MAGIC
SOFTWARE ENTERPRISES LTD

ANNUAL REPORT AND ACCOUNTS 1998

C O N T E N T S

H I G H L I G H T S

- Magic Software forms new "Magic Applications" business division
- Acquisition of new Magic Applications "Magic eMerchant" and "RentPro"
- New distributorships achieved in Korea and Brazil
- Establishment of joint venture subsidiaries Magic Software Japan and Magic Software Enterprises India
- Opening of Research & Development facility in Pune, India
- Magic Software Enterprises receives ISO 9001 Certification
- Magic Enterprise Edition wins 'DBMS Reader's Choice Award' as top application development tool for 1998
- Magic Software opens new East Coast office in New York, USA
- User Conference in Orlando, USA, with over 400 participants from over 40 countries
- Release of Magic Enterprise Edition V8.2 with Euro support.
- Release of Magic/400 V8.2 (Client and Server) for IBM's AS/400 Advanced Series
- Release of Magic for Linux Version 8.2.
- Release of Magic Web Online technology, phase one.

FINANCIAL HIGHLIGHTS

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

	1997	1998
Sales	37,432	38,760
Research and development costs	3,348	(2,797)
Operating income	(9,676)	(5,950)
Income before taxes	(10,164)	(6,272)
Taxes on income	476	50
Net income	(10,454)	(6,459)
Earnings per share	(2,15)	(1,10)
Weighted average number of shares outstanding	4,978	5,739

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

	1997	1998
Working capital	(550)	5,269
Total assets	29,192	32381
Short-term debt including current maturities	3,345	436
Payable to parent and affiliated companies	691	-
Shareholders' equity	11,436	17,136

ABOUT THE COMPANY

Magic Software Enterprises ("MSE") develops and markets application development technology, applications, and associated services. MSE's suite of products and services enables companies to solve business problems while leveraging their existing resources and taking advantage of emerging technologies.

In Magic, the

Magic Software Enterprises was established in 1986. It has been a public, NASDAQ-traded company (NASDAQ: MGIC) since 1991, and employs more than 560 people worldwide. Magic's products and services are available through a global network of subsidiaries, distributors, and Magic Solutions Partners in more than 50 countries.

Magic Software Enterprises develops, markets and supports its flagship product, Magic Enterprise Edition (Magic), a highly productive, cross-platform development and deployment environment for building e-commerce and enterprise level applications. In Magic, the time it takes to build and maintain mission-critical applications is drastically reduced. The developer builds sophisticated, strategic applications by using a unique, engine-based, programming paradigm which eliminates the repetitive and tedious aspects of coding.

Magic has repeatedly been proven the most rapid development technology on the market at industry developer competitions, customer sites, and in analyst evaluations. Magic's uniform development paradigm across a wide range of platforms, architectures, and the Internet, means that an organization needs only one technology and one set of development skills to develop for an enterprise-wide mix of platforms, architectures, and deployment environments.

Magic's decisive technological advantage has proven the competitive advantage of many MIS departments and independent software vendors. Its rapidity and portability let them deliver working prototype applications in days rather than weeks or months, directly resulting in reduced project costs, time frames, and ongoing maintenance overhead.

MSE markets selected "Magic Applications", the elite of the applications developed by its base of Magic Solutions Partners, in various vertical and horizontal markets. Magic Software's Professional Services provide product maintenance, technical support, installation services, application development services, consulting, project management, and Magic University training to help our clients and partners obtain the maximum from their investment.

MSE recently joined the Formula Group (TASE: FORMULA, NASDAQ: FORTY), Israel's largest public software group. Significant investments of Formula Group in Mashov Computers and directly in MSE have resulted in Formula Group holding approximately 53% of Mashov and 26% of MSE.

With over 100,000 development units and 1,300,000 end-user deployment units sold to date, Magic's installed base of corporate IS system staff, VARs, systems integrators, independent developers and software publishers, is continually growing. Magic solutions perform strategic functions in some of the world's most prestigious organizations including McKesson HBOC, Ernst & Young, Hitachi, Seimens Nixdorf, Club Med, Financial Times, Gap, Johnson & Johnson, Philip Morris, Saab, and many more.

TIME

It takes to build and maintain mission critical apps is drastically reduced

LETTER TO THE SHAREHOLDERS

1998 Was A For Magic

David Assia

Jack Dunietz

Dear Shareholders:

1998 was a turnaround year for Magic Software Enterprises. The year began with heavy losses, but reversed half-way through to deliver a profitable third quarter and the best fourth quarter in our Company's history. Revenues for 1998 increased to $38.8 million from $37.4 million recorded in the previous year. Net loss for the year was $6.5 million compared to the $10.5 million loss posted for 1997. MSE increased its gross margin percentage from approximately 60% in the fourth quarter of 1997 to roughly 66% in the fourth quarter of 1998. MSE's cash position tripled, from $1.4 million in the fourth quarter of 1997 to $5.8 million in 1998.

Early in the year we identified a need for strong financial backing to provide us with credibility and a guarantee of existence into the medium and long term to show to our potential and existing customers. This we managed to procure from Formula Systems, Israel's largest software group, who invested $12 million in MSE during the course of 1998.

Following heavy losses incurred in the first half of the year, we performed a major restructuring in mid 1998. In response to continuing market signals of a shift towards solutions purchase and away from development tools, we decided to reposition the company as a provider of broader business solutions for the enterprise market. At the same time, we continue to strengthen our core expertise as a premier provider of a rapid application development environment. We have realized that the future of our industry belongs to those who can integrate a broad spectrum of tools, applications, and associated services, under a single offering. Acting upon this realization, we now offer complementary applications, training, and services to our customers, where before we concentrated mostly on our development tool.

In 1998 we introduced Magic V8.20 for the Windows, AS/400 and UNIX platforms. This received an extremely positive response from industry analysts, media, and customers, who are increasingly using the software to develop e-commerce and Web-based applications. We continue to nurture and focus on our strategic relationship with IBM's AS/400 division, and achieved significant sales in 1998 on this platform, including sales to German furniture supplier Moebel Unger, US-based Paradise Cruises and many others.

We embarked upon an aggressive cost containment program, which has significantly lowered operating and SG&A expenses. This was

Turnaround Year Software Enterprises

evidenced by the fourth quarter decline of 33% in cost of software sales, 14% in sales and marketing expenses, and 10% in G&A. Around the world, we've raised productivity and shed costs. The efficiency story is repeated all across MSE as our departments and subsidiaries challenge themselves to achieve lower costs, greater efficiency and higher productivity.

An integral part of our new strategy is our determination to leverage our international presence, which our larger, multinational enterprise customers demand. As part of our efficiency story, we are forging a more cohesive and tightly knit corporate identity. We are fostering teamwork between our departments and subsidiaries across the world; encouraging sharing and reuse of labor, skills, materials, and expertise. Not only, in this way, do we cut costs, but we also increase sales, encouraging distributors and subsidiaries to leverage one another's experience and base of customer references to their mutual benefit. We look forward to extending this in 1999 to include our broader channel of Value Added Resellers and Magic Solutions Partners in the actualization of an identifiable, self-aware, Magic Community of developers and users.

MSE made several investments in 1998 to strengthen its position as a solutions provider. We purchased a 75% interest in MRTI, an Israeli company that develops and markets a leading car rental application developed using Magic, and acquired the rights to “Magic eMerchant,” a Magic-based, ecommerce, business-to-business application.

MSE is committed to Asia/Pacific as a promising growth market for the 21st century. We signed an agreement with Wacom, MSE exclusive distributor in Japan for the past 10 years, to form “Magic Software Japan,” a Japanese subsidiary held 80% by MSE and 20% by Wacom. MSE increased its equity holding in Magic (Infotech) India (MII) from 30% to 51%, and took a two-year option to acquire 60% of Next Step, an Indian software house specializing in banking. We have just signed an agreement to acquire a controlling interest in Magic Thailand, our Thai distributor for the last eight years, and in Magic Group Australia, our Australian distributor.

MSE invested heavily in the future during 1998. We added significantly to our talent base, focused our strategy, increased our operating efficiency, and took steps to expand and adapt our product offering to facilitate penetration into new markets and industries, while improving service to our existing loyal customer base.

We are confident that 1999 will be a record-breaking year for our company.

Yours sincerely,

David Assia
Executive Chairman

Jack Dunietz
CEO

M c K E S S O N H B O C

Name: McKessonHBOC
Headquarters: London, UK
Business: Software and technology provider to the health industry
Product: Pathways patient administration system

McKessonHBOC

McKessonHBOC, the world's largest supplier of software solutions and technological innovations to the health industry, turned to Magic to develop Pathways – a new patient administration system for deployment by health services throughout Europe and across the globe. Pathways handles everything from management of patient referrals, patient flow, and contract administration, to hospital and outpatient scheduling and access to archive data. Pathways runs on MS Windows NT and SQL Server, and McKessonHBOC plans to use Magic to quickly port Pathways to many other RDBMS and operating environments.

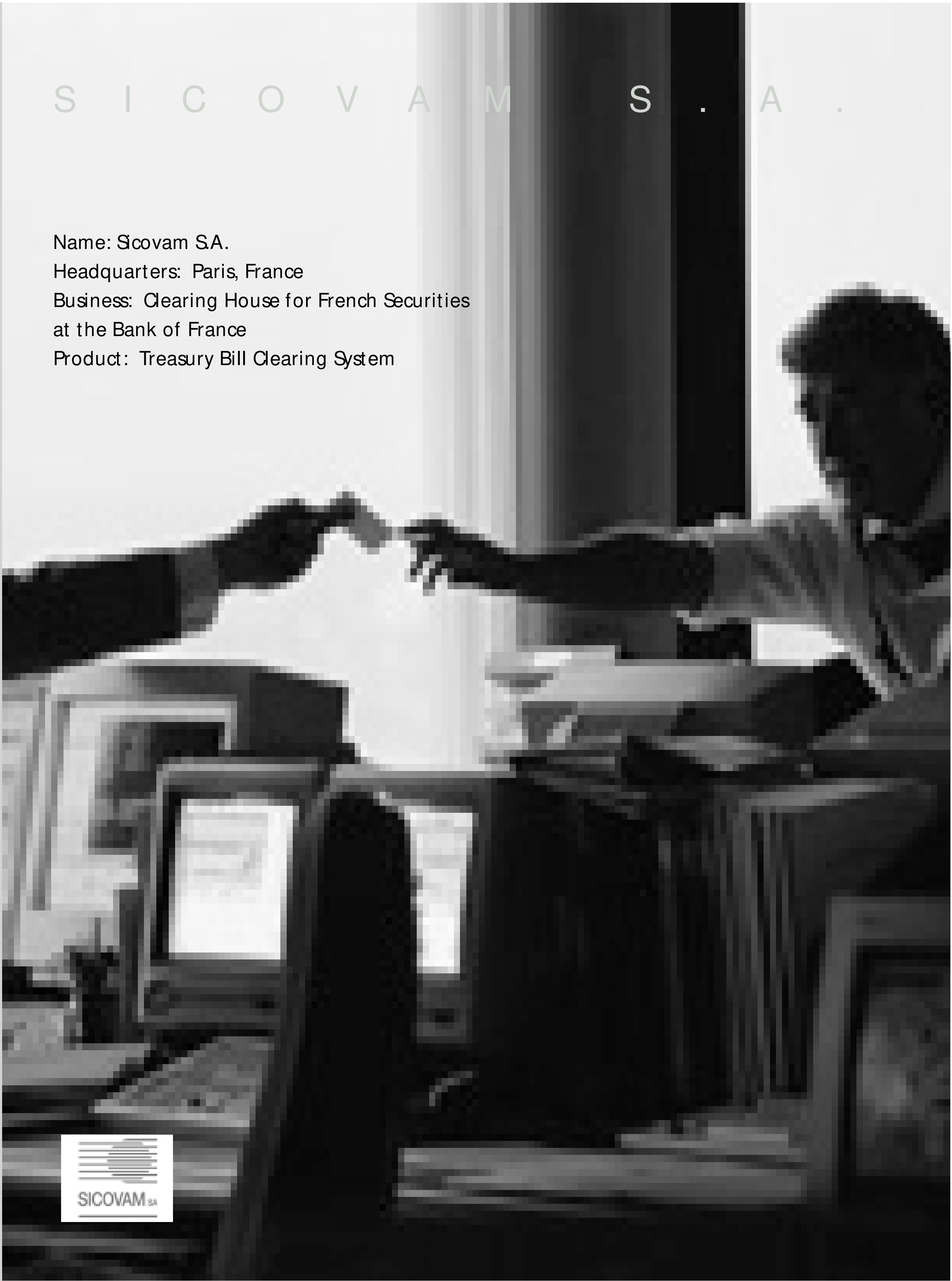
Magic Allows Us to Develop Pathways In a Modular Fashion

"Adaptability is vital to healthcare providers…products must employ an open systems architecture that enables them to add functionality without making their current systems obsolete. Magic allows us to develop Pathways in a modular fashion."

Peter Loomes
Program Manager, McKessonHBOC

S I C O V A M S . A .

Name: Sicovam S.A.
Headquarters: Paris, France
Business: Clearing House for French Securities
at the Bank of France
Product: Treasury Bill Clearing System



SICOVAM SA

Sicovam S.A., established in 1949, keeps in custody and clears all trades for the Central French Securities Depository, handling over $1 billion in trades a day. They selected Magic Solutions Partner ESDS to build the Euro-compliant system, RGV, in Magic, following a failed project begun with another tool in 1995. RGV manages Sicovam's off-market trading and treasury bonds operations with real-time delivery against payment and a turnkey client workstation. RGV, developed in only 11 months, is the only system to have received unreserved approval from the European Central Bank. Thanks to RGV, Paris is the world's only financial center to offer Euro transactions, settled with central bank money, in real time.

Magic Could Quickly React In an Ever-Changing Business Environment

"Euro issues are behind us. ESDS's ability to implement RGV within such a tight deadline showed how well Magic could meet our needs and quickly react in an ever-changing business environment."

Jean-Marc Eyssautier
Executive Vice President of
Marketing, Sicovam S.A.

S Y N T E L

Name: Syntel Financial Software
Headquarters: Reeuwijk, The Netherlands
Business: Financial Services Software Provider
Product: EuroPort

Syntel
FINANCIAL SOFTWARE

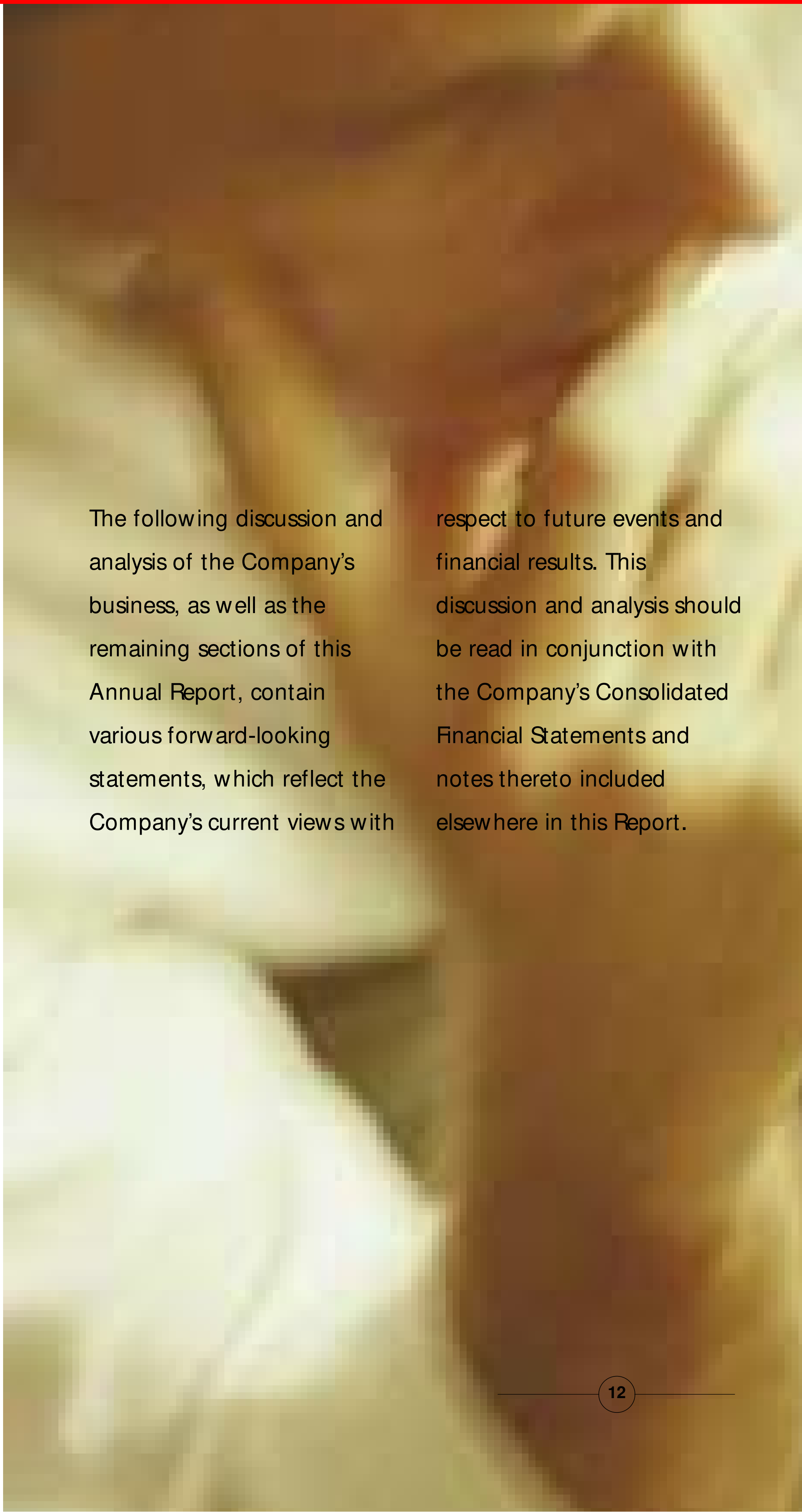
Syntel Financial Software, established in 1979, is a leading Magic Solutions Partner. Syntel numbers amongst its clients a distinguished list of international banks. Syntel used Magic to develop EuroPort, a sophisticated banking system for administration of securities, derivatives, current accounts, custodial accounts, and all related activities for the real-time pricing and administration of stocks and bonds. EuroPort features an Internet browser-enabled front end, which enables clients to trade stocks and bonds online by directly accessing the relevant financial markets. EuroPort runs on C-ISAM, Oracle, and the IBM RS/6000.

With Magic, we can rapidly develop transaction-intensive e-business systems

"With Magic, we can rapidly develop transaction-intensive e-business systems, enabling us to lead the way in a competitive and demanding market."

Marco Grimberg, Marketing Manager,
Syntel Financial Software.

M A N A G E M E N T



The following discussion and analysis of the Company's business, as well as the remaining sections of this Annual Report, contain various forward-looking statements, which reflect the Company's current views with respect to future events and financial results. This discussion and analysis should be read in conjunction with the Company's Consolidated Financial Statements and notes thereto included elsewhere in this Report.

The Company's consolidated financial statements are stated in U.S. dollars and prepared in accordance with Israeli GAAP and U.S. GAAP, which as applicable to these financial statements are practically identical in all material respects. The currency of the primary economic environment in which the operations of the Company are conducted is the U.S. dollar which is the functional and reporting currency of the Company and its subsidiaries.

Transactions and balances originally denominated in U.S. dollars are presented at their original amounts. Transactions and balances in other currencies are remeasured into dollars in accordance with the principles set forth in Financial Accounting Standards Board ("FASB") Statement No. 52. Remeasurement of gains and losses are included in financial income and expense.

ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

Income Statement Data:

	1994	1995	1996	1997	1998
	Year Ended December 31, (In thousands, except per share data)				
Revenues:					
Software sales	$18,764	$19,856	$28,085	$24,026	$20,479
Services	2,608	5,528	8,331	13,406	18,281
Total revenues	21,372	25,384	36,416	37,432	38,760
Costs of revenues:					
Software sales	3,604	3,103	4,085	4,327	2,994
Services	2,068	4,484	7,108	10,402	12,352
Total cost of revenues	5,672	7,587	11,193	14,729	15,346
Gross profit	15,700	17,797	25,223	22,703	23,414
Operating expenses:					
Research and development, net	2,158	2,878	2,611	3,348	2,797
Selling and marketing, net	10,712	11,391	15,963	17,520	16,073
General and administrative	2,879	3,757	4,112	6,090	7,817
Restructuring and other non-recurring expenses	-	-	-	5,421	2,677
Total operating expenses	15,749	18,026	22,686	32,379	29,364
Operating income (loss)	(49)	(229)	2,537	(9,676)	(5,950)
Financial expenses, net	1,249	66	521	488	322
Income (loss) before income taxes	(1,298)	(295)	2,016	(10,164)	(6,272)
Income taxes	190	333	456	476	50
	(1,488)	(628)	1,560	(10,640)	(6,322)
Equity in earnings (loss) of an affiliate	-	67	(115)	(51)	(149)
Minority interest in losses (earnings) of consolidated subsidiary	88	123	(47)	237	12
Net income (loss)	$ (1,400)	$ (438)	$ 1,398	$ (10,454)	$ (6,459)
Basic earnings (loss) per share	$ (0.34)	$ (0.10)	$ 0.30	$ (2.15)	$ (1.10)
Shares used to compute basic earnings (loss) per share	4,158	4,303	4,720	4,853	5,870
Diluted earnings (loss) per share	$ (0.34)	$ (0.10)	$ .029	$ (2.15)	$ (1.10)
Shares used to compute diluted earnings (loss) per share	4,158	4,303	4,975	5,042	5,870

Balance Sheet Data:

	1994	1995	1996	1997	1998
Working capital (deficit)	$ 7,376	$ 6,213	$9,820	$(519)	$ 5269
Total assets	20,436	24,559	34,007	29,192	32,381
Total debt	535	1,955	990	3,345	436
Shareholders' equity	14,889	15,109	21,956	11,436	17,136

ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

Overview

The Company was established in 1983 and completed an initial public offering of its Ordinary Shares in the United States in August 1991. In 1994, the Company began to experience a number of changes in its business environment which impacted on its operating and financial performance. As a result of the strong acceptance of the Windows operating system, sales of the DOS version of Magic began to decline. As a result, the Company began focusing on sales to cross platform client/server environments for use in large departments or on an enterprise-wide basis. In addition, the Company accelerated its development of a Windows compatible product which was released in September 1995.

With the introduction and shipment of its Windows-based product, Magic 6, and its ability to offer advanced client/server functionality, the Company began to realize accelerated sales growth and a return to profitability in 1996. In 1996, the Company had sales of $36.0 million and net income of $1.4 million.

The enterprise market generally requires a longer sales cycle and a greater degree of up-front support. In order to facilitate the sales of its tools for UNIX VMS, IBM AS/400, Windows, and other client/server environments into this market, the Company increased its sales force in a number of countries, including the United Kingdom, Germany and France. The UK also began to offer an increasing amount of fee-based consulting services and technical support throughout the produce life cycle. The cumulative impact of these changes was a decline in the Company's rate of growth, an increase in services as a percentage of revenues as well as an increase in sales, marketing and research and development expenses.

In 1998, the Company incurred a net loss of approximately $6.5 million due to its financial results in the first two quarters of the year. Of such amount $2.68 million was attributable to non-recurring expenses, a provision for doubtful receivables of $1.2 million (mainly in Southeast Asia) and expenses resulting from the Company's restructuring plan, especially in the Israeli sales office, which began in 1997. The Company further attributes its losses to the continuing trend of organizations to purchase packaged application for enterprise information management instead of building them.

As a result of improved margins, a significant reduction in expenses, increase in revenues in France and Germany and a positive contribution from Magic USA, the Company returned to profitability in the third quarter of 1998. The Company also

ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

benefited from a sharp increase in earnings from its maintenance, consultancy and other services. Such increase was a result of the Company's adoption of a strategic decision to become a provider, together with its MSPs, of complete solutions to key vertical markets and business processes as well as being a provider of development tools.

Accounting Matters

Revenues from software license agreements are recognized upon delivery of the software if: (i) collection is probable, (ii) all license payments are due within one year, (iii) the license fee is fixed or determinable, (iv) vendor - specific evidence exist to allocate the total fee to the undelivered elements of the arrangement, and (v) persuasive evidence of an arrangement exists.

Revenues from consulting services, maintenance contracts and training are recognized ratably over the contractual period or as services are performed.

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

Royalty-bearing grants from the Government of Israel and others for funding certain approved research projects and marketing activities are recognized at the time the Company is entitled to such grants on the basis of the related costs incurred. The Company applied during 1998 to the BIRD-F with the objective of canceling the agreement it had reached in the past which amounted to $350,000.

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

	Year Ended December 31,		
	1996	1997	1998
Total research and development costs	$6,950	$6,758	$4,080
Less royalty bearing grants	(1,922)	(285)	--
Less capitalization of software	(2,417)	(3,125)	(1,283)
Research and development, net	$2,611	$3,348	$2,797

ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

Results of Operations

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

	1996	1997	1998
Revenues:			
Software sales	77%	64%	53%
Services	23	36	47
Total revenues	100	100	100
Cost of revenues:			
Software sales	11	12	8
Services	20	28	32
Total cost of revenues	31	40	40
Gross profit	69	60	60
Operating expenses:			
Research and development, net	7	9	7
Selling and marketing, net	44	47	41
General and administrative expenses	11	16	20
Restructuring and other non-recurring expenses	0	14	7
Total operating expenses	62	86	75
Operating income (loss)	7	(26)	(15)
Financial income (expenses), net	(1)	(1)	(1)
(Loss) income before income taxes	6	(27)	(16)
Income taxes	(2)	(1)	0
Equity in earnings of an affiliate	0	0	0
Minority interest in losses of consolidated subsidiary	0	1	0
Net (loss) income	4%	(27)%	(16)%

ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

Year Ended December 31, 1998 Compared with Year Ended December 31, 1997

Total Revenues. Revenues consist primarily of: (i) software sales (ii) maintenance and technical support and (iii) services (including consulting services and training). Total revenues increased 3.5% to $38.8 million in 1998 from $37.4 million in 1997. Software sales decreased 14.8% to $20.5 million in 1998 from $24.0 million in 1997. This decrease was principally attributable to the decline in software revenues in Japan and Southeast Asia, where economic turmoil disrupted sales. Revenues from technical support and maintenance increased 37.8% to $5.8 million in 1998 from $4.2 million in 1997 and revenue from services increased 35.7% to 12.5 million from 9.2 million in 1997. This growth, mainly in Europe, reflects the Company's increased efforts to grow its fee-based consulting and training services to external contractors.

Cost of Revenues. Cost of revenues for software sales consists primarily of: (i) amortization of capitalized software; (ii) software production costs (including media, packaging, freight and documentation); (iii) certain royalties and licenses payable to third parties (including the Chief Scientist); and (iv) pre-sale technical support costs. Cost of revenues for services consists primarily of personnel expenses and other related costs. Cost of revenues for maintenance and technical support consists primarily of personnel expenses for the European and Israeli technical support center and other related costs. Cost of revenues increased 4.2% to $15.3 million in 1998 from $14.7 million in 1997. Costs of revenues for software sales decreased 30.8% in 1998 to $3.0 million from $4.3 million in 1997 as a result of the decline in software production to the Japanese market. Cost of revenues for services increased 17.4% to $9.0 million in 1998 from $7.7 million in 1997 as a result of the Company's shift from software sales to services. Cost of revenues for maintenance and technical support increased 22.7% to $3.3 million in 1998 from $2.7 million in 1997.

Gross profit. Gross profit increased 3.1% to $23.4 million in 1998 from $22.7 million in 1997. In 1998, the Company's gross margin (gross profit as a percentage of total revenues) on software sales increased to 85% from 82% in 1997. The Company's gross margin on services increased to 28% in 1998 from 16% in 1997. The Company's gross margin on maintenance and technical support increased to 43% in 1998 from 37% in 1997. The Company expects its gross margin to vary in the future due to changes in the composition of its revenue and its product and customer mix.

ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

Research and Development, Net. Research and development costs consist primarily of salaries of employees engaged in on-going research and development activities and other related costs. Grants for research and development and the capitalization of software development expenses are applied as reductions to total research and development costs to calculate net research and development expenses. Total research and development costs decreased to $4.1 million in 1998 from $6.8 million in 1997. The decrease was primarily a result of the decreased expenses associated with the restructuring plan. Net research and development costs decreased to $2.8 million in 1998 from $3.3 million in 1997. The Company did not receive any grants from the Chief Scientist in 1998 as compared to $285,000 in 1997. The Company did not accrue any grants from the BIRD-F in 1998. The Company expects that its total research and development costs as a percentage of sales will decrease approximately 3.8% in 1999 as compared to 1998.

In 1998 the Company reached an agreement with the Chief Scientist according to which the Company will pay royalties on all of the Company's consolidated revenues. As a result, the Company provided for the full amount of the royalty commitment, which amounted to approximately $1.0 million.

Selling and Marketing, Net. Selling and marketing expenses consist of costs relating to promotion, advertising, trade shows and exhibitions, compensation, sales support, travel and related expenses and royalties payable to the Israeli Government's Fund for the Encouragement of Marketing Activities (the "Marketing Fund"). Selling and marketing expenses decreased 8% to $16.1 million in 1998 from $17.5 million in 1997. Selling and marketing expenses as a percentage of sales decreased to 41.5% in 1998 from 46.8% in 1997, principally as a result of the decrease in software sales. The Company expects that selling and marketing expenses will increase in 1999 as a result of the planned increase in marketing and sales efforts for the Company's new products, but are expected to decrease as a percentage of sales.

General and Administrative. General and administrative expenses consist of compensation costs for administration, finance and general management personnel and office maintenance and administrative costs. General and administrative expenses increased to $7.8 million in 1998 from $6.1 million in 1997. The increase was primarily attributable to the costs associated with the Company's increased activities in the United States, Germany and France - and the overall growth in the Company's operations.

ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

General and administrative expenses as a percentage of revenues increased to 20.2% in 1998 as compared to 16% in 1997. The Company expects that general and administrative expenses will increase by 54% in 1999 compare to 1998 and as a percentage of sales will decrease 1% as a result of the continued growth in the Company's operations.

Financial Income (Expenses), Net. Financial expenses consist of interest expense from borrowings and currency transaction adjustments and financial income consists of income on cash and cash equivalent balances. The Company's financial expenses were $322,000 in 1998 as compared to financial expenses of $488,000 in 1997 as a result of Formula's equity investment in the Company during the second half of 1998, which helped the Company to reduce its bank liabilities, and due to the positive trend in European currencies.

Income Taxes. The Company incurred income taxes of $50,000 in 1998 and $476,000 in 1997. These taxes are attributable to withholding taxes paid in Japan on the royalty payments received by the Company from its Japanese distributor. The Company did not pay any taxes in Israel in either period. The Company expects that it will continue to be unable to offset its withholding taxes in Japan against taxable income in Israel in 1999.

Equity in Results of Affiliates. Equity in earnings of an affiliate represent the Company's proportionate share of Micronova, MII, MRTI, and Magic Thailand. In 1998, the Company recognized a loss of $45,000 from its 42% minority interest in Micronova and 20% minority interest in Magic Thailand as compared to a loss of $13,000 in 1997. In 1998 the Company also recognized a loss of $95,000 from its 20% minority interest in MRTI and its 35% minority interest in MII.

Minority Interest in Profits of Consolidated Subsidiaries. Minority interest in profits of consolidated subsidiaries represents the minority shareholders' share of the profits of the subsidiaries, Magic Benelux and Magic Italy, in which the Company currently holds 100% and 81% interests, respectively. In 1998, the Company recognized a minority interest of $12,000 from the losses attributed to the minority shareholders of Magic Benelux and Magic Italy as compared to $237,001 from the losses attributed to such minority shareholders in 1997.

Net Income (Loss). As the result of the foregoing, the Company incurred a net loss of $6.5 million or ($1.10) per share for the year ended December 31, 1998 as compared to a net loss of $10.5 million or ($2.15) per share in the year ended December 31, 1997.

ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

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

Total Revenues. Total revenues increased 3% to $37.4 million in 1997 from $36.4 million in 1996. Software sales decreased 15% to $24.0 million in 1997 from $28.1 million in 1996. This decrease was principally attributable to the shift in product sales from the department level to the enterprise level and a change in the buying habits of the Company's larger customers. Revenues from services increased 61% to $13.4 million in 1997 from $8.3 million in 1996. This growth, mainly in Europe, reflects the Company's increased efforts to grow its fee-based consulting and training services to external contractors. Revenue from maintenance and technical support increased 366% to $4.2 million in 1997 from $1.1 million in 1996 due to the Company's great efforts to grow its fee based maintenance and support contracts.

Cost of Revenues. Cost of revenues increased 32% to $14.7 million in 1997 from $11.1 million in 1996. Costs of software sales increased 5% in 1997 to $4.3 million from $4.1 million in 1996. Cost of services increased 22% to $7.7 million in 1997 from $6.3 million in 1996. Costs of maintenance and technical support increased 338% to $2.7 million in 1997 from $800,000 in 1996.

Gross profit. Gross profit decreased 10% to $22.7 million in 1997 from $25.2 million in 1996. In 1997, the Company's gross margin (gross profit as a percentage of total revenues) on software sales decreased to 82% from 85% in 1996. The Company's gross margin on services increased to 16% in 1997 from 12% in 1996. The Company's gross margin on maintenance and technical support increased to 36% in 1997 from 30% in 1996.

Research and Development, Net. Total research and development costs decreased slightly to $6.8 million in 1997 from $6.9 million in 1996. The decrease was primarily a result of the decreased expenses associated with the postponing of additional development of the next generation "Leapfrog" product. Net research and development costs increased to $3.3 million in 1997 from $2.6 million in 1996 primarily because of a decrease in grants from the Chief Scientist. The Company received $285,000 in grants from the Chief Scientist in 1997 as compared to $1.5 million in 1996.

Selling and Marketing, Net. Selling and marketing expenses increased 9.8% to $17.5 million in 1997 from $16.0 million in 1996. Selling and marketing expenses as a percentage of sales increased to 46.8% in 1997 from 43.8% in 1996, principally as a

ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

result of the decrease in software sales. The Company accrued grants of $156,000 in 1997 from the BIRD-F.

General and Administrative. General and administrative expenses increased to $6.1 million in 1997 from $4.1 million in 1996. The increase was primarily attributable to the costs associated with the Company's increased activities in the United States, the Netherlands and the United Kingdom and the overall growth in the Company's operations. General and administrative expenses as a percentage of revenues increased to 16% in 1997 as compared to 11% in 1996.

Financial Income (Expenses), Net. The Company's financial expenses were $488,000 in 1997 as compared to financial expenses of $521,000 in 1996.

Income Taxes. The Company incurred income taxes of $476,000 in 1997 and $456,000 in 1996. These taxes are attributable to withholding taxes paid in Japan on the royalty payments received by the Company from its Japanese distributor which declined substantially in [1997]. The Company did not pay any taxes in Israel in either period.

Equity in Results of Affiliates. In 1997, the Company recognized a loss of $13,000 from its 42% minority interest in Micronova as compared to a loss of $115,000 in 1996, and recognized a loss of $38,000 from its 20% minority interest in Magic Thailand.

Minority Interest in Profits of Consolidated Subsidiaries. In 1997, the Company recognized a minority interest of $237,001 from the losses attributed to the minority shareholders of Magic Benelux and Magic Italy as compared to $47,000 in profits attributed to the minority shareholders in 1996.

Net Income (Loss). As the result of the foregoing, the Company incurred a net loss of $10.5 million or ($2.15) per share for the year ended December 31, 1997 as compared to net income of $1.4 million or $0.30 per share in the year ended December 31, 1996.

QUARTERLY RESULTS OF OPERATIONS

The following tables set forth certain unaudited quarterly financial information for the two years ended December 31, 1998. The data has been prepared on a basis consistent with the Company's audited financial statements included elsewhere in this Report and includes all necessary adjustments, consisting only of normal recurring accruals that the Company considers necessary for a fair presentation. The operating results for any quarter are not necessarily indicative of results for any future periods.

1997 QUARTER ENDED 1998

(In thousands, except per share data)

	March 31, 1997	June 30, 1997	Sept. 30, 1997	Dec. 31, 1997	March 31, 1998	June 30, 1998	Sept. 30, 1998	Dec. 31, 1998
Revenues:								
Software sales	$6,778	$5,272	$5,841	$6,135	$4,594	$4,642	$4,702	$6,542
Services	2,787	3,814	3,307	3,498	3,591	4,200	4,642	5,848
Total revenues	9,565	9,086	9,148	9,633	8,186	8,842	9,343	12,389
Cost of revenues:								
Software sales	1,287	1,195	759	1,086	604	725	938	727
Services	2,079	2,942	2,660	2,721	2,536	3,153	2,729	3,498
Total cost of revenues	3,366	4,137	3,419	3,807	3,140	3,878	3,666	4,225
Gross profit	6,200	4,948	5,729	5,825	5,046	4,964	5,677	8,164
Operating expenses:								
Research and development, net	714	930	848	856	806	717	661	613
Selling and marketing, net	4,448	4,486	3,484	5,102	3,882	4,545	3,797	4,377
General and administrative	1,218	1,406	1,684	1,782	1,463	3,565	1,182	1,607
Restructuring and other non-recurring costs	2,703	-	2,718	--	2,677	--	--	
Total operating expenses	6,380	9,525	6,016	10,455	6,151	11,504	5,640	6,597
Operating income (loss)	182	4,575	287	4,632	(1,105)	(6,448)	37	1,567
Financial income (expenses), net	(210)	(106)	(113)	(59)	112	(47)	(110)	272
Capital gain	-	-	-	5	--	--	--	--
Income (loss) before income taxes	(385)	(4,689)	(400)	(4,621)	(1,217)	(6,496)	147	1,295
Income taxes	144	84	124	124	25	11	--	14
Equity in earnings (loss) of an affiliate	2	(62)	(30)	39	(70)	16	(30)	(65)
Minority interest in losses (earnings) of a consolidated subsidiary	33	54	(24)	174	73	(29)	--	(32)
Net income (loss)	494	4,781	578	4,602	(1,239)	(6,520)	117	1,184
Net income (loss) per share	($0.10)	($0.98)	($0.12)	($0.09)	($0.25)	(1.15)	$0.02	$0.18

QUARTERLY RESULTS OF OPERATIONS

	1997				QUARTER ENDED 1998			
	(In thousands, except per share data)							
	March 31,	June 30,	Sept. 30,	Dec. 31,	March 31,	June 30,	Sept. 30,	Dec. 31,
Revenues:								
Software sales	71%	58%	64%	64%	56%	52%	50%	53%
Services	39	42	36	36	44	48	50	47
Total revenues	100	100	100	100	100	100	100	100
Cost of revenues:								
Software sales	13	13	8	11	7	8	10	6
Services	22	32	29	29	32	36	30	29
Total cost of revenues	35	45	37	40	40	44	39	34
Gross profit	65	54	63	60	60	56	61	66
Operating expenses:								
Research and development, net	7	10	9	9	10	8	7	5
Selling and marketing, net	46	49	38	53	46	50	41	35
General and administrative	13	15	18	19	18	40	13	13
Restructuring and other non-recurring costs	--	30	--	28	0	30	0	0
Total operating expenses	66	104	65	109	74	128	56	53
Operating income (loss)	(1)	(50)	(3)	(49)	(13)	(73)	0	13
Financial income (expenses), net	(1)	(1)	(1)	(1)	(1)	1	(1)	2
Income (loss) before income taxes	(4)	(52)	(4)	(48)	(15)	(73)	2	10
Income taxes	2	1	1	1	0	0	0	0
Equity in earnings (loss) of an affiliate	(1)	0	0	0	(1)	0	0	(1)
Minority interest in losses (earnings) of a consolidated subsidiary	0	1	(1)	2	1	0	0	0
Net income (loss)	5%	53%	6%	48%	(15%)	(74%	1%	10%

LIQUIDITY AND CAPITAL RESOURCES

Liquidity and Capital Resources

At December 31, 1998, the Company had $5.8 million in cash and cash equivalents and working capital of $5.3 million as compared to $1.38 million in cash and cash equivalents and a $519,000 working capital deficit at December 31, 1997.

In 1998, the Company incurred a net loss of approximately $6.5 million, although it returned to profitability in the third quarter of 1998. Such loss included $2.68 million of non-recurring expenses, a provision for doubtful receivables of $1.2 million and expenses resulting from the restructuring plan initiated by the Company in 1997.

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

In April 1998, the Company completed a private transaction pursuant to which it sold 800,000 Ordinary Shares of the Company (representing approximately 15% of the Company's Ordinary Shares) in consideration of $4.0 million to Formula, an Israeli software company. The Company further granted to Formula a right of first refusal in the event of the issuance of additional securities by the Company for the period ended June 30, 1999.

In July 1998 the Company raised an additional $3.5 million in capital through the sale of 1,000,000 Ordinary Shares to Mashov and in December 1998 the Company raised an additional $4.8 million through the sale of 1,200,000 of the Company's Ordinary Shares to Formula.

In January 1998 the Company entered into an agreement with Wacom for the formation of a new subsidiary, MSJ. In January 1999 the Company increased its ownership interest in MSJ to 80% and MSJ assumed full responsibility for all business and research and development activities of Magic in Japan. In connection with the Company's obtaining the rights relating to the Japanese versions of Magic's products, MSJ agreed to pay Wacom $3.0 million, of which $1.5 million was paid by the Company as of June 30, 1999, an additional $500,000 will be paid by the end of 1999 and the $1.0 million balance will be paid as royalties in fixed quarterly payments over a four-year period ending in 2003. In addition, MSJ agreed to pay Wacom a preferred dividend at the rate of 35% of its

LIQUIDITY AND CAPITAL RESOURCES

net income, commencing in the first quarter of 1999. MSJ's undertaking to pay such cash dividend will expire upon the occurrence of the earlier of (i) the 32nd quarterly payment, or (ii) the accumulated payment of $1.8 million.

The Company anticipates that its cash requirements for the foreseeable future will be satisfied by cash flows from operations, existing cash and, if needed, short-term borrowings. The Company has no significant financial commitments outstanding other than those relating to the new subsidiary in Japan and to the development and introduction of new products.

The Year 2000 Issue

Many currently installed computer systems and software products are coded to accept only two digit entries in the date code field. Beginning in the year 2000, these date code fields will need to accept four digit entries to distinguish twenty-first century dates from twentieth century dates. As a result, in less than a year computer systems and/or software used by many companies may need to be upgraded to comply with such "Year 2000" requirements. Significant uncertainty exists in the software industry concerning the potential effects associated with such compliance. Although Magic releases starting with version 5.0 are designed to be Year 2000 compliant, earlier releases prior to version 5.0 are not. There can be no assurance that the Company's software products that are designed to be Year 2000 compliant contain all necessary date code changes.

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

Although the Company believes that it has identified substantially all of the major computers, software applications and related equipment used in connection with its internal operations that must be modified, upgraded, or replaced to minimize the possibility of a material disruption to its business, the Company

LIQUIDITY AND CAPITAL RESOURCES

cannot provide any assurance to this effect. The Company has commenced the process of modifying, upgrading and replacing major systems that have been identified as adversely affected and expects to complete this process in a timely manner.

In addition to computers and related systems, the operation of the office and facilities equipment of the Company, such as fax machines, photocopiers, telephone switches, security systems and other common devices, may be affected by the year 2000 problem. The Company is currently assessing the potential effect of, and costs of remediating, the year 2000 problem on its office and facilities equipment. The Company estimates that the total cost of completing the required modifications, upgrades or replacements of these internal systems will not have a material adverse effect on its business or results of operations but it cannot provide any assurance to this effect.

The Company has also initiated communications with third party suppliers of the major computers, software and other equipment used, operated or maintained by the Company to identify and, to the extent possible, to resolve issues involving the year 2000 problem. However, the Company has limited or no control over the actions of these third party suppliers. Thus, while the Company expects that it will be able to resolve any significant year 2000 problems with these systems, there can be no assurance that these suppliers will resolve any or all year 2000 problems with these systems before the occurrence of a material disruption to the Company's business or the business of any of its customers. Any failure of these third parties to resolve year 2000 problems with their systems in a timely manner could have a material adverse effect on the Company's business, financial condition and results of operations.

The Company believes that it is not possible to determine with complete certainty that all year 2000 problems affecting it have been identified or corrected. The number of devices that could be affected and the interactions among these devices are simply too numerous. In addition, it is not possible accurately to predict how many year 2000 problem related failures will occur, or the severity, duration or financial consequences of these perhaps inevitable failures. The discussion of the Company's efforts and management's expectations relating to year 2000 compliance are forward looking statements. The Company's ability to achieve year 2000 compliance and the level of incremental costs associated therewith could be adversely impacted by, among other things, the availability and cost of programming and testing resources; vendors' ability to modify proprietary software; and unanticipated problems identified in the ongoing compliance review.

LIQUIDITY AND CAPITAL RESOURCES

Effective Corporate Tax

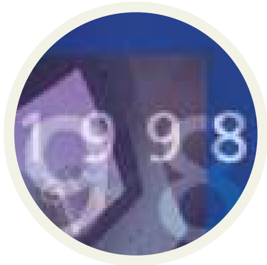
The production facilities of the Company have been granted Approved Enterprise status under the Law for Encouragement of Capital Investments, 1959 and consequently are eligible for certain tax benefits for the first several years in which they generate taxable income. The Company has elected to participate in the Alternative Package with respect to its current Approved Enterprises. The income derived from facilities granted Approved Enterprise status is exempt from income tax in Israel for two to four years commencing in the year in which the specific Approved Enterprise first generates taxable income. Following such periods, the "Approved Enterprises" are subject to corporate tax at reduced rate of 25% for the following three to six years. See Note 10 to Notes to Consolidated Financial Statements. After August 1991 at least 25% of the Company's shares have been held by non-Israeli residents and according to the Law for the Encouragement of Foreign Investments, the Company is entitled to 10 years of reduced corporate tax. As a result of its Approved Enterprise status, the Company's operations in Israel were subject to reduced tax rates of approximately 3% for both 1997 and 1998.

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

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

The dollar cost of the Company's operations in Israel is influenced by the extent to which any increase in the rate of inflation in Israel is not offset (or is offset on a lagging basis) by a devaluation of the NIS in relation to the dollar. During the two years ended December 31, 1996, the rate of inflation in Israel exceeded the rate of devaluation of the dollar against the NIS. In 1995 and 1996 the rate of inflation in Israel was 8.1% and 10.6%, respectively, while the rate of devaluation was 3.9% and 3.7%, respectively. In 1997 and 1998, the rate of inflation was 7.0% and 8.6%, respectively, while the rate of devaluation was 8.7% and 17.6%, respectively.

I N D E X



REPORT OF INDEPENDENT AUDITORS TO THE SHAREHOLDERS OF MAGIC SOFTWARE ENTERPRISES LTD.

We have audited the accompanying consolidated balance sheets of Magic Software Enterprises Ltd. and its subsidiaries as of December 31, 1997 and 1998, and the related consolidated statements of operations, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 1998. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of certain subsidiaries, which statements reflect assets constituting 23% and 26% of the consolidated assets as of December 31, 1997 and 1998, respectively, and revenues constituting 37%, 35% and 56% of the related consolidated revenues for each of the three years in the period ended December 31, 1998. These statements were audited by other auditors whose reports has been furnished to us, and our opinion, insofar as it relates to data included for these subsidiaries, is based solely on the reports of the other auditors.

We conducted our audits in accordance with generally accepted auditing standards in the 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 and the reports of the other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the reports of other auditors, the consolidated financial statements present fairly, in all material respects, the consolidated financial position of Magic Software Enterprises Ltd. and its subsidiaries as of December 31, 1997 and 1998, and the related consolidated results of their operations and cash flows for each of the three years in the period ended December 31, 1998, in conformity with generally accepted accounting principles in the United States.

Kost, Forer and Gabbay
KOST FORER and GABBAY
A member of Ernst & Young International
February 8, 1999

Tel-Aviv, Israel

CONSOLIDATED BALANCE SHEETS (U.S. DOLLARS IN THOUSANDS)

	December 31, 1997	December 31, 1998
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 1,380	$5,828
Trade receivables (net of allowance for doubtful accounts of $ 670 in 1997 and $ 990 in 1998)	12,339	11,466
Related parties (Note 13c)	-	40
Other receivables and prepaid expenses (Note 3)	1,956	1,724
Inventories	234	-
Total current assets	15,909	19,058
LONG-TERM INVESTMENTS:		
Investments in affiliates (Note 4)	336	404
Severance pay fund (Note 9)	716	988
	1,052	1,392
MINORITY INTEREST	237	-
FIXED ASSETS, NET (Note 5)	5,949	5,108
OTHER ASSETS, NET (Note 6)	6,045	6,823
	$ 29,192	$ 32,381

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

CONSOLIDATED BALANCE SHEETS (U.S. DOLLARS IN THOUSANDS)

	December 31, 1997	December 31, 1998
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Short-term bank credit (Note 7)	$ 3,345	$ 436
Trade payables	2,931	1,918
Related parties (Note 13c)	691	-
Accrued expenses and other liabilities (Note 8)	9,461	11,435
Total current liabilities	16,428	13,789
ACCRUED SEVERANCE PAY (Note 9)	1,293	1,445
MINORITY INTEREST	35	11
SHAREHOLDERS' EQUITY (Note 11):		
Share capital:		
Authorized: 10,000,000 Ordinary Shares of NIS 0.1 par value; Issued and outstanding: 4,853,150 and 7,853,150 shares as of December 31, 1997 and 1998, respectively	183	261
Additional paid-in capital	17,213	29,362
Accumulated other comprehensive loss	(181)	(249)
Accumulated deficit	(5,779)	(12,238)
Total shareholders' equity	11,436	17,136
	$ 29,192	$ 32,381

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

CONSOLIDATED STATEMENTS OF OPERATIONS (U.S. DOLLARS IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

	Year ended December 31,		
	1996	1997	1998
Revenues (Note 12a):			
Software sales	$ 28,085	$ 24,026	$ 20,479
Maintenance	1.146	4,196	5,780
Services	7.185	9,210	12,501
Total revenues	36,416	37,432	38,760
Cost of revenues:			
Software sales	4,085	4,327	2,994
Maintenance	802	2,694	3,306
Services	6306	7,708	9,046
Total cost of revenues	11,193	14,729	15,346
Gross profit	25,223	22,703	23,414
Operating expenses:			
Research and development, net (Note 12c)	2,611	3,348	2,797
Selling and marketing, net	15,963	17,520	16,073
General and administrative	4,112	6,090	7,817
Restructuring and other non-recurring costs (Note 1c)	-	5,421	2,677
Total operating expenses	22,686	32,379	29,364
Operating income (loss)	2,537	(9,676)	(5,950)
Financial expenses, net (Note 12d)	(521)	(488)	(322)
Income (loss) before taxes on income	2,016	(10,164)	(6,272)
Taxes on income (Note 10)	456	476	50
	1,560	(10,640)	(6,322)
Equity in losses of an affiliate	115	51	149
Minority interest in losses (earnings) of a consolidated subsidiary	(47)	237	12
Net income (loss) for the year	$ 1,398	$ (10,454)	$ (6,459)
Earnings (loss) per share (Note 15):			
Basic earnings (loss) per share	$ 0.30	$ (2.15)	$ (1.10)
Diluted earnings (loss) per share	$ 0.29	$ (2.15)	$ (1.10)

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

STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (U.S. DOLLARS IN THOUSANDS)

	Share capital	Additional paid-in capital, net	Accumulated other comprehensive income (loss)	Retained earnings (accumulated deficit)	Comprehensive income (loss)	Total shareholders' equity
BALANCE AS OF JANUARY 1, 1996	$ 158	*) $ 11,674	$ -	$ 3,277		$ 15,109
Other comprehensive income:						
Foreign currency translation adjustments	-	-	23	-	23	23
Amortization of deferred compensation	-	102		-	-	102
Net income	-	-	-	1,398	1,398	1,398
Total comprehensive income					1421	
Issuance of shares, net	19	4,988	-	-		5,007
Stock options (exercised)	1	316	-	-		317
BALANCE AS OF DECEMBER 31, 1996	178	*) 17,080	23	4,675		21,956
Other comprehensive loss:						
Foreign currency translation adjustments	-	-	(204)	-	(204)	(204)
Amortization of deferred compensation	-	72	-	-		72
Net loss	-	-	-	(10,454)	(10,454)	(10,454)
Total comprehensive loss					(10,658)	
Stock options (exercised)	5	61	-	-		66
BALANCE AS OF DECEMBER 31, 1997	183	*) 17,213	(181)	(5,779)		11,436
Other comprehensive loss:						
Foreign currency translation adjustments	-	-	(68)	-	(68)	(68)
Net loss	-	-	-	(6,459)	(6,459)	(6,459)
Total comprehensive loss					(6,527)	
Issuance of shares, net	78	12,149	-	-		12,227
BALANCE AS OF DECEMBER 31, 1998	$ 261	$ 29,362	$ (249)	$ (12,238)		$ 17,136

* The additional paid-in capital is net of loans to employees and directors for purchase of stock.

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

CONSOLIDATED STATEMENTS OF CASH FLOWS (U.S. DOLLARS IN THOUSANDS)

	Year ended December 31, 1996	1997	1998
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income (loss)	$ 1,398	$ (10,454)	$ (6,459)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Write-off of capitalized computer software development costs	-	1,950	512
Depreciation and amortization	1,849	2,508	2,783
Capital gain on sale of fixed assets	(11)	-	-
Equity in losses of an affiliate	115	51	149
Minority interest in earnings (losses) of a consolidated subsidiary	47	(237)	(12)
Amortization of deferred compensation	102	72	-
Exchange loss on long-term loans	(54)	-	-
Decrease (increase) in deferred income taxes, net	(166)	66	-
Decrease in trading marketable securities	191	-	-
Decrease (increase) in trade receivables	(3,588)	1,983	1,003
Decrease (increase) in related parties	(387)	981	(731)
Decrease (increase) in other receivables and prepaid expenses	(648)	175	232
Decrease (increase) in inventories	(250)	282	234
Increase (decrease) in trade payables	472	1,216	(1,102)
Increase in accrued expenses and other liabilities	2,474	2,423	1,894
Increase (decrease) in accrued severance pay, net	152	7	(120)
Net cash provided by (used in) operating activities	1,696	1,023	(1,617)
CASH FLOWS FROM INVESTING ACTIVITIES:			
Capitalized software costs	(2,417)	(3,125)	(1,283)
Purchase of fixed assets	(1,800)	(1,204)	(846)
Additional investment in a subsidiaries	(210)	(306)	(176)
Investment in affiliates	-	-	(351)
Proceeds from sale of fixed assets	96	238	118
Investment in other assets	-	-	(750)
Long-term investments	-	(52)	-
Net cash used in investing activities	(4,331)	(4,449)	(3,288)

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

CONSOLIDATED STATEMENTS OF CASH FLOWS (U.S. DOLLARS IN THOUSANDS)

	Year ended December 31,		
	1996	1997	1998
CASH FLOWS FROM FINANCING ACTIVITIES:			
Proceeds from the exercise of stock options	317	66	-
Proceeds from issuance of Ordinary Shares, net	5,007	-	12,227
Changes in short-term bank credit, net	(911)	2,400	(2,909)
Net cash provided by financing activities	4,413	2,466	9,318
Effect of exchange rate changes on cash and cash equivalents	(1)	(70)	35
Increase (decrease) in cash and equivalents	1,777	(1,030)	4,448
Cash and cash equivalents at the beginning of the year	633	2,410	1,380
Cash and cash equivalents at the end of the year	$ 2,410	$ 1,380	$ 5,828
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:			
Net cash paid during the year for:			
Income taxes	$ 658	$ 403	$ 50
Interest	$ 243	$ 237	$ 140
Non-cash activities:			
Additional investment in subsidiaries in consideration of decrease in minority interest and changes in other payables	$ 415	$ -	$ 479

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

NOTE 1:- GENERAL

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

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

b. During 1998, the Company issued a total of 3,000,000 Ordinary Shares to Mashov Computers Ltd. ("Mashov") and Formula Systems (1985) Ltd .("Formula") (see note 11).

Pursuant to a voting agreement between Mashov and Formula, Mashov controls 66.6% of the voting stock of the Company and therefore, the Company continues to be a consolidated subsidiary of Mashov.

On February 7, 1999, Mashov's board of directors resolved to distribute to all of Mashov's shareholders, in proportion to their holdings, the Company's shares held by Mashov as an "in hand" dividend, subject to the approval of the general meeting of shareholders and the completion of the other procedures prescribed by applicable law.

c. Restructuring and other non-recurring costs:

During 1997 and 1998, the Company incurred costs of $ 4,395 and $ 2,327, respectively, in implementing its restructuring plan. The restructuring plan included terminating distributor agreements in certain areas, a reduction in the number of employees and the exit of a product line.

In addition, the Company applied during 1998 to the Binational Industrial Research and Development Foundation ("BIRD-F") with the objective of canceling the agreement it had reached in the past which amounted to $ 350. The Company has decided not to accept any additional funds from the BIRD and to refund the funds received .

In 1997 the Company reached an agreement with the Office of the Chief Scientist of the Israeli Ministry of Industry and Trade ("OCS") according to which the Company will pay royalties on all of the Company's consolidated revenues. As a result, the Company provided for the full amount of its royalty commitment, which amounted to $ 1,026.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (U.S. DOLLARS IN THOUSANDS)

The following is a breakdown of the costs incurred:

	Year ended December 31,	
	1997	1998
Write-off of capitalized computer software development costs	$ 1,950	$ 512
Expenses for termination of employment	789	1,208
Termination of distributor agreements	1,362	372
Others	294	235
Total restructuring	4,395	2,327
Provision for repayment of grants	1,026	350
	$ 5,421	$ 2,677

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States.

a. Use of estimates:

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

b. Financial statements in United States dollars:

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (U.S. DOLLARS IN THOUSANDS)

c. Principles of consolidation:

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

d. Cash equivalents:

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

e. Inventories:

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

f. Investment in affiliates:

The investments in M.N.S. Micronova Systems Ltd. ("Micronova"), Magic Rental Ltd. ("Rental"), Magic Infotech India ("Magic India"), Barter Ltd. ("Barter") and Magic Thailand are accounted for using the equity method of accounting. Investments in which the Company holds less than 20% of the voting shares are accounted for using the cost method of accounting.

g. Fixed assets:

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

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

h. Research and development costs:

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

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

Capitalized software costs are amortized by the greater of (i) the ratio of current gross revenues from sales of the software to the total of current and anticipated future gross revenues from sales of that software or (ii) the straight-line method over the remaining estimated useful life of the product (not greater than five years).

The Company wrote down to net realizable value during 1997 and 1998, capitalized software costs for certain products in the amount of $ 1,950 and $ 512, respectively. (see note 1c).

i. Goodwill:

Goodwill is amortized by the straight-line method over five to ten years. The Company examines the realizability of the intangible assets annually and the appropriateness of the amortization period based on the estimated future undiscounted cash flows derived from the acquired businesses. Any impairment loss is recognized in the statement of operations.

j. Income taxes:

The Company accounts for income taxes in accordance with SFAS 109, "Accounting for Income Taxes". This statement 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 provides a valuation allowance, if necessary, to reduce deferred tax assets to their estimated realizable value.

k. Basic and diluted earnings (loss) per share:

Basic earnings (loss) per share is computed based on the weighted average number of Ordinary Shares outstanding during each year. Diluted earnings (loss) per share is computed based on the weighted average number of Ordinary Shares outstanding during each year, plus the dilutive potential of Ordinary Shares considered outstanding during the year, in accordance with Financial Accounting Standards Board ("FASB") Statement No. 128, "Earnings Per Share".

l. Stock based compensation:

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

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

m. Revenue recognition:

Revenues from software license agreements are recognized upon delivery of the software if: (i) collection is probable; (ii) all license payments are due within one year; (iii) the license fee is fixed or determinable; (iv) vendor-specific evidence exists to allocate the total fee to the undelivered elements of the arrangement; and (v) persuasive evidence of an arrangement exists.

Revenues from consulting services, maintenance contracts and training are recognized ratably over the contractual period or as services are performed.

n. Royalty-bearing grants:

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

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

o. Concentrations of credit risk:

Financial instruments which potentially subject the Company to concentrations of credit risk consist principally of cash and cash equivalents, and accounts receivable. The Company's cash and cash equivalents are invested primarily in deposits with major banks worldwide. At times, such deposits in the U.S. may be in excess of insured limits. Management believes that the financial institutions that hold the Company's investments are financially sound, and accordingly, minimal credit risk exists with respect to these investments. The Company's trade receivables are derived from sales to customers located primarily in the U.S., Europe, South-East Asia and Israel. The allowance for doubtful accounts is provided with respect to all balances deemed doubtful of collection. During 1998, the Company wrote off bad debts in the amount of $ 320.

p. Fair value of financial instruments:

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

q. Segments reporting:

The Company adopted SFAS No. 131, "Disclosures About Segments of an Enterprise and Related Information", in 1998. SFAS No. 131 superseded SFAS No. 14, replacing the "industry segment approach" with the "management approach" whereby companies report financial and descriptive information about their operating segments. Operating segments are revenue-producing components of the enterprise for which separate financial information is produced internally and are subject to evaluation by the chief operating decision maker in deciding how to allocate resources to segments (see Note 12).

r. Impact of recently issued accounting standards:

In June 1998, the FASB issued Statement No. 133, "Accounting for Derivative Instruments and Hedging Activities", which is required to be adopted for the years beginning after June 15, 1999. The Company does not expect the impact of this new Statement on the Company's consolidated balance sheets or results of operations to be material .

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (U.S. DOLLARS IN THOUSANDS)

NOTE 3:- OTHER RECEIVABLES AND PREPAID EXPENSES

	December 31, 1997	December 31, 1998
Prepaid expenses and others	$ 1,202	$ 1,333
Employee loans [1]	754	391
	$ 1,956	$ 1,724
[1] Including loans to directors and officers, linked to the Israeli Consumer Price Index ("CPI"),	$ 138	$ 181

NOTE 4:- INVESTMENTS IN AFFILIATES

a. Investments in affiliates consist of the following :

	December 31, 1997	December 31, 1998
Equity:		
Cost of shares	$ 596	$ 1007
Goodwill	(269)	(269)
Equity in losses	(76)	(324)
Foreign currency translation adjustments	(4)	(10)
	247	404
Goodwill:		
Cost	269	269
Amortization	(180)	(269)
	89	-
	$ 336	$ 404

b. During 1998, the Company invested $ 411 in several affiliates. In each of the affiliates the Company holds between 20%-40% ownership interest.

c. In January 1998, the Company acquired an additional 16% interest in Magic B.V., a subsidiary, in consideration of $387, obtained a 100% interest.

d. In January 1998, the Company acquired an additional 30% interest in Magic Italy, a subsidiary, in respect of credit Intercompany transaction, and thus obtained an 81% interest.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (U.S. DOLLARS IN THOUSANDS)

NOTE 5:- FIXED ASSETS

	December 31, 1997	December 31, 1998
Cost:		
Buildings	$ 3,500	$ 3,500
Computers and peripheral equipment	5,303	5,968
Office furniture and equipment	867	946
Motor vehicles	344	239
	10,014	10,653
Accumulated depreciation:		
Buildings	438	588
Computers and peripheral equipment	3,187	4,438
Office furniture and equipment	365	441
Motor vehicles	75	78
	4,065	5,545
Depreciated cost	$ 5,949	$ 5,108

Depreciation expenses amounted to $ 1,020, $ 1,115 and $ 1,480 for the years ended December 31, 1996, 1997 and 1998, respectively.

As for charges, see Note 14c.

NOTE 6:- OTHER ASSETS

	December 31, 1997	December 31, 1998
Cost:		
Capitalized software	$ 7,798	$ 9,081
Goodwill	1,213	2,262
	9,011	11,343
Accumulated amortization:		
Capitalized software	2,617	3,961
Goodwill	349	559
	2,966	4,520
Other assets, net	$ 6,045	$ 6,823

Amortization expenses amounted to $ 751, $ 1,059 and $ 1,554 for the years ended December 31, 1996, 1997 and 1998, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (U.S. DOLLARS IN THOUSANDS)

NOTE 7:- SHORT-TERM BANK CREDIT

The weighted average interest rates for short-term credit in unlinked NIS as of December 31, 1997 and 1998, is 6.04% and 6.84%, respectively. The Company reduced its unused credit line to the amount of $ 1,084 (of which an amount of $684 has been unused) as of December 31, 1998.

NOTE 8:- ACCRUED EXPENSES AND OTHER LIABILITIES

	December 31,	
	1997	1998
Employees and payroll accruals	$ 2,273	$ 2,536
Accrued expenses	2,677	4,947
Deferred revenues	1,987	2,868
Office of the Chief Scientist	1,862	-
Fund for Encouragement of Marketing Activities	562	842
Other	100	242
	$ 9,461	$ 11,435

NOTE 9:- ACCRUED SEVERANCE PAY, NET

Under Israeli law, the Company is required to make severance payments when dismissing employees and terminating their employment under certain circumstances. The Company's liability for severance pay pursuant to Israeli law is fully provided for. Part of the liability is funded through insurance policies. The value of these policies is recorded as an asset in the Company's balance sheets. Severance pay expenses for the years ended December 31, 1996, 1997 and 1998 were $ 448, $ 482 and $ 728, respectively.

NOTE 10: TAXES ON INCOME

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

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

Six expansion projects have been granted status of "Approved Enterprises" under the Law.

The six expansion programs are as follows:

1. Income derived from the first program was tax-exempt for the two-year period ended December 31, 1991, and was subject to a reduced tax rate of 25% for the five-year period ended December 31, 1996.
2. The second program was tax-exempt for the two-year period ended December 31, 1991 and was subject to a reduced tax rate of 25% for the six-year period ended December 31, 1997.
3. The third program entitles the Company to a tax-exemption for the four-year period ended December 31, 1995, and is subject to a reduced tax rate of 25% for the six-year period ending December 31, 2001.
4. The fourth program entitles the Company to a tax-exemption for the four-year period ended December 31, 1997, and is subject to a reduced tax rate of 25% for the-six year period ending December 31, 2003.
5. In February 1996, the Company received approval for the fifth program, which entitles the Company to a two-year tax exemption period and to a reduced tax rate of 25% for an additional period of eight-years. The period of benefits for this expansion has not yet commenced.
6. In January 1998, the Company received approval for another expansion of its "Approved Enterprises". This program will entitle the Company to a two-year tax exemption period and to a reduced tax rate of 25% for an additional period of eight years. The period of benefits for this expansion has not yet commenced.

Due to the time limits specified under the Law, the benefit periods of the Company's fifth and sixth "Approved Enterprise" will expire in 2009 and 2011, respectively.

If a dividend were to be distributed out of tax-exempt profits deriving from an expansion program, the Company will be liable to corporate tax at the rate of 25%. The Company does not anticipate paying dividends in the foreseeable future.

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

Should the Company and its Israeli subsidiary derive income from sources other than the Approved Enterprises during the relevant benefit periods, such income will be taxable at regular corporate tax rate of 36%.

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

The Company is an "Industrial Company", as defined by the Encouragement Law and, as such, is entitled to certain tax benefits, mainly accelerated depreciation of machinery and equipment, as prescribed by regulations published under the Inflationary Adjustments Law, the right to claim public issuance expenses and amortization of patents and other intangible property rights as a deduction for tax purposes.

c. Non-Israeli subsidiaries:

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

d. Net operating losses carryforwards:

The Company has accumulated losses for tax purposes as of December 31, 1998, in the amount of approximately $ 6 million which may be carried forward and offset against taxable income in the future for an indefinite period.

Through December 31, 1998, Magic Inc. had U.S. federal net operating loss carryforwards of approximately $ 12.4 million, that can be carried forward and offset against taxable income for 15 years and will expire from 2007 to 2013.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (U.S. DOLLARS IN THOUSANDS)

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

Income (loss) before taxes on income:

	Year ended December 31,		
	1996	1997	1998
Domestic	$ 5,021	$ (5,151)	$ (3,285)
Foreign	(3,005)	(5,013)	(2,987)
	$ 2,016	$ (10,164)	$ (6,272)

f. The provision for taxes consists of the following:

Current:			
Domestic	$ 620	$ 406	$ 47
Foreign	2	4	3
	622	410	50
Deferred:			
Domestic	(166)	66	-
Foreign	-	-	-
	(166)	66	-
Taxes on income	$ 456	$ 476	$ 50

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (U.S. DOLLARS IN THOUSANDS)

g. Deferred tax assets consist of the following:

	December 31, 1997	December 31, 1998
Deferred tax assets:		
Loss carryforwards	$ 6,714	$ 8.588
Allowances and reserves	855	826
	7,569	9,414
Less: valuation allowance	(7,569)	(9,414)
Net deferred tax	$ -	$ -

The Company provided a 100% valuation allowance against the deferred tax assets in respect of its tax losses carryforward and other temporary differences due to uncertainty concerning its ability to realize these deferred tax assets in the future. Management currently believes that it is more likely than not that the deferred tax regarding the loss carryforwards and other temporary differences will not be realized.

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

A reconciliation of theoretical tax expense, assuming all income is taxed at the statutory rate applicable to the income of companies in Israel, of 36% and the actual tax expense, is as follows:

	Year ended December 31, 1996	1997	1998
Income (loss) before taxes on income, as reported in the consolidated statements of operations	$ 2,016	$ (10,164)	$ (6,272)
Statutory tax rate in Israel	36%	36%	36%
Theoretical tax expense (benefit)	726	(3,659)	(2,258)
Decrease in taxes resulting from:			
"Approved Enterprise" (benefit) [1]	(1,197)	-	-
Carryforward losses and other deferred taxes for which valuation allowance was provided	1,000	3,518	1,993
Tax adjustment in respect of inflation in Israel	(446)	(266)	(82)
Non-deductible expenses	373	883	397
Taxes on income in the statements of operations	$ 456	$ 476	$ 50
[1] Per share amounts of the benefit resulting from the exemption.	$ 0.24	$ -	$ -

NOTE 11:- SHAREHOLDERS' EQUITY

a. The Ordinary Shares of the Company are quoted on the National Stock Market ("NASDAQ") in the United States.

On March 12, 1998, the Company issued Formula 800,000 Ordinary Shares at a price of $ 5 per share, in consideration of approximately $ 4 thousand.

The Company granted Formula for no additional consideration options to purchase 600,000 Ordinary Shares (first option) and 800,000 Ordinary Shares (second option) at an exercise price of $ 5 per share. Since the first option was not exercised during the exercise period ending September 30,1998, the second option was terminated as well.

On July 30, 1998, the Company issued Mashov 1,000,000 Ordinary Shares at a price of $ 3.50 per share, in consideration of approximately $ 3.5 thousand.

On December 31, 1998, the Company issued Formula 1,200,000 Ordinary Shares at a price of $ 4 per share, in consideration of approximately $ 4.8 thousand.

b. Stock Option Plan:

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

Under the Plan, 1,700,000 Ordinary Shares of the Company were reserved for issuance. Options which are canceled or not exercised within the option period become available for future grants. The Plan will terminate on August 14, 2001, unless previously terminated by the Board of Directors.

On December 7, 1998, the Company implemented a re-pricing plan, with respect to 611,989 options issued to employees, whose new exercise price was determined at $ 3 per share. The original exercise price of these options ranged from $ 5.125 to $ 9 per share. The re-pricing had no effect on the Company's consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (U.S. DOLLARS IN THOUSANDS EXCEPT PER SHARE AMOUNTS)

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

	Year ended December 31,					
	1996		1997		1998	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
Outstanding at the beginning of the year	666,517	$ 6.77	790,416	$ 7.32	963,735	$ 7.11
Granted	243,250	8.66	369,322	6.58	233,169	4.24
Exercised	(11,915)	8.40	(5,376)	8.73	-	-
Forfeited *)	(107,436)	6.80	(190,627)	7.28	(194,540)	6.90
Outstanding at the end of the year	790,416	$ 7.32	963,735	$ 7.11	1,002,364	$ 5.55
Exercisable at the end of the year	356,379	$ 7.31	438,328	$ 7.21	544,739	$ 6.42
Weighted average remaining contractual life (years)		4.24		5.15		4.11

*)Forfeited options are returned to the pool of options for future grant.

The options outstanding as of December 31, 1998 have been separated into exercise price categories, as follows:

Exercise price	Options outstanding as of December 31, 1998	Weighted average remaining contractual life(years)	Weighted average exercise price
$ 3 - $ 5	183,169	4.5	$ 4.24
$ 6.5 - $ 7	612,596	2.55	$ 6.74
$ 8 - $ 16	206,599	1.91	$ 8.83

Pro-forma information regarding net income and earnings per share is required by SFAS No. 123, and has been determined as if the Company had accounted for its employee stock options under the fair value method of that Statement. The fair value for these options was estimated at the date of grant using a Black-Scholes Option Valuation Model with the following weighted-average assumptions for 1996, 1997 and 1998: risk-free interest rates of 6.00%, dividend yields of 0%. Volatility factors of the expected market price of the Company's Ordinary Shares of 0.804 for 1996, 0.532 for 1997 and 0.584 for 1998 and a weighted-average expected life of the option of four years.

The weighted average fair values at grant dates of options granted during 1996, 1997 and 1998, were $ 8.66, $ 6.58 and $ 4.24, respectively.

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

For purposes of pro-forma disclosure, the estimated fair value of the options is amortized as an expense over the options' vesting period. The pro-forma information is as follows:

	Year ended December 31,		
	1996	1997	1998
	U.S. dollars (In thousands, except per share amounts)		
As reported net, income (loss) for the year	$ 1,398	$ (10,454)	$ (6,459)
Pro-forma net income (loss)	$ 524	$ (11,612)	$ (7,344)
Pro-forma basic earnings (loss) per share	$ 0.11	$ (2.39)	$ (1.25)
Pro-forma diluted earning (loss) per share	$ 0.11	$ (2.39)	$ (1.25)

c. Dividends:

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (U.S. DOLLARS IN THOUSANDS)

NOTE 12:- SELECTED STATEMENTS OF OPERATIONS DATA

a. Summary information about geographic areas:

The Company manages its business on a basis of one reportable segment. See Note 1 for a brief description of the Company's business. The Company's business is divided into six main geographic areas: Israel, Europe (except England), England, North America, Asia and other regions. Total revenues are attributed to geographic areas based on location of customers.

This data is presented in accordance with SFAS 131 "Disclosures about Segments of an Enterprise and Related Information", which the Company has retroactively adopted for all period presented.

The following presents total revenues for the year ended December 31, 1996, 1997 and 1998:

	1996	1997	1998
Israel	$ 3,257	$ 4,101	$ 3,726
Europe (except England)	12,780	14,794	17,310
England	3,426	6,024	7,320
North America	6,784	5,945	6,289
Asia	6,659	5,151	1,764
Other	3,510	1,417	2,351
	$ 36,416	$ 37,432	$ 38,760

The Company's long-lived assets as of December 31, are as follows :

Israel	$ 11,297	$ 11,114	$ 11,168
Europe (except England)	400	319	364
England	174	244	175
North America	458	317	189
Asia	-	-	35
Other	-	-	-
	$ 12,329	$ 11,994	$ 11,931

b. Data on major distributors, percentage of total revenues (Note 16):

	Year ended December 31,		
	1996	1997	1998
Wacom Co. Ltd. ("Wacom")	18 %	10 %	4 %

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (U.S. DOLLARS IN THOUSANDS)

c. Research and development costs:

	Year ended December 31,		
	1996	1997	1998
Total costs	$ 6,950	$ 6,758	$ 4,080
Less - royalty-bearing grants	(1,922)	(285)	-
Less - capitalization of software costs	(2,417)	(3,125)	(1,283)
Research and development, net	$ 2,611	$ 3,348	$ 2,797

d. Financial expenses, net:

Interest and bank charges	$ (413)	$ (240)	$ (268)
Loss arising from foreign currency transactions	(108)	(248)	(54)
	$ (521)	$ (488)	$ (322)

NOTE 13:- RELATED PARTIES - TRANSACTIONS AND BALANCES

a. In 1995, the Company signed an agreement with Mashov whereby the Company agreed to lease 41% of the building owned by Mashov for a period of five years. The annual lease expense is $ 190.

b. Transactions with related parties:

	Year ended December 31,		
	1996	1997	1998
General and administrative expenses [1]	$ 436	$ 798	$ 542
Financial expenses, net	$ 169	$ 473	$ 51

[1] Including rent expenses paid to Mashov and management fees to a principal shareholder.

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (U.S. DOLLARS IN THOUSANDS)

NOTE 14:- COMMITMENTS AND CONTINGENT LIABILITIES

a. Lease commitments:

The Company leases part of its facilities from Mashov (see Note 13a). Certain subsidiaries rent facilities under operating leases for periods ending in 1999 - 2004.

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

1999	$ 726
2000	341
2001	206
2002	102
2003-2004	96
	$ 1,471

Rent expenses for the years ended December 31, 1996, 1997 and 1998 were approximately $ 694, $ 915 and $ 738, respectively.

b. Guarantees:

1. The Company has guarantees to several banks amounting to $ 800, in favor of its affiliates.
2. As of December 31, 1998, the Company provided guarantees in connection with bank credit to suppliers in the amount of $ 63.

c. Charges:

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

d. Legal proceedings:

The Company is involved in arbitration with an affiliated company. In the opinion of the Company's management, all of the claims will be rejected and, therefore, no provision in respect of such claims has been recorded in the Company's financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (U.S. DOLLARS IN THOUSANDS EXCEPT PER SHARE AMOUNTS)

NOTE 15:- EARNINGS (LOSS) PER SHARE

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

	Year ended December 31,		
	1996	1997	1998
Net income (loss)	$ 1,398	$ (10,454)	$ (6,459)
Numerator for basic and diluted earnings (loss) per share - income available to shareholders	$ 1,398	$ (10,454)	$ (6,459)
Denominator for basic earnings (loss) per share - weighted average shares	4,720	4,853	5,870
Effect of dilutive securities	75	-	-
Denominator for diluted earnings (loss) per share - adjusted weighted average shares and assumed conversions	4,795	4,853	5,870
Basic earnings (loss) per share	$ 0.30	$ (2.15)	$ (1.10)
Diluted earnings (loss) per share	$ 0.29	$ (2.15)	$ (1.10)

NOTE 16: - SUBSEQUENT EVENTS

a. On January 1, 1999, the Company entered into a joint venture with its distributor in Japan, Wacom. Magic Software Japan ("MSJ"), a company that is owned 80% by Magic and 20% by Wacom, will buy from Wacom all the rights relating to the Japanese version of Magic products. MSJ paid in 1998 $ 750 to Wacom and will pay an additional amount of $ 1,250 in 1999. Wacom will also be entitled to royalty payments in fixed quarterly payments totaling $ 1,000 over a four-year period.

   In addition, MSJ will pay preferred dividend at the rate of 35% of its net income to Wacom, commencing in the first quarter of 1999. This preferred dividend will expire upon the earlier of (i) the 32nd quarterly payment or (ii) the accumulated payment of the amount of $ 1,800

b. In January 1999, the Company exercised an option to increase its ownership interest in Rental to 75%.

CORPORATE INFORMATION

David Assia
Executive Chairman

Jack Dunietz
President & CEO

Danny Goldstein
Director

Yigal Berman
Director

Gad Ariav
Director

Gad Goldstein
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Form 20-F
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