,873 of the purchase price was allocated to customer relationships, as described above. The Company amortizes its intangible assets over periods ranging from 4-15 years, based on two types of customer relationships identified.

On October 31, 2010, the Company purchased an 88% interest in Xsell Resources Inc, a consulting and staffing services company including a put and call option provided to the seller and to the Company, respectively, allowing b. to increase its holdings to 100%. The option price is calculated based on a multiple of gross profit. The Company paid a cash purchase price of \$ 1,600. The acquired company provides a comprehensive range of consulting and staffing services for information technology industry.

The acquisition was accounted for by the purchase method. The results of operations were included in the consolidated financial statements of the Company commencing October 31, 2010. The consideration for the acquisition was attributed to net assets on the basis of fair value of assets acquired and liabilities assumed, based on an appraisal performed by management, which included a number of factors, including the assistance of independent appraisers, which was completed in 2011.

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed:

Net liabilities	\$ (908 )
Non-controlling interest	(165 )

Goodwill	1,988
Customer relationships	685
Total assets acquired	\$1,600

Identifiable intangible assets, including customer relationships, were valued using a variation of the income approach known as the "Multi-Period Excess Earnings Approach." This method utilized a forecast of expected cash inflows, cash outflows and contributory charges for economic returns on tangible and intangible assets employed.

An amount of \$ 685 of the purchase price was allocated to customer relationships, as described above. The Company amortizes its intangible assets over a period of 6 years, based on the identified customer relationships.

**MAGIC SOFTWARE ENTERPRISES LTD.**

**AND ITS SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**U.S. dollars in thousands (except share and per share data)**

**NOTE 3:- BUSINESS COMBINATION, SIGNIFICANT TRANSACTION AND SALE OF BUSINESS (Cont.)**

During 2012, the Company exercised its call option and acquired the remaining 12% interest thereby completing the acquisition of 100% of the shares for an additional consideration of \$ 314. As a result, the Company adjusted the non-controlling interest related to the acquisition that was initially recorded at the date of acquisition by an aggregate amount of \$ 165, and a related adjustment to additional paid-in capital of \$ 149.

On January 1, 2011, the Company acquired a 51% ownership interest in its South African distributor, Magix Integration (Proprietary) Ltd., ("Magix Integration") for total consideration of up to \$ 1,560 based on achievement by Magix Integration of certain performance targets for 2011, and an option to increase its holdings by 24% to 75% in total with a fair value of \$ (807). The Company made an advance payment in cash as of December 2010 of \$1,160 on account of this acquisition. Magix Integration specializes in the software integration and application development of the Company's platforms as well as the support of large-scale and complex systems in the public and financial sectors in South Africa. The Company believes that this acquisition will contribute to the Company's growth and presence in the region. Acquisition related costs were immaterial.

The acquisition was accounted for by the purchase method. The results of operations were included in the consolidated financial statements of the Company commencing January 1, 2011.

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed:

Fixed assets	\$8
Non-controlling interest	(1,323)
Deferred tax liability	(437 )
Goodwill	2,159
Customer relationships	1,560
 Total assets acquired	 1,967
 Liabilities due to acquisition activities	 (807 )

Net assets acquired \$1,160

Identifiable intangible assets, including customer relationship were valued using a variation of the income approach. This method utilized a forecast of expected cash inflows, cash outflows and contributory charges for economic returns on tangible and intangible assets employed.

An amount of \$ 1,560 of the purchase price was allocated to customer relationships, as described above. The Company amortizes its intangible assets over a period of ten years, based on the customer relationships identified.

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**MAGIC SOFTWARE ENTERPRISES LTD.**

**AND ITS SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**U.S. dollars in thousands (except share and per share data)**

**NOTE 3:- BUSINESS COMBINATION, SIGNIFICANT TRANSACTION AND SALE OF BUSINESS (Cont.)**

On April 1, 2011, the Company exercised its option to acquire the 24% in Magix Integration as stipulated in the original acquisition agreement for \$ 1,105. On October 1, 2011, the Company purchased additional shares in Magix Integration, thereby completing the acquisition of 100% of the shares in Magix Integration for an additional consideration of up to \$ 587 based on achievement by Magix Integration of certain performance targets through 2012. As a result, the Company adjusted the non-controlling interest related to Magix Integration that was initially recorded at the date of acquisition and income attributed to the Magix Integration non-controlling interest up-to the exercise of the option and additional purchase by an aggregate of \$ 1,466, and a related adjustment to additional paid in capital of \$ 226.

In May 2011, the Company acquired a 95% interest in Complete Business Solutions Ltd, and a 100% interest in Complete Information Technology Ltd., The companies are prominent software solution providers and leading Business Partners of SAP with many years of experience in distributing and implementing SAP Business One ERP Software. The Company paid a cash purchase price of \$ 5,967.

The Company believes that the acquisition of this business will enable it to expand its offers and leverage its relationships with top tier customers. Acquisition related costs were immaterial.

The acquisition was accounted for by the purchase method. The results of operations were included in the consolidated financial statements of the Company commencing May 2011.

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed:

Net assets	\$572
Non-controlling interest	(262 )
Intangible assets	2,359
Deferred tax liability	(589 )
Goodwill	3,887
Net assets acquired	\$5,967

In the 2011 financial statements, the Company included provisional amounts of the estimated fair values of the tangible and intangible assets. In 2012, the Company completed the valuation of the tangible and intangible assets. \*)As a result, the main adjustments recorded in the fair value of the tangible and intangible assets and liabilities at the purchase date were increase in goodwill of \$ 480 and recognition of deferred tax liability of \$ 589. Adjustments recorded in profit and loss were immaterial.

Identifiable intangible assets, including customer relationship were valued using a variation of the income approach. This method utilized a forecast of expected cash inflows, cash outflows and contributory charges for economic returns on tangible and intangible assets employed.

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**MAGIC SOFTWARE ENTERPRISES LTD.**

**AND ITS SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**U.S. dollars in thousands (except share and per share data)**

**NOTE 3:- BUSINESS COMBINATION, SIGNIFICANT TRANSACTION AND SALE OF BUSINESS (Cont.)**

Amounts of \$ 1,930 and \$ 429 of the purchase price were allocated to customer relationships and the non-compete agreement, respectively. The Company amortizes the customer relationships and non-compete agreement over periods of 4-10 years and 8 years, respectively.

On December 27, 2011, the Company completed the acquisition of the AppBuilder activity of BluePhoenix Solutions ("AppBuilder"), a leading provider of value-driven legacy IT modernization solutions, for \$ 12,565. During 2012, the Company paid an additional amount of \$ 140 with respect to the acquisition. AppBuilder is a comprehensive application development infrastructure used by many enterprises around the world. This premier enterprise application development environment is a powerful, model-driven tool that enables development teams to build, deploy, and maintain large-scale, custom-built business applications. The Company believes the acquisition will broaden its product portfolio and strengthens the presence in numerous global markets. Acquisition related costs were immaterial.

The acquisition was accounted for by the purchase method. The results of operations were included in the consolidated financial statements of the Company commencing January 1, 2012.

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed:

Net liabilities	\$(3,248 )
Intangible assets	7,251
Goodwill	8,702

Net assets acquired \$12,705

\*)In the 2011 financial statements the Company included provisional amounts of the estimated fair values of the tangible and intangible assets. In 2012, the Company completed the valuation of the tangible and intangible assets. As a result, the main adjustments recorded in the fair value of the tangible and intangible assets and liabilities at the

purchase date were increase in intangible assets of \$ 1,465 and increase in deferred revenues of \$ 1,348. Adjustments recorded in profit and loss were immaterial.

Identifiable intangible assets, including customer relationship were valued using a variation of the income approach. This method utilized a forecast of expected cash inflows, cash outflows and contributory charges for economic returns on tangible and intangible assets employed.

Amounts of \$ 4,430, \$ 2,138 and \$ 683 of the purchase price were allocated to customer relationships, developed technology and backlog, respectively. The Company amortizes the customer relationships, backlog and acquired technology over periods of 15 years, 15 years and 3.5 years, respectively.

**MAGIC SOFTWARE ENTERPRISES LTD.**

**AND ITS SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**U.S. dollars in thousands (except share and per share data)**

**NOTE 3:- BUSINESS COMBINATION, SIGNIFICANT TRANSACTION AND SALE OF BUSINESS (Cont.)**

In July 2012, the Company acquired an 80% interest in Comm-IT Group, (including "Comm-IT Technology Solutions" and "Comm-IT Software"), a software and systems development house that specializes in providing advanced IT and communications services and solutions, for a total consideration of \$ 9,021, of which \$ 4,990 was paid upon closing and the remaining \$ 4,031 is to be paid during the next two years, of which, \$ 1,414 is contingent upon the acquired business meeting certain operational targets in 2012 and 2013, and \$ 2,617 in deferred payments. The Purchaser and the seller hold mutual Call and Put options respectively for the remaining 20% interest in the group. As a result of the Put option, the Company recorded redeemable non-controlling interest in the amount of \$ 1,880.

As of December 31, 2012 the Company's liability towards the sellers is estimated at \$ 4,042. The Company believes that the acquisition of this business will enable it to expand its professional services offering and leverage its relationships with top tier customers. Acquisition related costs were immaterial.

In accordance with ASC 805-30-35-1, the Company re-measures the contingent consideration based on the fair value at each reporting date until the contingency is resolved or the payment is made, while the changes in fair value are recognized in earnings in the financial expenses using the interest method over the period. The contingent payment was recorded at present value and was amortized using the interest method during the relevant period into financial expenses.

The acquisition was accounted for by the purchase method. The results of operations were included in the consolidated financial statements of the Company commencing July 1, 2012.

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed:

Net assets	\$1,219
Non-controlling interest	(1,880)

Intangible assets *)	3,873
Goodwill *)	5,809
Net assets acquired	\$9,021

\*) The estimated fair values of the tangible and intangible assets are provisional and are based on information that was available as of the acquisition date to estimate the fair value of these amounts. The Company believes the information provides a reasonable basis for estimating the fair values of these amounts, but is waiting for additional information necessary to finalize those fair values. Therefore, provisional measurements of fair value reflected are subject to change. The Company expects to finalize the tangible and intangible assets valuation and complete the acquisition accounting as soon as practicable as but no later than the measurement period.

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**MAGIC SOFTWARE ENTERPRISES LTD.****AND ITS SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

U.S. dollars in thousands (except share and per share data)

**NOTE 3:- BUSINESS COMBINATION, SIGNIFICANT TRANSACTION AND SALE OF BUSINESS (Cont.)**

Below are certain unaudited pro forma combined statements of income data for the year ended December 31, 2011 and 2012, respectively, as if the acquisition in Note 3f had occurred at January 1, 2011, after giving effect to purchase accounting adjustments, including amortization of intangible assets. This pro forma financial information is not necessarily indicative of the combined results that would have been attained had the acquisition taken place at the beginning of 2011, nor is it necessarily indicative of future results.

	Year ended December 31,	
	2011	2012
	Unaudited	
Total revenues	\$ 122,873	\$ 132,251
Net income attributable to Magic Software Enterprises shareholders	\$ 15,668	\$ 16,225
Earnings per share		
Basic	\$ 0.43	\$ 0.44
Diluted	\$ 0.42	\$ 0.44

**NOTE 4:- MARKETABLE SECURITIES**

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

	December 31, 2011				2012			
	Amortized cost	Unrealized losses	Unrealized gains	Market value	Amortized cost	Unrealized losses	Unrealized gains	Market value
Available-for-sale:								
Governmental bonds	\$407	\$ -	\$ 28	\$ 435	\$407	\$ -	\$ 20	\$ 427

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Commercial bonds	571	-	67	638	192	-	45	237
Equity funds	118	-	50	168	118	-	108	226
<u>Total</u> available-for-sale marketable securities	\$1,096	\$ -	\$ 145	\$1,241	\$717	\$ -	\$ 173	\$ 890

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**MAGIC SOFTWARE ENTERPRISES LTD.****AND ITS SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands (except share and per share data)****NOTE 4:- MARKETABLE SECURITIES (Cont.)**

The amortized costs of available-for-sale debt securities at December 31, 2012, by contractual maturities, are shown below:

	Amortized cost	Gross unrealized gains (losses)		Estimated fair value
		Gains	Losses	
Due in one year or less	\$ -	\$ -	\$ -	\$ -
Due between one year to five years	599	65	-	664
	\$ 599	\$ 65	\$ -	\$ 664

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

The following is the change in the other comprehensive income of available-for-sale securities during 2011:

	Other comprehensive income
Other comprehensive income from available-for-sale securities as of January 1, 2011	\$ 218
Reclassification to earnings of realized gain from available-for-sale securities	(20 )
Unrealized loss from available-for-sale securities	(53 )
Other comprehensive income from available-for-sale securities as of December 31, 2011	\$ 145

The following is the change in the other comprehensive income of available-for-sale securities during 2012:

	Other comprehensive income
Other comprehensive income from available-for-sale securities as of January 1, 2012	\$ 145
Reclassification to earnings of realized gain from available-for-sale securities	-
Unrealized gain from available-for-sale securities	28
Other comprehensive income from available-for-sale securities as of December 31, 2012	\$ 173

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**MAGIC SOFTWARE ENTERPRISES LTD.****AND ITS SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands (except share and per share data)****NOTE 5:- FAIR VALUE MEASUREMENTS**

In accordance with ASC 820, the Company measures its investment in marketable securities and foreign currency derivative contracts at fair value. Generally marketable securities are classified within Level 1, this is because these assets are valued using quoted prices in active markets. Foreign currency derivative contracts and certain corporate bonds are classified within Level 2 as the valuation inputs are based on quoted prices and market observable data of similar instruments.

Contingent consideration is classified within Level 3. The Company values the Level 3 contingent consideration using discounted cash flow of the expected future payments, whose inputs include interest rate.

The Company's financial assets measured at fair value on a recurring basis, excluding accrued interest components, consisted of the following types of instruments as of the following dates:

	December 31, 2011			Total
	Level 1	Level 2	Level 3	
Fair value measurements using input type				
Assets:				
Government bonds	\$ 435	\$ -	\$ -	\$ 435
Corporate bonds	-	638	-	638
Equity fund	168	-	-	168
Foreign currency derivative contracts	-	42	-	42
Total financial assets	\$ 603	\$ 680	\$ -	\$ 1,283
Liabilities:				
Contingent consideration	\$ -	\$ -	\$ 1,046	\$ 1,046
Total financial liabilities	\$ -	\$ -	\$ 1,046	\$ 1,046

	December 31, 2012			
	Fair value measurements using input type			
	Level 1	Level 2	Level 3	Total
<b>Assets:</b>				
Government bonds	\$ 427	\$ -	\$ -	\$ 427
Corporate bonds	-	237	-	237
Equity fund	226	-	-	226
Foreign currency derivative contracts	-	156	-	156
<b>Total financial assets</b>	<b>\$ 653</b>	<b>\$ 393</b>	<b>\$ -</b>	<b>\$ 1,046</b>
<b>Liabilities:</b>				
Contingent consideration	\$ -	\$ -	\$ 1,942	\$ 1,942
<b>Total financial liabilities</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ 1,942</b>	<b>\$ 1,942</b>

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**MAGIC SOFTWARE ENTERPRISES LTD.****AND ITS SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands (except share and per share data)**

## NOTE 5:- FAIR VALUE MEASUREMENTS (Cont.)

Fair value measurements using significant unobservable inputs (Level 3):

	December 31,	
	2011	2012
Opening balance	\$480	\$1,046
Increase in contingent consideration	750	1,192
Decrease in contingent consideration due to settlement	(225 )	(315 )
Amortization of interest	41	19
Closing balance	\$1,046	\$1,942

## NOTE 6:- OTHER ACCOUNTS RECEIVABLE AND PREPAID EXPENSES

	December 31,	
	2011	2012
Short-term lease deposits	\$817	\$615
Prepaid expenses	427	1,039
Government authorities	3,073	2,313
Deferred tax assets, net	1,878	2,522
Restricted deposits	-	163
Other	206	44
	\$6,401	\$6,696

## NOTE 7:- PROPERTY AND EQUIPMENT

December 31,

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	2011	2012
Cost:		
Leasehold improvements	\$472	\$470
Computers and peripheral equipment	9,396	9,826
Office furniture and equipment	1,790	1,875
Motor vehicles	243	244
Software	2,469	2,479
	14,370	14,894
Accumulated depreciation:		
Leasehold improvements	205	242
Computers and peripheral equipment	9,103	9,420
Office furniture and equipment	1,250	1,435
Motor vehicles	97	124
Software	1,686	1,775
	12,341	12,996
Depreciated cost	\$2,029	\$1,898

Depreciation expenses amounted to \$ 626, \$ 630 and \$ 757 for the years ended December 31, 2010, 2011 and 2012, respectively.

**MAGIC SOFTWARE ENTERPRISES LTD.****AND ITS SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands (except share and per share data)**

## NOTE 8:- INTANGIBLE ASSETS

## a. Intangible assets:

	December 31,	
	2011	2012
Original amounts:		
Capitalized software costs	\$49,723	\$54,599
Customer relationships	15,435	19,405
Backlog and non-compete agreement	1,112	1,112
Acquired technology	2,138	2,138
	68,408	77,254
Accumulated amortization:		
Capitalized software costs	37,370	41,191
Customer relationships	3,606	5,756
Backlog and non-compete agreement	31	472
Acquired technology	-	174
	41,007	47,593
Intangible assets, net	\$27,401	\$29,661

<sup>a</sup> Amortization expenses amounted to \$ 3,940, \$ 4,410 and \$ 6,687 for the years ended December 31, 2010, 2011 and <sup>b</sup> 2012, respectively.

c. The estimated future amortization expense of intangible assets as of December 31, 2012 is as follows:

2013	6,947
2014	5,537
2015	4,905

2016	3,899
2017	2,335
2018 and thereafter	6,038
	\$29,661

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**MAGIC SOFTWARE ENTERPRISES LTD.****AND ITS SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands (except share and per share data)**

## NOTE 9:- GOODWILL

Changes in the carrying amount of goodwill for the years ended December 31, 2011 and 2012 according to the Company's reporting units are as follows:

	IT professional services	Software services	Total
As of January 1, 2011	\$ 12,428	\$ 12,196	\$ 24,624
Business combination	-	14,245	14,245
Adjustments due to finalized purchase price allocation	(520 )	363	(157 )
Foreign currency translation adjustments	-	185	185
As of December 31, 2011	11,908	26,989	38,897
Business combination	5,809	-	5,809
Additional consideration in conjunction with acquisitions	-	140	140
Foreign currency translation adjustments	-	(502 )	(502 )
As of December 31, 2012	\$ 17,717	\$ 26,627	\$ 44,344

In 2010 and 2011, the Company determined the fair value of each reporting unit using the income approach. The material assumptions used for the income approach for years 2010 and 2011 were four years of projected net cash flows, a discount rate of 14%-15% and a long-term growth rate of 3.0%. The Company considered historical rates and current market conditions when determining the discount and growth rates to use in its analyses. If these estimates or their related assumptions change in the future, the Company may be required to record impairment charges for its goodwill. In 2012, the Company adopted the provisions of ASU 2011-08 and performed a qualitative test for each of its reporting units. Since there were no indicators for impairment, a quantitative test was not performed.

The Company performed annual impairment tests during the fourth quarter of 2012 and did not identify any impairment losses (see Note 2).

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**MAGIC SOFTWARE ENTERPRISES LTD.**

**AND ITS SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**U.S. dollars in thousands (except share and per share data)**

**NOTE 10:- ACCRUED EXPENSES AND OTHER ACCOUNTS PAYABLE**

	December 31,	
	2011	2012
Employees and payroll accruals	\$6,228	\$7,073
Accrued expenses	1,865	1,917
Deferred and contingent payments related to acquisitions	2,325	3,828
Government authorities	3,177	2,175
Other	2,157	2,544
	\$15,752	\$17,537

**NOTE 11:- TAXES ON INCOME**

a. Israeli taxation:

1. Corporate tax rate in Israel:

Taxable income of Israeli companies is subject to tax at the rate of 25% in 2010, 24% in 2011 and 25% in 2012 and onwards.

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

Certain production and development facilities of the Company have been granted "Approved Enterprise" status pursuant to the Law, which provides certain tax benefits to its investment programs including tax exemptions and reduced tax rates. Income not eligible for Approved Enterprise benefits is taxed at regular rates.

In the event of distribution of dividends from the said tax-exempt income, the amount distributed will be subject to corporate tax at the rate ordinarily applicable to the Approved Enterprise's income. The tax-exempt income attributable to the benefit period of the Approved Enterprise programs mentioned above can be distributed to shareholders without subjecting the Company to taxes, only upon the complete liquidation of the applicable Israeli subsidiary.

The benefit periods under the Law have not yet commenced.

The entitlement to the above benefits is conditional upon the fulfilling of the conditions stipulated by the Laws and regulations. Should they fail to meet such requirements in the future, income attributable to its Approved Enterprise programs could be subject to the statutory Israeli corporate tax rate and they could be required to refund a portion of the tax benefits already received, with respect to such programs. As of December 31, 2012, management believes that the Company's Israeli subsidiaries are in compliance with all the conditions required by the Law.

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**MAGIC SOFTWARE ENTERPRISES LTD.**

**AND ITS SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**U.S. dollars in thousands (except share and per share data)**

NOTE 11:- TAXES ON INCOME (Cont.)

Effective January 1, 2011, the Knesset enacted the Law for Economic Policy for 2011 and 2012 (Amended Legislation), and among other things, amended the Law, ("the Amendment"). According to the Amendment, the benefit tracks in the Investment Law were modified and a flat tax rate applies to the Company's entire preferred income. The Company will be able to opt to apply (the waiver is non-recourse) the Amendment and from then on it will be subject to the amended tax rates as follows: 2011 and 2012 - 15%, 2013 and 2014 - 12.5% and in 2015 and thereafter - 12%. As of December 31, 2012, the Company has not applied for this amendment.

<sup>3</sup> The Company's Israeli entities have received final tax assessments for their Israeli tax return filings through the year 2008.

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

The Company qualifies as an Industrial Company within the meaning of the Law for the Encouragement of Industry (Taxes), 1969 (the "Industrial Encouragement Law"). The Industrial Encouragement Law defines an "Industrial Company" as a company that is resident in Israel and that derives at least 90% of its income in any tax year, other than income from defense loans, capital gains, interest and dividends, from an enterprise whose major activity in a given tax year is industrial production. Under the Industrial Encouragement Law, the Company is entitled to amortization of the cost of purchased know-how and patents over an eight-year period for tax purposes as well as accelerated depreciation rates on equipment and buildings.

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

b. Non-Israeli subsidiaries:

Non-Israeli subsidiaries are taxed according to the tax laws in their respective domiciles of residence. If earnings are distributed to Israel in the form of dividends or otherwise, the Company may be subject to additional Israeli income taxes (subject to an adjustment for foreign tax credits) and foreign withholding taxes.

c. Net operating loss carryforwards:

As of December 31, 2012, the Company and its Israeli subsidiaries had operating loss carryforwards of \$ 19,596, which can be carried forward and offset against taxable income in the future for an indefinite period.

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**MAGIC SOFTWARE ENTERPRISES LTD.**

**AND ITS SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**U.S. dollars in thousands (except share and per share data)**

NOTE 11:- TAXES ON INCOME (Cont.)

The Company's subsidiaries in Europe had estimated total available tax loss carryforwards of \$ 5,199 as of December 31, 2012, to offset against future taxable income.

The Company's subsidiaries in the U.S. had estimated total available tax loss carryforwards of \$ 3,835 as of December 31, 2012, which can be carried forward and offset against taxable income for a period of up to 20 years, from the year the loss was incurred.

Utilization of U.S. net operating losses may be subject to substantial annual limitations due to the "change in ownership" provisions ("annual limitations") of the Internal Revenue Code of 1986 and similar state provisions. The annual limitation may result in the expiration of net operating losses before utilization.

d. Income before taxes on income:

	Year ended December 31,		
	2010	2011	2012
Domestic	\$4,288	\$7,197	\$10,462
Foreign	4,985	7,866	6,092
	\$9,273	\$15,063	\$16,554

e. Taxes on income:

Taxes on income (tax benefit) consist of the following:

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Year ended December 31,  
2010 2011 2012

Current:

Domestic	\$446	\$447	\$(1,291)
Foreign	1,234	1,000	302
	1,680	1,447	(989 )

Deferred taxes:

Domestic	(2,681)	(1,800)	414
Foreign	899	150	669
	(1,782)	(1,650)	1,083

Taxes on income (tax benefit) \$(102 ) \$(203 ) \$94

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**MAGIC SOFTWARE ENTERPRISES LTD.****AND ITS SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

U.S. dollars in thousands (except share and per share data)

## NOTE 11:- TAXES ON INCOME (Cont.)

## f. Deferred tax assets and liabilities:

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

	December 31,	
	2011	2012
Net operating loss carryforwards	\$8,403	\$5,938
Allowances, reserves and intangible assets	993	809
Deferred tax assets before valuation allowance	9,396	6,747
Less - valuation allowance	(2,891)	(888 )
Deferred tax assets	6,505	5,859
Capitalized software costs	(1,575)	(1,772)
Deferred tax assets, net	\$4,930	\$4,087

Both current deferred tax liabilities and long term deferred tax liabilities are in respect of acquired intangible assets.

	December 31,	
	2011	2012
Current tax assets	\$1,877	\$2,522
Non-current tax assets	3,053	1,565
Deferred tax assets	\$4,930	\$4,087

Current taxes are included under other accounts receivable and prepaid expenses and non-current tax assets are included under other long term receivables.

Significant components of the Company and its subsidiaries deferred tax liability are as follows:

	December 31,	
	2011	2012
Current liabilities	\$(2,509)	\$(2,355)
Non-current liabilities	(735 )	(738 )
Net deferred tax liabilities	\$(3,244)	\$(3,093)

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**MAGIC SOFTWARE ENTERPRISES LTD.****AND ITS SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands (except share and per share data)**

## NOTE 11:- TAXES ON INCOME (Cont.)

## g. Reconciliation of the theoretical tax expense to the actual tax expense:

Reconciling items between the 2010, 2011 and 2012 statutory tax rate (25%, 24% and 25%, respectively) of the Company and the effective tax rate is presented in the following table:

	Year ended December 31,					
	2010		2011		2012	
Income before taxes, as reported in the consolidated statements of income	\$9,273		\$15,063		\$16,554	
Statutory tax rate	25	%	24	%	25	%
Theoretical tax expenses on the above amount at the Israeli statutory tax rate	\$2,318		\$3,615		\$4,139	
Tax adjustment in respect of different tax rates	525		866		444	
Deferred taxes on losses for which full valuation allowance was provided in the past	(1,663)		(37 )		651	
Changes in valuation allowance	(2,676)		(4,429 )		(2,003 )	
Tax benefits in respect of prior years, net	318		(73 )		(1,126 )	
Nondeductible expenses	181		40		*)	20
Uncertain tax position and other differences	895		(185 )		**)	(2,031)
Income tax (tax benefit)					\$ (102 )	\$ (203 ) \$ 94

\*) In 2012, the Company reversed its writeoff of tax prepayment advances from prior years since the Company believes the utilization of the prepayments is more-likely-than not in the near future.

\*\*\*) This amount is mainly comprised of tax provisions reversal due to statute of limitation of prior years' tax assessments amounting to \$1,270.

**MAGIC SOFTWARE ENTERPRISES LTD.**

**AND ITS SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**U.S. dollars in thousands (except share and per share data)**

NOTE 11:- TAXES ON INCOME (Cont.)

The Company applies ASC 740, "Income Taxes" with regards to tax uncertainties. During the years ended h. December 31, 2010, 2011 and 2012, the Company recorded \$ 874, \$ 727 and \$(240) of tax expenses (income), respectively, as a result of this application.

A reconciliation of the beginning and ending balances of the total amounts of gross unrecognized tax benefits is as follows:

Gross unrecognized tax positions at January 1, 2011	\$1,194
Increase in tax positions taken in the year	710
Gross unrecognized tax positions at December 31, 2011	1,904
Increase in tax positions taken in prior years	270
Decrease in tax positions taken in prior years	(489 )
Gross unrecognized tax benefits at December 31, 2012	\$1,685

The Company recognizes interest and penalties related to unrecognized tax benefits in taxes on income. During the years ended December 31, 2011 and 2012, the Company recorded \$ 17 and \$ (21), respectively, for interest and penalties expenses (income) related to uncertain tax positions. The liability for unrecognized tax benefits included accrued interest and penalties of \$ 76 and \$ 55 at December 31, 2011 and 2012, respectively.

As of December 31, 2012, the entire amount of unrecognized tax benefit could affect the Company's income tax provision and the effective tax rate.

NOTE 12:- SHAREHOLDERS'  
EQUITY

a. The ordinary shares of the Company are listed on the NASDAQ Global Select Market in the United States and are traded on the Tel-Aviv Stock Exchange in Israel.

b. Issuance of ordinary shares:

On December 23, 2010, the Company issued 3,287,616 ordinary shares at a price of \$ 6.5 per share and in a total amount of \$ 20,290 net of issuance expenses. The shares were issued to institutional investors in a private placement. In addition, certain of the purchasers received warrants to purchase up to an aggregate of 1,134,231 ordinary shares at an exercise price of \$ 8.26 per share. The warrants are exercisable as of six months from the date of issuance, have a term of three years, and the exercise price is subject to future adjustment for various events, such as stock splits or dividend distributions. Following the Company's dividend distribution and in respect to warrants issuance agreement, exercise price was adjusted to \$ 8.07 per share as of December 31, 2012.

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**MAGIC SOFTWARE ENTERPRISES LTD.****AND ITS SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

U.S. dollars in thousands (except share and per share data)

## NOTE 12:- SHAREHOLDERS' EQUITY (Cont.)

## c. Stock Option Plans:

Under the Company's 2007 Stock Option Plan, as amended ("the Plan"), options may be granted to employees, officers, directors and consultants of the Company and its subsidiaries. Pursuant to the 2007 Stock Option Plan, the Company reserved for issuance 1,500,000 ordinary shares. In 2012, the Company increased the amount of ordinary shares reserved for issuance by additional 1,000,000 ordinary shares in connection with the 2007 Stock Option Plan (mentioned above). As of December 31, 2012, an aggregate of 1,227,415 ordinary shares of the Company are still available for future grants under the Plan. Each option granted under the Plan is exercisable for a period of ten years from the date of the grant of the option. The 2007 Plan will expire on August 1, 2017.

The exercise price for each option is determined by the Board of Directors and set forth in the Company's award agreement. Unless determined otherwise by the Board of Directors, the option exercise price shall be equal to or higher than the share market price at the grant date. The options generally vest over 3-4 years. Any option that is forfeited or canceled before expiration becomes available for future grants under the Plans.

A summary of employee option activity under the Plans as of December 31, 2012 and changes during the year ended December 31, 2012 are as follows:

	Number of options	Weighted average exercise price	Weighted average remaining contractual term (in years)	Aggregate intrinsic value
Outstanding at January 1, 2012	1,355,879	\$ 2.31	6.46	\$ 3,416
Granted	-	-		
Exercised	(136,708 )	\$ 2.53		
Forfeited	(61,786 )	\$ 2.13		

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Outstanding at December 31, 2012	1,157,385	\$ 2.74	5.87	\$ 2,298
Exercisable at December 31, 2012	791,797	\$ 2.54	4.86	\$ 1,738
Vested and expected to vest at December 31, 2012	1,117,531	\$ 2.70	5.77	\$ 2,261

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**MAGIC SOFTWARE ENTERPRISES LTD.****AND ITS SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands (except share and per share data)**

## NOTE 12:- SHAREHOLDERS' EQUITY (Cont.)

The weighted-average grant-date fair value of options granted during the years ended December 31, 2010 and 2011 was \$ 1.88 and \$ 4, respectively. During 2012, no options were granted. The aggregate intrinsic value in the table above represents the total intrinsic value that would have been received by the option holders had all option holders exercised their options on December 31, 2012. This amount is changed based on the market value of the Company's ordinary shares. Total intrinsic value of options exercised for the years ended December 31, 2010, 2011 and 2012 was \$ 1,895, \$ 2,197 and \$ 572, respectively. As of December 31, 2012, there was \$ 341 of unrecognized compensation cost related to non-vested share-based compensation arrangements granted under the Plans. This cost is expected to be recognized over a period of approximately three years.

The following table represents the employee option activity whose vesting is contingent upon meeting various departmental and Company's wide performance goals (including revenue growth and net gain index), as of December 31, 2012. These options have been included in the above table on employee option activity:

	Number of options	Weighted average exercise price	Weighted average remaining contractual term (in years)	Aggregate intrinsic value
Outstanding at January 1, 2012	139,250	\$ 1.44	6.55	\$ 519
Outstanding at December 31, 2012	139,250	\$ 1.44	5.55	\$ 454
Exercisable at December 31, 2012	114,250	\$ 1.51	5.45	\$ 364
Vested and expected to vest at December 31, 2012	138,905	\$ 1.44	5.55	\$ 452

During 2007 and 2008, the Company granted certain executives and other key employees, options to purchase 825,000 ordinary shares and 100,000 ordinary shares, respectively, with vesting contingent upon meeting various



departmental and Company-wide performance goals, including revenue growth and net gain index. The options have an exercise price equal to the fair market value of the Company's ordinary shares on the date of grant, contingently vest over a period of four years, and are for a term of ten years. The fair value of those options was estimated on the date of grant using the same option valuation model used for the other options granted. If such goals are not met, no compensation cost is recognized and any recognized compensation cost is reversed. The inputs for expected volatility, expected dividends, expected term and risk-free rate used in estimating those options' fair value are the same as those noted in the table related to options issued under the Plans.

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**MAGIC SOFTWARE ENTERPRISES LTD.****AND ITS SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands (except share and per share data)**

## NOTE 12:- SHAREHOLDERS' EQUITY (Cont.)

The options outstanding as of December 31, 2012, have been separated into ranges of exercise price categories, as follows:

Exercise price	Options outstanding	Weighted average remaining contractual life (years)	Weighted average exercise price	Options exercisable	Weighted average exercise price of exercisable options
In \$					
0-1	67,913	5.02	\$ 0.17	50,413	\$ 0.23
1.01-2	273,798	5.07	\$ 1.40	236,298	\$ 1.42
2.01-3	286,334	6.74	\$ 2.29	216,996	\$ 2.29
3.01-4	447,090	6.81	\$ 3.89	205,840	\$ 3.83
4.01-5	57,250	1.01	\$ 4.06	57,250	\$ 4.06
5.01-6	25,000	1.21	\$ 5.95	25,000	\$ 5.95
	1,157,385	5.87	\$ 2.74	791,797	\$ 2.54

e. Accumulated other comprehensive income:

	December 31,		
	2010	2011	2012
Accumulated realized and unrealized gain on available-for-sale securities, net	\$218	\$145	\$173
Accumulated foreign currency translation adjustments	218	(152)	(776)
Unrealized gain (loss) on derivative instruments, net	11	(12)	17
Total other comprehensive income	\$447	\$(19)	\$(586)

f.

On December 30, 2009, the Company declared a dividend distribution of \$ 0.50 per share (\$ 15,974 in the aggregate) which was paid on January 25, 2010.

On September 4, 2012, the Company's Board of Directors adopted a dividend distribution policy, subject to any applicable law. According to this policy, each year the Company will distribute a dividend of up to 50% of its annual distributable profits. It is possible that the Board of Directors will decide, subject to the conditions stated above, to declare additional dividend distributions. The Company's Board of Directors may at its discretion and at any time, change, whether as a result of a one-time decision or a change in policy, the rate of dividend distributions and/or not to distribute a dividend, all at its discretion. In respect to the policy mentioned above, on September 10, 2012 and on February 14, 2013 , the Company declared a dividend distribution of \$ 0.10 per share (\$ 3,661 in the aggregate) and \$ 0.12 per share (\$ 4,397 in the aggregate) which were paid on October 17, 2012 and on March 14, 2013, respectively.

**MAGIC SOFTWARE ENTERPRISES LTD.**

**AND ITS SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

U.S. dollars in thousands (except share and per share data)

**NOTE 13:- SELECTED STATEMENTS OF INCOME DATA**

a. Research and development costs, net:

	Year ended December 31,		
	2010	2011	2012
Total costs	\$5,667	\$7,269	\$7,916
Less - capitalized software costs	(3,595)	(5,222)	(4,969)
Research and development, net	\$2,072	\$2,047	\$2,947

b. Financial income (expenses), net:

Interest income net of bank charges	\$24	\$397	\$20
Interest expenses related to liabilities in connection with acquisitions	(173)	(112)	(48)
Interest income from debt instruments	96	67	49
Loss arising from foreign currency translation and other	(171)	(131)	(11)
Financial income(expenses), net	\$(224)	\$221	\$10

**NOTE 14:- COMMITMENTS AND CONTINGENCIES**

a. Lease commitments:

Certain of the motor vehicles, facilities and equipment of the Company and its subsidiaries are rented under long-term operating lease agreements. Future minimum lease commitments under non-cancelable operating leases as of December 31, 2012, are as follows:

2013	\$921
2014	579
2015	312
2016 and thereafter	202
	\$2,014

Rent expenses for the years ended December 31, 2010, 2011 and 2012 were approximately \$ 1,487, \$ 1,733 and \$ 1,701, respectively.

The Company leases motor vehicles under a cancelable lease agreement. The Company has an option to be released from this lease agreement, which may result in penalties in a maximum amount of \$ 371.

The Company currently occupies approximately 43,170 square feet of space based on a lease agreement expiring in December, 2014. The Company has an option to terminate the lease agreement in Israel and India upon six months prior written notice.

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**MAGIC SOFTWARE ENTERPRISES LTD.**

**AND ITS SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

U.S. dollars in thousands (except share and per share data)

**NOTE 14:- COMMITMENTS AND CONTINGENCIES (Cont.)**

The aggregated amount of lease commitment for the next 6 months in Israel and India mentioned above is approximately \$ 277.

**b. Guarantees:**

The Company and certain of its subsidiaries have provided three of their clients with performance bank guarantees totaling \$ 163, which are linked to the New Israeli Shekels, all of which will be terminated during 2013.

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

Lawsuits have been brought against the Company in the ordinary course of business. The Company intends to defend itself vigorously against those lawsuits.

1. In March 2006, a client of one of the Company's subsidiaries filed a lawsuit against the subsidiary claiming an alleged breach of the agreement between the parties. The plaintiff is seeking damages in the amount of € 488 thousand (approximately \$ 643). In June 2009, the court rejected the plaintiff's claims. In July 2009, the plaintiff filed an appeal. The appeal was dismissed in February 2012.

2.

In August 2009, a software company and one of its owners filed an arbitration proceeding against the Company and one of its subsidiaries, claiming an alleged breach of a non-disclosure agreement between the parties. The plaintiffs are seeking damages in the amount of approximately NIS 52 million (approximately \$ 13,930). The arbitrator determined that both the Company and the subsidiary breached the non-disclosure agreement, but closing summaries regarding damages have not yet been submitted.

In June 2011, the plaintiffs filed a motion to allow them to amend the claim by adding new causes of action and increasing the damages claimed in the lawsuit by approximately additional NIS 238 million (approximately \$ 63,755) based on new arguments. Following discussions, the arbitrator rejected the motion and determined that if the plaintiffs wish to claim the additional damages (and the additional causes of action) they should do so in a separate legal proceeding. To date the plaintiffs did not file an additional lawsuit.

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**MAGIC SOFTWARE ENTERPRISES LTD.**

**AND ITS SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**U.S. dollars in thousands (except share and per share data)**

**NOTE 14:- COMMITMENTS AND CONTINGENCIES (Cont.)**

At this time, given the multiple uncertainties involved and in large part to the highly speculative nature of the damages sought by the plaintiff, which leaves a wide discretion to the arbitrator in quantifying and awarding the damages, the Company is unable to estimate the amount of the probable loss, if any, to be recognized. However, the Company recorded an accrual to cover future related expenses, as estimated by the Company's legal counsel.

In February 2010, a U.S. based company filed a lawsuit against the Company and one of its subsidiaries, claiming an alleged breach by the Company and the subsidiary of its intellectual property rights in connection with one of the Company's products. In July 2011, the Company entered into a settlement agreement with the plaintiff according to which it paid a lump sum to the plaintiff for future maintenance and support until 2018, subject to a complete release of all claims.

In addition to the above mentioned legal proceedings, the Company is also involved in various legal proceedings arising in the normal course of its business. Based upon the advice of counsel, the Company does not believe that the ultimate resolution of these matters will have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows.

d.

Royalty commitments:

The Government of Israel, through the Fund for the Encouragement of Marketing Activities ("the Fund"), awarded the Company grants for participation in its foreign marketing expenses. The Company received an aggregate amount of grants of \$ 1,526 for the years up to and including 2005. The Company is committed to pay royalties at the rate of 3% of the increase in exports, up to the amount of the grants. As of December 31, 2012, the remaining contingent obligation of the Company amounted to \$ 188. No expense was recorded in years 2010, 2011 and 2012 for royalties payment.



**MAGIC SOFTWARE ENTERPRISES LTD.****AND ITS SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands (except share and per share data)**

## NOTE 15:- NET EARNINGS PER SHARE

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

	Year ended December 31,		
	2010	2011	2012
Numerator for basic and diluted earnings per share - net income available to Magic shareholders	\$9,375	\$15,044	\$16,183
Weighted average ordinary shares outstanding:			
Denominator for basic net earnings per share	32,139,686	36,267,739	36,502,264
Effect of dilutive securities	591,360	777,968	605,406
Denominator for diluted net earnings per share	32,731,046	37,045,707	37,107,670
Basic and diluted earnings per share	\$0.29	\$0.41	\$0.44

## NOTE 16:- SEGMENT GEOGRAPHICAL INFORMATION AND MAJOR CUSTOMERS

The Company reports its results on the basis of two reportable business segments: software services (which include proprietary and non proprietary software technology) and IT professional services, each of which is comprised of two reporting units. The entities included in the Company's IT professional services business segment are Coretech Consulting Group LLC, Fusion Solutions LLC and Xsell Resources Inc which are considered as one reporting unit<sup>a</sup> and Comm-IT Software, Comm-IT Technology Solutions and Comm-IT Embedded, which is a separate reporting unit. The reporting unit of the proprietary and non proprietary software technology segment is comprised of Complete Business Solutions Ltd., Complete Information Technology and all of the Company's other subsidiaries in each of the respective years.

The Company evaluates segment performance based on revenues and operating income of each segment. The accounting policies of the operating segments are the same as those described in the summary of significant

accounting policies. This data is presented in accordance with ASC 280, "Segment Reporting."

Headquarters' general and administrative costs have not been allocated between the different segments.

### **Software services**

The Company develops markets, sells and supports a proprietary and none proprietary application platform, software applications, business and process integration solutions and related services.

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**MAGIC SOFTWARE ENTERPRISES LTD.****AND ITS SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands (except share and per share data)**

NOTE 16:- SEGMENT GEOGRAPHICAL INFORMATION AND MAJOR CUSTOMERS (Cont.)

**IT professional services**

The Company offers advanced and flexible IT services in the areas of infrastructure design and delivery, application development, technology planning and implementation services, communications services and solutions, as well as supplemental staffing services.

There are no significant transactions between the two segments.

b. The following is information about reported segment results of operation:

	Software services	IT professional services	Unallocated expense	Total
2010				
Total revenues	\$46,262	\$ 42,316	\$ -	\$88,578
Expenses	36,556	39,249	3,435	79,240
Segment operating income (loss)	\$9,706	\$ 3,067	\$ (3,435 )	\$9,338
Depreciation and amortization	\$3,610	\$ 615	\$ 341	\$4,566

	Software services	IT professional services	Unallocated expense	Total
2011				

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Total revenues	\$ 58,137	\$ 55,191	\$ -	\$ 113,328
Expenses	44,086	50,468	4,057	98,611
Segment operating income (loss)	\$ 14,051	\$ 4,723	\$ (4,057)	) \$ 14,717
Depreciation and amortization	\$ 3,837	\$ 853	\$ 350	\$ 5,040

2012

Total revenues	\$ 65,410	\$ 60,970	\$ -	\$ 126,380
Expenses	50,497	55,456	4,019	109,972
Segment operating income (loss)	\$ 14,913	\$ 5,514	\$ (4,019)	) \$ 16,408
Depreciation and amortization	\$ 5,937	\$ 1,182	\$ 344	\$ 7,463

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**MAGIC SOFTWARE ENTERPRISES LTD.****AND ITS SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****U.S. dollars in thousands (except share and per share data)****NOTE 16:- SEGMENT GEOGRAPHICAL INFORMATION AND MAJOR CUSTOMERS (Cont.)**

The Company's business is divided into the following geographic areas: Israel, Europe, the United States, Japan and other regions. Total revenues are attributed to geographic areas based on the location of the customers. The Company has adjusted all prior year comparative amounts to reflect this change in classification to be consistent for all periods presented.

The following table presents total revenues classified according to geographical destination for the years ended December 31, 2010, 2011 and 2012:

	Year ended December 31,		
	2010	2011	2012
Israel	\$4,405	\$7,982	\$11,561
Europe	21,788	24,351	29,139
United States	48,888	60,727	64,591
Japan	10,806	12,111	12,661
Other	2,691	8,157	8,428
	\$88,578	\$113,328	\$126,380

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

	December 31,	
	2011	2012
Israel	\$39,567	\$48,452
Europe	1,836	2,171
United States	16,225	15,459
Japan	6,804	6,164
Other	3,895	3,657

\$68,327 \$75,903

e. The Company does not allocate its assets to its reportable segments; accordingly, asset information by reportable segments is not presented.

f. In 2010, 2011 and 2012, the Company had one customer, included in the IT professional services segment, which accounted for 29%, 25% and 19% of the group revenues, respectively.

#### NOTE 17:- SUBSEQUENT EVENTS

On February 14, 2013, the Company declared a dividend distribution of \$ 0.12 per share (\$ 4,397 in the aggregate) which was paid on March 14, 2013. The dividend distribution relates to the Company's earnings in the second half of 2012.

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**MAGIC SOFTWARE ENTERPRISES LTD.****AND ITS SUBSIDIARIES****APPENDIX TO CONSOLIDATED FINANCIAL STATEMENTS**

## DETAILS OF SUBSIDIARIES AND AFFILIATE

Details of the percentage of control of the share capital and voting rights of subsidiaries and an affiliate as of December 31, 2012:

Name of Company	Percentage of ownership and control %	Place of incorporation
Magic Software Japan K.K.	100	Japan
Magic Software Enterprises Inc.	100	U.S.A.
Magic Software Enterprises (UK) Ltd.	100	U.K.
Hermes Logistics Technologies Limited.	100	U.K.
Magic Software Enterprises Spain Ltd.	100	Spain
Coretech Consulting Group Inc.	100	U.S.A
Coretech Consulting Group LLC.	100	U.S.A
Fusion Solutions LLC.	100	U.S.A
Xsell Resources Inc.	100	U.S.A
Magic Software Enterprises (Israel) Ltd.	100	Israel
Magic Software Enterprises Netherlands B.V.	100	Netherlands
Magic Software Enterprises France	100	France
Magic Beheer B.V.	100	Netherlands
Magic Benelux B.V.	100	Netherlands
Magic Software Enterprises GMBH	100	Germany
Magic Software Enterprises India Pvt. Ltd.	100	India
Onyx Magyarorszag Szsoftverhaz .	100	Hungary
Magic Software Ltd.	100	Israel
Magix Integration (Proprietary) Ltd	100	South Africa
Appbuilder Solutions Ltd	100	U.K.
Complete Information Technology Ltd	100	Israel
Complete Business Solutions Ltd	95	Israel
Comm-IT Technology Solutions Ltd	80	Israel
Comm-IT Software Ltd	80	Israel
Comm-IT Embedded Ltd (shares held by Comm-IT Technology Solutions Ltd.)	51	Israel

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Levy Cohen & Co.

Registered Auditors

37 Broadhurst Gardens, London NW6 3QT *Tel: 020 - 7624 2251 Fax: 020 - 7372 2328*  
*E - mail: lc@levy-cohen.co.uk*

To the Board of Directors and Shareholders

Magic Software Enterprises (UK) Limited

We have audited the accompanying balance sheet of Magic Software Enterprises (UK) Limited (the “Company”) as of December 31, 2012 and 2011, and the related profit and loss account and changes in shareholders’ equity for each of the three years in the period ended December 31, 2012. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, based on our audits, the financial statements referred to above present fairly, in all material respects, the financial position of the Company at December 31, 2012 and 2011, and the related profit and loss account and changes in shareholders’ equity for each of the three years in the period ended December 31, 2012, in conformity with U.S. generally accepted accounting principles.

Yours sincerely,

LEVY COHEN & CO.

Registered Auditors and Certified  
Public Accountants

January 30, 2013

J. Cohen

C.P.A. (ISR) Registered to carry out audit work in the UK by The Institute of Chartered Accountants in England and Wales. Details about our audit registration can be viewed at [www.auditregister.org.uk](http://www.auditregister.org.uk) under

R. Shahmoon reference no. C008178288.

ACA

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Levy Cohen & Co.

Registered Auditors

*37 Broadhurst Gardens, London NW6 3QT Tel: 020 - 7624 2251 Fax: 020 - 7372 2328  
E - mail: lc@levy-cohen.co.uk*

To the Board of Directors and Shareholders

Hermes Logistics Technologies Limited

We have audited the accompanying balance sheet of Hermes Logistics Technologies Limited (the "Company") as of December 31, 2012 and 2011, and the related profit and loss account and changes in shareholders' equity for each of the three years in the period ended December 31, 2012. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, based on our audits, the financial statements referred to above present fairly, in all material respects, the financial position of the Company at December 31, 2012 and 2011, and the related profit and loss account and changes in shareholders' equity for each of the three years in the period ended December 31, 2012, in conformity with U.S. generally accepted accounting principles.

Yours sincerely,  
LEVY COHEN & CO.

Registered Auditors and Certified  
Public Accountants

February 8, 2013

J. Cohen

C.P.A. (ISR) Registered to carry out audit work in the UK by The Institute of Chartered Accountants in England and Wales. Details about our audit registration can be viewed at [www.auditregister.org.uk](http://www.auditregister.org.uk) under

R. Shahmoon reference no. C008178288.

ACA

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of

Magic Software Japan K. K.

We have audited the accompanying balance sheets of Magic Software Japan K.K. (the “Company”) as of December 31, 2011 and 2012, and the related statements of operations and cash flows for each of the three years in the period ended December 31, 2012. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2011 and 2012, and the related statements of operations and cash flows for each of the three years in the period ended December 31, 2012 in conformity with accounting principles generally accepted in the United States of America.

Tokyo, Japan

January 30, 2013 /s/ KDA Audit Corporation  
KDA Audit Corporation

Magic Benelux B.V.

*Independent auditor's report*

**Report on the financial statements**

We have audited the accompanying financial statements 2010 of Magic Benelux B.V., Houten, which comprise the balance sheet as at December 31, 2010 and 2009, the profit and loss account and the notes, comprising a summary of the accounting policies and other explanatory information for each of the three years in the period ended December 31, 2010.

*Management's responsibility*

Management is responsible for the preparation and fair presentation of these financial statements and for the preparation of the management board report, both in accordance with U.S. generally accepted accounting principles. Furthermore management is responsible for such internal control as it determines is necessary to enable the preparation of the financial statements that are free from material misstatement, whether due to fraud or error.

*Auditor's responsibility*

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with standards of the Public Company Oversight Board (United States). This requires that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error.

In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

*Opinion with respect to the financial statements*

In our opinion, the financial statements give a true and fair view of the financial position of Magic Benelux B.V. as at December 31, 2010 and 2009 and of its its related statements of operations for each of the three years in the period ended December 31, 2010 in conformity with U.S. generally accepted accounting principles.

**Magic Benelux B.V.**

**Report on other legal and regulatory requirements**

Pursuant to the legal requirement under Section 2:393 sub 5 at e and f of the Dutch Civil Code, we have no deficiencies to report as a result of our examination whether the management board report, to the extent we can assess, has been prepared in accordance with Part 9 of Book 2 of this Code, and whether the information as required under Section 2:392 sub 1 at b-h has been annexed. Further we report that the management board report, to the extent we can assess, is consistent with the financial statements as required by Section 2:391 sub 4 of the Dutch Civil Code.

Dordrecht, January 28, 2011

Verstegen accountants en adviseurs,

Drs. L.K. Hoogendoorn RA MGA

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To the Board of Directors and Shareholders of

Magic (Onyx) Magyarország Szoftverház K ft.

We have audited the accompanying balance sheet of Magic (Onyx) Magyarország Szoftverház Kft. (the “Company”) as of December 31, 2010 and 2009, and the related statements operations, changes in shareholders’ equity and cash flows for each of the three years in the period ended December 31, 2010. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, based on our audits, the financial statements referred to above present fairly, in all material respects, the financial position of the Company at December 31, 2010 and 2009, and the related statements operations, changes in shareholders’ equity and cash flows for each of the three years in the period ended December 31, 2010, in conformity with U.S. generally accepted accounting principles.

Budapest, Hungary /s/ Maria Négyessy  
January 28, 2011 Maria Négyessy  
Reg. Auditor

SIGNATURES

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

MAGIC SOFTWARE  
ENTERPRISES LTD.

By: /s/ Guy Bernstein  
Name: Guy Bernstein  
Title: Chief Executive Officer

Dated: May 13, 2013